Structural Transformations and The Political Roots of Fiscal Capacities in Latin America: The Case of Chile, 1900-2010

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22nd January, 2017

Abstract

There is a very strong consensus on the positive role fiscal capacities play on state formation. In this paper, I provide quantitative evidence for the origins of fiscal capacities, a subject generally overlooked by scholars of political development. Taking a sectoral politics approach, this paper argues that strong states saw the emergence of a strong industrial sector that interrupted the political monopoly held by the landed elite. Leveraged strong industrial sectors managed to demand economic and political policies in exchange of being income-taxed. Building on the fiscal sociology paradigm, I argue that the introduction of the income tax, as a state-building institution, was a major structural transformation that triggered a series of institutional investments. I tests this theory using cross-national panel data from a sample of Latin American countries from 1900 to 2010. As a first step, the Chilean example is offered as an illustrative case, in the hope of eventually generalizing this framework to other countries.

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*I thank Bob Kaufman, Dan Kelemen, Doug Blair, Christopher Zorn, Paul Poast, Matthias vom Hau, Dídac Queralt, Florian Hollenbach, William Young, Jose Pablo Silva and participants of the 50th LASA Congress for all the useful comments. I also thank the School of Arts and Sciences at Rutgers for granting me funds to collect part of the data used in this project and the Department of Political Science at Rutgers University for conference travel funds. All errors are my own.

I. Introduction

The only important coercion which is crucial to development is taxation

Arthur Lewis, 1965

The budget is the skeleton of the state stripped of all misleading ideologies

Schumpeter, 1991

According to most political economists, fiscal sociologists, development economist and economic historians, fiscal capacities are a prerequisite for strong states. Much effort has been devoted to understanding the relationship between the politics of taxation and state capacities in a number of European cases. Moreover, research on Latin America has mostly focused on tax reforms, but the origins of the fiscal Latin American state remain relatively unclear. Since wars in Latin America have been rare, it is difficult to extend models based on external threats originally developed to understand the medieval European case. Furthermore, existent models for the Latin American case have traditionally focused on a limited number of cases, compromising their generalizability. Building on the fiscal sociology paradigm, in this paper I present quantitative evidence of the origins of the fiscal Latin American state from a sectoral perspective.

Much effort has been devoted to the study of *tax reforms*. Fairfield [2013] studies different strategies policymakers pursue to tax elites starting in 1990. Mahon [2004] and Focanti et al. [2013] study the causes of tax reform in Latin America starting in the 1980s and 1990, respectively. Similarly, Ross [2004] studies the relationship between taxation and representation between 1971 and 1997, whereas Sokoloff and Zolt [2007] study the evolution of tax institutions comparing the U.S. with Latin America. This paper contributes to the literature on state and fiscal capacities by presenting a historical comparative macro-structural argument centered on inter-elite conflicts. The argument outlines the conditions under which endogenous investments in fiscal capacities were most likely to happen in Latin America starting in 1900. An elite divided on an *economic* cleavage is at the same time divided on their *political* preferences, particularly regarding their attitude towards state centralization.[1] Consequently, an elite split along economic interests will use state power to influence certain policies and hence, growth and state building. The connection between state-building / institutional development, fiscal capacities and sectoral conflicts is hardly new. Gallo [1991, 7-8] studies the Bolivian case and the origins of the fiscal apparatus from a sectoral perspective. Waldner [1999, 3] points out that "levels of elite conflict determine whether state transformation occurred

[1] See for example Llavador and Oxoby [2005].

simultaneously with or before popular incorporation," while Saylor [2014, 8] looks at the "coalitional basis of state building." Building on this literature, the contribution of the paper is twofolds: to provide quantitative evidence in support of the idea that the income tax was an important additional building block in the state-building process, and that the sectoral divide between the agricultural and industrial sectors captures the tension between the institutions that helped perpetuating the predominance of the landowning elites since colonial times and the institutions proper of a modern state.[2]

I argue that the implementation of a modern fiscal system was the product of an inter-sectoral conflict that took place around in early 1900's between the agricultural elite and an emerging and politically excluded industrial sector. While the process of state-building had started earlier immediately after independence, the income tax was an important additional building block in that process. The tax was not important because of the new revenue collected, but because its implementation required a series of inter-elite bargaining, while its administration triggered a series of other institutional investments. When agricultural elites were challenged by a strong industrial sector, the income tax law was imposed early in history, tying the countries to an institutional development path. However, when agricultural elites were not challenged, landowners were never challenged and there were less pressures to centralize the state, making less likely further institutional investments.

Before the income tax law was implemented, political institutions and social norms, largely inherited from the colonial period, were designed to promote biased agricultural development, benefiting the landowning class only. However, the emergence of a new industrial sector rose a new political elite who demanded new political and economic reforms beneficial for them. In this paper, two such demands are identified: the opening of the political system, marking the beginning of the 19th century *oligarchic* republics in Latin America, and the first manifestations of protectionist organized groups which were fundamental during the ISI time. When the industrial sector had enough economic leverage, they accepted being income-taxed in exchange for gaining access to state power and protectionist tariffs. Both the taxation and the oligarchic political competition dimensions gave rise to a series of other institutional investments such as the implementation of checks-and-balances mechanisms (to monitor tax spending) and the development of skilled bureaucracies with enough know-how to collect and administer the revenues of the tax. Protectionist tariffs helped the industrial sector to expand further. One important positive externality was the development of a strong urban middle class which supplied the state with a critical mass of educated individuals. Importantly, industrialization then altered the political and economic status quo not by rising

[2]Though the public economics literature focuses predominantly on tax revenues, higher revenues do not mean higher stateness levels. For example, since American institutions were deliberately designed to limit the exercise of state power, the U.S. taxes very little (Fukuyama [2004, 6]). However, it is not reasonable to say that the U.S. has a "weak state." Here the focus is on the *politics* of taxation (see for an example Focanti et al. [2013]).

incomes (*á la* modernization theory) but by nurturing a political challenger. Hence, what caused political development was not industrialization *per se*, but the development of a political competitor. However, when industrial output was slow, agricultural elites faced higher opportunity costs, and industrial demands were not considered, keeping the small and weak industrial class excluded from politics.

