

Institutions or Factor Endowments? – Income Taxation in Argentina and Australia

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‘In sum, it is the LACK OF SOLIDARITY between the taxpayer and the treasury that is the cause of evasion. Without that indispensable bond, without an acceptance, not formal but REAL of joint responsibility, it will not be possible to tackle those actions needed to achieve the common good.’ (Peire 1959), p.41

Why compare Income Taxation in Argentina and Australia?

The comparison of income taxation in Argentina and Australia is part of a larger thesis interested in the big question of what determines development. The comparison of Argentina and Australia is well suited to this. Both were settler economies with similar prospects for development, but after rapid convergence in the late nineteenth and early twentieth centuries, there was clear divergence from the mid twentieth century. This paradox of similar environments for development and starkly different outcomes once attracted much attention from economic historians. It holds the promise of getting beyond deterministic explanations of development such as factor endowments and geography, as Argentina was far better positioned in these terms than Australia. Yet it was Australia that continued to prosper as a developed country, and Argentina that regressed to developing country status.¹ Argentine institutions ultimately failed to generate the compromises required for development, entering a 'latent civil war'² from the 1930s onwards, one that hopefully exhausted itself in the early 1980s. In the Argentine-Australian comparison, the construction of the state and its credibility explains much of their divergence. Fiscal institutions are a promising means of investigating state credibility, as they clearly reflect it. The particular example of income taxation should be in theory, and was in practice, important. The divergence in fiscal institutions, especially in income taxation, was behind divergent development. Argentina and Australia took different development paths due to their differing institutional environments. Their example could clarify the more fundamental reasons for development elsewhere.

Argentina and Australia shared the external environment of developing on the periphery of the world market, with similar opportunities determined by their

¹ Argentina is a particularly challenging example to the factor endowments argument most recently exemplified in Engerman, S. L. and K. L. Sokoloff (2002). "Factor Endowments, Inequality, and Paths of Development among New World Economies." National Bureau of Economic Research Working Paper 9259. They argue that factor endowments are the fundamental causation of development, as they determine institutions through their production function, e.g. slave plantations lead to dictatorial institutions whereas small farms lead to democracy. Engerman & Sokoloff propose that North American development was more successful due to factor endowments that encouraged small farms. Yet Argentina had similar factor endowments that did not result in small farms. Their fix is to argue that Argentina's unique response of inequitable land tenure encouraged the wrong kinds of institutions. Besides the inherent self-contradiction, it also contradicts the Australian experience. Australia had highly inequitable land tenure with successful democratic institutions.

² Díaz Alejandro, C. F. (1970). Essays on the economic history of the Argentine Republic. New Haven, Yale University Press.

underlying wealth in land. These commodity export opportunities were the main development paths taken by each in the nineteenth and early twentieth centuries, and were highly successful. Argentina was a late starter, but by the turn of the twentieth century it caught up with the wealthiest 12 European countries in terms of GDP per capita, and was nearing the leading ‘western offshoots’ of Australia, New Zealand, the USA, and Canada.³ It reached its peak in the late 1920s, by which time it exceeded or rivalled European GDPs per capita, and was almost at a par with Australia. Relative failure set in some time thereafter, but this was not clear until the postwar period. During the interwar period Argentina and Australia turned away from the world market, beginning largely unsuccessful attempts at internally led development. After World War II (WWII) the world market re-emerged as a powerful option for development. Australia managed to continue its former export led development path alongside a newer protectionist path, whereas Argentina could not maintain such a balance, abandoning export led development in spite of renewed opportunities. Both pursued similar paths to development, but Argentina proved unable to revive its export sector in the postwar period.

Considering factor endowments, Argentina was able to diversify into a wide range of staple exports whereas Australia had a much lower rate of diversification due to more limited factor endowments. Excluding Antarctica, Australia is the world’s driest continent with some of its oldest and poorest soils.⁴ Argentina in contrast is richly blessed in soil, climate, and geography. Yet many obvious opportunities stemming from rich factor endowments were left untaken in Argentina. It shares the same Andean cordillera with Chile, but its mining sector is insignificant. Why do Chile and Australia, but not Argentina, export so many minerals? Australia was less blessed, having little to sell besides wool for much of its history. This required significant collective action (enabled by institutions of compromise) to overcome limited factor endowments. The best placed actor to provide such collective action was the state. It emerged early on as the leading investor in public goods such as railways, but also in scientific research to overcome problems related to low soil fertility, persistent drought, and plagues. It was able to play such a role due to its high credibility, backed

³ Maddison, A. (2003). *The World Economy: Historical Statistics*. Paris, OECD Development Centre. **2005**.

