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Taxation and Public Goods in Peru

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By Richard Webb

This paper argues that Peru suffers from a deficit of public goods, and discusses causes, effects and possible remedies for the imbalance. In particular, the paper argues that the public goods deficit was probably a major factor in the recent near-breakdown of democracy.

My minimum list of public goods includes security, justice, equality, the physical environment, basic education, basic health, the creation and diffusion of knowledge, the care and best use of finite natural resources, financial stability, infrastructure including airwave communications, culture and historical preservation. It is also expected that the state will foster social values, such as honesty, solidarity and a sense of purpose. The list can surely be expanded.

I take the provision of public goods to be a state responsibility, whether the goods are provided directly by the state, or whether the state simply ensures that private suppliers do the job.

A Paradoxical Crisis

Public confidence and approval of government have undergone wide swings in Peru in recent years. During the nineties, President Fujimori succeeded in stabilizing prices, initiating an economic recovery and ending terrorism, and was rewarded with high levels of public approval through most of the decade. In 1998, however, his support was eroded by an economic recession and by his decision to force through an unconstitutional reelection. Then in 2000, revelations of corruption and electoral fraud precipitated his resignation and a new election. Confidence returned with the election of President Toledo in 2001, buoyed by democratic renewal and by expectations of economic recovery. From 2002, however, Toledo's government was suffering from his lack of experience, an undisciplined majority party, and successive scandals and cabinet turnovers, all of which caused a steady slide in public approval.

In February 2004, the slippage suddenly developed into a major political crisis that came close to forcing him out of office. Reacting to a new scandal that compromised close political allies, Toledo's approval ratings collapsed to seven percent. During several weeks, the possibility of an interruption of his term of office, a previously taboo subject, became a matter for open discussion. Respected journalists and business groups demanded that he at least "step aside" in some way that would minimize the damage to constitutional order. The February crisis was temporarily resolved by a change of cabinet and by a presidential decision to delegate more authority over appointments and priorities to the new cabinet. Opposition groups chose not to press the issue further at that moment, perhaps because public rejection of the Toledo government was paralleled by an equally strong disapproval of most of the political establishment. In March, for instance, public approval of Congress had fallen to eight percent. Toledo's departure could easily have precipitated a purge of the entire political establishment.

The February crisis was unprecedented in its origin. Threats to a democratic regime are usually associated with major economic breakdowns, most often, some combination of inflation, devaluation, bank failures, and collapse in production and employment. Yet none of these events occurred recently in Peru. Inflation has been negligible since the year 2000, and the exchange rate has been stable for a similar period. In fact, the Central Bank has repeatedly intervened to prevent a revaluation of the domestic currency. International reserves are at a record high and still growing.

The financial system is stable, and has recovered from the severe recession and bank failures that occurred between 1998 and 2000. Production grew over 4 percent annually over the two year period 2001-2003. Peru's economy is highly diversified, so average growth of 4 percent implies a large number of promising growth points, such as tourism, mining, export-oriented agro-industry, and textile exports. Also, Peru's large informal and illegal sectors provided additional strength to the outcome, much of which is probably not fully reflected in the official statistics. A favorable view of Peru's recent economy is reflected in its falling sovereign risk rating, down from a margin of over 600 points above U.S. Treasuries at the start of the Toledo government to about 345 points in March 2004.

Certainly, one can point to weak spots in the economy. Real wages have been stagnant over the last two years and open unemployment has risen slightly. Moreover, a growing tax share has captured part of the increase in GDP, meaning that private incomes grew less than the rise in GDP. Investment has fallen. Furthermore, the growth in primary production, especially in highly capital intensive mining output, contributed disproportionately to the rise in GDP, restricting the extent of spillover from a higher GDP. But these qualifications do not explain a near breakdown in democracy. The overall economic picture is favorable whether compared to Peru's own performance over past decades or to the recent performance of other countries in the region. Toledo's February crisis happened despite, not because of economic performance.

At a psychological level, one could also argue that patience may simply have worn out. Per capita GDP in 2003 was barely equal to that recorded in 1974. Recent improvement was too little too late. Disappointment may have been aggravated by Toledo's excessive campaign promises, which were made credible by his personal rise from a background of racial discrimination and provincial poverty. The frustration of those exaggerated hopes may explain the disproportional punishment meted out not only to Toledo but to the entire political system.

The Public Goods Deficit

A more direct and objective explanation for the recent political crisis can be suggested, however. The case turns on the observation that a major component of personal and national welfare consists of public goods, which are not adequately measured by gross national product. My view is that a large deficit has arisen in the provision of those goods, and that citizens are far more conscious of the lack than are government statisticians. The state has fallen behind in meeting its function as a provider of public goods, and this governmental failure is the best way to understand the current political malaise.