Some scholars situate the critical juncture at the end of the colonial period, before the class compromises I identify in this paper. Kurtz [2013] for example explains that the first critical juncture corresponds to the post independence political economy, i.e. whether local rural elites recruited their workers through servile means, while Soifer [2015, 6] argues that the tipping point is whether "local administrators were outsiders in the communities in which they served." Both critical junctures happened *before* 1900, the time span studied here. This paper builds on this literature, and while it recognizes that the process of state-building started earlier, this paper identifies the income tax as an important *additional* building block in that process. Some others have argued that the economic divide was not *inter* but *intra* sectoral. As an example, Saylor [2014] explains that the divide consisted on an export/import oriented cleavage which did not overlap with an industrial/agricultural cleavage. I borrow from the from *balanced growth* model, and follow Dixit [1973, 325] in that an economy divided in agriculture and industry provides a significantly better description of the economy because "it reflects several vital social and economic distinctions." In the same vein, Johnston and Nielsen [1966, 280] explain that "[t]he reality found in most underdeveloped countries approximates this dichotomy [...] sufficiently." In fact, Díaz-Alejandro [1966, 25] argues in his classic series of papers that in Argentina "while the correspondence between exports and rural products, and between imports and manufactured goods has not been perfect [...] such correspondence has been quite close." Similarly, Bergquist [1986, 8] explains that "Colombia's two traditional political parties [...] reflected in many respects the dual nature of the Colombian economy." In this paper I present the Chilean case in more detail. Finally, I argue that it was the emergence of the industrial sector what modified the political economy ruled by agricultural elites which had inherited their privileges from colonial times. However, a number of scholars have argued that the independence wars made collapse all colonial institutions. For example Mahoney [2010, 191] explains that the "wars of independence were violent and destructive; they saw the collapse of the colonial fiscal system [...] and the elimination of the colonial political order." Saylor [2014, 55], Uribe-Uran [2001] and López-Alves [2000, 27-28, 35-36] are other examples. Even if that were true, the collapse of a number of institutions does not necessarily mean the collapse of '*the* colonial order.' Capoccia and Kelemen [2007, 349] argue that "[e]ven where various institutions are interconnected, the occurrence of a critical juncture for one institution need not constitute a critical juncture with respect to all of its counterpart." Following their advise of finding "the decision-making process, [and] identify[ing] which decisions were most influential," I find in the Chilean case study that the

landed elite did have privileges that the industrialists did not have *because* of the inertia of colonial institutions. In fact, elsewhere I find that the implementation of the income tax reverted this inertia, putting countries in a path of *economic* development.

II. Taxation and State Formation

Building on the "fiscal sociology" paradigm, this paper studies state capacities looking at the *origins* of fiscal capacities. This paradigm proposes that the great modern cleavage was not the rise of capitalism (Marx) nor the rise of modern bureaucracy (Weber), but the rise of the "tax state," which developed institutions to penetrate private and *individual* economies.[3] Given this degree of penetration, taxation offers the key for a theory of the state.[4] In fact, according to Schumpeter [1991, 108], "[t]axes not only helped to create the state. They helped to form it." Importantly, the origins of the fiscal apparatus are rooted in sectoral and class conflicts, in agreement with work that has argued that "tax struggles are among the oldest forms of class struggle."[5]

Not all kinds of taxes play a state-*formative* role. Broadly speaking, there are two general types of taxes, *indirect* and *direct* taxes. Indirect taxes are, for our purposes, taxes that are collected by a third party, i.e. not the state. Hence, indirect taxes do not need the development of strong fiscal capacities. According to Best [1976, 53], "indirect taxes are but substitutes for direct taxes," and hence they are typically administered by weak states.[6] Since indirect taxes are easier to levy, this kind of revenue is generally considered "unearned income"[7] or "easy-to-collect source of revenues."[8] Given the low costs states have to incur to collect indirect taxes, they have a nearly null impact on state-building, stable domestic alliances and bureaucratization. In fact, when early Latin American states depended heavily on the taxation of international trade, the state apparatus tended to be less developed.[9] Since customs administrations have always been concentrated in a few critical locations, especially ports, tariffs and customs duties did not require an elaborate fiscal structure.[10]

What played a formative role was the implementation of income taxation, which I argue is a "state-building" institution. Since direct taxation involves a *compulsory transfer* from private hands to the government sector for public purposes,[11] it is harder to collect.[12] Of all types of direct taxation, the most invasive one (and hence the most difficult to levy) is the *income tax*. This type of tax is quite complex since it classifies and transfers private income into public property.[13]

[3] Moore [2004b, 298]. This view is also shared by Schumpeter [1991, 100] and Lewis [1965, 42] - See epigraphs.
[4] Musgrave [1992, 99].
[5] Goldscheid (1925), in Campbell [1993, 168].
[6] This view is also supported by Moore [2004a, 14].
[7] Moore [2004b, 304].
[8] Coatsworth and Williamson [2002, 10].
[9] Campbell [1993, 177].
[10] Bertola and Ocampo [2012, 132].
[11] *Cfr.* Raja Chellia, "Trends in Taxation in Developing Countries," in Migdal [1988, 282].
[12] Kurtz [2013, 62].
[13] Musgrave [1992, 98].

From a historical standpoint, its introduction "was one of the major events in fiscal history that contributed to the growth in government observed during the past 150 years."[14] Political alliances should exist to overcome logistic, institutional and political domestic challenges associated with direct taxation. Critically, economic elites, should agree to comply with direct taxation[15] and inter-elite class tensions should be resolved prior to adopting these policies. As others have pointed out, since tax revenues depend upon the interests of different classes as they attempt to use state power for their own purposes,[16] class conflicts are more likely to resolve in favor of direct taxation where income inequality *among the elite* is low.[17] Here I argue that a political compromise among the elite was the critical juncture that helped create the endogenous incentives to overcome the initial lack of administrative skills necessary to collect direct taxes. As others have also explained,[18] since income taxes require extensive monitoring and enforcement, "administrative constraints are identified as the main constraint to the ability of states to collect [an] income tax."[19] Thus, cases in which the income tax law was imposed very late developed incompetent bureaucracies and low levels of stateness. For example, Chile imposed the income tax law in 1924, and the *Servicio de Impuestos Internos* is among the finest tax institutions in Latin America. However, Guatemala imposed the income tax law very late, in 1963, and by 1967 the national income tax office employed 194 people, and only 9 of whom had graduated from college.[20]

III. Unpacking the Mechanisms: Chile 1850-1950

Historians still debate whether agriculturalists and industrialists comprised two different elites. Some claim that this dualism is incorrect.[21] They argue that there was a blurry class division between the mining, banking and agricultural sectors.[22] For example, landowners were also invested in industry.[23] However, others have pointed out that it was common practice that industrialists had to invest in real state *just* to obtain credit. Kirsch [1977, 59] explains that "in a *rural society* land offered one of the best guarantees for loans [since] loans could not be secured by equipment, machinery, or inventory. Only real estate was acceptable collateral."[24] There were also instances