⁴ Flannery, T. F. (1995). *The future eaters : an ecological history of the Australasian lands and people*. New York, G. Braziller.

by solid, if basic, fiscal institutions. Considering the similarity in models adopted for development and factor endowments, Argentina was better placed to develop than Australia. Australia's greater success was largely due to the greater abilities of its state. Institutions are more important than factor endowments in explaining divergence.

In order for the state and its institutions to play a positive economic role, it requires credibility to tax and borrow sustainably (i.e. fiscal institutions). State credibility goes to the core of the state's institutional capacity, and thus institutional explanations for development. Fiscal institutions are an important physical representation of state credibility. Less credible states are limited by weak fiscal institutions, and compulsion is highly ineffective in collecting revenue. Strong fiscal institutions must ultimately rely upon cooperation, which is only widely possible in a credible state. Income taxation is a fiscal institution that is highly dependent upon cooperation, and that has proven to be the most lucrative of all. In the first half of the twentieth century, it became the most important fiscal institution in Argentina and Australia. Yet it failed in the postwar period in Argentina. The comparative history of income taxation is important in order to determine the role that state credibility, and thereby institutions, played in the story of divergence.

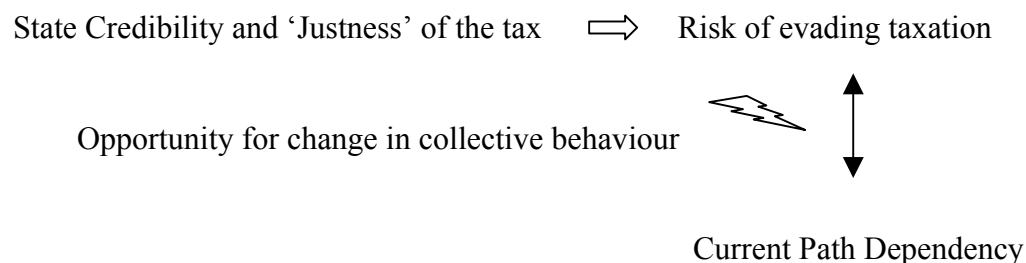
The Crux of Divergence

The key experience in the postwar history of Argentine and Australian fiscal institutions was the respective failure and success of income taxation. Argentina successfully, if belatedly, introduced income taxation in 1932. Yet it clearly began to fail from the 1950s, quickly degenerating into a relatively insignificant fiscal institution. Australia successfully introduced federal income taxation in 1915 during World War I (WWI), which became its most important fiscal institution by the mid twentieth century.

Income taxation is a strong indicator of state credibility as it is a direct tax that requires much cooperation from individuals. For instance, even when the state is capable of measuring incomes at their source, workers can still choose to opt out of the legal labor market. Individuals calculate how much they are willing to pay,

measuring the cost and benefits of paying against those of not paying. The balance is largely determined by state credibility. One study finds that the majority of Australian taxpayers pay income taxation despite the very low chance of being caught, and the practice of self-assessment and voluntary compliance.⁵ In the long run, the state's credibility determines both the justness of taxation and the risk of being caught. Yet in the short run, the prevailing proportion of taxpayers paying determines the risk of being caught. If many people pay income tax, it is easier to discover those who do not, and vice versa. The prevailing proportion of taxpayers is akin to path dependency in the short run. Even if many feel income taxation is unjust, the risk of not paying will remain high as long as most people pay. This path dependency relies upon the difficulty of coordinating individuals' collective behaviour, and will work to maintain the status quo until an opportunity arises for change.⁶ State credibility ultimately determines tax cooperation in the long run, but has to await opportunities for collective expression in the short run. Path dependency can give previously credible states plenty of rope, and may make it more difficult for newly credible states to increase their fiscal resources.

