A tale of two taxes: The diverging fates of the federal property and income tax decrees in post-revolutionary Mexico

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ABSTRACT

The Mexican tax system in the 1800s was almost entirely composed of indirect taxes. However, the Revolution opened a window for change. In the early 1920s, President Álvaro Obregón created two direct taxes by decree: the federal property tax and the income tax. It was a clear disruption of the status quo, naturally raising opposition from those affected by the new taxes. Yet the attempt to establish the federal property tax failed, while the income tax was a relative success. This paper explains the divergent fates of these two tax decrees. In order to explain the divergent outcomes I focus on the political struggles behind both decrees. I argue that the roles played by both the opposition groups and the government in the two struggles differed greatly and help explain the fates of these taxes. The political and ideological background behind both tax struggles also help to explain the failure of the federal property tax and the implementation of the income tax.

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Historia de dos impuestos: suertes divergentes de los Decretos sobre el Impuesto Federal a la Propiedad y el Impuesto sobre la Renta en el México de la post-revolución

RESUMEN

El sistema tributario mexicano en el siglo XIX era predominantemente indirecto. Sin embargo, la Revolución abrió una ventana al cambio. A inicios de la década de 1920 el presidente Álvaro Obregón creó, por decreto, dos impuestos directos: el impuesto federal a la propiedad y el impuesto sobre la renta. Ello significó una clara alteración del status quo y la oposición franca de quienes se verían afectados por los nuevos impuestos. El IP fracasó y el IRPF supuso un éxito relativo. Este artículo explica la divergencia de las suertes de los dos decretos centrándose en analizar la lucha política que se produjo tras ambos decretos. El papel que jugaron los grupos opositores y el gobierno, en ambos procesos de lucha, fue muy distinto y ello explica la suerte entre uno y otro impuesto. El contexto político e ideológico de la época tras ambas luchas impositivas contribuye también a explicar el fracaso del impuesto federal a la propiedad y la introducción del impuesto sobre la renta.

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1. Introduction

The Mexican tax system of the 1800s was almost entirely composed of indirect taxes despite the many attempts to introduce direct taxes throughout the century. Post-independence governments praised direct taxes as the best way to finance the State; the
liberal ideology of the time considered the preponderance of indirect taxes unfair and economically inefficient. Nevertheless, direct taxes during the 19th century never contributed more than 5.5% of the total fiscal revenue (Servín, 1939b, p. 8).

However, the Revolution opened a window for change. In the early 1920s, a period of economic and political reconstruction, the issue of direct taxes reappeared on the fiscal agenda. Post-revolutionary governments needed money and had to fulfill social justice demands, which called for redistribution and greater social spending; direct taxes made sense as the best fiscal response to both.

It took some years after the adoption of the 1917 constitution for the ‘revolutionary change’ to take place in the fiscal domain. The aftermath of the Revolution was characterized by a state not yet in control of the territory and in a precarious financial situation. President Venustiano Carranza and his minister of finance, Rafael Nieto, took the first steps to stabilize public finances and to establish order in the financial system, creating a commission ‘for the financial and administrative reorganization of Mexico’ in August 1917.1 The members of the commission, in turn, invited the American economists Henry Alfred E. Chandler and Edward Kemmerer to produce an analysis of the fiscal system and to advise on monetary policy, respectively.2 Supported by these experts’ views, the commission concluded that balancing the budget was a priority, which entailed the renegotiation of the external debt, the reduction of defence spending and reforming the tax structure mainly by introducing direct taxes (Lomeli, 2002, p. 313). However, it was not until Alvaro Obregón’s presidency that the federal government was in position to address these challenges. With these changes there would be better grounds to reform the regressive and low-revenue generating tax system.

The tax system of the early 1920s depended a great deal on the tariff system, the stamp tax and the federal contribution tax,3 which together constituted about 77% of total fiscal revenue. In other words, the tax system was still mostly composed of regressive taxes, which was dissonant not only with the social justice demands that emanated from the Revolution, but also with the transformation of tax systems that had taken place in more advanced countries at the turn of the 20th century (Steinmo, 1993).

