Tax systems and tax reforms in Latin America: coubtry studies and general issues.

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TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA

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Countries Studies of Tax Systems and Tax Reforms in Latin America

CONTENTS

1. ARGENTINA

by

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Abstract
This paper is part of a wider research on “Tax Systems and Tax Reforms in Latin America”, carried on at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. This paper reviews Argentina’s tax system. After a general introduction, the second section describes the reforms of the tax system that took place between 1990 and 2005. The third section presents the institutional features of the principal taxes collected in the country while the final section explores ideas for a future reform agenda.

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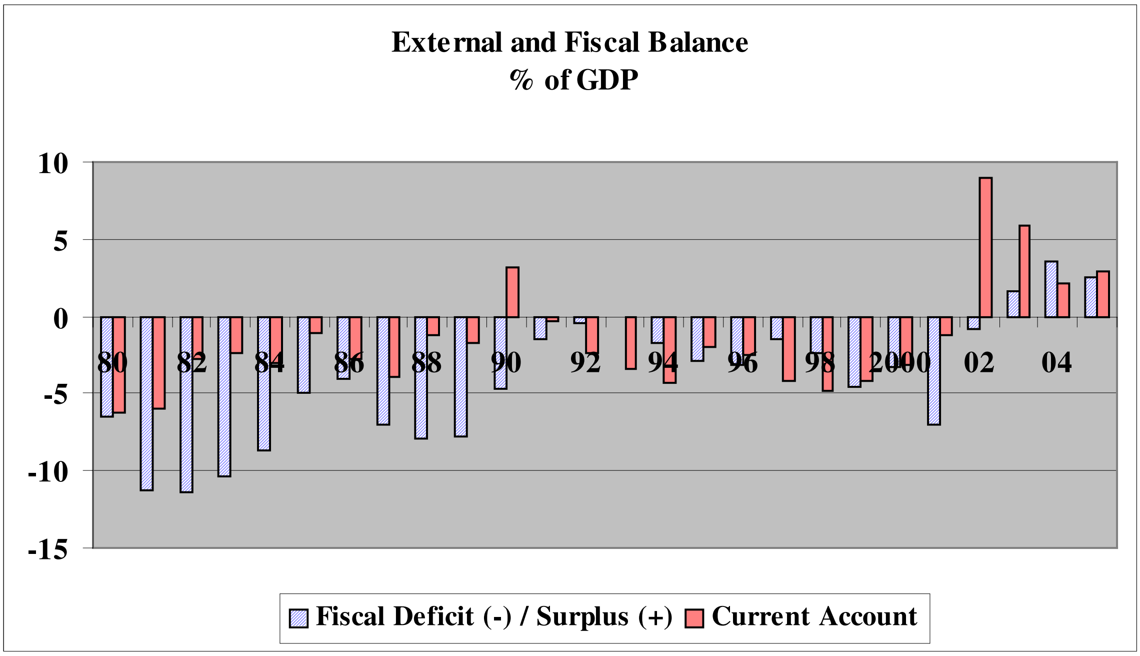
1. Introduction and contents*

Upon taking office in July 1989, President Menem embraced a reform agenda aimed at reverting the previous decade of economic stagnation. The reform program faced serious implementation issues, as exemplified by the initial privatizations that did not adequately address regulatory issues while attempts at stabilizing the economy after the hyper-inflation bouts of 1989 and 1990 were short-lived. In January 1991 Domingo Cavallo was appointed Economy Minister, and his first concern was re-establishing credibility in the Administration's economic policies. At the heart of this lack of credibility were the fiscal imbalances that had stubbornly resisted policymakers over the previous decade and which ended up being monetized and reflected in very high inflation.



Cavallo introduced a currency board, which came to be known as *convertibilidad*. This monetary regime required that the monetary base be backed by foreign currency at an exchange rate of 1 peso per 1 US dollar. This rule prevented the government from balancing its accounts by printing money, reduced the ability of the Central Bank of acting as a lender of last resort to the financial sector and eliminated the possibility of indexation, all of which

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were perceived as the ultimate causes of inflation[1]. A law was passed in support of the monetary regime in order to enhance its credibility, demonstrating the political system's commitment to it. *Convertibilidad* was in place for over a decade, until its collapse amid Argentina's political and economic meltdown in December 2001[2]. An improvement in fiscal performance was a requirement of *Convertibilidad*. On the expenditure side, there was a widely held view that while the level of spending was more or less rigid its composition was not. Financial support of state enterprises would be eliminated as a result of the privatization program, but these resources would be required to increase health and education spending as well as the transitional costs of economic reforms. The conclusion was that the thrust of improvements in fiscal accounts would need to come from the revenue side. The reform of the tax system implemented at the early 1990s was designed to support fundamental economic reforms required by the new development paradigm adopted by the country.

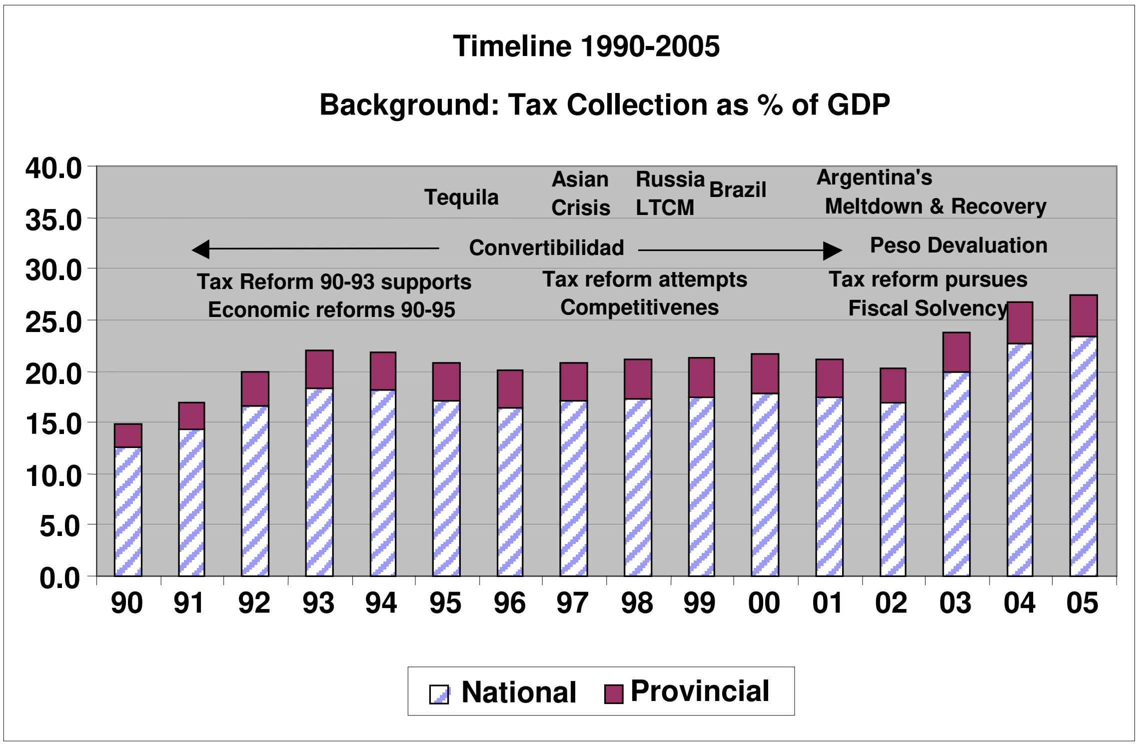
A brief reference to the time period will enhance the readers' understanding of the reforms. While sixteen years may not seem an extensive period in a country's history, it would be a mistake to assume that the economic policies implemented since 1990 were unchanged throughout this period. As a result several sub-periods are specified in order to facilitate the understanding of this chapter. In the field of tax policy, changes were introduced in response to the government's reform agenda, to variations in policymakers' preferences as well to changes in the economic constraints, mainly from the international arena. A time line summarizes the domestic and the international events that took place during this period and provides context for the policy reforms in tax policy described in the chapter.

The first period runs from mid-1989 to 1995, during Menem's first term. Its highlights are an initial four years of economic reform, which taper out as the Constitution is modified in order to allow the president's reelection while the first major emerging market crisis of the decade takes place (Tequila). During the second period, which runs from 1996 to 1999, the reform agenda was reduced to fine-tuning first generation reforms as no political consensus emerged regarding the direction of additional measures. This was mainly due to Menem's ambitions of a third presidential term, which distracted political capital from economic reform. Even though the country's expansive fiscal policy was inconsistent with *Con-*

[1] Additionally, the widespread use of indexation mechanisms made changes in relative prices costlier in terms of inflation and/or economic activity, reducing the effectiveness of exchange rate adjustments in order to increase the relative price of tradables *vis a vis* non-tradables.

[2] The Convertibility Law was abandoned on January 2002. This only formalized the end of currency board, which had effectively collapsed by early December, 2001, when the "Corralito" was introduced. Measures were implemented between March and December of 2001 with the aim of introducing flexibility in the monetary re-

vertibilidad, access to international financial markets allowed policymakers to procrastinate in adopting policies that would reduce fiscal imbalances. This was a period of intense volatility in emerging markets, triggered by Thailand and South Korea's external collapse in 1997 and followed by comparable events in Russia (1998), Long Term Capital Management (1998) and Brazil (1999).



The third period extends from December 1999 to December 2001. The main focus of the new government that took office in December 1999 was to restore fiscal solvency, an increasingly challenging task as the economy reacted negatively to fiscal adjustment and international financial markets signaled Argentina as the next major emerging economy that would face a currency crisis. While different changes in economic policies were attempted, they hardly qualify as economic reforms, but rather as desperate, and in the end futile, attempts to ward off devaluation and default. The fourth and last period began in 2002 and continues until today. It started when the authorities formally abandoned the currency board regime in the midst of a political meltdown and an unprecedented economic collapse. The new monetary and exchange rate framework that emerged in 2002 was followed by policies

gime to jump-start the economy, which was by that time in a period of severe depression, and avoid default in Argentina's sovereign debt. For a description of Argentina's collapse see Mussa (2002) and Blustein (2005).

devoted to produce a fiscal surplus in response to the goal of reducing economic vulnerabilities and to the limited access to private financial markets and foreign resources[3].

An overview of the development of the tax system since the ear1y 1990s will be the subject of the second section. The economic goals pursued by policymakers, their choice of tax policy instruments and the main results presented within a macroeconomic framework will be explored in this section. A description of the main taxes currently collected in Argentina will be presented in section three. At the national level this involves the income tax, the VAT, excises on a group of selected products, export taxes, import tariffs and social security taxes. The two main tax assignments of the provinces, the turnover tax and property taxes are also presented[4]. A final section will explore some ideas for a reform agenda for Argentina's tax system.

2. The evolution of the tax system since the ear1y 1990s

This section explores the main changes introduced in Argentina's tax system since 1990. These reforms are conceptually linked and, revenue sharing arrangements aside, these taxes ultimately all feed into the government's revenue pool. However for presentation purposes they are organized around three categories: domestic, trade and social security taxes. A brief description of tax administration strengthening is included at the end of the section.

2.1 Reforms in domestic taxation

Argentina's tax assignments are heavily biased in favor of the central government. The central government is responsible for VAT, excises, trade, payroll and income taxes, but must share the proceeds of tax revenue with provincial governments and the social security system. While this is the result of the country's history, it is also justified on technical grounds, as a

[3] Consensus emerged in Argentina after default regarding the need to avoid the debt orgy of the 1990's, when debt grew from $55.1 billion to $144.3 billion between 1990 and 2001. After economic collapse in early 2002, Argentina's government initially requested significant net resources from an IMF led support program. However by mid 2002, a new economic team indicated that it would not attempt to access net resources but rather requested a program designed to roll-over multilateral debt as it matured. The principal reason for this change was the profound discrepancy between Argentina's policymakers and the IMF regarding policies to be adopted by the country. This was consistent with the shifting paradigm regarding multilateral support programs that the new US Administration had been promoting since 2001. The result was that Argentina was the only major economy at the time that faced an economic crisis without multilateral assistance, making net payments to the IMF, World Bank and Inter-American Development Bank of $26.5 billion between January 2002 and April 2006.

centralized administration of taxes that have a moveable tax base is more efficient than a decentralized one.[5]

VAT was the centerpiece of the initial steps of domestic taxation reform, which began in late 1989. Initial enhancements in VAT were implemented by extending the tax base and increasing the tax rate. The starting point was reducing the extensive list of goods and services exempted from this tax, which included most foodstuffs, petroleum products and natural gas, many raw materials, paper products, published material, certain capital goods and most services. This list was greatly reduced between 1989 and 1990 and coverage was extended to public services whose provision was being transferred to the private sector through an ambitious if not always well-planned privatization process. The tax rate was increased from 15 per cent to 16 per cent, after an initial short-lived reduction to 13 per cent. Although the tax base was expanded somewhat during the following years, increases in the tax rate became the instrument of choice when changes were introduced in VAT. The rate was raised to 18 per cent in 1992 and a temporary surcharge of three percentage points was introduced in 1995 in response to fiscal constraints faced during the Tequila Crisis. This surcharge was made permanent in 1996. As a result of these measures as well as improvements in tax administration the share of VAT in total tax collection almost trebled between 1990 and 1995 reaching 6.8 per cent of GDP. While these measures aimed at increasing government revenue, they also improved the design of the tax system by eliminating a large amount of excise taxes and optimizing those that remained. These were maintained as they taxed a small group of relatively expensive goods (e.g. automobiles and car parts), had an inelastic demand (e.g. oil products) and/or also had negative externalities (e.g. alcoholic beverages, tobacco products).

Measures to reform direct taxation were introduced in 1990. The initial changes were centered in reducing tax rates of the corporate and personal income taxes. This reform followed the precepts of the US income tax reform of 1986, which reduced the tax burden on corporations and individuals and simplified the tax system. The different tax rates in place for domestically owned firms and foreign owned firms were reduced in 1990 from 33 per cent to 20 per cent and from 45 per cent to 36 per cent respectively. They were eventually unified at

[4] Some provincial governments also receive royalties from mining and oil and gas operations. The main source of municipal revenue is a user fee that is very similar to a real estate tax. Neither royalties nor municipal revenue will be analyzed in this chapter.

[5] This arrangement originated in the Constitution adopted by Argentina in the nineteenth century, which assigned taxes on trade to the federal government while consumption taxes were to be shared by the federal and provincial governments. A revenue sharing scheme was adopted between the national and provincial governments, as expenditure decisions were increasingly decentralized. Basically four taxes were assigned at the provincial level in 1990: on real estate, on vehicles, a gross sales tax and a stamp tax. The first two are predetermined by the tax administration while the latter two are self-assessed by the taxpayer.

30 per cent in 1992 and subsequently raised to 33 per cent in 1996. The maximum rate of the personal income tax was reduced from 35 per cent to 30 per cent, while six income brackets replaced the previous eight. Initial changes in the tax base of the corporate income tax involved provisions designed to increase allowances for loss carryovers as well as temporary measures authorizing expensing of incremental investment. Changes in rates on withholding tax on dividends and other payments were introduced with the dual aim of reducing dispersion and the level of rates. The concept of world income in the definition of the tax base was also introduced. Changes in the tax base of personal income tax were centered on limiting medical expense deductions.