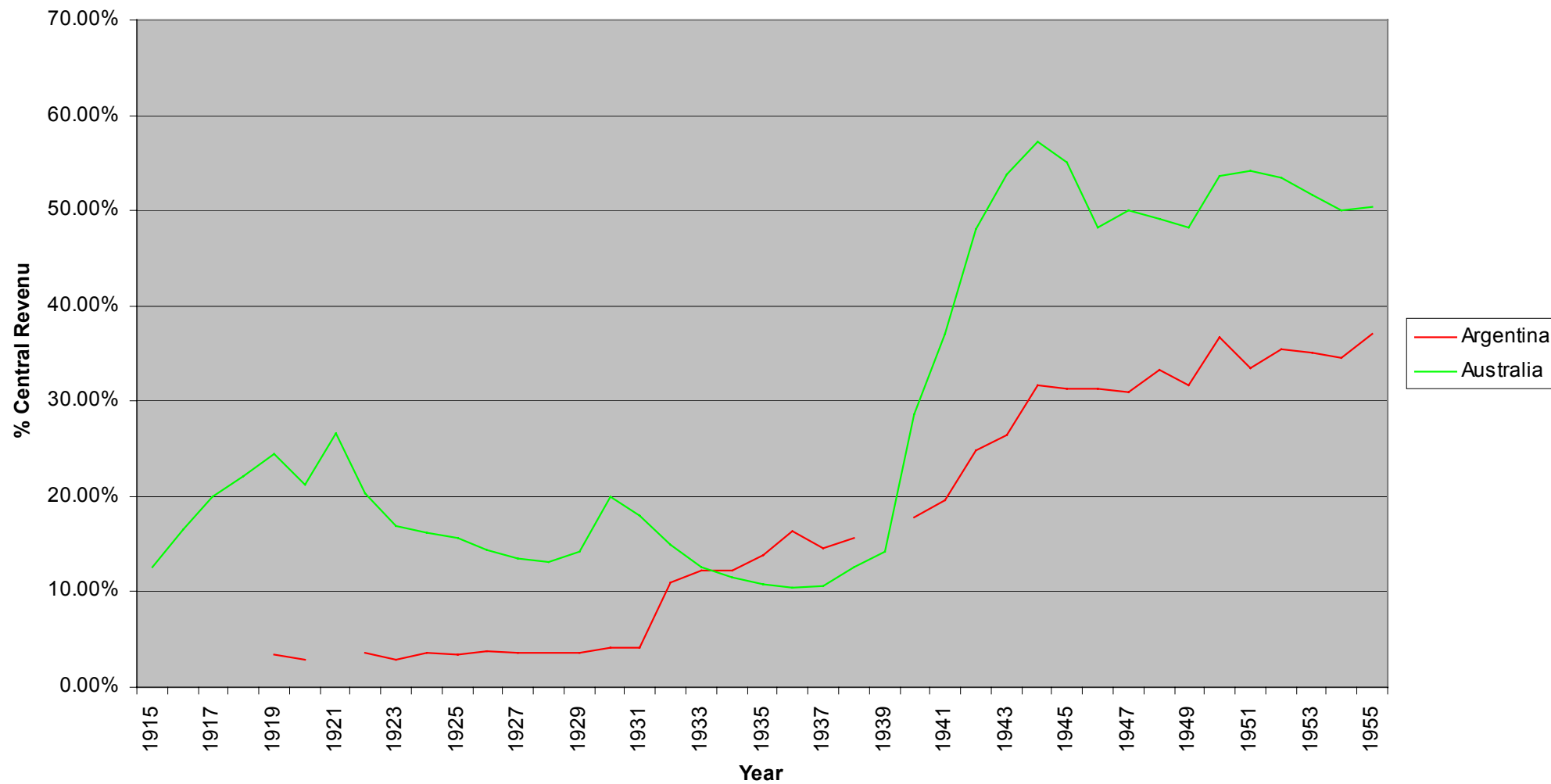
An ideogram of the process above:



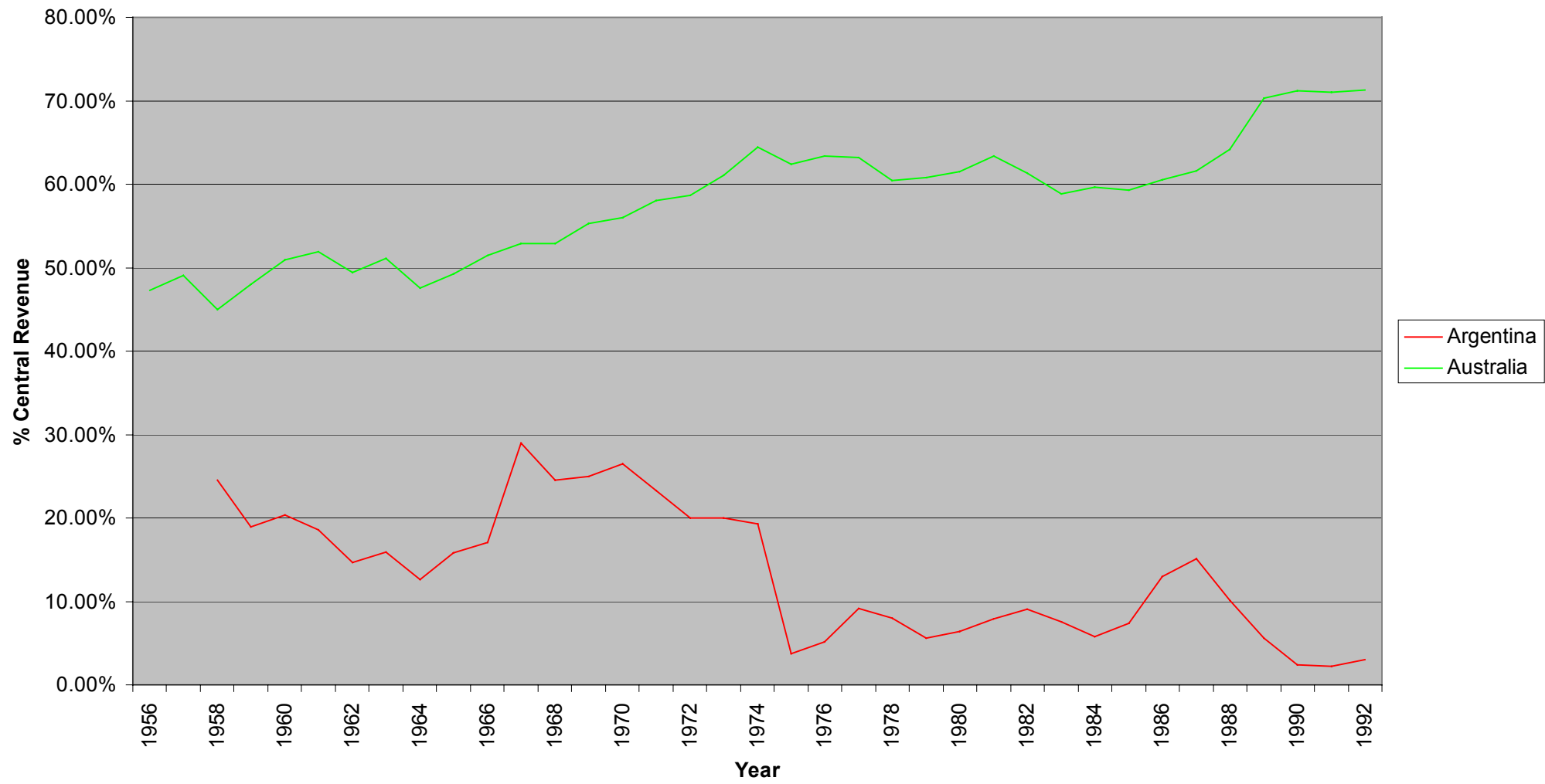
⁵ Torgler, B. and K. Murphy (2004). "Tax Morale in Australia: What Factors Shape it and has it Changed over Time?" Manuscript re-submitted to Journal of Australian Taxation, pp.2-4