[14] Aidt and Jensen [2009, 171].
[15] Best [1976, 71] argues that the "actual composition of taxes can be viewed as dependent upon the distribution of power rather than as an expression of the free choice of the majority of the people."
[16] Best [1976, 50].
[17] Tani [1966, 157] explains that the absence of "wealth groups" makes passing an income tax law easier.
[18] Lieberman [2002, 99].
[19] Di John [2006, 5].
[20] Di John [2006, 5].
[21] See for example Mamalakis [1976, 125].
[22] Bauer [2008, 30, 44, 94, 108].
[23] Kirsch [1977, 57, 95] who cites Bauer [2008]. See also Coatsworth and Williamson [2002, 23] argue that "[t]he only landowners that mattered in 19th century Latin American politics were those for whom land represented but one asset in a much broader portfolio." In the same vein, Bauer [2008, 180] argues that "[m]iners and merchants bought haciendas but landowners in turn invested in banks, insurance companies, commercial firms and the incipient industrial sector."
[24] Emphases are mine.

where miners were invested in banking. However, Segall [1953] argues that Chilean bankers, after the crisis of the mining sector around the 1870s, acquired a number of mineral deposits given as collateral years before. All in all, the lack of dualism seems confounded by the very demands and practices of how these predominately agricultural societies were structured.

Here I argue that initially the political economy was dominated by agricultural political interests. Keller [1931, 13] argues that in all Latin American economies during and right after the colonial period, agriculture was the most important sector, while Wright [1975, 45-46] points out that the economic interests of the agricultural elite were the only economic interests represented in politics, and Chile was not the exception. In the same vein, Collier and Collier [2002, 106] argued that the "national government was dominated by the central part of the country, with owners of large agricultural holdings playing a predominant role." Similarly, McBride [1936, 15] explains that "Chile's people live on the soil. Her life is agricultural to the core. *Her government has always been of farm owners. Her Congress is made up chiefly of rich landlords.* Social life is dominated by families whose proudest possession is the ancestral estate."[25] Finally, I have shown elsewhere that political institutions and social norms inherited from the colonial period were designed to allocate economic inputs (and hence *growth*) in a way that benefited the landowning class only.

There existed an important asymmetry. While the industrial sector was growing, they were kept from participating in politics in similar conditions. Being the industrial elite blocked, it was easy for the agricultural elite to produce policies that were designed to enhance only their sector. Zeitlin [1984, 13] argues that "landowners controlled both the vote and the labor power of the agrarian tenants (*inquilinos*) and dependent peasants (*minifundistas*), and this was the *sine qua non* of their continuing political hegemony." In Congress, and the presidency itself, landowners were the single most important group,[26] leaving the modern sector heavily under-represented. As Baland and Robinson [2008, 1748] argue, "[c]ongressional representation was heavily weighted in favor of rural districts." For example, immediately following independence in 1823, the secretary of the treasury, Diego José Benavente, addressed a predominately *agricultural* congress to propose an agricultural income tax. The congress rejected his idea, especially due to pressure from the landowning class.[27] Indeed, fiscal pressures in favor of agricultural taxes were minimal compared to mining taxes,[28] leaving the agricultural sector systematically - and substantially - undertaxed relative to other sectors.[29] Though eventually an agricultural income tax was imposed, it was weak and was

[25] Emphases are mine.

[26] Bauer [2008, 45].

[27] Sagredo [1997, 306] It is important to stress that during this period, "political parties" did not follow very clear ideological divisions. Most of the secretaries/ministries were recruited because of their technocratic skills.

[28] As explained, mining was one of the first manifestations of industrial activity.

[29] Best [1976, 56]. Bauer [2008, 81] provides a very plausible explanation for why the agricultural sector was "structurally" protected against taxation. As he explains, "[t]he availability of an easily accountable source of public revenue - bags of nitrate or bars of cooper - meant that any need for the Chilean government to intrude into the affairs of landowners was reduced [...] the state kept its political hands off the countryside until the overwhelming urban demands for more food and political support in the 1960s." Zeitlin [1984, 38] also points out that "public

abolished after the civil war of 1891. This bias was consistent with other state practices. Historians explain that "[i]n those areas where the government did interfere in the countryside, the effect was to strengthen the position of the landowning class."[30] For example, the little public infrastructure that existed benefited the agricultural sector. The state would either invest huge amounts of money or borrow resources to build infrastructure capable of mobilizing agricultural goods, starting with the gold rush in both California and Australia.[31] Presidents were not the exception. For example, "the Montt regime did invest in the construction of Chile's railways but only in the Central Valley and south-central zones [b]ut there was no public investment [...] in railroads built in the Norte Chico mining provinces."[32] Critically, agriculturalists engaged in several predatory practices as well. Agricultural exports in Chile, such as wheat production, had a boom between 1865 and 1880.[33] However, "[t]he importance of trade taxes as sources of public revenues began a steady decline in 1918, which lasted until 1925."[34] As some historians have argued, incumbents engaged in "nationalization by means of naturalization, government intervention, and government participation."[35] Chile, Perú and Uruguay, among others, went through a clear process of nationalization of non-agricultural assets during the 1920s.[36]

For nearly 400 years, mining was the most important activity outside of agriculture. Minerals had to be processed near where they were mined in order to keep transport costs to a minimum, leading to the construction of foundries and refineries, which became the cornerstones of the early industrialization processes.[37] Although mining was very important during the colonial period, "Latin American's consumption of industrial metals continued to be very small until toward the end of the nineteenth century." Mining was also rudimentary, with little or no technological refinement.[38] Most, if not all of the mineral-related industry was foreign-owned, except in Chile.[39] Mining elites made their fortunes during the 1840s and 1850s during the mining boom. However, the mining sector failed to catch up with more efficient technologies better suited to exploit low-grade ores,[40] and collapsed eventually.

After the mining boom, mining elites shifted their focus to what is considered the first *true*

revenues came almost exclusively from taxes on mining and its exports."

[30] Bauer [2008, 118].

[31] Rippy [1971], Marichal [1989], Zeitlin [1984], Bauer [2008].

[32] Zeitlin [1984, 41].

[33] Bauer [2008, 68-69-70]. See also Lederman [2005, 55]. Custom duties declined also in several other Latin American countries. For the Bolivian case, see Gallo [1991, 95]. For a general overview, see Bulmer-Thomas [2003, 245].