The taxation of personal and business assets was also modified. On the one hand the capital gains tax as well as taxes on corporate and personal net worth were eliminated while a tax on the gross assets of businesses was introduced in 1989, with a tax rate set at 1 per cent. It was designed to address non-compliance of the corporate income tax as payments made on the gross asset tax could be credited against income tax liabilities but payments exceeding these liabilities did not create a tax credit for the corporations. Finally, the tax rate on checking accounts was reduced from 0.007 per cent to 0.003 per cent and payments could no longer be credited towards other tax liabilities. Aside from isolated measures such as the increase in the VAT tax rate and some additional adjustments in the income tax designed to reduce existing loopholes, the fundamental reforms of the domestic tax system were in place by the end of 1992. Increasingly however, between 1992 and 1995, tax policy was selectively employed to improve the competitiveness of economic sectors facing difficulties arising from the fixed exchange rate regime. An example of these measures was the elimination of the federal stamp tax as well as the exemption of the gross asset tax for sectors that faced declining prices in international markets for their products. The latter comprised the bulk of agricultural and industrial commodities produced in the economy.

Some additional modifications to the domestic tax system were made in 1998. The first significant change was the introduction of a simplified tax regime, aimed at improving compliance of small entrepreneurs and the self-employed. Income tax, VAT and social security taxes were met through a single presumptive tax, appropriately called the *monotributo.* Payments were made monthly on the basis of four basic parameters: gross annual sales, unit prices charged for services, physical size of businesses and their energy use. While the *montributo* was a pragmatic approach to improving compliance of the informal sector of the economy, it introduced a bias against declaring economic activities above the thresholds defined for these parameters.[6] Persisting unemployment drove the need for additional tax legislation seeking to address the existing factor bias against labor and in favor of capital and was finally approved in December 1998. These measures attempted to reduce the cost of labor by reducing payroll taxes, compensating the loss of revenue by increasing the collection of VAT and corporate income taxes as well as other taxes on capital. A constraint of the reform was that it had to be revenue neutral as the fiscal imbalance and mounting debt obligations did not allow further deterioration of the government accounts. This required a political negotiation of the revenue sharing agreement as social security contributions are not shared between the central and provincial governments while VAT and income taxes are. While employer contributions to the social security system varied by geographical region and economic sector, the average rate was estimated at 10.5 per cent. The goal of the policy was to reduce this in several steps to 4.5 per cent starting in 1999. Changes in VAT consisted of increases of the tax rate of some services to the full rate (21 per cent) and extending the base for cable TV at a rate of 10.5 per cent. A reduction of the tax rate to 10.5 per cent for a basket of goods was also approved in the legislation.

Several elements of the corporate income tax were also modified. In the first place, a surcharge of two percentage points, from 33 per cent to 35 per cent, was applied on annual profits that exceeded $200.000 while the tax base was extended by including cooperatives. Additional measures to deal with cross border tax avoidance schemes of domestic and foreign corporations were also introduced. A modified version of the gross asset tax, named the presumptive minimum profits tax was introduced. The tax base and rate were similar to that of the gross assets tax but payments of the corporate income tax were now credited towards the new tax. From a conceptual point of view, the most significant change in this set of tax legislation was the introduction of a tax on paid interest. The tax base were the interest payments made on the debt owed by non-financial enterprises and the tax rate was set at 15 per cent if the lender was a corporation and 35 per cent if it was an individual. The tax aimed at reducing thin capitalization, the bias in favor of debt financing in a firm's capital structure that arises from the possibility of deducting interest payments in income tax assessments. Thin capitalization was believed to be a widespread vehicle for tax avoidance adopted by locally owned firms and by affiliates of foreign owned firms. While the former may act through shell companies in tax havens or through back-to-back operations with a bank, the

[6] This problem is referred to as *enanismo fiscal* (fiscal pigmies) in Argentina.

latter typically is implemented through a loan from the parent company to the affiliate.[7] As was mentioned earlier in this chapter, a key element of the reform of domestic taxation implemented at the beginning of the decade was the introduction of a greater degree of neutrality in the tax system, supporting the fundamental reforms that reflected the new development paradigm adopted by the country. However, the policy changes introduced in December 1998 were an attempt to offset significant distortions in relative prices that resulted from the rigid exchange rate system that was in place since 1991 and that discouraged the employment of the non-tradable factor (labor) and encouraged that of the tradable factor (capital). Ultimately, changes in tax policy were no match when Brazil devalued its currency in 1999 while Argentina held on to its currency board: economic activity declined and fiscal accounts worsened. The morale of the story is that while tax policy can improve allocation decisions, it cannot compensate for significant inconsistencies in other policies.

A new government was sworn into office in December 1999. The incoming economic authorities faced an unsustainable fiscal deficit, which had worsened as a result of the recession triggered by the said Brazil's devaluation.[8] Given the commitment of the newly elected government to maintaining the currency board, the need to jumpstart the economy was constrained by the limited access of resources to finance expansive fiscal policy. Revenue measures were introduced under an IMF supported program with the aim to raise revenue in order to reduce the imbalance of government accounts by 1.8 per cent of GDP. The rationale behind fiscal tightening in this recessive scenario was that markets would reward these measures by reducing the risk premium, stimulating economic activity through the consumption and investment channels. Among the adopted tax policy measures were adjustments in the personal income tax which reduced deductions, raised tax rates and introduced an emergency surcharge. An increase in the personal wealth tax was also put in place. Changes in indirect taxation involved the introduction on new excise taxes as well as the equalization of tax rates on gasoline and some extension of the VAT base. These measures were eventually complemented by cuts in public expenditure that included reductions of salaries of government employees and of pensions in nominal terms. A new economic team took office in March 2001 and announced further expenditure cuts, resigning shortly after due to the lack of political support.

[7] Greater tax neutrality regarding the capital structure of firms benefit smaller sized companies as they have less access to credit than larger corporations. See Fiel (2006).

[8] The federal government's fiscal deficit was $7.1 billion dollars in 1999. This amount rises to around $11 billion dollars if one-time proceeds from privatization are added, representing 3.9 per cent of GDP.

Cavallo was appointed Minister of Economy again in March 2001 as a desperate attempt to address the looming economic crisis within the framework of *Convertibilidad*. A financial transactions tax was introduced in April 2001, initially at a rate of 0.25 per cent while the base was the gross value of debit and credit transactions. The rate was increased to 0.4 per cent a month later with the increase credited towards VAT and income tax liabilities. A third rate increase was introduced in August 2001, raising it to 0.6 per cent. Exemptions and reductions in gasoline taxes and the income tax were also eliminated in August 2001, but by then the economy was in a tail-spin. In early December 2001, a run on bank deposits forced a de-facto suspension of *Convertibilidad*. The currency board was formally abandoned a month later as the country sank deeper into its political and economic crisis.

Although fiscal solvency remained a key challenge in early 2002 and in some areas policy reversal was contemplated and/or implemented during this period, reforms in domestic taxes, social security and trade liberalization were largely unaffected, though export taxes were introduced once again as will be seen in section 2.2. Nominal collection of domestic taxes was stagnant in 2002, the result of a collapse of 10.9 per cent of GDP and an inflation rate of 41 per cent. The economic team that took over in May 2002 resisted attempts to introduce additional shocks to the economy, including tax policy. Income tax brackets were not adjusted for inflation and corporations were not allowed to index their depreciation allowances, although these gains in terms of tax collection were partially offset by the carry-over of losses that took place during 2001 and 2002. The result was a significant increase in tax revenue, which responded to strong economic recovery summarized by an average annual growth rate of 9 per cent in real GDP and 7.4 per cent in inflation between 2003 and 2005.

2.2 Reforms in trade taxes

By the end of the 1980's, the main elements of Argentina's trade policy were: (1) widespread use of quantitative and administrative restrictions on imports, (2) high import tariffs, (3) a large dispersion of import tariffs, (4) export taxes on primary products, (5) drawback payments on some manufactured goods, (6) an overvalued exchange rate and (7) restrictions on purchasing currency for imports and of disposing foreign currency earnings of exports. The poor performance of the economy during the eighties, characterized by sluggish growth, high inflation and frequent fiscal and current account crises can undoubtedly be traced to the economy's anti-trade bias as well as to its debt overhang. Initial measures towards trade reform were taken in 1987, consisting mainly of reducing quantitative restrictions on imported goods. By July 1990, administrative restrictions on trade were lifted for the majority of goods, although some administrative and quantitatives restrictions still applied to a small group of manufactured products, including steel and automobiles. Currency restrictions were increasingly relaxed.

Reform of tariff rates was introduced in 1989, when they were grouped around six tiers and dispersion between them was reduced. The maximum *ad-valorem* tariff was reduced from 50 per cent to 24 per cent while the minimum tariff rate was increased from 0 to 10 per cent. The result was a reduction of the weighted average tariff from 28 per cent to 18 per cent by June 1989 (IMF, Red Nov. 21st, 1990). The government maintained taxes on exports of primary products and initially extended them to manufactured goods after the massive devaluations that took place during 1989. It did this with a twofold goal: raising government revenue and mitigating regressive income distribution by moderating price increases of agricultural products, which are an important component of the consumption basket of low-income groups. Export taxes on manufactured products were eliminated in 1990 when currency markets stabilized, while those affecting primary products were reduced from to 11 per cent by December 1990, from a high of 27 per cent a year earlier. A further simplification of the tariff structure was introduced in April 1991. A new three-tier tariff structure was introduced: raw materials and capital goods were not taxed, intermediate products were taxed at an *ad-valorem* rate of 11 per cent while final products were subject to a rate of 22 per cent.[9] The lower rates and reduced dispersion resulted in a weighted average tariff rate of 9 per cent. All remaining export taxes were eliminated with the exception of those on soybeans and sunflower seeds. Quantitative and administrative restrictions were eliminated, while quotas on automobile imports were auctioned. Furthermore, exchange rate restrictions were lifted, as they were not consistent with the country's currency board. This meant not only that exporters no longer had to surrender foreign exchange earnings to the Central Bank but that this institution gave up its role a provider of export financing and pre-financing, an activity which would be handled by private markets. The prevailing rebate arrangements were changed, reducing the rates and making all payments in cash instead of bonds.

The analysis of trade reform in Argentina would not be complete without examining Mercosur. On March 1991, Argentina, Brazil, Paraguay and Uruguay signed the Treaty of Asunción, creating Mercosur (*Mercado Común del Sur*). The four countries signed the Ouro

[9] Resolution 1239/92 modified the tariff structure without affecting the essence of the policy reform. Imports of automobiles were subjected to a special regime.

Preto Protocol in December 1994 creating a customs union and adopting a common external tariff AEC (*Arancel Externo Común*). Some exemptions persisted, e.g. for the automobile industry. The AEC is an eleven-tier tariff structure starting at 2 per cent. Each tier increases by two percentage points and higher tariffs are associated with higher value added products. A uniform tariff increase of three percentage points was put in effect in 1998, although countries retained flexibility in applying it. Temporary tariff increases were adopted in 2001, 2002 and 2003 in response to the economic crisis affecting the region, but by 2004 they were eliminated.

The implications of trade liberalization should not be minimized. From a resource allocation perspective, they reversed a decades old policy that has often been associated with the country's disappointing economic performance in the post-war era. The new trade regime dramatically improved governance, as quantitative restrictions and administrative controls were replaced by automatic price mechanisms that reduced the opportunity for discretion in the system. The fact that a government of a recently re-established democratic regime accomplished this should not be lost to the reader.[10] The elimination of export taxes and quantitative and administrative restrictions on imports, the reduction of the level of import tariffs and their dispersion as well as the creation of Mercosur resulted in a significant increase in trade during this period. Imports and exports grew at an annual rate of 7.5 per cent between the early 1990s and 2005. The fiscal implications were no less important. The customs union reduced the tax base as the share of imports from Mercosur doubled by 2005 while the tariff rates applied to the remaining set of goods was greatly reduced, although the net effect in terms of revenue was ultimately positive due to a greater volume. Additionally, by eliminating export taxes in 1991, the government surrendered a major source of resources, equivalent to an 8.4 per cent of its tax revenue in 1990.

Foreign exchange restrictions and export taxes were re-established as a result of the collapse of the currency board regime in December 2001. The former was associated with the need to preserve international reserves while economic agents fled local currency as a result of a massive shift in portfolio preferences and the meltdown of the country's banking system. The latter was aimed at propping government revenue and simultaneously moderating domestic price increases. The exchange rate was floated after being pegged briefly. The float coexisted with currency restrictions affecting transactions in the current and the financial accounts of the balance of payments. These restrictions sought to accelerate the surrendering of

[10] See Rodrik (2002).

foreign currency by exporters and extend payment periods of importers and private debt obligations and they were gradually relaxed as economic conditions improved.[11] While import tariffs were not changed, quantitative restrictions were introduced in a few sectors such as textiles and home equipment. Export taxes were set at 10 per cent for primary products (agriculture and energy commodities) and 5 per cent for industrial goods during March 2002. Export taxes on primary products were raised to a range of 20 per cent to 23 per cent and most energy products were later taxed at a shifting scale as the price of oil increased in the international market. Trade reform has proven resilient to severe changes in the economic scenario. This is the result of the structural changes of the economy, which has become more open to international competition over the past decade through Mercosur and exposure to other markets. The use of export taxes does not qualify this conclusion even if an export tax could be seen as a second best solution from a revenue point of view. Indeed, export taxes should be seen as a pragmatic response to the practical limitations and weaknesses of administrating income taxes in the agriculture and energy sectors as well as the dual goal of moderating the domestic price level in the context of weaker real exchange rate.

2.3 Social Security Reform

By the early 1990's, the main problems faced by the Social Security System were the inconsistency between the expected retirement benefits and the resources provided to fund them, the incentive structure embedded in the social security system, judicial rulings requiring increased benefits as well as the country's demographic trends. Legislation to reform Argentina's social security system was passed by Congress in 1993 and the new system, known as "*Sistema Integrado de Jubilaciones y Pensiones*" (SIJP) came into effect in July 1994. The new legislation reformed the pension schemes of employees of the central government, the private sector and of individuals who were self-employed[12]. Employers' contributions remained at 16 per cent of wages, while employee contributions were increased by one percentage point, reaching 11 per cent of wages[13]. The minimum retirement age was raised 5 years to 60 years in the case of women and 65 years for men while the number of years re-

[11] The government introduced restrictions on the *inflow* of capital as domestic economic conditions improved and liquidity increased in international markets. The aim was to reduce volatility in the exchange rate, which in the short run would impact through currency appreciation.

[12] Other pension systems e.g. provincial government employees, security forces, and professional groups were not part of the reform. Provincial governments were allowed to transfer their social security systems to the SIJP.

quired to contribute into the system was raised by 10 years and was set at 30 years. Finally, a mixed component was introduced and workers were allowed to choose between a defined benefit government-managed pay-as-you-go (PAYG) pension scheme and a defined contribution (capitalization) scheme operated by private pension funds. The 1994 pension reform introduced a greater degree of discipline to the social security system. It clearly defined the conditions and contributions required for individuals in order to access pension benefits, reducing administrative discretion in defining the level of benefits which led to fraud, abuse and excessive litigation.[14] A complementing piece of legislation, the Pension Solidarity Law, was approved 1995. Its aim was to limit pension expenditures and particularly those at the upper end of the scale by (1) requiring that any future increase of pension benefits be linked to the budget instead of wage increases, (2) restricting payments of arrears based on court decisions to the amount defined in that year's budget and (3) fixing the maximum monthly pension paid by SIJP at $3.100.