It should be recognized at the outset that the deficit in public goods is the result of both deficient supply and increased demand, and that it is hard to determine the contribution of each side of the equation. Certainly, there are indications that both sides of the equation have played a significant role; recent government performance has been unusually ineffective just at the moment when the return of democracy has created greater awareness and demand for good government, and the coincidence has produced a sudden and sharp perception of political failure by the state, the political equivalent of a perfect storm.

Welfare is produced by both private and public goods. Private goods can be appropriated and enjoyed by individuals, whereas public goods are inherently available to all. Public goods are not bought and sold in markets and are therefore largely ignored in the measurement of welfare. And when it comes to explaining the ups and downs of political life, the variables that get all the attention are those that come with seemingly credible numbers attached, such as GDP, while the unmeasured value of public goods is ignored. Yet it is a common sense observation that public goods are major determinants of total welfare, an observation that is beginning to be supported by the new art of survey research, which has begun to explore and publicize subjective perceptions of public goods, such as security, public morals and the environment, and to attach numbers (of a kind) to those findings.

This is not to say that GDP completely ignores public goods. Standard GDP accounts do in fact include estimates of government output but, because public goods are not priced in markets, national accounts use cost of production –payroll and other government costs- as a proxy measure of value. Appealing to common sense again, it is obvious that government hiring, salary levels and other spending decisions are likely to be grossly misleading valuations of the supply of public goods, and equally, of short run variations in that supply.

It bears noting that a public good deficit has consequences that go beyond the discomfort of a non-optimal consumption basket. Public goods serve not only for direct consumption but are key inputs into the productive process. Their scarcity has contributed to Peru's economic stagnation since the mid-seventies and to its weak redistributive performance.

A review of public good provision produces a litany of growing deficiencies. Thus, educational attainment scores published by an international evaluation carried out in 41 countries, PISA, placed Peruvian students at the bottom of the list, well below Mexico, Argentina and Brazil. Educational spending per student in primary school is about one fifth what Chile spends and one third of Brazil's spending. UNESCO data show a backsliding in key health and nutritional indicators, while government statistics show a doubling over the last five years in the calorie deficit in Coastal and Jungle regions of Peru. Delinquency and street violence are rising, and show up as major concerns in public opinion surveys. Drug production has been cut under U.S. pressure, but the consumption of narcotics within Peru is rising. Public investment has fallen to its lowest level in decades, while the privatization and concessions program has slowed to a walking pace. Public spending on industrial technological research and development and on agricultural research and extension are almost negligible, and below that of previous years. The judicial system is blatantly corrupt, and vies with Congress and President Toledo for the lowest ratings in measures of public confidence. Peru's historical and archaeological heritage is being rapidly destroyed, along with the massive spoiling and destruction of the environment. And, almost daily revelations of political mendacity, opportunism and corruption disappoint the general need for moral leadership.

Fujimori raised the banner of solidarity by creating social programs targeted at the very poor and these programs have continued under Toledo, yet the public image of these programs increasingly highlights poor targeting, waste and corruption. The one public good success has been the preservation of monetary and financial stability. On balance, the overall picture is one of a severe and growing deficiency in the supply of public goods.

At the same time, however, the perception of deficit in the provision of public goods is the product of higher expectations and increased demand. Starting in 2000, Peru emerged from fifteen years of submerged and repressed democracy. During the first five years of the period 1985-1990, Peru was governed by an elected democracy, but the entire state apparatus was dominated by one party. The APRA government used its comfortable congressional majority and traditional party discipline to concentrate power in the presidency and curtail the effective independence of autonomous bodies such as regional governments, the judiciary, the military and the central bank. Presidential power became even greater under Fujimori, initially legitimized by the economic and terrorist emergencies, but increasingly based on corruption, cooptation and legal and electoral fraud. The media, in particular, were silenced by pay-offs, threats and outright government purchases. Local governments were either co-opted by budgetary favors and social programs, or ostracized.

Fujimori's departure released a flood of repressed and pent-up demands. The result has been a political process that could be characterized as hyper-democracy, a political state that is certainly disorderly and, for some, verging on chaos. Presidential power is shared with an activist Congress that is not disciplined by a majority party, with newly created regional (state-level) governments in addition to local municipalities, and with autonomous agencies, including the Judiciary, that have regained constitutional autonomy.