[34] Lederman [2005, 54-55]. He continues: "This downfall is explained by the fall of export revenues caused by the collapse in the prices of Chile's major exports during the war," while Gallo [1991, 148] adds, "the economic crisis of the 1930s forced most Latin American states to shift their sources of revenue from export-based to domestic economic activities."

[35] Rippy [1971, 238].

[36] Chua [2010]. Bulmer-Thomas [2003, 255, 342-343] explains that it was very common to nationalize assets such as transport companies, financial institutions, and mining industries.

[37] Bertola and Ocampo [2012, 129].

[38] Rippy [1971, 230].

[39] Stephens et al. [1992, 165, 176, footnote 5, 324].

[40] Kirsch [1977, 53].

industrial work which, unexpectedly, began under agricultural auspices: the cotton mills.[41] The first industries were called *obrajes*. Though servile labor and slave labor were used at the end of the colonial period, all labor was free and wage-earning starting the independence. "Large-scale *obrajes* existed alongside smaller units of production - modest workshops and prosperous artisan-dominated enterprises - in virtually all urban centres."[42] Beyond textiles, early industrialists processed other agricultural goods such as animal grease and tallow (for soap and candles), dried and cured meats, flour, bread, beer, wines and spirits, being most of them for domestic consumption.[43] Later, around 1900, other industries for domestic consumption such as tobacco, pottery, felt hats, matches and footwear also developed.[44] The industrial sector was boosted by favorable international conditions as well, many times stimulating a positive complementarity between two industries. For example, "[m]eat exports required the development of cold-storage technologies."[45] From an international trade perspective, Haber [2005, 5] argues that given a change in the metallic standard, "exchange rate depreciation resulted in the expansion of the tradables sectors at the expense of non-tradables." Lower transportation costs and higher demand for processed grains in Europe also played a big role in boosting early industrial production. As Bauer [2008, 68] argues, "[b]ad harvests in Europe and disruptions caused by wars were other factors that enabled Chilean grain to be sold on European Markets." In sum, industrial activities started very small,[46] progressing "from the shop to the factory during the latter half of the nineteenth century."[47] Moreover, modern industrialization did *not* begin with ISI, but around 1900. In fact, Haber [2005, 2] finds that the "development of large-scale, mechanized (and even "heavy") industry can be dated back to the 1890s."[48]

In Chile, the industrial elite was composed by an incipient, yet strong and cohesive group of individuals. As historian Francisco Encina explains, "[i]t was precisely this segment of the dominant class that consummately personified the development of Chilean capitalism (mineowner and banker, railroad magnate and manufacturer, shipper and trader, *hacendado* and miller were [...] not only

[41] See Rippy [1971, 231]. As Bethell [1986, 271] argues, "[t]he first power looms were brought [in Perú, Ecuador, and Venezuela] in the 1840s, 1850s; but in all three they were a failure, some of the early mills in Ecuador being destroyed by an earthquake. It was not until after 1890 that the textile industries of these nations began to operate with reasonable success. Guatemala's first cotton mill was established in 1882, and between that date and 1910 a few mills appeared in Chile, Argentina, Uruguay, and Colombia."

[42] Bethell [1986, 271]. Emphasis in original. Flour mills were very important too, and they experienced a number of technological improvements. "The flour mills were probably the first of the Chilean industrial plants to utilize steam power" (Rippy and Pfeiffer [1948, 300]). Eventually, around 1900, the steam-powered stone mills were replaced by a "roller process of milling which employed a mechanized metal cylinder system often run by electric power" (Kirsch [1977, 38]).

[43] Bethell [1986, 272]. Other food industries, such as sugar were used in the production of chocolate, candies, biscuits (Bertola and Ocampo [2012, 129]). Vegetable oils were also very important.

[44] Specially in Argentina, Brazil, Chile, Uruguay and Perú (Rippy [1971, 235]).

[45] Bertola and Ocampo [2012, 129].

[46] Marichal [1989], Rippy and Pfeiffer [1948, 68].

[47] Rippy [1971, 235].

[48] Similarly, Rippy and Pfeiffer [1948] and Pfeiffer [1952] explain that by the 1870's the carriage industry was on a firm basis. Bertola and Ocampo [2012, 129] finds that the "fact that manufacturing was alive and thriving in Latin America before the 1929 crash is now beyond question."

close associates, or drawn from the same family, but they were the same individuals)."[49] In the process of going from mineowners to proto-industrialists, this incipient elite developed a strong sense of social *class* that led them to consistently seek political representation and influence. Sectoral interests were organized as follows. The *Sociedad de Fomento Fabril* (SOFOFA) was founded in 1883 to represent the interests of the the industrial sector against the interests of the agricultural sector, represented by the *Sociedad Nacional de Agricultura* (SNA), founded 45 years earlier in 1838. The SNA "was the most powerful associational interest group in nineteenth-century Chile,"[50] and according to Wright [1975, 51], it clearly thought of itself as a social class. Both sectors had class consciousness. Kirsch [1977, 41] explains that the founding of the SOFOFA clearly reflected a "tension created by the *awareness* of the incongruence between the *actual* exploitation of economic forces and the *potential* that could be extracted from them through industrialization."[51] The party system was product of this sectoral-economic tension. In fact, Collier and Collier [2002, 109] explain that the *Alianza Liberal* was "the political expression of the new groups that began to emerge in the late 19th century with the expansion of the commerce and industry and the opening of the new mining areas [...] As these groups gained social and economic importance, they began to emerge as a political force." And by the 1920s, industrialists started to "form trade associations to engage in lobbying and propaganda as more coherent interest groups."[52]

While both economic sectors were *similarly developed*, only the industrial elite had access to fair political representation, leaving industrial interests too exposed, putting pressures for these two 'antagonistic elites'[53] to confront each other in two bloody civil wars. Zeitlin [1984, 23] argues that the civil wars challenged a "large landed property [elite against a] productive capital [elite]." However, war was not sustainable over time. Given their relative similar degrees of economic development, both elites could mobilize armies with relatively *similar capabilities*.[54] War was then more likely to exhaust all existent resources without producing positive outcomes for either sector. Consequently, Chilean agricultural and industrial elites opted for a political compromise. Three institutional components were incorporated in the compromise: an income tax, equal access to the state and industrial protectionism. The faster the industrial growth, the higher the pressures to impose a tax to capture increasing industrial incomes. This is in line with Besley and Persson [2011, 59] who argue that "investing in fiscal capacity becomes more attractive [...] when wages or incomes [...] are higher."[55] In 1924 the income tax law was passed. As others have observed, "[t]here was

[49] In Zeitlin [1984, 30], emphasis in original. He describes several last names which are still associated with the Chilean elite, such as Ossa, Edwards, Vicuña Mackenna, Matta, Goyenechea, Cousiño, Urmeneta, Gallo and Subercasaux. Emphasis in the original. Similarly, Wright [1975, 48] supports the thesis that nitrate development led to the development of an "incipient industrial establishment."