Policymakers' initial attempts to improve the economy's competitiveness and reduce the anti-labor bias of the tax system by reducing employer contributions to the social security system began in 1994. These initiatives were fine-tuned in the following years with the aim of ensuring horizontal equity across economic sectors, although geographical disparities remained. A more comprehensive attempt, aimed at improving neutrality between labor and capital was mentioned in section 2.1. By 2001, policymakers reduced employee contributions from 11 per cent to 5 per cent in an attempt to jumpstart the economy. This was later partially reversed, raising the rate to 7 per cent as economic conditions improved but increasing the rate back to 11 per cent is still pending.

While it has overcome attempts of policy reversal, the social security reform faces major challenges if it is to fulfill the goals set out when it was approved 13 years ago. Any summary of these challenges should include: (1) the system's relatively low coverage, in which only 55 per cent/60 per cent of the workforce contributes on a regular basis; (2) future benefits of the privately managed accounts which will result from the reduced employee contributions of privately managed accounts; (3) the high cost associated with the capitalization scheme, representing around 2.5 percentage points of employee contributions; (4) the

[13] Additional payroll taxes amounting to 22 per cent of wages were not affected by the reform. They were earmarked for retiree health insurance (5 per cent), employee health insurance (9 per cent), family allowances (7.5 per cent) and a National Employment Fund (1.5 per cent).

[14] The non-contributory component of the pension system PNC (*pensiones no contributivas*) was not part of the SIJP. PNC is made up of seven programs that target specific groups: (1) old age individuals who have not contributed to the system; (2) handicapped individuals; (3) mothers of seven or more children; (4) relatives of indi-

high fiscal cost of the reform; (5) the impact of the country's debt default on portfolio of private pension funds, since they were forced to acquire government debt during the period preceding the crisis; and (6) improving the allocation of privately managed employee contributions, helping the development of the domestic capital market and financing the economy's investment needs.

2.4 Tax Administration Reform

The three entities assigned the administration of the domestic tax system, customs, and social security at the federal level are *Dirección General Impositiva* (DGI), *Dirección General de Aduanas* (DGA) and ANSES respectively. These institutions had not been immune to fiscal constraints of the 1980s and were in need of major investments in information technology, process re-engineering and human capital formation, including managerial skills. Their performance was also hampered by the lack of data sharing among the three institutions as well as the distortion of taxpayer information caused by a decade of triple digit inflation and the hyperinflation bouts of 1989 and 1990, which made most assessments by these entities almost meaningless. Furthermore, dealing with taxpayer non-compliance was made more difficult by the low share of transactions done through the banking system.

Taxpayer segmentation was the centerpiece of the institutional reform strategy at the DGI. This was initially focused on upgrading the collection function and by the mid nineties information of about 350,000 taxpayers representing close to 80 per cent of domestic tax collection was available on a daily basis. Another key element of the improvement in tax administration was the widespread used of withholding. DGI identified chains of economic activity and required the more formal elements of each chain to withhold tax liabilities from suppliers (back withholding) and clients (forward withholding). This proved to be extremely effective in terms of collection and was applied in other tax administrations in the region. Finally, the simplification of tax policy and modern information technology were the basis of improvements in the audit function, which was clearly observed in the case of VAT: non-compliance dropped from 65 per cent in 1990 to under 25 per cent a decade later.[15] Unfortunately these improvements were not always reflected in increased revenue as a lengthy and at times corrupt judiciary thwarted the tax administration's attempts of enforcing compliance. The in-

viduals who were victims of state terrorism (*desaparecidos*); (5) veterans of the Malvinas War; (6) assigned by specific laws; and (7) assigned by Congress (*graciables*).

[15] Non compliance in 2005 was estimated at 23.3 per cent by the tax administration. See AFIP (2006) for an explanation of the methodology employed.

creased volume and diversification of imports that resulted from trade reform guided the institutional reform process of the customs administration. Legislation was updated and processes were re-engineered in order to allow a greater selectivity of inspections. Investment in information technology became crucial as the greater volume of trade had increasing impact on domestic taxation (mainly VAT and excises), if not for tariffs and export taxes.

DGI was assigned the collection of payroll taxes in 1994, while ANSES retained the administration of benefits and claims. DGA and DGI were consolidated under a new entity called *Administración Federal de Ingresos Públicos* (AFIP) in 1996. The concentration of the collection, auditing and enforcement functions improved tax administration and were a key element in later increases of tax revenue. Challenges remain however, associated with the degree of informality in the economy, the complexity of the tax system and the shortcomings of the judiciary.

TABLE 1 NEAR HERE

3. Features of Argentina's main taxes

This section describes the salient features of the main taxes collected in Argentina until December 2005. At the national level this involves the income tax, taxation of assets, the financial transactions tax, VAT, excises on a group of selected products, social security taxes, the simplified tax regime (*monotributo*) and trade taxes.[16] The two main tax assignments of the provinces, the turnover tax and property taxes (real estate and automobiles) are also included in this section.

3.1 Income tax

The Income Tax is a federal government tax assignment. It is paid by individuals, undivided estates, firms incorporated in Argentina and foreign beneficiaries of locally generated income. Argentine residents have to pay income tax on their world income while non-residents are only taxed domestically from their income from Argentine sources. Religious institutions, public

[16] The main source of this section is *Ministerio de Economía y Producción* (2005), available at www.mecon.gov.ar. A feature that will not be presented in this text is the earmarking of tax revenue for specific destinations. The interested reader should consult *Ministerio de Economía y Producción* (2006).

charities and foundations are the main private agents exempted from this tax. Income from public and private bonds and some other financial sources are also exempted from it.

3.1.1 Personal income tax

The personal income tax applies to individuals and undivided estates. Four income categories are defined: income from real estate, from capital, business income and from personal services. This allows taxpayers that do not keep accounting records to submit detailed tax returns with different types of income. The tax base is the net income of each category, after deduction of allowed expenditures. The main deductible expenditures are maintenance payments, social security payments, personal and family allowances and minimum thresholds. Current annual values for family and personal allowances are presented in Table 1.[17] Special deductions included in this table have been introduced in order to compensate for the degree of informality in the economy. The relatively higher tax compliance of employees and public officials *vis a vis* the self employed explains the difference in the level of allowances.

Table 1: Annual Family and Personal Allowances

	US$
Threshold	1.960
Spouse	1.570
Child	785
Other exemptions	785
Special deductions for self employed	1.960
Special deduction for retirees, employees, and public officials	7.450

A salient feature of the personal income tax is that these allowances are subject to a decreasing scale in response to higher net income, which is presented in Table 2.

Table 2: Reduction of Allowances

Taxable Income		**% of reduction**
0	12.745	0
12.745	21.240	10
21.240	29.740	30
29.740	42.480	50
42.480	63.725	70
63.725	72.220	90
72.220	-.-	100

Finally, specific tax rates are applied at different levels of income.

[17] All values in this section will be expressed in US dollars and will be rounded. The exchange rate used throughout this section is 3.06 argentine pesos per 1US dollar.

Table 3: Tax brackets				
Taxable Income		Amount due		
		Fixed amount	Plus %	Over the excess
0	3.270	-.-	9	-.-
3.270	6.535	295	14	3.270
6.535	9.805	750	19	6.535
9.805	19.610	1.370	23	9.805
19.610	29.410	3.630	27	19.610
29.410	39.215	6.275	31	29.410
39.215	-.-	9.315	35	39.215

The personal income tax is self-assessed. Statements are filed and payments are made through the banking system. The banking system consolidates payments and information and submits it to the tax administration. Five advance payments, estimated on the previous year's net income are made every two months. Taxpayers file the previous year's income tax return in April and any balances are paid in May.

3.1.2 Corporate income tax

The corporate income tax applies to firms registered in Argentina. The income tax law authorizes deductions of expenses associated with income generation as well as those associated with ensuring the permanence of the corporation. The law also provides a comprehensive set of rules for the treatment of expenses and specifies the items that may be deducted when estimating the tax liability. Expenses can only be deducted if invoices support them, while those made abroad are presumed to be associated with foreign income and are not deductible unless the taxpayer can prove otherwise. The usual expense categories apply and the main ones are the following:

a) Compensation paid to employees, including social security payments. The law caps the amount of Directors' fees that may be deducted for tax purposes.

b) Interest payments. The law requires that: *(i)* total liabilities may not exceed 250 per cent of total equity and *(ii)* total interests must not exceed 50 per cent of taxable net income computed before the deduction of interest. These limitations aim at preventing tax avoidance through thin capitalization.

c) Depreciation. The only depreciation rate set in legislation is that of buildings (2 per cent per annum) while the deduction of automobile depreciation is limited to $6.540 (net of VAT). The generally accepted rates are 10 per cent for equipment and 20 per cent for vehicles. The cost of research and development may be expensed in the same period it is incurred.

d) Charitable contributions. They are limited to 5 per cent of taxable profits. Any excess of this amount may not be carried forward.

Losses faced by taxpayers may be offset against future income for a period of five years. Corporations are required to combine the operating profits and losses of all branches in the country. However, the Argentine branch of a non-resident corporation is treated as a separate business, requiring that the income from the national source be identified. Losses generated from transactions in corporate stock can only be offset against the same source within the next five years. The same applies to foreign source losses. The corporate income tax is self-assessed and payments and filing of statements is done through the banking system. The banking system consolidates payments and information and submits it to the tax administration. Ten monthly advance payments are made, are estimated on the basis of the previous year's net income. The first payment is equivalent to 25 per cent of this amount while the following 9 payments are equal to 8.33 per cent. The corporate tax rate is 35 per cent. Shares or any other instrument supporting property rights in a corporation are nominative.

3.2 Taxation of assets

There are three main taxes on assets: the personal assets tax, the tax on presumptive minimum income and the tax on property (real estate and vehicles). The first two are central government tax assignments while the latter is assigned to the provinces.

3.2.1 Personal assets tax

This tax is levied on assets held by individuals or undivided estates at the end of each year. Argentine residents must pay this tax on their assets, regardless of their location while non-residents are only taxed on their assets located in Argentina. The principal assets included in the tax base are real estate, vehicles and financial assets. Argentine residents are exempted with a threshold of $33,431. The tax rate for assets above this threshold and up to $65,360 is 0.5 per cent while a rate of 0.75 per cent is applied to assets above this amount. A higher rate, of 1.5 per cent, is applied when tax avoidance by domestic residents is presumed. Examples of these are real estate (residence, vacation home) held by a foreign corporation or financial assets held by foreign corporation where the country of origin does not register such assets. These apply to corporations whose main line of activity is to invest funds outside their country of origin. The personal assets tax is self-assessed and payments and filing of statements is done through the banking system. The banking system consolidates payments and information and submits it to the tax administration. Five advance payments are made every other month, amounting to 20 per cent of the estimation of the previous year's net income.

3.2.2 Presumptive minimum income tax

Firms incorporated in Argentina, trusts, investments funds, single-individual firms and civil associations and foundations not specifically exempt from it, pay this tax. Individuals and undivided estates also pay this tax on their holdings of farm property. The main assets exempted are those located in *Tierra del Fuego*, used in mining activities as well as those belonging to taxpayers registered under the simplified tax-regime for small taxpayers. The tax base is the value of all assets held at the end of each fiscal year. There is a tax holiday for assets that may be amortized during the first two years they were acquired, with the exemption of automobiles. Banks and insurance companies will assess as their tax base 20 per cent of their assets liable for this tax. The equivalent percentage for traders of agricultural primary products will be 40 per cent. There is an exemption for the first $65.360 in assets held by a taxpayer. Taxpayers may credit payment made to foreign tax authorities on similar taxes of assets located abroad. The tax rate is 1 per cent. The presumptive minimum income tax is self-assessed and payments and filing of statements is done through the banking system. The banking system consolidates payments and information and submits it to the tax administration. Eleven monthly advance payments are made, amounting to 9 per cent of the estimation of the previous year's net income. Payments made on this tax are credited to income tax liabilities. Payments made on the income tax and on the financial transactions tax may be credited towards payments made to the presumptive minimum income tax.

3.2.3 Tax on property

Taxation of real estate and motor vehicles are an assignment of provincial governments. Each of the 23 provinces and the City of Buenos Aires has the autonomy to assess property values and tax rates, which explains the dispersion of the contribution of this tax to government revenue. Given the large number of jurisdictions, this analysis of real estate taxes in Argentina is based on the Province of Buenos Aires. Property is classified as urban and rural. As in most places, this tax is predetermined by the tax administration (*i.e.* it is not self assessed). The assessment of urban property disaggregates between the price of land and any construction built on it. Public and private entities participate in the assessment of the land prices, which is updated periodically. An estimation of the construction cost of a building is made on the basis on its records (i.e. construction permit, physical inspections, etc.), adjusted by an amortization allowance. The resulting tax-base will fall in one of the thirteen tax-brackets that were defined for the current year. The tax is the sum of a fixed amount of any bracket and a variable item that is estimated as a percentage of the difference between the assessed value and the lower range of any bracket. The tax rate only exceeds one percent in the higher brackets, but the effective rate is usually lower as property assessments do not keep up to market values.

3.3 Financial transactions tax

The basis of this tax is the gross value of debit and credit bank transactions. While some transactions are exempt, the basis of the tax is fairly comprehensive. The main exemptions are credits on salaries and pension payments as well as debits up to a similar amount to the same beneficiaries, clearing mechanisms by the financial system, accounts of promoted economic activities (mining, forestry, alternative energy), accounts of religious groups. The tax rate is 0.6 per cent per transaction. Reduced rates are charged for traders of agricultural primary products, operators of payment systems (credit cards, food coupons, etc.). Payments made on this tax are credited to income and presumptive minimum income tax liabilities.

3.4 Value added tax (VAT)

Argentina's VAT follows the destination principle, in which the tax is imposed on the value added of domestically consumed goods and services. The tax base of domestic transactions is the net price, including associated services provided jointly with it. A tax credit is originated by each purchase made. The VAT is self-assessed on a monthly basis, with payments made through the banking system within the month following the filing of the tax liabilities. The tax basis of imports is the price declared in the customs invoice, which must include any import tariff levied in the good or service. VAT on imports is paid jointly with import taxes before the goods or services leave customs. The tax covers the sale of most goods and services, as some exemptions exist. The main exempt goods are, at the consumption stage, books and other published material, bread, milk and mineral water. Medicines are taxed at the production or import stage, whichever the case may be. Airplanes are also exempted. The main VAT exemptions on the service side are educational services, health services supplied by non-profits, international transport services of goods and individuals and monthly rents below $490.

A general tax rate of 21 per cent is defined for the majority of goods and services. However, the main public utilities (electricity, natural gas, water and sanitation, telecommunications) are taxed at a rate of 27 per cent. Similarly, a lower rate of 10.5 per cent is applied on primary agriculture production, agrochemical products, domestic transport services of individuals, home repair, newspaper, magazines and other published material, services provided by registered worker cooperatives. The tax rate of exports is 0 per cent, giving rise to a refund of accumulated tax credits. Tourists receive a rebate for purchases above $23.