⁶ For instance war, depression, and extensive inflation.

Income Taxation as a Proportion of Central Revenue, 1915-55



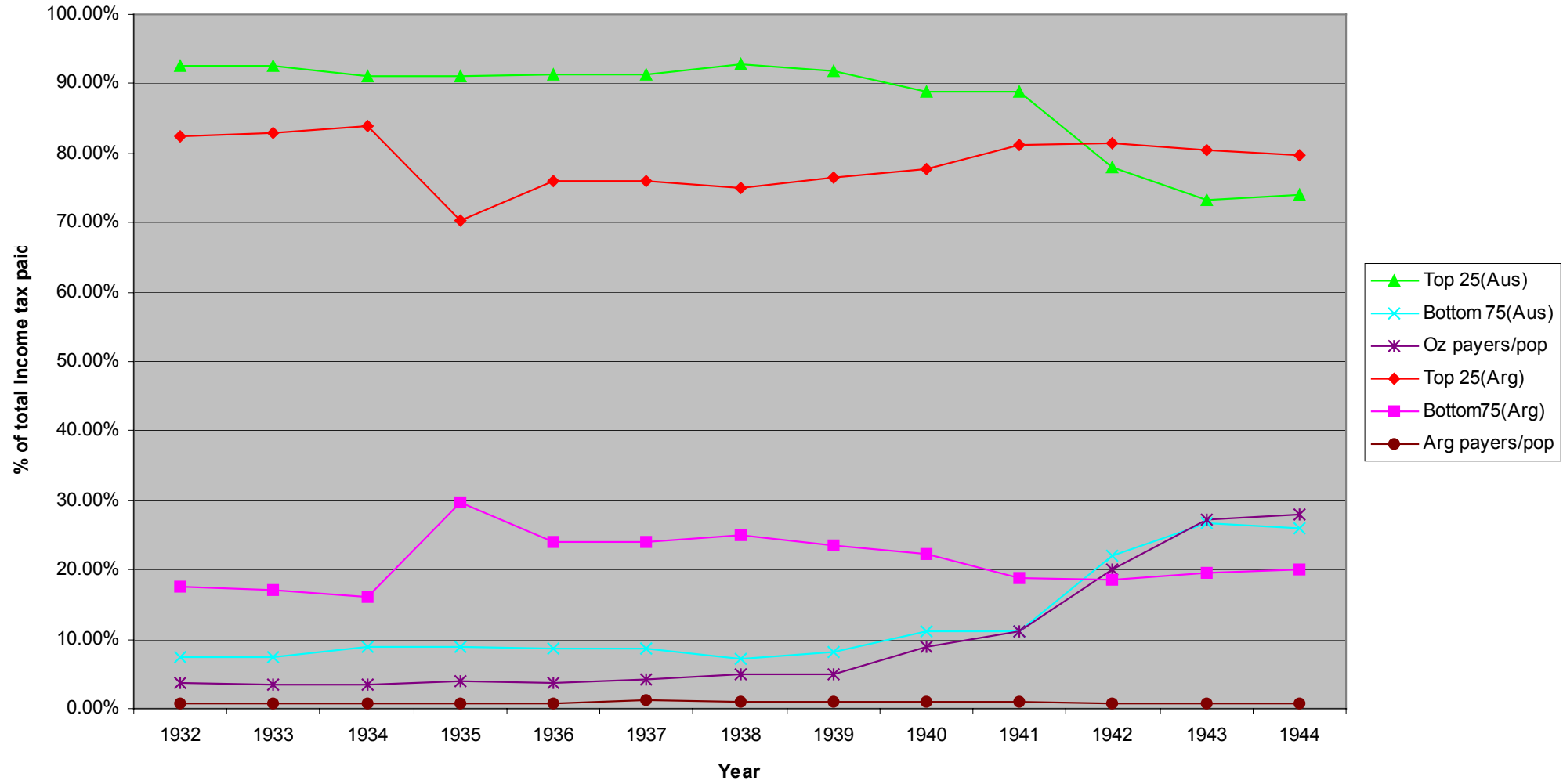
Income Taxation as a Proportion of Central Revenue, 1956-92