[50] Wright [1973, 244].

[51] Emphases are mine.

[52] Weaver [1980, 107].

[53] Keller [1931, 37-38]. Geddes [1991] argues that competition between two rival parties of about the same size creates clearer incentives to invest in political institutions.

[54] Boix [2015].

[55] Similarly, see Campbell and Allen [1994, 647] who explain that "economic development should be directly related

visible bargaining: [the non-agricultural sector] (reluctantly) accepted taxation, *while demanding state services and expecting to influence how tax revenues were spent.*"[56] The SOFOFA pursued an agenda in favor of protective industrial tariffs. This goes in line with Lederman [2005, 53] who argues that the timing of protectionist and income taxation cycles matches, and with Sokoloff and Zolt [2007, 122] who explain that the expansion of "manufacturing production [...] helped to nurture the development of a powerful constituency for higher tariffs."[57] In particular, "by the early 1920s Chile's manufacturers were no longer just demanding (and obtaining) protective tariffs, they actively lobbied for government subsidies to establish a range of new industries."[58] Eventually, the Aguirre Cerda government in 1939 created the CORFO, an agency that planned, directed and supported emergent industries by providing "various sorts of credits, subsidies [and] government investments."[59] This was of the greatest importance since the money market was primarily established to "meet the credit needs of landowners."[60]

The political compromises triggered a series of other investments in state institutions. The early Chilean government "was able to impose a substantial tax [...] and pay the salaries of government and military employees."[61] Importantly, the income tax law was influential beyond the capital city of Santiago, reaching the whole territory. *Artículo 104* and *Artículo 105* of the income tax law[62] empowered all municipalities to collect the tax. In fact, all municipalities had to send to the central government a detailed list of taxpayers *twice* a year, forcing the implementation of local bureaucracies able to count and classify the population not only according to their personal incomes, but also to the sources of this income. In turn, protectionist tariffs helped to develop an even stronger industrial sector, which in turn was the basis for the new middle class, the most important ingredient in the development of the modern bureaucracy.[63] The aperture of the political system, while breaking the agricultural-led political monopoly, also helped the industrial class gain influence over how the income tax was spent. Critically, both elites channeled their sectoral demands through political institutions. The connection between political aperture and the emergence of the industrial sector in Chile has been mentioned before. Collier [1977, 683] points out that "the real story of Chilean industrialization belongs to the Parliamentary period" (1891-1925). In a similar vein, Kurtz [2013, 36] explains that the incorporation of *all* major upper-class actors into the national political system was crucial to enabling substantial taxation, public goods provision and essentially, state building.[64]

to individual and corporate income tax rates."

[56] Carmenza Gallo, in Brautigam et al. [2008, 165]. Emphases are mine. She refers specifically to nitrate producers.
[57] See for a similar view Haber [2005, 18].
[58] Haber [2005, 18].
[59] Collier and Collier [2002, 393].
[60] Kirsch [1977, 59].
[61] Bauer [2008, 80]. He refers particularly to taxes on "nitrate exports."
[62] *Decreto* number 1269.
[63] Stephens et al. [1992, 185].
[64] Similarly, Kurtz [2009, 481] argues that where "no faction can easily become permanently dominant," state