Table 4: Summary of VAT Rates

	Rate
General rate	21%
Higher rate: Public Utilities: electricity, natural gas, water and sanitation, telecommunications	27%
Reduced Rate: Primary agriculture production, agrochemical products, domestic transport services of individuals, home repair services, newspapers and other published goods, services provided by registered workers cooperatives	10.5%
Zero rate: Exports	0%

While the VAT is structured as a tax on consumption, a special feature of VAT in Argentina is the rebate introduced in favor of consumers when purchases have been made by debit and credit cards. This feature was introduced in order to mitigate the regressive impact of consumption taxes on low-income individuals while at the same time improving tax-compliance by requiring electronic transactions. Eligible expenditures are capped at $330 per month and the refund is 2.12 per cent on the purchase of fuel and 4.13 per cent on the purchase of other goods and services when the transaction is made using a debit card. The equivalent rates for credit cards are 1.27 per cent and 2.48 per cent. The amounts credited to cardholders are netted of the VAT, income tax, and presumptive minimum income tax liabilities of card issuers.

3.5 Excise taxes

This tax is levied in a single stage for a limited number of goods and services. As the destination principle is followed, it is applied at the level of the manufacturer or importer. The taxable products are tobacco, alcoholic beverages, soft drinks, motor vehicles and parts, recreation watercraft and aircraft, certain electronic appliances and fuel. Certain insurance activity and cellular telephone services are also taxed.

3.5.1 Excises on goods

Table 5: Excise Rates	
Product	**Rate**
Tobacco	
Cigarettes	60%
Cigars	16%
Tobacco consumed as leaves	20%
Alcoholic beverages	
Whiskey, cognac, brandy, pisco, gin, rum, etc	20%
Beer	8%
Soft drinks and mineral waters	4% to 8%
Luxury articles	20%
Automobiles, motorcycles, recreational boats and airplanes	
Sales price higher than $4.900 and up to $7.190	4%
Sales price higher than $7.190	8%
Electronic devices	17%

The tax-base of most excises is the sale price, net of discounts, VAT and other financial costs. The cigarette tax-base is the price paid by the consumer. In the case of imports, the tax-base will be 130 per cent of the amount resulting from the addition of the price of the good, import tariff and any other tax with the exception of VAT. This generates a tax credit for the importer that is netted against other taxes when the good is sold in the domestic market.

3.5.2 Excises on services

Excises are levied on insurance activity and cellular telephone services. The insurance premiums are the tax base of insurance services, net of VAT payments. Agricultural, life, personal accidents and surgery and maternity insurance are exempt. The tax rates applied are 2.5 per cent for work-related injury insurance, 8.5 per cent for general risk insurance and 23 per cent for a general risk insurance policy that is issued by a company that is not authorized to operate in Argentina. In the latter case, the individual contracting the insurance is responsible for paying the tax at the time the premiums are payable. Excises on cellular telephones services are levied on final users at a rate of 4 per cent. Exemptions include international roaming fees, connection fees to other networks as well as other value-added services.

3.5.3 Excises on fuels

The sale of fuel is taxed in Argentina. The tax-base is the sale price, net of discounts, VAT, other excises and financial costs. Tariffs are added for imported fuel. In the case of compressed natural gas, the tax-base is the price faced by consumers. Although fuels are taxed at an individual *ad-valorem* rate, law specifies a minimum amount to be paid per unit of fuel.

Table 6: Excise rates on fuels		
Product	**Rate**	**Minimum amount – dollars per litre**
Gasoline		
Unleaded – up to 92 octane rating	70%	0.18
Unleaded - more than 92 octane rating	62%	0.18
Leaded - up to 92 octane rating	70%	0.18
Leaded - more than 92 octane rating	62%	0.18
Virgin	62%	0.18
Turpentine / Solvent	62%	0.18
Gas-Oil / Diesel-Oil / Kerosene	19%	0.05
Compressed Natural Gas	16%	-.-

There are additional taxes levied on fuel consumption. The most important ones are:

a) A surcharge of 20.2 per cent on gas-oil and liquefied gas for car use. This surcharge is implemented at a single phase and exports of these products are exempt. (Law 26.028).

b) A surcharge of $ 0.02 per liter of gasoline and per liter of natural gas used for cars. These resources are earmarked for investment projects in the transportation and water sector as well as recovery of land affected by floods (Decree 1381/01).

c) A surcharge of 7.5 per cent of the price of natural gas at the point of entry of the transportation system. These resources are earmarked to consumers of gas and liquefied petroleum gas in the provinces that are producers of these products (Lay 25.565).

d) A surcharge of $ 0.001 per Kwh. This tax is structured as a single phase, imposed at the wholesale level (Law 15.536 and its modifications).

3.6 Gross turnover tax

The gross turnover tax is a provincial tax assignment, generating approximately two thirds of the tax revenue collected by the provinces. The cascading effect that results from its multiphase design imposes a bias against exports and in favor of imports as the latter are taxed only when the goods arrive at customs while the former are taxed during each phase. Another undesirable effect of this tax is that it introduces an incentive towards vertical integration in order to avoid the tax. Each province sets the tax rate, which differs by economic activity. The rate on primary production and manufacturing has been set at 0 if these activities take place in the province that is setting the rate. This percentage rises to 1 per cent/1.5 per cent if the goods are sold in a different province. There is a wide dispersion of tax rates between sectors and between provinces within a sector. The average tax rate for construction activity is set at 2.3 per cent, with a low of 0 per cent and a high of 3.7 per cent. Something similar occurs in the financial sector, were most rates are set within a range of 4.1 per cent/5 per cent but some provinces charge up to 8.5 per cent.[18]

3.7 Social security taxes

Although the national social security system covers employees, self employed individuals and domestic help, due to brevity concerns only the first one of these will be covered in this section.

MOPRE (*Módulo Previsional* or retirement module) is the unit employed to define the payment adjustments of the PAYG regime, the amount of the presumed income of the self-employed and the maximum income level subject to social security taxes. The value of MOPRE when this chapter was written was set at $ 26. The minimum income on which social security taxes must be paid is set at a multiple of 3 of the value of MOPRE, or $78. At the other end of the income scale, incomes are capped at 60 times the value of MOPRE, or $1.570. Employees and employers must make six different contributions to the social security system: the integrated retirees and pensioners system; the health care system of retirees and pensioners; the family subsidy regime; the national employment fund; and contributions to health services. The employer withholds the employee's tax liabilities and makes payments on a monthly basis. Payments are made to AFIP, which then distributes the proceeds to the different public institutions as well as to the privately managed pension funds in the case of employees that have opted for this system. The cumulative rates, once employee and employer contributions to all components of the system are taken into account, are in the range of 36 per cent to 44 per cent.

Two additional features of employer contributions must be highlighted. In the first place, employers have to contract insurance for employment related activities. Insurance premiums are set by private parties and they depend on the employers' line of economic activity as well as their safety measures. The second feature is that, subject to geographical considerations that favor less developed regions of the country, employers may credit part of their share of social security contributions towards their VAT liabilities.

[18] For a table of tax rates see FIEL (2006).

Table 7: Social Security System Tax Rates			
Concept	**Employee PAYG**	**Employee Capitalization**	**Employer**
1. Retirement	11%	7% (1)	
2. Retirees Health Services (INSSJP)	3%	3%	
3. Family Subsidy Regime	-	-	
4. National Employment Fund			
Subtotal (1+2+3+4)	**14%**	**10%**	**17%/21%** (2)
5. Health Benefits	3%	3%	6%
Total	**17%**	**13%**	**23%/27%**

Note: (1) Employee contributions were set at 11% when the social security reform was implemented in 1994. This rate was reduced to 5% in 2001 in an attempt to jump-start the economy by increasing disposable income. The rate was set at 7% as economic conditions improved in 2003, and a timeline has been adopted for raising the rate to 9% in October 2006 and to 11% in 2007.
(2) A rate of 17% has been set for small and medium enterprises, government entities as well as some other non-profit organizations. The remaining employers are taxed at a rate of 21%.

3.8 Simplified tax regime - *Monotributo*

The simplified tax regime covers VAT, income and social security taxes for small taxpayers. Small taxpayers are defined as individuals that sell goods, works and services, members of registered workers cooperatives, undivided estates and partnerships of up to three members as long as their economic activities do not exceed certain financial and physical parameters. Physical parameters are used as a proxy for taxpayer income. Importers of goods and services are excluded from this regime. The main financial parameters to qualify under the simplified tax regime are the following: (1) gross sales of services and or rentals shall not exceed \$23,530 per fiscal year; (2) gross sales of any remaining economic activity shall not exceed \$47,060 per fiscal year; (3) the maximum unit sale price shall not exceed \$285. The tax liability is determined by taking gross revenue and the physical parameters into account, with a scale ranging from \$11 to \$70 per month for rentals and providers of services and \$11 to \$165 for the remaining economic activities. The main contribution of the *Monotributo* is that it allows AFIP to focus on taxpayers of greater revenue generating potential while providing the rest of them with an opportunity for formalizing their economic activities.

3.9 Trade taxes

Argentina applies taxes on imports and on exports. Import tariffs for most goods are applied on an *ad-valorem* basis, which range from 0 to 20 per cent. An exception is the automobile sector, which faces a maximum rate of 35 per cent, as well as some sectors (e.g. textiles) were specific tariffs are applied. Export taxes were introduced in 2002. Exports of goods are taxed at rates that vary in a range of 5 per cent to 25 per cent, with an inverse relationship between the export tax and the value added of the good.

a) Oil is taxed at 25 per cent. An additional surcharge was introduced in August 2004, which triggers when the price of the barrel of West Texas Intermediate (WTI) exceeds $ 32. The surcharge follows the following schedule:

Price Range of WTI – $ per barrel	Surcharge
32.01 to 34.99	3%
35.00 to 36.99	6%
37.00 to 38.99	9%
39.00 to 40.99	12%
41.00 to 42.99	15%
43.00 to 44.99	18%
45.00 and higher	20%

b) Gasoline is taxed at a rate of 5 per cent, propane and butane at a rate of 20 per cent.

c) Grains, edible oil and pellets are taxed at per cent. Soybeans and sunflower seeds at 23.5 per cent.

d) Meats are taxed at a rate of 15 per cent.

e) Products classified as regional production (fruits, vegetables, rice, honey, etc.) are taxed at a rate of 10 per cent.

f) Cheese is taxed at 10 per cent and the rest of diary products at a rate of 15 per cent

g) The remaining products (i.e. manufactured goods) are taxed at a rate of 5 per cent.

4. Some ideas for a reform agenda of Argentina's tax system

This section explores ideas for a reform agenda of Argentina's tax system. Several elements of this reform agenda should be highlighted. In the first place, fiscal solvency should not be undermined by any "improvement" in the tax system. The reason is all too evident since until recently policymakers' neglect of fiscal solvency has led to macroeconomic instability and unsustainable debt accumulation that ended in economic collapse and debt default. A second element is that policymakers should not be dazzled by taxes that may be analytically superior but that ultimately can't be collected by the tax administration. Tax policy should internalize the degree of informality under which different sectors of the economy operate and adopt pragmatic responses to this environment. A third element of a possible reform agenda is that tax policy should include automatic and transparent incentives to promote growth. Devolution of tax assignments to lower levels of governments is a fourth element of this agenda. However, devolution must acknowledge the relatively weak institutional capacity of provincial tax administrations *vis a vis* AFIP as well as the difficulties of decentralizing the administration of taxes that have a movable tax base. Finally, even though a goal of a more equal income distribution is probably better served through targeted expenditure policy, there is a scope for improving the design of the tax system while at the same time contributing to greater equity.[19]

4.1 Devolution

The goal of increasing provincial tax assignments faces several constraints. In the first place, the federal government's fiscal balance must not deteriorate[20]. A second concern is that provincial governments must exploit their tax assignments, avoiding the politically less costly alternative of not taxing their constituencies and demanding federal funds through tax-sharing mechanisms instead. Additional elements are the relative institutional weaknesses of provincial tax administrations *vis a vis* AFIP as well as the relative ease of centrally administrating taxes with a movable tax base. Some tax reform ideas that would support the goal of devolution are the following.

a) Personal Income Tax. A surcharge on the federal government's tax rate could be introduced. Congress would authorize a range for this surcharge, between 0 and 5 per cent, and each provincial government would set the tax-rate it would apply within the authorized range, simply *piggy-backing* on the federal government's schedule as is done in the US. The tax would continue to be administered by AFIP, overcoming the issues of institutional weaknesses and movable tax base previously mentioned.

b) Personal Assets Tax. AFIP's role in administrating this tax derives from the fact that individuals frequently have assets in more than one province, and occasionally in more than one country, as well as to the need to check the consistency of asset and income tax data. However, due to the relatively low level of the country's financial depth, a large share of an individual's wealth is held in real estate. Increasing the accuracy of real estate assessments would greatly improve the revenue collected by this tax and that is a task of provincial governments. A similar rationale applies to other real property (e.g. vehicles, boats, etc.). A possible incentive to

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[19] An additional element of the reform agenda is the introduction of environmental taxes, which should be increasingly employed in a post-Kyoto framework to curb carbon emissions.

[20] After decades of deficits, the federal and provincial government showed significant surpluses between 2003 and 2005.While still high the fiscal surplus is threatened by demands for increases in public employee wages and pensions in the PAYG segment as well as by public investment requirements.

improve the productivity of this tax would be to replace the revenue sharing formula currently employed by devolving taxation of real property held by individuals to the provinces and preserving the taxation of financial assets and assets held abroad at the national level.

c) Export taxes on agricultural production. Under the current tax assignments, the federal government levies export taxes while the each province collects the rural property tax and neither tax is shared. The export tax on agricultural products could partially be replaced by an increase in the rural property tax, although a revenue neutral outcome would require reducing the amount of tax revenue shared between the federal and provincial governments from other sources. Under this alternative, the federal government would compensate the loss in revenue by reducing the amount of tax revenue it transfers to the provinces that concentrate agriculture production (e.g. Buenos Aires, Córdoba, Entre Ríos, La Pampa and Santa Fe). This group of provinces would offset the loss of shared tax revenue by increasing rural property taxes. This arrangement has the potential of significantly increasing tax revenue for these provinces, as the collection of the rural property tax is poorly implemented in Argentina.[21] In addition to the benefits deriving from devolution and the possible increase in revenue, replacing export taxes with rural property taxes would have the advantage of reducing the welfare losses at the production and consumption level associated with the export tax. This should increase agricultural production and the volume of exports in response to the higher output and reduced consumption. Additionally, replacing a portion of the export tax with the rural property tax would help isolate government revenue from the cyclical behavior of commodity prices, reducing volatility in fiscal accounts. There are two main costs to be paid if this proposal would be implemented. In the first place, export taxes are not expensive or technically challenging to administer *vis a vis* property taxes. The second consideration refers to the regressive impact on low salaries of a higher price level in food products, as it would reduce the wedge between domestic and international prices of food commodities.