Argentina: (Mitchell 2003); Australia: (Mitchell 2003); (Vamplew 1987)

There was remarkable convergence in income taxation until 1955, and striking divergence thereafter. The year 1955, when the military broke Argentine democratic institutions for a second time in the twentieth century, marked a watershed in the decline of Argentine state credibility by this measure. In contrast Australian state credibility grew roughly continuously from WWI onwards. The open failure of Argentine income taxation began the mid 1950s, accelerating in the 1970s. It should have been preceded by a failure in state credibility. The opportunity for change in both instances was inflation, which greatly increased the opportunities for income tax evasion.

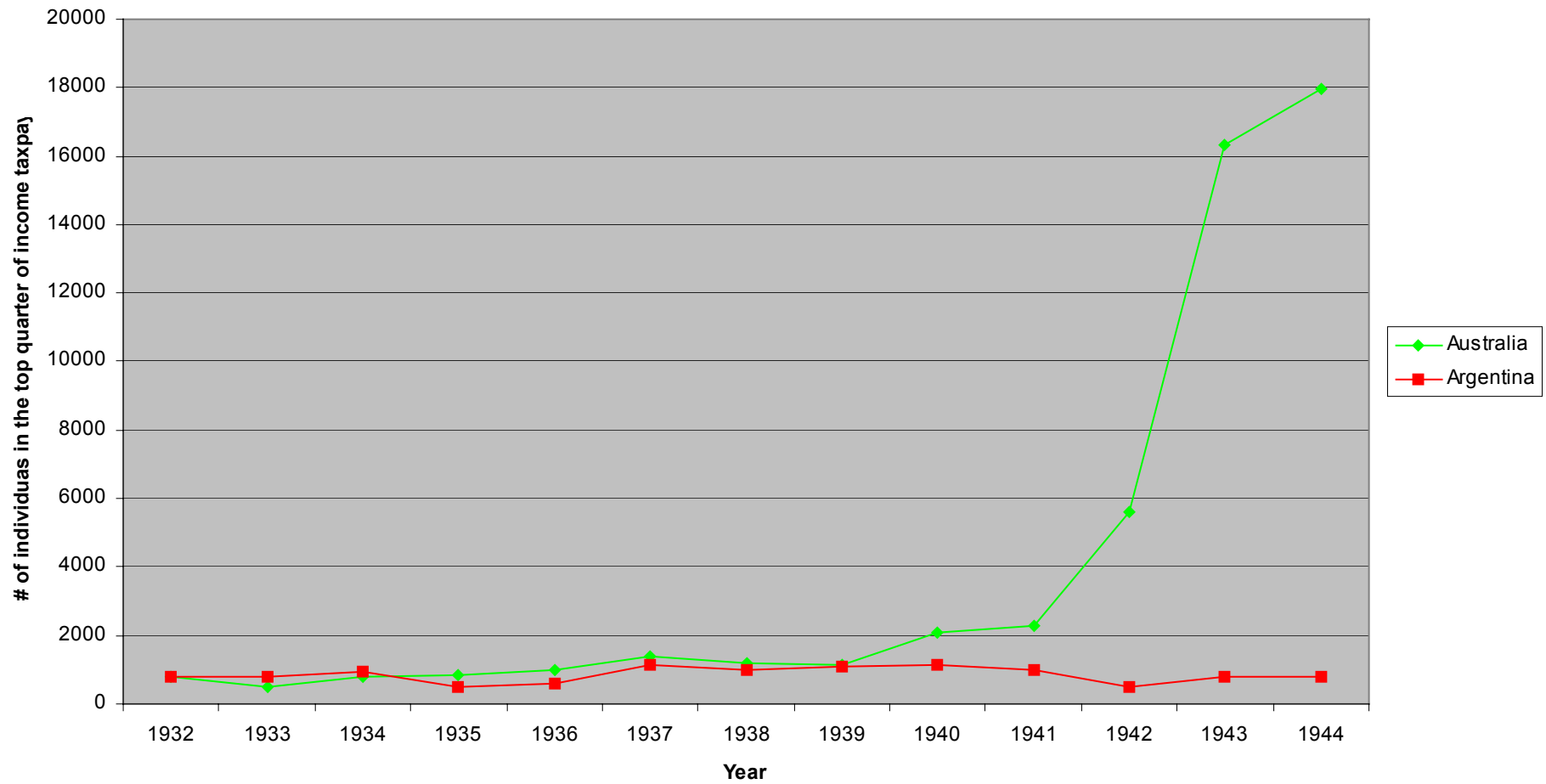
Wealthier minority vs. Poorer majority? - Australia 1932-44