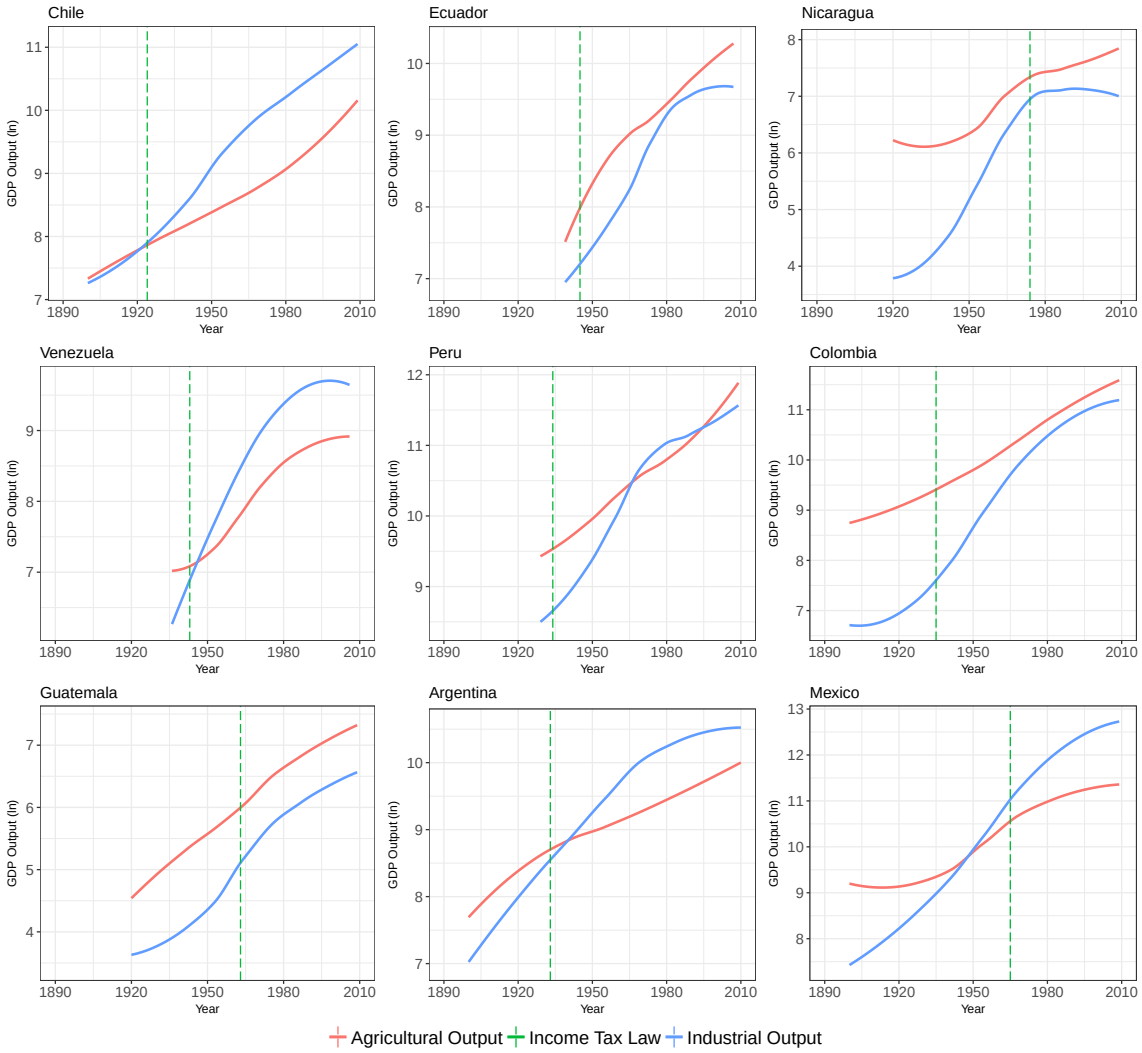

Figure 1: *Industrial and Agricultural Outputs, and The Passage of the Income Tax Law*

IV. Econometric Analyses

This paper argues that the origins of the modern fiscal apparatus is explained by the rise of a new elite who challenged a political economy designed to benefit the landowning class. Last section presented the case of Chile. Now I statistically test this argument in an effort to suggest this hypothesis could be generalizable. Following the typology of economic development suggested in Mahoney [2010, 5], nine polities were selected. Three 'higher level' countries (Argentina, Chile and Venezuela), three 'intermediate level' countries (Mexico, Colombia, Perú), and three 'lower level' countries (Ecuador, Nicaragua, Guatemala). I proxy sectoral competition using the industrial and agricultural sectoral growth rates. The idea is to quantify how much sectoral economic leverage each elite had. I use the MOxLAD data,[65] and the dataset spans from 1900 to (potentially) 2010. According to Astorga

et al. [2005, 790], this dataset provides extended *comparable* sectoral value-added series in constant purchasing power parity prices. Using secondary information, Table 1 states *when* the income tax was implemented, what specific law it was, and its corresponding source(s). Figure 1 shows both sectoral outputs (independent variable) and the year when the income tax law was passed (dependent variable). As a control variable, I included population size. Population has been associated with the probability that elites expanded the franchise.[66] Denser populations also expand the tax base. The scarcity of people meant that local and state governments were extremely concerned with attracting migrants. Because population inflows would lower the cost of labor, and boost land values and tax revenues, these societies were induced to adopt institutions attractive to immigrants. Among these, were cheap land and political participation.

Complete table.

Before start estimating models, it is important to rule out the possibility that income taxation and sectoral development are not linked through a spurious, time-dependent relationship. The occurrence of the outcome of interest (taxation) should not be directly related to time itself, but to the rise of the industrial elite proxied by industrial growth. Within the framework of survival analyses, Figure 2 shows the failure rate of the average country in the sample of implementing an income tax if the size of the industrial sector had increased by half.[67] The figure strongly suggests that the implementation of the income tax law is greatly accelerated when the size of the industrial sector grows.

?? shows 5 models.[68] Following Aidt and Jensen [2009], Model 1 computes the lagged conditional hazard ratio that a country which has not yet adopted the income tax adopts it in a given year as a function of the relative size of the agricultural and industrial sectors. This model assumes a Cox proportional hazard parameterization and computes the hazard rate that a country in a given year will "fail" (i.e., implement the income tax law) conditional on baseline covariates.[69] Countries drop out of the sample when they adopt the income tax.[70] Model 2 is also a Cox regression, but it computes the *instantaneous* effects (i.e., not lagged) of the (logs) of industrial and agricultural growth. By including different time-transformed variables, in the form of a lagged dependent variable

capacities should be stronger. Cárdenas [2010, 40], in his formal and empirical models, also finds that the "concentration of political and economic power reduces the incentives to invest in state capacity."

[65] "These data build on the studies and statistical abstracts of the Economic Commission for Latin America, but also rely on Mitchell's International Historical Statistics, International Monetary Fund's International Financial Statistics, the World Bank's World Development Indicators and a variety of national sources." I used the *agriculture value-added* and *manufacturing value-added* variables. The former measures "the output of the sector net of intermediate inputs and includes the cultivation of crops, livestock production, hunting, forestry and fishing." The later "[r]eports the output of the sector net of intermediate inputs." Both of them are expressed in local currency at 1970 constant prices.

[66] Engerman and Sokoloff [2005, 892-893].

[67] "Failure" in this case means "implementing" the income tax law.

[68] All tables were produced using the `texreg` package (Leifeld [2013]). All Cox models were computed using the `survival R` package (Therneau [2015]). The GEE logistic regression was computed using the `geepack` package (Hojsgaard et al. [2016]). This paper was written in LaTeX using the dynamic report `R` package `knitr` (Xie [2016]), for fully replicable research.

[69] Box-Steffensmeier and Jones [2004].

[70] That is why the time span goes from 1900 to *potentially* 2010.

Country	Available Data	Year Income Tax	Law	Source
Chile	1900 - 2009	1924	*Ley* 3996	Mamalakis [1976, 20] and LeyChile.Cl (official)
Peru		1934	*Ley* 7904	
Venezuela		1943	*Ley* 20851	*Gaceta Oficial*
Colombia	1900 - 2009	1935	*Ley* 78	Figueroa [2008, 9]
Argentina	1900 - 2010	1933	*Ley* 11682	Infoleg.Gob.Ar (official)
Mexico	1900 - 2009	1965	*Ley de Impuesto sobre la Renta*	Díaz González [2013, 130-133] and Diario Oficial (official)
Ecuador		1945	*Ley*	Aguilera and Vera [2013, 135]
Nicaragua	1920 - 2009	1974	*Ley* 662	Legislacion.Asamblea.Gob.Ni (official)
Guatemala	1920 - 2009	1963	*Decreto* 1559	Instituto Centroamericano de Estudios Fiscales [2007, 165]