4.2 Incentives to promote investment and growth

Several investment incentives have been in place in Argentina's tax system for some time, implemented around the corporate income tax and the VAT[22]. More recently, legislation was

[21] Using 2005 data, we can estimate that a reduction of a percentage point in the export tax rate of cereals, grains and edible oils requires an increase of $1.63 per hectare per year in the rural property tax of the five provinces mentioned above in order to obtain a revenue neutral yield. This estimation is on the high side as it ignores second order effects: the positive supply response of higher prices of these products as well as a reduced consumption, both of which will result in increases of exported volumes and hence increases in export tax revenue.

[22] For an analysis of these incentives see González Cano (2005).

passed in 2004 creating limited investment incentives, consisting of accelerated depreciation allowances to be deducted in the corporate income tax as well as immediate devolution of VAT credits in new projects. While care should be placed in order to avoid an undesirable erosion of tax-bases, the tax system could benefit from explicit rules in terms of a stable regime of saving and investment incentives. A set of possible ideas would be the following.

a) Personal Income Tax. An amount of an individual's yearly income could be deferred from the personal income tax if it were invested for a minimum amount of time in the purchase of financial assets through the formal financial sector. These funds would be channeled through individual saving accounts that would be managed by the financial sector. The latter would withhold tax liabilities when assets were sold.

b) Corporate Income Tax. Two sets of incentives could be introduced. The first one consists of rules allowing accelerated depreciation to be deducted from income tax liability as well as immediate devolution of VAT credits in new projects. The second one consists of reducing the tax rate on retained income to 25 per cent and taxing distributed income at 10 per cent. This creates an incentive to build equity in firms, specially benefiting small and medium enterprises that usually finance their expansion through retained earnings as they have less access to credit. Establishing an implementation period during which this rule would be phased in could mitigate short-term concerns regarding the fiscal impact of the erosion of the tax base.

4.3 Increasing VAT productivity and equity measures

A direct consequence of Argentina's very disappointing economic performance over the past three decades has been increased poverty and worsened income distribution. While the country's tax system cannot be blamed for this outcome, it has not contributed to reverting it either. Some measures could be introduced in the tax system to alleviate poverty and target inequality in income distribution, even though the main results in this field will come from better jobs and targeted expenditure policy promoting human capital formation, water and sanitation, housing and security.

a) Value Added Tax. A brief description of goods and services exempted from VAT were presented in section 3.4. The overriding argument that is used when exempting goods and services is the need to avoid the negative distributional impact of including them in the tax basis. The problem with this rationale is that exemptions benefit all consumers and not only low-income groups. An alternative would be to follow a targeted approach that would extend the tax base in order to include the greatest possible universe of goods and services and at the same time introduce refunds to low-income groups. Extending the tax-base would improve tax administration, which would be reflected in the improvement of VAT's productivity, currently around 0.37 in Argentina. Individuals receiving the two lowest deciles of income would receive refunds for their increased VAT payments, which would be credited electronically to a debit or credit card. The amount of refunds would be capped at 10 per cent of the income of the two lowest deciles. This program would build on the existing system of tax rebates implemented by AFIP described in section 3.4 as well as on the government's program of conditional cash transfers to low-income individuals. A reduction of the VAT general rate could be analyzed if net tax revenue (*i.e*. after transfers to low income individuals) increases above certain levels.

b) Personal Income Tax. As proposed by Barreix and Roca (2006), the income from financial assets should be included in the tax base of the personal income tax. The tax rate should be in the range of 10 per cent, although a lower rate of 5 per cent could be applied in peso denominated assets in order to discourage dollarization.

4.4 Social security system

The social security system faces challenges on several fronts. Although over the past four years only the lowest pensions have been increased, Supreme Court rulings require extending these increases to the rest of the beneficiaries, which will erode the fiscal surplus. A second concern is in regards to the benefits of future retirees affiliated with the privately administered pension funds, as they are contributing at a lower rate than the one required by the system. The high cost associated with the management of individual accounts is also an issue of concern and will require a review of insurance premiums paid as well as the commercial activities employed by the industry in capturing clients. Additionally pension reform has contributed very little towards capital market development, a claim made by early supporters of the reform. Finally, initiatives are required to address the issue that less then half of employed workers are making retirement contributions. Some ideas that would contribute to solving the problems that were identified previously are as follows.

a) Employee contributions. The current contribution rate of 7 per cent should be increased over time to 11 per cent as originally envisioned to ensure funding of future pensions.

b) Employer contributions. Rates paid by employers could be reduced from the current 17 per cent/21 per cent by 3 to 5 percentage points. A minimum threshold could be introduced, partially financed by raising the current ceiling that caps contributions on salaries at $1.570 per month. The rationale is to encourage the formalization of low-income individuals, as they accumulate fewer assets towards their retirement.

c) Coverage. Measures mentioned regarding employer contributions should be complemented by administration efforts to ensure formalization of employment relations. Non-contributory pensions should target individuals that have not been employed in the formal sector at their retirement age.

d) Cost of the privately managed system. Pooling disability and life risks will reduce the dispersion in insurance costs for individuals contributing to the privately managed system. Additionally, competition would be enhanced with the introduction of standardized retirement accounts, investing in bank deposits, government bonds and AAA private securities, that would serve as an alternative vehicle to privately managed pension funds.

e) Role of Pension Funds. Pension Funds should play a more pro-active role in channeling pension saving towards meeting the economy's investment needs, avoiding the excessive concentration of government securities in their portfolios. This requires building the institutional capacity as well as the legal framework that would enable investments in, e.g. trust funds financing infrastructure, industry or mortgage based securities.

4.5 Transactions with "tax havens"

To a large degree, the success of a tax administration in enforcing tax legislation depends on the possibility of analyzing the consistency of information provided by taxpayers with other sources of data. While domestic data is usually not a major issue, some countries do not share information, encouraging individuals or corporations to set up tax avoidance schemes in them. An example of this is provided by agribusiness exports: according to AFIP, 83 per cent of the $3 billion dollars exported by Argentina in 2005 of edible oil and grease is done through countries that will not provide tax information. The presumptive elements of the tax system should be re-enforced, penalizing transactions with those tax jurisdictions that refuse to share taxpayer information. Penalties would range from imposing steep surcharges on existing rates on these transactions to deny authorization of operating in Argentina. While Argentina's tax legislation already applies surcharges (e.g. the personal assets tax described in 3.2.1), a greater rate is required to effectively discourage these transactions.

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Table 1

Argentina: Tax Burden - as a percentage of GDP

	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05
Income, Assets, etc	1.6	2.3	2.0	2.2	2.6	2.7	2.9	3.1	3.5	3.9	4.4	5.4	4.8	6.3	7.4	7.6
Income Tax	0.5	0.6	1.1	1.8	2.3	2.5	2.5	2.9	3.2	3.3	3.8	3.5	2.5	3.6	4.7	5.3
Personal	0.0	0.0	0.3	0.6	0.7	0.8	1.0	0.9	1.0	1.1	1.4	1.4	1.1	1.3	1.4	1.5
Corporate	0.0	0.6	0.8	1.3	1.5	1.7	1.6	2.0	2.2	2.2	2.4	2.1	1.4	2.3	3.4	3.8
Personal Assets Tax	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.3	0.2	0.4	0.3	0.2	0.4	0.4	0.3
Presumptive Min Income Tax	0.3	0.5	0.3	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.4	0.3	0.2
Financial Transactions Tax	0.3	0.9	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.1	1.6	1.6	1.7	1.8
Others	0.5	0.3	0.3	0.2	0.1	0.2	0.3	0.2	0.3	0.6	0.7	0.6	0.6	0.8	0.7	0.3
Consumption Taxes	5.3	6.1	8.2	8.9	8.7	8.5	8.7	9.2	9.1	9.0	9.2	8.1	7.1	7.7	9.0	9.0
VAT	2.3	3.4	5.9	6.9	6.7	6.8	6.9	7.0	7.0	6.6	6.7	5.7	4.9	5.6	6.9	6.9
Excises Int Unificados	0.8	1.3	1.2	1.1	1.1	1.0	0.9	0.8	0.8	1.1	1.2	1.0	0.7	0.8	0.9	1.0
Energy	1.7	1.4	1.2	0.9	0.9	0.8	0.9	1.4	1.3	1.3	1.3	1.4	1.5	1.4	1.3	1.1
Trade Taxes	1.5	0.9	1.0	1.1	1.1	0.8	0.9	1.0	1.0	0.8	0.7	0.6	2.0	3.0	3.0	3.0
Import (inc Statistics)	0.3	0.5	0.9	1.0	1.1	0.8	0.8	1.0	0.9	0.8	0.7	0.6	0.4	0.6	0.7	0.7
Export (inc Statistics)	1.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6	2.5	2.3	2.3
Social Security	3.7	4.3	5.0	5.6	5.4	4.7	4.0	3.8	3.7	3.5	3.4	3.2	2.8	2.8	3.0	3.1
Other	0.3	0.7	0.4	0.5	0.4	0.4	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.2	0.7
Gross Collection National	12.5	14.4	16.6	18.3	18.1	17.2	16.4	17.1	17.3	17.5	17.9	17.5	16.9	20.0	22.7	23.4
Net Collection National	12.5	14.3	16.5	17.9	17.7	16.7	16.1	16.9	17.1	17.3	17.7	17.3	16.5	19.6	22.3	22.4
Provincial Taxes	2.3	2.6	3.3	3.7	3.8	3.6	3.6	3.7	3.9	3.9	3.8	3.6	3.4	3.8	4.0	4.1
Gross Collection Total	14.8	16.9	19.8	22.0	21.9	20.7	20.0	20.8	21.2	21.4	21.7	21.1	20.3	23.8	26.7	27.5
Net Collection Total	14.8	16.9	19.7	21.6	21.5	20.3	19.7	20.6	21.0	21.2	21.5	20.9	19.9	23.4	26.4	26.5

Source: Based on data from Ministerio de Economía y Producción – Secretaría de Hacienda

2. BRAZIL

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Abstract:
This paper is part of a wider research on "Tax Systems and Tax Reforms in Latin America", carried out at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. Herein the Brazilian tax system is reviewed in detail, covering the key points of its main taxes and contributions. A brief historical overview spanning the tax system as well as the budgetary and economic framework is provided, accompanied by extensive data on the tax structure. Two other relevant issues are subsequently addressed: the regressive nature inherent in the system and the tax competition that exists between sub-national governments. Finally, the paper assesses the two recent failed attempts to reform the tax system and suggests some hypotheses as to why these attempts failed.

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JEL Codes: H20, H50, H70

1. Introduction[*]

Brazil is Latin America's largest nation in demographic, economic and geographical terms, and boasts the world's tenth largest gross domestic product - GDP (US$796 billion), the fifth largest population (184.2 million) and the fifth largest land area. The Brazilian economy experienced profound structural changes throughout the last century and the nation became urbanized at a very rapid rate. Following a long period of stagnation during much of the 19th century, the Brazilian economy registered the fastest pace of growth of any country in the world in the period between the 1870s and the 1970s. In the last twenty-five years however, this rate of economic growth, which had been especially robust following the Second World War, has suffered a strong downturn. Between 1951 and 1980, a period encompassing the so-called Brazilian Miracle, the average annual rate of growth was of 7.3%, whilst in the period that followed (1981-2005) this pace dropped back to just 2.5% p.a. As a result, the country's per capita income is ranked eighty-sixth (US$7,450)[1] and 22.8% of the population still lives below the poverty line.[2] An even more worrying aspect of this situation is the high degree of income concentration: the Gini index for Brazil was at 0.568 in 2005, placing the country in amongst the world's most unequal under this gauge. The present federative structure is composed of three tiers: the central tier, referred to as the Union, is better known as the federal government; the intermediate tier is made up of 26 states plus the Federal District; and the local tier is made up of 5,564 municipalities. The institutional framework existing today was imposed by the Federal Constitution of 1988, which resulted in a sharp decentralization, that was not only political but also administrative and fiscal.

The tax system is made up of taxes, fees and contributions. The latter have specific characteristics in Brazil as they are not exclusively levied on payrolls. The 1988 Constitution diversified their sources, which resulted in social contributions also being levied on the revenues and profits of employers as well as on lotteries, government revenues, licensing among others. The two most relevant social contributions are called PIS/ PASEP and COFINS and are levied on any type of revenue earned by the firms. These two contributions are discussed in more details in section 3.4.2. Today, these different contributions already account for half the total Brazilian tax burden (19.5% of GDP in 2005, or over one percentage point more than was raised

[*] *The opinions herein expressed are those of the authors and not necessarily of the institutions to which they are linked. The authors would like to thank Maria Cristina Barroso, Ana Carolina Freire and Kleber Castro for their assistance in research.*

[1] According to the 2002 World Bank classification related to *per capita* gross domestic product, measured using purchasing power parity.

through traditional taxes), this thanks to strong expansion since the last reform. This has basically been due to the fact that central government has taken on exclusivity in levying contributions, that is, it doesn't have to share them with sub-national governments, as in the case of taxes on similar bases.

The tax burden went through an expansionist phase in the post-war period, which accelerated towards the end of the last decade (see Table 1). The bases of the present tax system were defined in the mid-1960s. From that time until 1993, the total tax burden averaged around the equivalent of 25% of GDP, which was already a high level compared with many other emerging economies, and especially those in Asia. The stabilization of the economy in 1994 resulted in two expansionist cycles. Firstly, the Real (R$) took the tax burden to 29% of GDP levels[3], which in reality was already the prevailing rate but which had been somewhat hidden until then by the so-called Tanzi effect[4] Either way had the burden stayed at that level then Brazil would be on a par with other emerging market economies today. The second cycle came in the wake of the serious external crisis of 1998, when the country began an impressive and steady process of expansion of the total tax burden that continued, even after the change of government in 2003 and the resulting crisis of confidence had dissipated.

As a consequence, by far the most striking characteristic of the Brazilian tax system today is the size of its total burden: 39% of GDP. This percentage exceeds, and considerably, the average of emerging market economies[5] and is a serious hindrance to the competitiveness of Brazilian goods. Worse than the burden's size, is its structure that is concentrated on indirect taxes: more than half of the total tax revenue comes from different forms of taxing the domestic market of goods and services, with many of these taxes being of a cumulative nature . This places a burden directly on capital goods (and helps increase the cost of fixed investment, whose participation in national accounts is very low), and indirectly on exports (even in the case of value added type taxes, it is not easy to recover accumulated tax credit balances). The most perverse side of this system can be seen in the distribution of the tax burden amongst households, where the poorest families pay proportionally more tax relative to their household income than the richest families – and this in a country that is already marked by a high level of poverty and social inequality.

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[2] According to (FGV, 2006), which considers those with per capita income of less than R$121 per month as poor. This was the same source used in the Gini Index.

[3] The Real plan was also made up of some revenue raising measures aiming at covering the fiscal gap that would emerge with the end of the inflationary revenues.

[4] The Tanzi effect is the name given to the tax loss that occurs, in high inflation periods, between the moment the due tax is generated or calculated and its payment. Thus, the nominal tax burden becomes greater than the real one. Once the inflationary process ceases, the real tax burden converges to the nominal one.

[5] Excluding transition economies like the East European countries.