Toledo's failure to win a reliable, controlling majority in Congress has heightened political competition and legislative activism, with two effects that bear on the public goods deficit. On the demand side, Congressional activism has exacerbated the perception of unmet needs, as rival politicians use those frustrations to compete by championing specific demands. On the supply side, Congress has become an obstacle to good administration, and thus, to the actual satisfaction of needs; the multiplication of congressional criticism and legislative initiative gets in the way of coherent, continuing ministerial execution. The problem is compounded by a high level of turnover of ministers and key officials who become scapegoats for congressional and media dissatisfaction. The newly created regional governments and the now liberated municipal governments have also contributed to a heightened demand for public goods. Finally, the quantum jump in the speed and volume of communications made possible by modern technology, and the creation and spread of civil society organizations have combined to further empower citizens, and to increase awareness of public good deficiencies.

Increased Tax Revenues as a Solution

In 2003, tax revenues and fees collected by the Peruvian central government equaled 14.7 percent of GDP. Strikingly, the tax ratio has remained almost unchanged over four decades, fluctuating between 14 and 16 per cent.

Far more revenue is clearly required to meet public expectations and modern standards for public goods. Services such as basic education, primary health and internal security require armies of workers and essential equipment. The unfinished tasks of social integration and market creation, in turn, require substantial public investments in road construction and maintenance. This includes a network of secondary and feeder roads, and major new highways to connect Peru with Brazil and with other neighbors. In addition, the state must meet demands for a host of other public goods and services. There is a fundamental need, for instance, for the reform and modernization of the judicial system, for better statistics and information, and for the protection of Peru's largely abandoned cultural heritage and physical environment. Finally, tax funds are needed to consolidate decentralization in a country where centralization has been an instrument of inequality and authoritarian rule. State-level governments were introduced in 2003, but real decentralization requires that those new administrations, along with Peru's long-neglected and starved provincial and district governments, be supported to establish their effective capacity to govern. This means a redistribution of government revenues but also some general increase in administrative costs.

There is no way to measure the cost of closing the public good deficit –needs are always relative- but there is an undoubted need for a much higher level of public sector revenue. The size of the additional effort required is better appreciated if it is remembered that about one third of all revenues are now spent on pensions and interest on the public debt, in other words, on past rather than current provision of public goods. For the purposes of meeting current expenditures, the government can count on only two of every three dollars it collects.

The tax ratio, however, has defied almost annual "tax reforms," innumerable foreign tax advisory missions, and the direct self-interest of most of the political class, ranging from socialist generals in the seventies, social democrats in the late eighties, and centrist administrations under presidents Belaúnde and Fujimori. The effort to raise government revenues has been a political constant, irrespective of ideology. Yet current revenues were 13.9 percent of GDP in 1970 and, as mentioned above, for most of four decades remained within a range of 14.0 to 16.0 percent. They rose to a peak 17.1 percent in 1980, boosted that year by the combined help of oil discoveries and an export price boom, and they dropped to 6.5 percent in 1989 and 6.6 percent in 1990 as the direct result of hyperinflation and severe recession. Hyperinflation explains the collapse over those two years: with prices rising 20 to 40 percent every month over that two-year period, even the normal one-month lag in tax payments meant a loss of a large part of their real value by the time payments reached the Treasury. The sudden end to inflation at the end of 1990 immediately produced a recovery in former tax levels. This Tanzi effect was reinforced during the early nineties by a highly effective administrative tax reform, implemented by a team of central bank staff seconded to the Ministry of Finance. By 1995, central government current revenues had recovered to 15.2 percent of GDP, rose to a decade peak of 15.9 percent in 1997, but fell to 14.1 percent in 2001 under the combined effect of recession and reductions in some tax rates decreed by the first post-Fujimori administration.

The Toledo government has made a commendable effort to improve that performance, empowering an independent tax authority, the Superintendencia Nacional de Administracion Tributaria, to propose legal reforms and to carry out major administrative improvements, and appointing a strong and highly trained Superintendent to lead the effort. With the help of administrative improvements plus some tax rate hikes, government revenues rose by one half of one percentage point, from 14.1 to 14.7 percent of GDP. In recognition of that effort, the tax Superintendent, Miss Beatriz Merino, was later to become Prime Minister. Her final contribution was to propose the introduction of a controversial tax on banking transactions, a proposal that was enacted after her departure from government, and that so far is surviving vigorous attack by opposition groups, independent economists, business lobbies and even the IMF. The legality of the tax will be reviewed by Peru's Constitutional Tribunal later this year. Even the current Minister of Finance, Pedro Pablo Kuczynski, criticized the tax before his recent appointment and, after his appointment, proposed to reduce the rate by one half. If the tax survives, it is expected to yield between 0.25 to 0.5 percentage points of GDP in additional revenues directly, but its supporters argue that the indirect benefit, as an instrument to police the bank accounts of tax evaders, could be more significant.