Table 1: *Sample, Data Available and Year the Income Tax was Implemented*

(to account for partial adjustment of behavior)[71] and "the use of the natural log transformation [to capture] different forms (or "shapes") of the baseline hazard,"[72] Models 1 and 2 are specially equipped to account for time dependency. Model 3 shows the estimated coefficients of the generalized estimating equations (GEE). Generalized estimating equations were introduced by Liang and Zeger [1986] to fit clustered, repeated/correlated and panel data.[73] This method is especially well suited when the data are binary.[74] GEE methods require analysts to parameterize the working correlation matrix. Though Hedeker and Gibbons [2006, 139] explain that "the GEE is robust to misspecification of the correlation structure,"[75] Zorn [2006, 338] explains that whereas the choice of estimator makes little or no difference, the unit on which the data are grouped makes a big difference. Hence, following the advice of Hardin and Hilbe [2013, 166], who point out that when "the observations are clustered (not collected over time) [...] the exchangeable correlation structure" should be used, I assume an "independence" working covariance structure, that is, that there is "no within-unit correlation."[76] From a substantive standpoint, GEE models provide an estimated marginal mean, or the *weighted average* of all cluster-specific effects (or conditional means). Model 4 is a conditional logit ("fixed effects" model). One important advantage of this strategy is the ability to account for country-specific effects. For example, fiscal capacities could be a function of prior state-building capacities.[77] A number of scholars rightly argue that post-colonial state capacities are in part a function of pre-colonial state-capacities.[78] Fixed-effects should be able to account for this and other unobserved or hard-to-measure covariates, which if left unaccounted for would introduce omitted variable biases.[79] Model 5 accounts for possible spatial dependence.[80] Given that the countries I am

early or late implementers.

	(1) Cox (1 lag)	(2) Cox (ln)	(3) Logit GEE	(4) Conditional Logit (FE)	(5) Spatial Dependence
Manufacture Output$_{t-1}$	1.451*				
	(0.569)				
Agricultural Output$_{t-1}$	−0.859				
	(0.740)				
Total Population	−0.000***				
	(0.000)				
Manufacture Output (ln)		0.970***	1.543***		1.277
		(0.161)	(0.333)		(1.036)
Agricultural Output (ln)		−1.185***	−1.107**		−0.818
		(0.292)	(0.369)		(1.071)
Total Population (ln)		1.012*	0.065	−0.844	−0.842
		(0.405)	(1.219)	(0.531)	(0.830)
Manufacture Output$_{t-1}$ (ln)				1.279	
				(0.710)	
Agricultural Output$_{t-1}$ (ln)				−0.819	
				(0.788)	
AIC	22.788	4135.812		25.093	25.091
R^2	0.021	0.392		0.013	0.013
Max. R^2	0.078	0.995		0.080	0.078
Num. events	9	570		9	9
Num. obs.	281	842	842	272	281
Missings	0	0		0	0
PH test	0.937			0.722	0.217
Num. clust.			9		

***$p < 0.001$, **$p < 0.01$, *$p < 0.05$. Robust Standard Errors in All Models

Table 2: *Structural Origins of Income Taxation: Income Tax Law and Democratic Development*

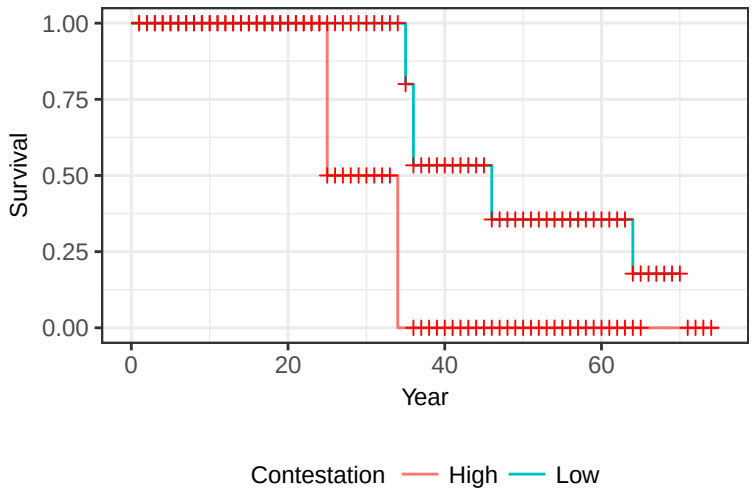

Figure 2: *Kaplan-Meier Curves: Size of the Industrial Sector and the Accelerated Rate of the Imposition of Income Tax Law*

modeling are all contiguous neighbors, it is reasonable to expect a "domino" effect. Theoretically, being the first country to implement the income tax cannot have the same effect as being the last one. There are clearly diminishing returns which should be accounted for. Early-implementers have no prior experience and, hence, it should be harder for them to pass the law in the first place. Similarly, it should be easier for late-implementers: these countries can observe whether this policy worked elsewhere, and adopt it accordingly. To account for this spatial dependence, a cumulative count of countries which have implemented the law at time t was included.[81]

Following Gandrud [2015] and King et al. [2000], the two panels in Figure 3 show different variables of interest each simulated 1000 times. Using a variant of model 2 in Table 2, panel **a** and **b** simulate the average effect of industrial and agricultural outputs on the hazard of passing the

[71] Wawro [2002].
[72] Box-Steffensmeier and Jones [2004, 75].
[73] Zorn [2006, 322].
[74] Hanley et al. [2003].
[75] Carlin et al. [2001, 402] argue that "[r]elatively minor differences in estimates may arise depending on how the estimating equations are weighted, in particular within the generalized estimating equation (GEE) framework." Westgate and Burchett [2016] and Gardiner et al. [2009, 227] make the same point.
[76] Zorn [2006, 332].
[77] I thank Matthias vom Hau for this suggestion.
[78] Wimmer [2015, 10], Mahoney [2010] and Lange et al. [2006, 1426].
[79] Angrist and Pischke [2008].
[80] I thank both Christopher Zorn and David Darmofal for this suggestion.
[81] Given the small number of events (no event, democracy or taxation, and taxation and democracy) and the small panel (just seven countries, where some of them experience taxation/democratization rather early, shortening the panel length), the variable could not be introduced on the RHS due to a perfect classification problem. Instead, I opted to cluster the results at the counting variable level. Clustering by the counting variable allows me to cluster by