Table 1 – Global Total Tax Burden Composition Evolution: 1980-2005 (In % of GDP)

Tax/Year	*1980*	*1985*	*1990*	*1995*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
TOTAL	24,52	24,06	28,78	29,41	33,36	35,12	36,63	35,85	37,03	38,94
International Trade	0,70	0,40	0,39	0,76	0,77	0,76	0,59	0,52	0,52	0,46
Goods and Services	9,98	10,06	14,06	13,73	15,63	16,37	16,16	15,81	16,85	17,25
being, General Tax (ICMS)	*4,87*	*5,44*	*7,24*	*7,30*	*7,47*	*7,69*	*7,65*	*7,53*	*7,73*	*7,92*
Industrial Products	*2,19*	*1,84*	*2,40*	*2,07*	*1,59*	*1,57*	*1,37*	*1,15*	*1,19*	*1,24*
Revenues (social security)	*1,02*	*1,43*	*2,68*	*3,34*	*4,37*	*4,74*	*4,70*	*4,76*	*5,47*	*5,57*
Financial Transactions	*0,00*	*0,00*	*0,00*	*0,50*	*1,59*	*1,73*	*1,80*	*1,76*	*1,79*	*1,80*
Property	0,27	0,17	0,27	0,80	1,01	1,02	1,04	1,02	1,04	1,07
Income & Gains	3,01	5,13	5,67	5,69	5,15	5,62	6,53	6,30	6,21	7,10
being, General Income Tax	*3,01*	*5,13*	*5,13*	*4,78*	*4,36*	*4,88*	*5,61*	*5,30*	*5,12*	*5,81*
Profits (social security)	*0,00*	*0,00*	*0,54*	*0,91*	*0,79*	*0,75*	*0,92*	*1,01*	*1,09*	*1,29*
Payroll	5,96	5,84	6,56	6,41	6,95	7,43	7,59	7,56	7,81	8,10
being, Social Security	*4,66*	*4,73*	*5,11*	*4,89*	*5,25*	*5,67*	*5,92*	*5,95*	*6,21*	*6,43*
Other Taxes	4,60	2,46	1,82	2,03	3,86	3,91	4,72	4,64	4,60	4,96

Source: (Afonso e Meirelles, 2006) (Araujo (2001). Global Tax Burden defined according to the National Account System.
Other Taxes = fees, economic contributions (such as royalties), other taxation bases, small amount revenues from abovementioned tax bases

Despite these distortions, all the initiatives undertaken to try to reform the tax system have failed. and indeed there has been no lack of such projects in recent years. Some have argued for a radical change (such as the popular creation of a single tax), whilst others have suggested specific changes to be implemented on a gradual basis, with some of these changes proposed by federal government bills (in principle, with greater parliamentary backing), but the majority put forward by individual Congressmen (more sensitive to the demands of sub-national governments and taxpayers). As the definition of tax responsibilities is set down in writing in the National Constitution, which also details the norms set down for many taxes (especially the state tax on the circulation of goods, whose interstate taxation system is fully regulated by the text), any attempt at reform, however limited its scope, would inevitably require an amendment to the Constitution. (which depends on the approval of two-thirds of the members of the two Houses of Congress, in two rounds of voting). The few tax reform proposals that have been discussed have always avoided issues sensitive to the federative debate. The few measures that have managed to be approved have involved merely topical changes that have almost always been aimed at increasing the tax burden.

The debate on tax reform has returned to the national political agenda since the announcement that economic growth had fallen short of estimates, once again. There is absolute consensus over the need for such reform, but when the debate shifts to the details of proposals, so dissention increases. This lack of agreement in relation to the ideas and measures put forward comes from the broad gulf that separates different interests, not only between taxman and taxpayer (which is natural in any system around the world), but also between the governments of different regions and at different levels (see the federative question) and between sectorial interest groups. (many benefited by constitutional earmarkings).

This paper aims to describe the present tax system in Brazil and to reflect on its recent evolution and attempts at its reform. It has been organized into five sections, including this introduction. The next section sets out a general view of public finances. The third section details the characteristics of the main taxes. The fourth discusses topics that are relevant to the present day, such as the issue of regressive taxation and the federative question and the final section looks at the recent debate over tax reform initiatives, both those that have failed and those that are necessary.

1. A General View and the Recent Development of Taxation

Brazil has had a long history in which the State has played a leading role in the economy, and at the same time, seen a strong decentralization of public administration (Afonso and Rezende, 2006). The option for a federal regime (imposed "from up downwards" to ensure national integrity) explains the tendency towards lengthier constitutions. This is especially the case of the tax system: the distribution between different levels of government of the responsibilities for taxation has helped shape the division of power in the federation.

Subnational governments have always benefited from a broad level of autonomy, both in terms of legislating on their taxes, levying them directly, and also deciding on how to allocate resources, and generate and provide accounts. In view of the profound regional inequalities that have always existed, a vertical division of revenues has always been adopted, from upper to lower levels of government, and with a horizontal distribution in favor of less developed regions and localities. The historical relevance that state governments have always had within the federative division of tax powers, explains the predominance of indirect taxation at the different levels of government. These governments applied a tax on sales in general, which was then substituted by the reform program imposed by the Military in 1965 with an innovative tax on the circulation of goods of the value added type. Not only was this the first time in the world that such a tax was created on a national scale, but it was also the only time that such a tax was delegated to an intermediate tier of government. From a political standpoint, ending the state government power to levy tax on goods is seen as an impossible task, largely because this has become the largest single source of own income for this tier of government, and the more developed the state, the more income it receives. The last tax reform was carried out by the National Constituent Assembly 1987-1988. This reform was neither innovative nor did it alter the tax structure significantly, largely because efforts were rather concentrated on fiscal decentralization. Five federal taxes on strategic inputs were eliminated (fuels, electric energy, minerals and transport and communication services).

Table 2 – Historical Evolution of the Total Tax Burden and Tax Revenue Federative Division

Concept	Central	State	Local	Total	Central	State	Local	Total
	Tax Burden - in % of GDP				Composition - in % of Total			
OWN TAXATION								
1960	11,14	5,45	0,82	17,41	64,0	31,3	4,7	100,0
1980	18,31	5,31	0,90	24,52	74,7	21,6	3,7	100,0
1988	16,08	5,74	0,61	22,43	71,7	25,6	2,7	100,0
2005	26,72	10,01	2,26	38,99	68,5	25,7	5,8	100,0
AVAILABLE REVENUE								
1960	10,37	5,94	1,11	17,41	59,5	34,1	6,4	100,0
1980	16,71	5,70	2,10	24,52	68,2	23,3	8,6	100,0
1988	13,48	5,97	2,98	22,43	60,1	26,6	13,3	100,0
2005	22,53	9,70	6,76	38,99	57,8	24,9	17,3	100,0

Source: Afonso e Meirelles (2006) - based on data from STN, SRF, IBGE, Social Security Ministry, CEF, Confaz e Local Gov Balances.
National Accounts System methodology includes taxes, fees and contributions, including financial transactions tax and other taxes levied on the payroll, as well as the revenue obtained from the stock of overdue taxes.
Direct Taxation: tax revenue collected by every government level with its own means. Available Revenue: direct taxation plus/ minus intergovernamental transfers

These had previously been levied using a single rate with resulting cumulative effects, and their bases were now integrated into the old state tax on the circulation of goods (ICMS), which was theoretically non-cumulative. Its management was entirely delegated to these state governments, who furthermore had the power to freely fix tax rates on the internal circulation of goods (rates on interstate flows remained in the hands of the Senate). Central government continued to levy tax on value added, but limited this to other industrialized products (IPI) and the local governments maintained their tax (cumulative) on services in general (ISS). Most of the attention in the 1988 reform was focused on continuing to raise the sharing out of federal tax revenues in favor of sub-national governments: the percentage of the two main federal taxes, on income (IR) and on industrial products (IPI), transferred to the state (FPE) and municipal (FPM) participation funds increased from 18 to 44 percent between 1980 and 1993; in the case of the

IPI, a further 10% was set aside for exporter states. The implementation of this system remodeling resulted, firstly in a strong decentralization of tax revenues and, secondly, in a steady and vigorous increase in the tax burden (see Table 2). The redistribution of resources had clear directional results: in vertical terms, all the relative gains favored the municipal tier, when adopting the concept of available revenue (own exclusive tax revenues plus or minus the constitutional sharing out of tax revenues), meaning that both the federal tier and the state tier lost out in terms of their proportion of the total tax revenue; in horizontal terms, the additional resources of sub-national governments were transferred in greater proportion to less developed regions - rather than reverting the high economic concentration in wealthier regions through the sharing out of available tax revenues as well as expenditure. Central government effectively reacted to the decentralization of taxes by creating and successively expanding the incidence of contributions (non-shared), which resulted in a rise in the tax burden and the cumulativeness of indirect taxes. It especially placed a heavy burden through the levying of contributions on strategic inputs and services, which had escaped from the scope of the IPI, and, more recently, also on imports. [6] Recent changes to the composition of the national tax burden suggest disregard for the process of gradual change combined with reasonable flexibility in federative relations (Serra and Afonso, 2006). Public policies, from macroeconomic to social point forcefully to a fiscal re-centralization, not least to satisfy the growing pressure from enormous federal government spending on the transfer of income. This ranges from pension and assistance benefits to interest on public sector debt in treasury note form.

International comparisons of tax burdens show that Brazil is significantly above the prevailing standard among emerging market economies (Graph 1)[7]. The Brazilian tax burden is on a par with the average burden of developed nations (39% of GDP), and a full 12 points above the developing nation average. It is important to look deeper into our analysis and divide up the

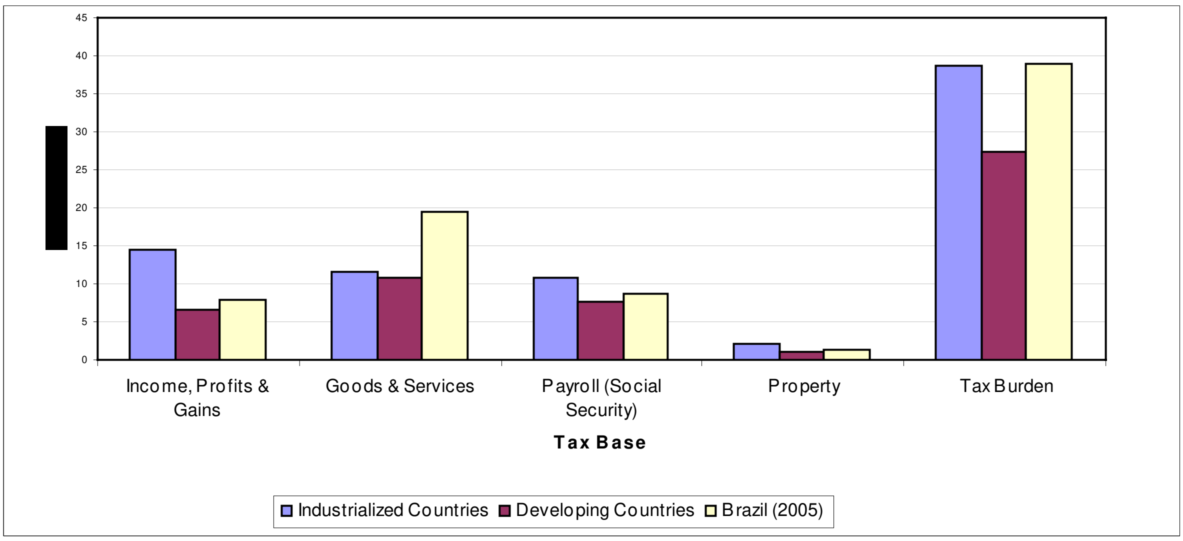
[6] The performance of the federal tax burden structure speaks for itself. On one hand, there has been a drastic reduction in the burden of the only value added type federal tax, the IPI: in 1970, this raised the equivalent of 4.4% of GDP; in 2005, revenue from IPI fell to just 1.2 percent, one of the lowest levels in its history. On the other hand, social contributions levied on revenues in general and on earnings (PIS and COFINS) have been vigorously expanded since the last reform: in 1980, revenue was the equivalent of only 1 percent of GDP; in 2005 it hit a record 5.6 percent of GDP; if we also include revenue equivalent to 1.5 percent of GDP obtained with contribution on financial transaction (CPMF) and 1.3 percent of GDP CSLL levied on profit, the total tax burden of these four contributions alone hit 8.4 percent of GDP in 2005. The total raised through such contributions was equivalent to more than six times that raised through federal industrial tax and already exceeded state value added tax or even federal income tax.

[7] Taking as a base, data from 2004 contained in the last government finance yearbook published by the International Monetary Fund (IMF). In the correlation between income per capita and level of taxation, Brazil is level with the economies of the old Communist block, such as Byelorussia, the Ukraine and Bulgaria, the only countries that manage to ignore the rule and combine low income with a high tax burden.

burden according to bases of incidence: although the Brazilian tax burden is equal to that of many rich nations in percentage of GDP terms, the situation is quite different when we look at types of incidence. In the case of taxes on income and profit, the average of the rich nations is 84% greater than that of Brazil: 14.4% against 7.9% of GDP. An expressive difference can also be seen in taxes on assets: the average of rich nations is 70% greater than that of Brazil: 2.1% against 1.2% of GDP. The highest burden falls considerably in the case of contributions incident on payrolls: the rich nations levy 24% more than Brazil: 10.8% against 8.6% of GDP. This picture changes radically when we look at taxes incident on the domestic market for goods and services in Brazil, which exceeds the average of the world's most industrialized nations by 70%: 19.5% against 11.5% of GDP.

In other words, it is the stark difference of the indirect tax burden that creates the unusual situation of the country being on the same level in terms of total taxation as the world's richest nations, and which ends up harming the country's competitiveness and fiscal fairnesss. A pioneering move to adopt a tax of the value added type on a national scale through reform in the mid-1960s, did not lessen the distortions because Brazil's indirect tax did not keep up with the evolution of the tax in other countries – the non-cumulative tax is limited to large taxpayers (by right or in fact) and even then continues to be tied to the old taxman regime, conceding capital gains tax credits with considerable delay and obstructing or even denying rebates of accumulated credit balances, especially by exporters; the greatest symptom of a cumulative system is the taxing of financial transactions.

Graph 1 – Tax Burden per Incidence and Compared with a Group of Nations: 2004



2. Institutional Characteristics of the Principle Taxes Levied

This section details the main characteristics of the Brazilian taxes resorting to the International Monetary Fund's typology for its explanation. Before analyzing the characteristics of the principle taxes levied in Brazil, one should stress the relative importance of each block or even each tax. This can be done by looking at the details of a recent composition of tax revenues: which totaled 38.9% of GDP in 2005 (Afonso e Meirelles, 2006). In principle, the methodology usually adopted in international statistics, interpreted in the strictest sense, divides up revenue between: taxes, in the broadest sense (78% of the total), and social contributions, in the strictest sense, incident only on payrolls (22% of the total). A broader analysis by type of incidence can also be adopted, using the classification recently adopted by the IMF (see Table 3).

Indirect taxation generates a little over half of natural tax revenue if we include in addition to taxes on the domestic market (16.4% of GDP), those which are incident on financial transactions – and is, alone, the size of the total tax burden of many Latin American and even emerging market economies.[8] The most relevant tax category is that which is levied on production and sales in general form: 42% of national tax revenue, ranging from the state tax on the circulation of goods to federal contributions on turnover and revenue.