The Limits to Tax Revenues

Is there a glass ceiling to tax revenues in Peru? What economic and political factors explain the apparent inability of successive governments to carry out a real tax reform?

If a ceiling exists, it applies to the collection effort rather than to rate levels. The current 19 percent value added tax is high by international standards and may already exceed an optimum level at which the additional incentive to evade offsets extra collection. Import duties, though lowered substantially as part of Fujimori's liberalization program, are nonetheless high for an era of globalization, averaging 12 percent. Moreover, Peru is negotiating trade agreements with other countries, meaning that tariffs are likely to be reduced in the near future. The impact on total revenues could be large, since over one quarter of total revenues are now collected by the Customs, almost all from imports. Taxes on exports are now limited almost entirely to the income tax on profits and, in the case of mining, to royalties. Fuel taxes are high, both historically for Peru and by international comparison, with 95 octane gasoline being sold at US$ 3.80 a gallon. Alcohol and tobacco taxes are at levels that have produced massive contraband. The income tax rate of 30 percent, supplemented by an additional 4 percent tax on dividends, is hard to increase in an era of easy capital mobility and international competition for investors, whether foreign or domestic. Criticism of inadequate income taxation has focused on the special deals offered to investors by the Fujimori administration during the early nineties, when Peru was struggling to emerge from its self-induced recession and foreign investment blacklist. Investors were offered tax stability contracts for fixed periods which protected them from subsequent rate changes, but the terms of those contracts are now running out. Companies also benefited from generous depreciation rules, which were additional sweeteners at the time, but are no longer operative. There is room to raise real estate taxes, but again, the principal problem is collection rather than rates, particularly after the delegation of those taxes to local governments. In general, there seems to be very little margin to raise tax rates or to introduce new taxes, certainly at rates that would produce a significant increase in total revenues.

The real barrier to adequate revenues is evasion. The burden on taxpayers who do not evade is high for three reasons. First, the rates themselves, as noted above, are relatively high by the standards of many countries. Second, in addition to the direct tax hit, honest taxpayers face the unfair competition of rivals who do not pay. Third, whereas taxpayers may bear similarly high, or even higher rates in other countries, they receive benefits from government that are not available in Peru, including benefits to the individual, such as good public education and good police protection, and benefits to their businesses, such as good roads, honest judges and reliable port services. The Peruvian taxpayer not only pays his taxes but must also send his children to private school, hire his own security, bribe corrupt officials and judges, and face the costs of bad infrastructure and communications. The short-term recourse of adding to the burden already paid by existing taxpayers has become a dead end, and is probably counterproductive in Laffer Curve terms, as is suggested by the inability of successive governments to raise revenues in that manner. Indeed, the solution would seem to be to backtrack, that is to reduce the incentive to evade by lowering rates, though this course has obvious risks and would probably mean incurring a political cost in the form of temporary revenue losses and spending cuts.

Non-Tax Financing

Successive governments have found different substitutes for tax revenues. The most obvious alternative has consisted of borrowing, the route chosen on a grand scale, first by the government of General Velasco (1968-1975), and later by that of President Belaúnde (1980-1985). In both periods, borrowing added four to five percentage points of GDP in additional spending capacity, easily exceeding any conceivable gain from a greater tax effort. Both presidents saddled future governments with higher debt payments, reducing future spending capacity. Velasco took a more radical tack, using the land reform and the industrial and mining community laws to ordain a direct redistribution from property owners to workers, a form of "spending" without the formalities of taxation. President Fujimori (1990-2000) financed spending from the proceeds of privatization. President Garcia (1985-1990) used price controls in a similar way: by fixing prices he in effect redistributed from seller to buyer. In this way he subsidized credit and foreign exchange on a large scale, and also many food products, public utility services, and other products. A full accounting of those hidden subsidies would probably show that total government spending reached record highs during the first years of his administration, before hyperinflation began to cancel out real values.

None of these alternatives appear to be available now. After the recent financial problems suffered by highly indebted developing countries, any further increase in Peru's public debt, which now stands at 40 percent of GDP, would be rash, and would probably raise country risk, and thus borrowing costs, sharply. For the next several administrations, Peruvian governments will be forced to limit borrowing, at most, to a level that maintains the current debt ratio. The tightness of this constraint will depend on the rate of GDP growth; a moderate growth rate of four percent would allow Peru to use limited borrowing to add one or two percentage points GDP to its spending, though this would be done at the cost of not lowering what is already an excessive level of debt.