In this context, Obregón in his first address to the nation in 1921, stated the need to reform the tax system in order to bring it into line with the “economic rebirth of the country” and “the new tendencies of social organization which entail(ed) a growing State’s responsibility for the masses’ wellbeing” (Obregón,1922, p. 31). The tax burden had to be distributed according to taxpayers’ ability to pay and the masses had to be relieved from the onerous taxes on consumption. Obregón considered the tax reform “an act of justice that will not only increase the treasury’s revenue but will also give the State a better chance to peacefully intervene by regulating in a more equitable way the distribution of wealth and assuring the collective good.”

Obregón, using his emergency powers, decreed two direct taxes: the federal property tax (FPT) (impuesto del uno al millar) in 1922 and the income tax (impuesto sobre la renta) in 1924.4 The former was only the most recent in a series of attempts by the national government to tax property, a tax commonly in the hands of local governments. The latter was a tax on income and constituted a more novel proposal that promised to modernize the tax system if adopted.

The two decrees responded to three goals: the federal government’s need for greater revenue to fund investments in education and other social expenditures; the commitment by revolutionary leaders to remedy the regressive tax composition inherited from the 19th century; and the centralization of fiscal power in the federal government. More importantly the enactment of the FPT and the income tax, as direct taxes, meant that resources to finance the state would be extracted from a social base that had previously been untaxed or tax-privileged.

However, the FPT failed to be put into practice while the income tax was a relative success. Why is it then that these two very similar new federal direct taxes decreed during a period of economic reconstruction in post-revolutionary Mexico and facing similar political opposition present different outcomes?

This paper explains the divergent fates of these two tax decrees. I focus on the political struggles triggered by the promulgation of both decrees and I analyze these processes in light of prevailing theory in the tax policy literature that seeks to explain the success of new tax initiatives. The analysis is based on a careful observation of the roles played by both the government and the opposition groups throughout the struggles to introduce these taxes.

First, the type of measures taken by the government to aid the introduction of a new tax varied in the two cases. The government was more effective at introducing the income tax. In contrast the government was not as skilful at the time of the FPT introduction. The FPT struggle shows a government incapable of implementing basic strategies to introduce coercive measures, such as a new tax. I argue that the government, in order to put in place taxes such as the FPT and the income tax, had to gain credibility in the eyes of taxpayers, be able to minimize opposition, and to portray and justify the new taxes on fairness grounds. According to Levi, those imposing a tax have to be able to convince taxpayers’ to comply, for which it is important to create confidence in the government’s credibility. Revenue extraction will be difficult if ‘(rulers) are not credible in regard to their own commitments’ (Levi, 1989, p. 60). Similarly, Hansen posits that in tax politics the government’s strategy should be ‘to minimize opposition rather than maximize votes’ (Hansen, 1983, p. 49). She suggests this can be done through two ways: using side-payments to persuade taxpayers to cooperate; and limiting the participation of popular opposition, which helps create an environment more conducive to introducing new taxes (Hansen, 1983, pp. 16–18, 47). Fairness arguments are always present in tax debates. It is crucial that taxpayers perceive the tax deal as fair in order to achieve compliance. In Levi’s perspective taxpayers will find it fair to pay when others are paying as well (Levi, 1989, pp. 52–55). Likewise, Hansen (1983, p. 17) argues that it is necessary to make the taxpayer feel that she is bearing a fair share of the burden if the government aims to introduce a coercive policy such as taxation.

Second, the opposition groups’ strategy and resources (instrumental power) used to resist tax implementation differed in the case of the FPT and the income tax. The FPT opposition was cohesive and highly organized; it was a strong opposition. In contrast the income tax opposition was fragmented and poorly organized; there was no clear and united strategy to block the passage of the income tax, as was the case during the FPT struggle.

1 The commission consisted of Luis Cabrera, Alberto Paní, M. Rodríguez Gutierrez and Henry Brue (Uhthoff, 2005, p. 162).
2 The Mexican government with the inclusion of these two American experts aimed to send a clear message to the international financial community that a deep economic reform was to take place (Lomeli, 2002, p. 327). After all, Carranza’s government had to smooth relations with foreign investors since it needed to renegotiate its external debt.
3 This estimation is based on Uhthoff (2005, pp. 174, 183) and Márquez (2005, pp. 146-147).
4 Obregón had previously decreed in February 1921 the Centenary tax, which was based on progressive rates and on income. The tax was designed and implemented as a test to measure public reaction and the actual functioning of a direct tax (Servín, 1939a, p. 18).
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