The very small size of the burden of taxes considered as selective or specific (less than four points of national tax revenues) can be explained by the unusual form in which the above-mentioned category of generic indirect taxes is levied. They do not follow general rules and do not always apply single tax rates and in fact, in the case of the exclusive bases of specific taxes (such as fuels, cars, tobacco and beverages) it is common practice to adopt different tax bands, rising from zero to higher rates levied by each tax (without mentioning the generalized use of tax substitution and other forms of presumption).

[8] Excluding some transition economies like the Eastern European countries..

Table 3 – Tax Revenues Composition: 2005

Global Revenue and by Categories	R$ billions	R$ per inhabitant	% of Total Revenue	Tax Burden % GDP
Global	754,4	4.160	100,0%	38,94%
Goods and Services	355,1	1.958	47,1%	18,33%
General Goods and Services	*317,7*	*1.752*	*42,1%*	*16,40%*
Excises Taxes	*27,7*	*153*	*3,7%*	*1,43%*
Public Services	*9,8*	*54*	*1,3%*	*0,50%*
Payroll	178,7	985	23,7%	9,22%
Employees, Public Servants, Self-employed	*37,8*	*208*	*5,0%*	*1,95%*
Employers	*128,5*	*709*	*17,0%*	*6,63%*
Others	*12,4*	*68*	*1,6%*	*0,64%*
Income and Gains	152,7	842	20,2%	7,88%
Families	*46,5*	*256*	*6,2%*	*2,40%*
Companies & Shareholders	*75,8*	*418*	*10,0%*	*3,91%*
Others	*30,5*	*168*	*4,0%*	*1,57%*
Financial Transactions	35,1	194	4,7%	1,81%
Property and Wealth	23,7	131	3,1%	1,22%
International Trade	9,0	50	1,2%	0,47%

Source: (Afonso e Meirelles, 2006), in accordance to the IMF Government Finance Yearbook classification.

The taxation of salaries constitutes the second large block., despite the loss of relative importance of salaries within income, a world phenomenon that in Brazil has taken on dramatic forms that have reduced the income of salaried workers to a level that constitutes a mere quarter of national income (excluding taxes). By computing the many different forms by which salaries, the payroll or manual labor wages are taxed, one comes to a burden equivalent to 9.2% of GDP (in 2005), of which 6.6% of GDP is retained at source by employers. reflecting the fact that Brazil is one of the countries that adopts among the highest aggregate employer tax rates in the world (close to the highest European examples). Contrary to the situation that exists in richer economies, taxation of income and profits and gains in Brazil accounts for a fifth of the total tax burden (8% of GDP). The difference (on the downside) is even more evident in the case of income tax levied on individuals: 6% of the national tax burden. On the other hand, taxation on the profits of companies and shareholders brings 10% of the total. One can consider as low, on the one hand, taxation levied on assets (1.2% of GDP) when comparing with the average in the richest countries, and on the other that levied on foreign trade (0.5% of GDP) relative to less developed economies, which reflects regional treaties and agreements, such as the Mercosur trade block, but covers up the fact that, implicitly, taxes and contributions on sales in general end up taxing exports via inputs. Finally, it is worth noting the decentralization (that has in the past been greater) in the direct generation of the tax burden of 38.9% of GDP in 2005: 68.4% was raised by central government (of which only 20% in the form of taxes); 26% by the state governments (of which 20% related to tax on goods); and 5.6% by municipal governments (who collect more tax on services than they do through traditional taxes on urban property – 0.7% against 0.5% of GDP).

3.1. Taxation of Income, Profits and Gains

3.1.1. Individuals

Brazil has had a long history of taxation – the first form of tax on the income of individuals (IRPF) was implemented in 1923. The taxation of individual incomes brought into state coffers 2.4% of GDP in 2005, of which only 0.4% was stated in, and paid under the annual income tax return. In other words, the bulk of this was paid at source.

Salaried workers are discounted tax direct at source in their pay packets and the employer pays the Income Tax Retained at Source (IRRF) on their behalf. Liberal professionals (self-employed) are obliged to issue receipts and pay tax due, direct and on a monthly basis. Lottery winnings are also taxed as income at source. The federal tax authorities raised 1.5% of GDP in 2005 through retentions related to income from work.[9] Retention of tax at source is also applied to other forms of income that are not considered salaries: income from capital, raffles, earnings abroad and services received by companies. In the specific case of financial investments (including gains in variable income investments) and withdrawals by shareholders of their companies' results, these are taxed exclusively at source (the normal tax rate is 15% but it rises to as much as 22.5% in the case of shorter-term investments) and are not levied according to the annual table (raised 1% of GDP in 2005).

The annual tax declaration or return is only for adjustment purposes – in other words, used to check on any additional tax due from those who have more than one source of income; or to establish whether any tax already paid needs to be refunded (rebate), due to the standard deduction (20%) or to deductible expenditures (dependents, allowances, schooling, health plans, private pension plans, or even donations to cultural or social entities such as charities, always

[9] A further 0.5% of GDP was collected by state and municipal administrations, which, for example do not pay the central government what they have retained at source from salary payments made to their public sector workers (this is the only form of concurrent tax responsibility existing in Brazil).

subject to limits and ability to provide evidence of payment). Taxation on income of individuals (at source and in the annual tax declaration or return) applies only two tax rates (15% and 27.5%) in accordance with brackets of income.[10] With the implementation of the economic stabilization plan in 1994, the automatic indexation of this table to past inflation was extinguished; readjustment of the tax brackets was made sporadically and always below the cost of living. As a result, the number of tax payers who declared income tax rose from 7.64 million in 1996 to 22 million in 2006, of which 21 million made their declarations or returns by means of the Internet. The coverage of income tax in Brazil is relatively low (the economically active population totaled 91 million), the direct result of a decreasing formalization of the labor market (only 44% of workers are formally registered with signed labor documents) and low salaries or wages paid (almost 90% of income declared by families in a household survey was within the exemption bracket, below US$7,000 earned in the tax year). Tax income from annual declarations is even more limited: of the total 16 million tax declarations or returns filed in 2003, only 31% concluded with tax due – according to (SRF, 2006b). [11]

3.1.2. Companies

Companies pay Corporate Income Tax (IRPJ) as well as a Social Contribution on Net Profit (CSLL), which is linked to financing social security and was created by the 1988 Constitution. Firms also pay a general revenue contribution, which is discussed thoroughly in section 3.4.2. Although they are two distinct taxes, the bases for incidence and the rules for levying are the same (the contribution is settled before the tax and offers fewer options of incentives). The tax rates within the normal accounting regime (real profit) are 15% in the case of the tax, and 9% in the case of the contribution. An additional 10% tax is payable on annual profits exceeding about US$110,000 p.a. In 2004, slightly fewer than 3 million annual company tax declarations were filed, which between them declared a total corporate income equivalent to 189% of GDP (SRF, 2006a). The regime of real profit (2003) included a mere 6% of the whole universe of taxpayers (176,030 companies and 2,693 financial institutions), but generated 81% of total tax revenues

[10] In 2006, the brackets were as follows: exemption, on up to approximately US$7,000 earned in the tax year; rate of 15%, on between US$7,000 and US$12,000; rate of 27.5% on anything over US$12,000 earned in the tax year. Application is gradual. Retention at source adopts the same table except with the annual amounts divided by twelve.

[11] The total income declared was equivalent to 33.1% of GDP in 2002 (the tax year in question), but the taxable amount in the declarations fell to 24.1% of GDP (the significant difference was basically caused by tax-exempt income, such as low value pensions and earnings from savings accounts); the total sum of net income was reduced even further after allowable deductions were made, to just 17.8% of GDP. In the end, tax due was equivalent to 1.7% of GDP and constituted an effective total average tax rate of 7.1% on the taxable income in the declarations. The total rebate or tax refund was 2.5 times greater than the amount of tax due. Despite the low level of coverage, those declaring income tax also declared a total of assets and rights that were equivalent to 120% of GDP.

(156% of GDP in 2003). As it offers the opportunity for deductions and incentives, at the end of the declaration period, corporate income tax (IRPJ) was found owing in 69,623 companies (in a total amount equivalent to 1.6% of GDP) and social contribution on net profits (CSLL) found owing in 62,439 companies (0.6% of GDP). In other words, out of the total number of companies, only 3.3% of the net revenue from their declared activities was found to be due in tax. The case of financial institutions was no different. They collected 0.5% of GDP, in both IRPJ and CSLL, but this was equivalent to a mere 1.4% of the total of their revenues from financial activities.

Companies with an annual turnover that is less than around US$22 million, may opt for the regime of presumed profit under which they only need to declare their turnover and apply a tax rate to that, which is differentiated by economic activity and reflects a profit margin that is set by legislation (varying from 1.6 to 32% on gross revenue).[12] A similar system is also applied to micro and small companies, who can opt for a simplified tax regime (SIMPLES), also applicable to other federal taxes (including substituting the employer's contribution to social security due on the payroll), in such a way as to levy a percentage on earnings that is differentiated by sector (the collecting entity is responsible for separating the proportion of each tax originally due within the official accounts).[13] Profits and dividends distributed by companies and interest on own capital, are not taxed. Finally, one should mention that some transactions are taxed at source. Typical examples include remittances abroad (at a rate of 15%, which rises to 25% if these remittances are earnings from business activities) and, of less importance, benefits from private pension plans and prizes or awards won in intellectual and artistic competitions, among others. These taxes raised 0.5% of GDP in 2005.

3.2. Taxation of Payrolls and the Workforce

This IMF adopted category is not taxed in Brazil but it is levied various contributions other than those linked to social security, although many are even levied on the same tax collection payment slip. Compared to the classic social contribution, the aggregate revenue from this group

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[12] The presumed profit regime was used by 683,000 corporate taxpayers (22% of the total number of taxpayers), who between them had revenues equivalent to 17% of GDP. They collected a total of 0.6% due in IRPJ and CSLL in 2003, which represented 3.7% of the total sales (a proportion slightly higher to that found in the case of the real profit regime).

[13] The largest contingent of companies (two thirds of the total) was made up of 1.6 million micro companies and 334,000 small companies, which opted for the special regime (SIMPLES) and declared revenue that was equivalent to 11.6% of GDP and tax due (not only income tax but all federal taxes) totaling 0.6% of GDP. This consumed 5.3% of the revenue pile, therefore an average proportion that goes against the popular belief that this regime should produce a significant reduction in the tax burden for this corporate segment.

is relatively small: 0.6% of GDP in 2005. The most important in this category is the Salary-Education contribution (0.3% of GDP in 2005), set down within the constitutional text itself in the chapter on education, and meant to provide an additional source of financing for public elementary education. Another two types of contribution that can also be levied on salaries have in common the fact that they are compulsory (once again, based on rulings set down in the Federal Constitution of 1988), and that the proceeds from both are passed on to private entities such as union, employer and worker representations (associations, trade unions etc.), which means that the management and application of these contributions does not form part of public budgets.

3.3. Property Taxation

This category deals with taxes which are levied in the case of the ownership of an asset or right, or the transfer thereof. In this sense, a restricted interpretation here also classifies the taxation of the transmission of financial assets, such as checks and other forms of bank debit. In other words, this category also includes the CPMF as levied in Brazil (and in few other emerging market economies). Thus, the tax burden on property and its transmission reached 2.7% of GDP in 2005, which was a very high percentage even if compared with richest nations; but, excluding the exceptional contribution (CPMF), this percentage dropped to 1.2% of GDP (largely the result of sub-national taxation on urban property and vehicles).

There is no general form of taxation on property, nor on corporate assets (such as in some countries).[14]

The taxation of real-estate in Brazil has always been separated into two distinct taxes – the tax on urban properties (IPTU), which has always been levied by municipalities and presently raises 0.5% of GDP; whilst the tax on rural property (ITR), at times in the past levied by other tiers of government, is now the domain of central government.[15] However, the ITR has always generated derisory revenues, which were equivalent to just 0.014% of GDP in 2005. The IPTU (tax on urban properties) meanwhile, has been given increasing attention by municipal governments, with revenues going from 0.14% to 0.5% of GDP between 1988 and 2005.

[14] The Constitution of 1988 innovated by attributing to central government the responsibility for taxing large fortunes. However, no such tax has even been implemented nor has there ever been any proposal put forward to regulate it.

[15] The contribution on improvements is a tax that for decades, according to the Constitution, the three tiers of government have been able to levy on any gain in value of property resulting from the carrying out of public works. It has however, been rarely applied, by just a few municipal governments in wealthier regions of the country, and presently raises a derisory 0.007 percent of GDP.

State governments are responsible for the Tax on the Ownership of Automotive Vehicles (IPVA), which accounted for 0.5% of GDP in 2005. The IPVA is levied each year on owners of cars, boats, trucks, motorbikes and aircraft, on the purchasable value, a definition that is based on market prices with rates fixed by each state's legislation of and differentiated by type and usage.

The taxation of debits and other bank transactions, as mentioned previously, is the most profitable and singular form of taxing the transfer of assets, in this case of financial assets. Initially, a federal tax was created (the IPMF), which was only levied in 1994, at a rate of 0.25% and produced revenue equivalent to 1% of GDP. In 1996, it was recreated, but this time in the form of a provisional contribution (the CPMF -contribution on financial transactions) to be used to finance the public health system, with a rate set at 0.2%. The term of validity of the CPMF was later successively extended (there have already been six constitutional amendments since the first tax) and is presently valid until 2007, with a single rate of 0.38% (since 1999) now applicable generating annual revenue that has been stable at around 1.5% of GDP since 2002. Its base of incidence includes financial transactions and its system of levying is very simple: it is levied on any operation that is settled or any issue that is carried out, which represent the contractual or physical circulation of money, which result, or not in the transfer of ownership of such monies, credits or rights. Thus, the CPMF is applied to withdrawals, deposits and bank loans, as well as payment orders and transactions in the futures or stock markets. Exemption is given to transfers by a title holder to himself (e.g. an individual or company transferring money from one account in their name to another account in their name), government and charitable transactions, simplified accounts of low-income individuals and public share offerings.

3.4. Taxes on Goods and Services

The taxation of goods and services in the domestic market constitutes by far the most important tax block within the national tax burden: was equivalent to 18% of GDP in 2005, of which 15.8% was in the form of general type taxes. Of these, the equivalent of 9.2% of GDP came from value added taxes (thus defined constitutionally, although they leave a lot to be desired in practice), and 5.8% came from contributions on sales in general (part levied in the form of a non-cumulative regime since 2003).

The three tiers of government all exercise tax powers within this block, contrary to the principles initially drawn up in the reform of 1988. These had attempted to divide up the bases in such a way that goods in general and communications would only be levied the state tax (the ICMS), services would be levied the municipal tax (the ISS) and industrialized goods (almost in the form of a selective tax) would be levied the federal tax (the IPI). Social and economic contributions, however, had their bases, and later, their rates successively expanded and increased by central government and this allowed for an excessive increase in the federal and the total tax burden on all bases. In fact, today, contributions on revenues (such as the COFINS and the PIS) have a broader base and a more sector diversified collection than the traditional state ICMS tax.