Toledo has announced privatization plans that would add to current spending capacity, but the greater part of state enterprises have already been sold, and in addition, both political and market climates are now less favorable to privatization. The other alternatives, price controls and expropriation, are do not appear to be viable options, particularly in view of the disastrous results of their previous application.

For the foreseeable future, therefore, Toledo and his successors will be forced to rely only on tax revenues to finance the needs for public goods.

Spending Efficiency

The obvious but little used route to increase public good output is to make government more efficient. The potential for higher productivity through a mix of process reengineering, modern technology, better human resource management and less corruption is enormous. Government after government, however, shies away from this route, for obvious reasons: administrative reform takes time; it is little appreciated or demanded by the public; and, above all, it means a loss of patronage and opportunities for corruption and for political uses of administrative power. The perverse incentives that riddle government administration can be overcome when chance throws up a reformist autocrat or, in a democracy, as a grudging response to citizen pressure.

During 2001, a team of experts reviewed needs and possible reforms in forty different areas of state responsibility in Peru. The conclusions, published as the *Carta de Navegación*, identified a large number of opportunities for raising the volume and quality of government output without incurring higher costs, in fact, often at lesser cost. Amongst the many suggestions, the report included recommendations for practical steps to improve schooling quality, forestry management, police effectiveness, congressional assessments of proposed legislation, citizen participation, and export promotion.

Many of the suggestions in the *Carta de Navegacion* required a new attitude by government: a new way to relate to society. In essence, they directed government to act more as a partner with private or civil society in addressing specific tasks, and less as a dictator and policeman. Experience in partnership is in fact already growing, in the form of Ministerial contracts with local communities to work together to meet as primary health needs, or contracts with community enterprises to maintain rural roads. Such partnerships in effect bring into play additional resources at the cost of a partial surrender of authority. However, the extension of such arrangements must be imposed on reluctant bureaucracies and political establishments that would lose a degree of power over hiring and spending decisions.

The potential for reform is hardly surprising, given the sheer depth of administrative inefficiency and the abundance of easily accessible administrative expertise in the world. Moreover, new information technology is a basis for radical jumps in governmental performance, as was demonstrated during the nineties by the reform carried out in Peru's Customs office. Over some six to seven years, the Customs office was transformed from a sinkhole of delay, corruption and ineffective collection into an international model of reform, in large part as a result of the application of paperless, computer-based processes.

Peru's current democratic renewal has opened the door to a multitude of new civil society organizations, including watchdog groups. Terms that were unheard of a decade ago – transparency, accountability and vigilance – are becoming common currency. The on-going debate over the banking transactions tax, which is close to a public rebellion against new taxes, is reflecting a new awareness by the public of the costs of government waste. At the same time, democracy is allowing for a greater degree of autonomous action and cross-checking within the state: Congress, the Audit Office, regulatory agencies, the Courts, the government attorney's office, an agency that regulates government purchasing, are in different ways acting to oversee the work of other government agencies. Indeed, one initial result of this escalation in oversight has been perverse: normal government is hindered because a high percentage of senior and even middle level officials must carry out their work while dealing with investigations and charges that may be substantive but that are often politically motivated. The main and permanent effect on the production of public goods of this increasing oversight, however, should be positive.

Conclusion

Peru suffers from a growing deficit in public goods. The exceptionally high disapproval of president Toledo and of most of the political establishment is probably a reflection of a new consciousness of that deficit.

The traditional resort to increased tax revenues as a way to fund higher expenditures on public goods may provide part of the solution, but only to the extent that additional revenues are the product of less evasion. There is very little room for new taxes or increased rates in Peru, and such efforts may even be counterproductive. However, administrative efforts to improve collection have been moderately successful and may continue to pay off. But even optimistic revenue projections from such efforts fall far short of the substantial requirements of the public goods deficit. In fact, that deficit is likely to continue to grow as democracy becomes more established and civil society more organized to monitor and demand services from government, many of which are even constitutional rights.

The only available solution would seem to consist of a significant upgrading of government efficiency and performance as a producer of public goods. Much of what needs to be done is well-known, and there is an abundance of administrative expertise on offer, within Peru and from outside. And in all areas of government there is room for gains in effectiveness from the application of easily available information technology. But sustainable administrative reform will not happen unless the political establishment is pressed in that direction by a high level of surveillance, vocal demand and the application of political penalties. The current political crisis can be interpreted precisely as such pressure.