The chart above compares the Argentine and Australian experiences of income taxation in 1932-44, roughly dividing the population of income taxpayers between the highest earning 25% from the remaining 75%. It also shows the proportion of income taxpayers to the entire population. The period was when Argentine income taxation became most successful in terms of revenue. Initially the main differences were: the greater dependence of Australian income taxation upon a wealthy minority, and the slightly larger proportion of Australian income taxpayers to population. Few people paid income taxation in both countries prior to WWII, and of those few the vast majority was paid by the highest earning quarter. Income taxation was a fragile tax upon a wealthy minority.

In Australia this changes with WWII, when income taxation became entrenched as a mass tax. The proportion of income taxpayers to population leaped from less than 5% to almost a third of the population, mirrored in an increasing burden upon the bottom 75% of income taxpayers (presumably because the wealthy were already paying much of what they would bear). In contrast Argentine income taxation remained a fragile tax paid by a wealthy minority.

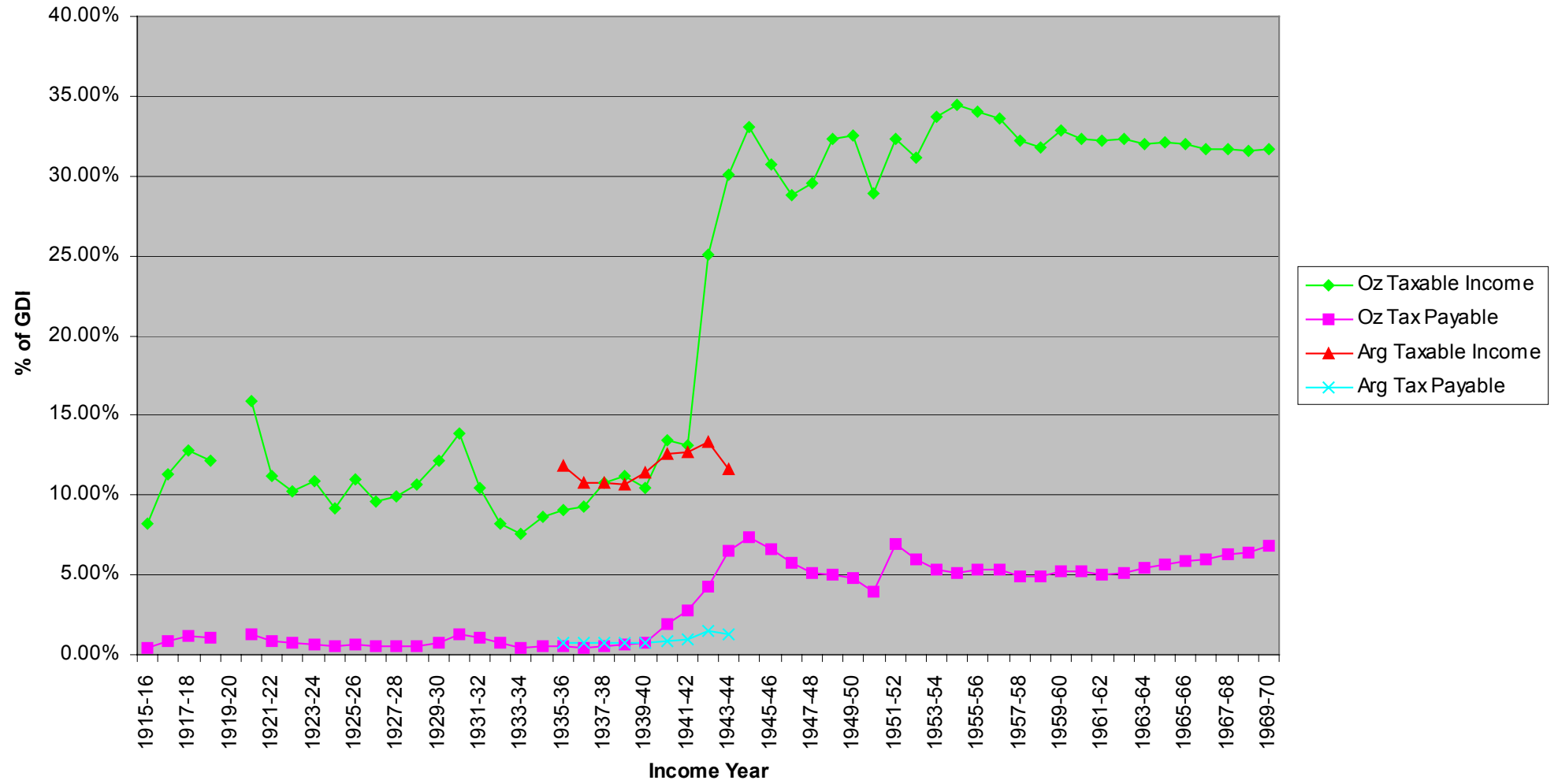
Dependence on Wealthy Few (numbers adjusted relative to Australian population)



Argentina: (Nacion 1935-1945),(Maddison 2003); Australia: (Taxation 1915-60), (Maddison 2003)

This chart above reinforces this by comparing the number of individuals within the top quarter of the income taxpayer population (adjusting for relative population size). It shows how fragile income taxation was in Argentina and Australia prior to WWII, when it was dependent upon the cooperation of surprisingly few individuals. Argentine income taxation depended upon a wealthy few, an average of only 1694 individuals from 1932-44, most of whom lived in the city of Buenos Aires. The boundaries to their collective action, e.g. to pay or not to pay, were not likely very high. An event that threatened the wealthy minority, such as the highly socially conflictive populist democracy of Peron in 1945-55, could have greatly reduced their cooperation. It is not hard to imagine a silent rebellion of increasing non-compliance emanating from the country clubs of Buenos Aires. Such a rebellion became much more difficult in Australia as income taxation was transformed into a mass tax.