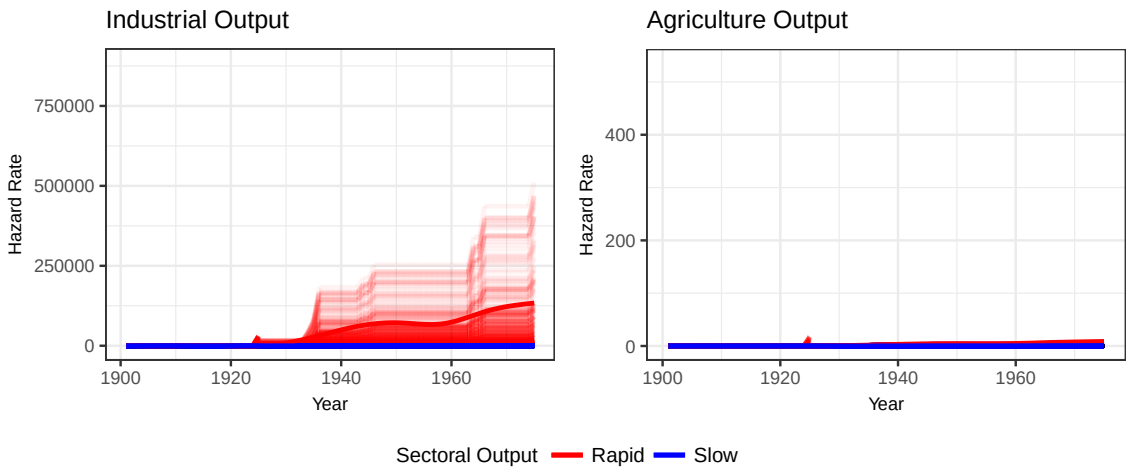

Figure 3: *First Differences of Industrial Output, Agricultural Output and Democratic Experience*

income tax law.[82] Using the estimations of the seventh model in Table 2, panel **c** simulates the effect of the cumulative democratic experience on the passage of the income tax law. These plots strongly suggest that higher industrial output substantively boosted the hazards of introducing the income tax, while higher agricultural output did not play a role in the modernization of the fiscal system. I argued in favor of an endogenous process involving oligarchic electoral competition and the development of a fiscal system. However, model 7 in Table 2 suggests that once we include oligarchic electoral competition on the right-hand-side, we find statistically significant results. Panel **c** in Figure 3 simulates those effects. However, income tax adoption does not fit oligarchic electoral competition (model 8). I leave this question open for future research.

These results strongly suggest that as the industrial sector developed, it challenged the agricultural political monopolists, making the passage of the income tax more likely. Once unobserved sources of heterogeneity are accounted for (in the "fixed effects" model), past stateness levels do not alter the mechanisms presented in this paper. The AG model suggests that once we assume taxation and early oligarchic electoral competition are the same process, the sizes, signs and statistical significance do not change either. However, when we assume them to be different and try to break the endogeneity "problem," we see that oligarchic competition "causes" income taxation, but not the other way around (model 7 and model 8, respectively).[83] When I cluster by early and late-implementers, results remain substantively identical. Finally, when per capita GDP is included, the model crashes and neither this measure of well-being nor higher levels of industrialization predict oligarchic competition/democratization or fiscal development. The GEE model includes a measure

[82] The `simPH` package does not handle natural logs well. The only difference was the inclusion of the unlogged variable. It is important to stress that *both* sectors were included in the model, hence one sector acts as the control variable for the other. In the appendix section, **??** shows the results of the model employed to generate the 2,000 simulations. The numbers differ from the main results in Table 2 because the scales are different.

[83] I use the term loosely, without claiming any causal inference.

of population density.

V. Discussion: Slow Industrial Growth and Lack of Contestation

This paper argued that in order to understand state capacities, it is necessary to understand the origins of the main "state-building" institution, income taxation. Direct taxation and especially, income taxation (being a much more complicated tax to collect), require the development of better bureaucracies, a fundamental part of the modern state. Its introduction was not important because of the new resources the treasury acquired, but because it triggered a series of inter-elite compromises as well as other institutional investments. My theory claims that the countries that made the big jump sustained fast industrial growth rates. These rates allowed industrial elites to challenge the traditional sector, forcing it to grant them political concessions. One of the most important of these was the opening of the post-colonial political system, which granted access to industrial organized groups. Specifically, the industrial class accepted an income tax in exchange for the ability to participate in politics. In terms of economic compromises, the industrial elite managed to articulate its demands as a coherent class, including in the bargain protectionist industrial tariffs. In this sense, the mechanism that allowed the rupture of the old political monopoly was similar sectoral output levels among agricultural and industrial elites. It is inter-elite *equality* that causes state formation and cooperation, not inter-elite inequality as other scholars have claimed.[84] A situation of balanced growth gave elites in each sector the potential to acquire the same level of military power, deterring sustained conflict and forcing both political and economic compromises. It was in this way that industrialization was important (as a contestation device), not in the way modernization theorists have argued. That is, it was not faster *overall* economic growth what created states, but balanced *sectoral* growth, allowing inter-sectoral competition.

[84] Boix [2015, 73] argues that states only exist to counteract potential conflict between agents with *different* economic interests and military capacities.

VI. Appendix

I. Model used for Simulation Plot

?? shows the estimates used to compute the 2,000 simulations in the Figure 3 (panels **a** and **b**).

II. Robustness Checks

Cox *proportional* models rest on the assumption that hazard rates are *proportional* to time dynamics.[85] Non-proportional hazard models are becoming an increasing problem across all subfields in political science.[86] In this section, I test whether this assumption holds. Non-significant p-values indicate that the proportionality assumption holds. Also, Figure A1 shows that the spline fitted lines are constant across time. Each of the seven dots represents the regression coefficients of the seven countries in the sample.[87] All in all, steady splines confirm that the hazard rates are, in fact, *proportional*.

```
##                     rho   chisq     p
## L_constmanufact  0.0152 0.00176 0.967
## L_constagricult -0.0299 0.00706 0.933
## totpop           0.3541 0.39632 0.529
## GLOBAL               NA 0.41604 0.937
```

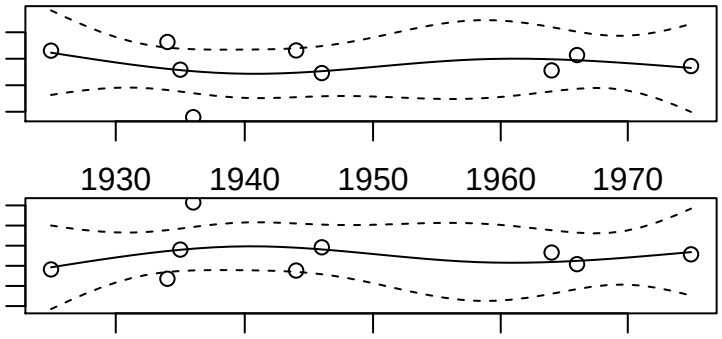

Figure A1: *Plots of the Coefficient Estimates against Time*

[85] Box-Steffensmeier and Jones [2004].
[86] Licht [2011].
[87] This is for our main model, column 2 in Table 2.

Word count: 6,415

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