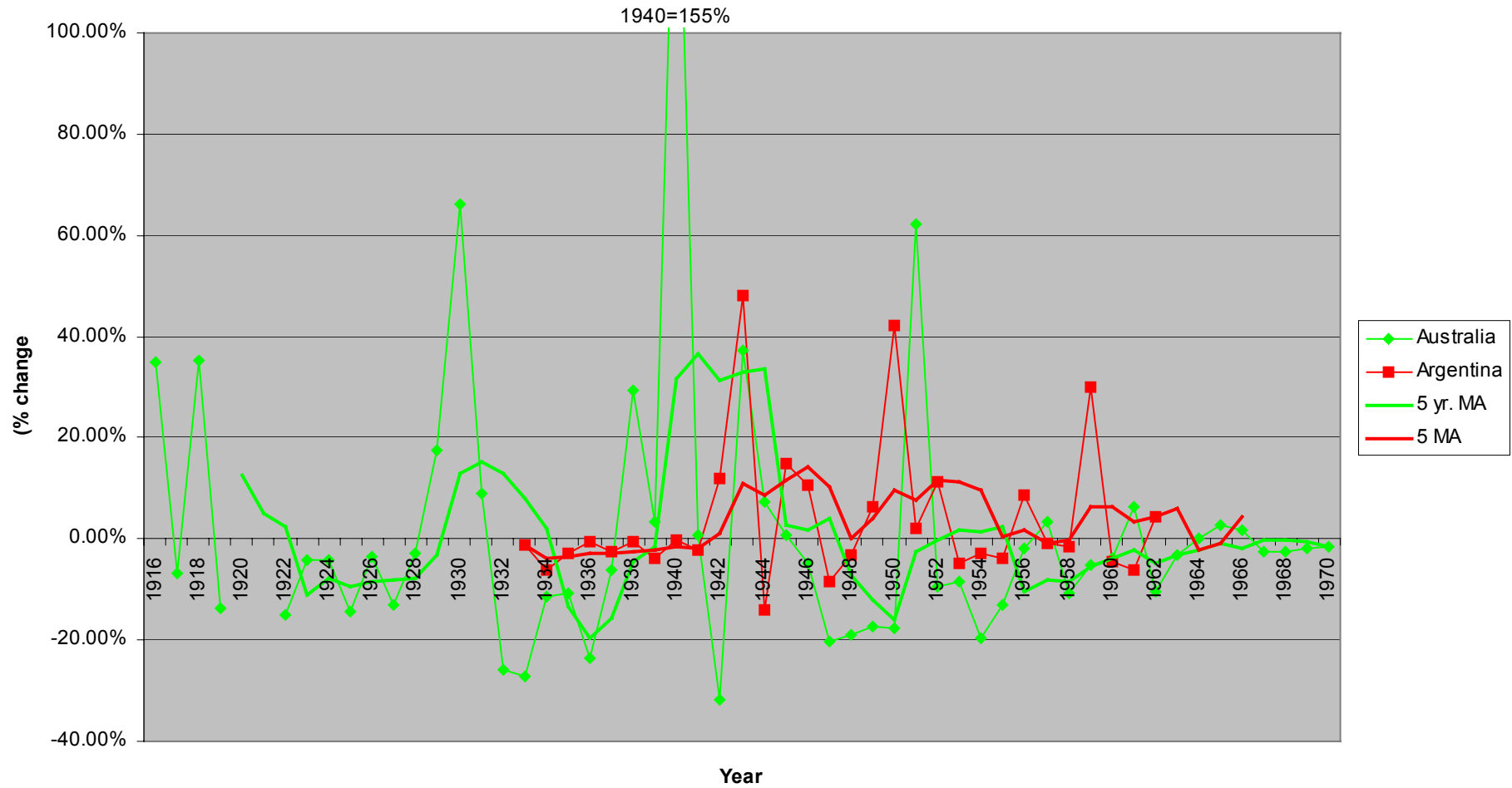
Elite Tax to Mass Tax - Income Taxation Compared



Argentina: (Nacion 1935-1945),(OXLAD); Australia: (Taxation 1915-60), (Statistics 1960-71), (Mitchell 2003)

The chart above gives yet another view on the move to mass taxation, comparing Argentine and Australian income taxation relative to GDP. Prior to WWII, Australia and Argentina were remarkably similar in both the amount of income subject to taxation relative to GDP, and the amount of income taxation that was taken relative to GDP.

Growth in Income Tax stripped of real Growth in GDP



The transition to mass tax would have been made easier by development. For instance, if the state used the increased resources provided by income taxation to promote development via the greater provision of public goods, development would increase the overall wealth of society and a greater proportion of people could afford to pay it. The chart above compares real income growth (change in real GDP) with growth in the average rate of income taxation. A state that is successfully encouraging development should be able to partly offset increases in taxation with growth in real incomes due to development. The gains may even be such that income taxation growth is negative when balanced by real income growth. This was largely the case in Argentina and Australia prior to WWII. This changed in the postwar period when Argentine income taxation grew persistently faster than economic growth, likely increasing its perceived unjustness. This contrasts strongly with Australia. It also suggests that the fall in Argentine state credibility may have begun as early as the mid 1940s, which fits with its later decline in the mid 1950s.

Conclusion

What does the experience of income taxation tell us of divergent development? It indicates the different experiences of state credibility and thereby institutional capacity to positively influence development. A great disparity emerged by the late 1950s in Argentina between those that allocated state expenditure and those that paid taxation. This disparity was largely due to a failure of state credibility. As the Argentine state increased its economic role and expenditure, it found its taxpayers were unwilling to fund it. Having not formerly transformed income taxation into a mass tax, it was far easier for it to fail in Argentina. The Australian state was able to continue to foster development and/or not obstruct it much. The Argentine state became a major liability to development, scrambling for resources. As its fiscal institutions eroded, it was unable to avoid undermining economic development via seigniorage and insufficient public goods provision (as it monopolised their provision). Ultimately the Argentine state's increasing impediment of development was driven by an inability to legitimately fund itself, by a 'lack of solidarity' between the state and society. The comparison of income taxation clearly demonstrates the

differing experiences of state credibility, and the importance that this had upon the ability of institutions to positively influence development.

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