3.4.1. Value Added Taxation

Brazil made a pioneering move, in 1965, when it replaced a state cumulative sales tax with a tax on the circulation of goods – the ICM (excluding fuels, electricity and minerals; items that were taken under the federal umbrella as a single levy tax), in which the charge was based on the value added, using however a system of physical credit[16] (maintained to this day) and a mixed system for apportioning the revenue from inter-state transactions. Under the same reform process, the central government was assigned a tax on industrialized products – the IPI (once again failing to cover the bases mentioned earlier), which was also levied on the value added but, in practice and over time, effectively became a selective federal tax, since the charges were concentrated on a limited tax base. An old municipal tax on professions was also replaced by a tax on services in general (the ISS), but it was charged cumulatively. The 1988 constitutional reform did not change the apportionment of the three taxation tiers, despite the already ample international experience of charging VAT on a national scale and familiarity with the problems, limitations and criticism of charging this tax in Brazil at the state level. The only step taken in 1988 was to do away with the selective federal taxes, including them instead within the state taxation base (as ICMS - Value-Added Tax on the Circulation of Goods and Services). This was done in such a way as to explicitly preclude the levying of federal IPI on such strategic inputs.

The ICMS is easily the greatest revenue earner among the nation’s taxes, yielding the equivalent of 8% of GDP, and has dominated attention during all the various attempts to institute tax reforms. In theory, state governments ought to observe the principles established in the Constitution (which addresses the issue in considerable detail) and the general regulations set down in complementary laws. However, this does not always occurs. Local governments resorted to a variety of creative expedients to get around the requirements, including fake loans and other credits, setting off an unprecedented fiscal war that has endured for more than a

[16] In the physical credit system, companies can only appropriate tax credits in a “competence basis” rather than in a cash basis which is the rule in all other value added tax system in the world. That is to say that in Brazil a firm that buys a new machine for its plant will only get the tax credit in 48 months, albeit an European firma would get the whole tax credit in the cash disbursement for the machine.

decade. The ICMS became, in practice, 27 different taxes, each with its own rules and rates, which vary considerably from state to state.

With regard to the rates, the first Brazilian anomaly is that the ICMS calculation base includes the tax itself. For inter-state transactions, it is set by the Federal Senate, which in 1989 created a dual system: the normal rate is 12%, but this drops to 7% on goods moving from the richer states to the poorer states (with the exception of fuels and electricity, where the distribution is constitutionally guaranteed). State law sets the nominal rates for internal transactions, the normal rate is 17% (in practice, the charge is 20.5% of the base value); two reduced rates are commonly used (set at 7% on goods that form part of the basket of staple goods and for low charge energy consumers, and at 12% on goods whose production is to be encouraged, such as automobiles and alcohol or diesel fuel), as well as two higher rates (set at 25% on fuels, electricity and communications and, occasionally, 35% for certain items considered superfluous, or weapons – equivalent to 33 and 53 percent, respectively, of the base value).

The Constitution assures that ICMS is to be non-cumulative and, since 1996, that it is not levied on exports; however, serious problems persist, for there is no safeguarding of the use of eventual accumulated credit balances; credits relating to the acquisition of capital goods can only be used over a period of four years; and those relating to consumer and durable goods are even today frequently undeclared. Even after the change, the states continued to tax exports, fully or in part, until they were stripped of this power by national law in 1996 (in exchange for compensatory transfers from the federal government); but up to this day, they resist and place barriers in the way of rebates of accumulated tax credit balances.[17] Once fiscal competition ceased to be a means of attracting productive investment to the smaller and poorer states and became a nationwide practice, together with the fact that dynamic activities such as services escaped this tax (and even municipal ISS, since the federal government took advantage of the lower taxation of the sector to increase its burden of contributions), the state administrations focused their efforts on raising the rates on strategic inputs and the output of oligopolies: 42% of the national ICMS revenue comes from oil and fuels, communications and electricity (19, 12 and 11%, respectively). The proportion is even higher, the less developed the state, where the rest of the ICMS revenue comes more and more from tax substitution and the advanced charging of inter-state revenues. At any rate, what was created as the most generalized domestic market tax

[17] The main legislative focus of this tax was on inter-state taxation: created originally as a purely at-source tax, it gradually transformed into a mixed tax, although it tends to be more beneficial to the state receiving the goods,

has been whittled down over the past ten years, taking on more and more the appearance of a selective or specific tax.[18]

The traditional federal value-added tax is the IPI, but the revenue generated is limited: just 1.2% of GDP and barely 3% of the overall tax burden, because the federal authorities largely ignored this tax after the 1988 reform raised the allocation of other tiers of government and regional funds to 57% (suffice it to say that the revenue was 3.5 times greater in 1968). In practice, it became a selective tax, and in this way met a principle established in the Constitution itself, which determines that its rates should take into account the essential degree of the product: hence, they were defined on a case by case basis, using a table divided into 21 sections and 97 sub-sections, and ranged from zero (for staple essential consumer goods) up to 42% on perfumes and 45% on snow or golf vehicles. On top of the sheer complexity of the tariff structure, the IPI is frequently used as a means for granting sectorial incentives (as in the recent case of the construction industry), since it doesn't involve much sacrifice, most of which is borne by the state and local government tiers. Never has the revenue from the IPI been so low, since its inception, and it is largely concentrated on just three superfluous items – automobiles, beverages and tobacco (one third of the total) and imports (accounting for a further 22%).

3.4.2. General Sales – Revenues Taxation

The taxing of revenues in general (not just on commercial, but on other types as well, such as financial income and even income from government work) is carried out by means of two social contributions charged by the central government: one is known as COFINS (Contribution for the Financing of Social Security); the other embraces two contributions (the Social Integration Program and the Public Service Employee Savings Program – PIS/Pasep), created in 1970 and, following the most recent constitutional reform, tied to the funding of unemployment benefit.

The COFINS raised the equivalent of 4.5% of GDP in 2005, making it the country's fourth largest source of tax revenue, behind the ICMS, income tax and payroll contributions to social welfare. It was raised to 3% of total revenue,[19] but special regimes were established, under which

above all in the less developed regions. As a result, the last constitutional reform included within its main body of text, a considerable quantity of detailing of rules.

[18] A good illustration of the depleting of the ICMS over time is to compare the 1968 tax burden with that of 2005: in that first year, the state ICM, without the major bases and with a general rate of 15 percent, accounted for 7.3 percent of a total of 8 percent of GDP, but fell to around 20 percent of the national tax burden, despite becoming the ICMS with the incorporation of fuels, power and communications, the significant rise in the general rate and the creation of special higher rates.

[19] COFINS is the tax that has grown the most, by far, since the 1988 reform – indeed, in that year, it yielded a mere 0.8% of GDP and the general rate was 0.5% of gross turnover.

financial institutions pay 4% of their net income from financial intermediation; large companies (which pay corporate income tax on their realized profit) pay 7.6% of the difference between what they sell and what they buy (known as the non-cumulative regime) and importers pay the same 7.6% at the moment of customs clearance (created following a constitutional amendment, in mid-2004, to give equal treatment to domestic and imported products).[20] Exports are not taxed and are granted specific exemptions and specific and varied treatment, according to specific cases (allowing large companies in certain sectors, for example, to avoid the non-cumulative regime).

I there was evident harm caused by the cumulative effect of the earlier COFINS system, aggravated by the excessively high rate of 3%, (see Varsano *et l.*, 2001) the recent changes have been mindful of the need to improve the quality of the taxation. However, they have brought fresh problems, such as a huge increase in the burden, resulting from the wilfully excessive level of the rate for the non-cumulative regime (the same change, effected a year before on the charging of PIS/PASEP, had clearly demonstrated the consequences of increasing the burden) and its retention even after the broadening of the calculation base by including imports, as well as the growing complexity. It should also be noted that, contributions were not converted into authentic non-cumulative taxes, because the companies within the non-cumulative regime buy from and sell to companies outside it – not to mention the special regimes; in effect, the COFINS and PIS have become a kind of distinctive bundle of indirect taxes. On the other hand, compared to the state ICMS, the COFINS at least has the advantage of being more productive, and applies national regulations and raises revenue in a more diversified fashion (for example, fuels, power and communications account for 22% of the total, 20 points less than in the case of the ICMS; moreover, services provided to companies and financial institutions, two bases not covered by ICMS, generate 12% of the total COFINS). Looking at it in another way, the COFINS will tend, in the future, to follow the country's indirect taxation reform agenda, taking over the former role of the ICMS, which has become less productive, more complex and heavily concentrated. As already mentioned, the second contribution levied on sales in general is the PIS/PASEP, which yields the equivalent of 1.1% of GDP and, for companies and financial institutions, adopts exactly the same levying arrangements as the COFINS, for the same contributors, but at much lower rates: 0.65% for companies under the cumulative regime and 1.65% under the non-cumulative regime. This contribution has one advantage over the COFINS: the contributor

[20] Special regimes were also created in order to impose tax substitution (as in the cases of cigarettes and vehicles) or even single levy tax regimes (for fuels and pharmaceuticals, among others) levied on certain specific activities – with rates ranging from 3.2% to 10.8%.

population is broader still, covering all legal entities, so that not-for-profit organizations also contribute, paying 1% of their payroll, while public administrations pay 1% of their current budget revenue. Another difference is with regard to the allocation: while the COFINS is of a general nature (financing social security as a whole), the PIS/PASEP is of a specific nature (for the workers' support fund, which covers unemployment benefit, an annual bonus and professional training, with a 40% reserve directed towards investment programs); in addition to a provisional constitutional ruling that set aside 20% for allocation by the central government (also applied to the other contributions).

3.4.3. Specific Taxation

The most important specific tax is that levied on services (the ISS) and has been exacted by the municipalities ever since the reform back in the 1960s. They have the autonomy to legislate, charge and inspect, but they can only levy against those services provided internally, that do not come within the sphere of the ICMS (inter-state communications and transport) and are specifically identified in a complementary national law (the last update occurred in 2003). To avoid the fiscal war that had been burgeoning, as the leading municipalities learned how to best exploit this tax, a constitutional amendment introduced a minimum rate (set at 2%) and prohibited the granting of tax incentives at a lower rate. Since each municipality can set its own rates, there is a broad and varied spectrum – the most common being 5%.

A federal tax (the IOF) is levied on credit, foreign exchange and insurance transactions and also those involving bonds or securities, the purpose of which is strictly regulatory (that is to say, its use is determined more by the guidelines of monetary, foreign exchange or credit policy than as simply a revenue source). It is true that, in 1990, it was utilized to effect the confiscation of 20% of national savings – under what was known as the Collor Plan.[21] Other specific duties (which are not taxes, as such) have also been introduced by the federal government since the late 1990s, to be levied on strategic inputs, such as fuels and communications, on the pretext of financing infrastructure investments in the respective areas. In practice, there was a reversal of all the original endeavours by the members of the Constitutional Assembly to do away with the

[21] The regulations are diverse and complex, with many exemptions and reduced rates: the maximum general rates are presently 1.5 percent per day, in the case of bond or security operations (but with a zero rate for 23 types of credit operation), and 25 percent on exchange operations (but falling to zero in the case of contracts stemming from the exporting of goods and services or the importing of services, among others); in the case of gold purchases, the rate is 1 (one) percent, based rather unusually on the text of the constitution (since revenue from this specific source pertains in its entirety to the government of the state and municipalities where the gold is produced, to compensate for the fact that no ICMS is charged on gold).

old single levy taxes on such inputs (which were initially included in the base of the general contributions, COFINS and PIS, and were also later to have other taxes, contributions and even disguised charges levied on them, often as a result of constitutional amendments) and reserve such bases for state ICMS or municipal ISS (which had been left behind during the building up of the overall tax burden, despite their rates having been raised substantially every time it was felt that the federal government was about to encroach upon these tax bases). The most significant example is the Contribution on Intervention within the Economic Domain (CIDE), charged by the federal government since 2001 on imports and the commercialization of oil and oil products, natural gas and fuel alcohol, at specific rates, yielding the equivalent of 0.4% of GDP.[22]

One source that is always surrounded by controversy, as to whether it should or should not be classified as a tax, is that of royalties and other forms of stake holding in the revenues and results from the production of oil, gas and electricity and the extraction of minerals. The aggregate revenue is sizeable: equivalent to 0.8% of GDP in 2005 (but it could even exceed 1%, given the relative growth of the GDP and oil prices, which accounts for the greater part of the revenue).

There is a wide range of other small forms of specific taxation of goods and services, or their use, or the permission to perform certain activities, which are always linked to actions or services of collective or individual interest.

3.5. Taxes on Foreign Trade

The federal import tax (II) currently yields the equivalent of 0.5% of GDP, which does not constitute a significant revenue inflow, despite the commercial opening up of the economy promoted since 1990; this is largely a reflection of the structure and regional trade accords. Thus, rates are defined within the sphere of the Mercosur trade bloc, comprising the TEC (Common External Tariff), with a minimum rate of zero and a maximum rate of 35% – that is to say, full members tax the same products at a unified rate and these products circulate freely within the trading bloc. Until 2008, each country may retain a list of exceptions, of up to 100 products, taxed at different rates to the TEC, and half yearly reviews may be conducted (allowing the changing of up to 20% of the items on the list). By definition, the tariff structure should have a low spread and a small number of different rates.

[22] A similar case is that of telecoms services, which contribute at the rate of 1% of operating revenue to the fund for universal telecom service coverage and at the rate of 0.5% to other fund to finance the operations of the sector's regulatory agency. The most peculiar feature of these revenues is that the lesser part actually goes towards those investments for which they were created – the greater part is put aside as a disguised indirect means of increasing the federal government's primary budget surplus.

The federal tax on exports, meanwhile, has a basic rate of 30%, and the government has the authority to reduce it or increase it by up to 150%, for foreign exchange or foreign trade policy purposes or to regulate supply. However, it is rarely charged and the revenue is negligible.

3.6. Payroll Social Contributions

The manuals and international experience define social contributions as those levied upon the payroll, generally being due from both the employer and the employees, and used to finance benefits and other forms of social support. In Brazil, the category social contribution, in legal terms, includes other calculation bases. However, in accordance with the methodology of the IMF, we will deal here with just the traditional contribution format: in line with the pattern of the wealthier countries, in 2005 they represented an important portion of the overall tax burden (22%), yielding the equivalent of 8.6% of GDP, of which 5.6 points was channeled into the general welfare regime and 3 percentage points went to the specific regimes of the public employees and the establishment of a worker's compulsory savings scheme. The size of these revenues would appear to reflect the imposing of an extremely heavy aggregate burden on the payroll, in excess of the norm for the majority of emerging economies and close to the total burden imposed in the European countries that give the greatest priority to the welfare state.

3.6.1 General Welfare Contributions

Of the total amount paid into social security, 44% comes from employers' contributions (companies pay a 20%rate and financial institutions 22.5% of the payroll, with no ceiling for the amount of the contribution) and 18% from wage earners (rates vary from 7.65% up to 11% of monthly earnings, on a progressive scale, but with a ceiling of one contribution salary (which is also the ceiling for normal retirement benefit) – currently set at US$ 1,300 a month.

This system means that the charges on higher incomes are proportionally much higher for the employer than for the employee, thus discouraging the formal hiring of higher income employees and frequently stimulating the dismissal of such employees, for subsequent re-engagement as service providers, either as private enterprises or as self-employed professionals (nevertheless, this last segment represents less than 4% of the total revenue collected). Attention is drawn to the fact that around one third of the social security revenue comes from sources other than the above-mentioned standard contributions – among which are the contributions of the owners of micro and small businesses under the 'Simples' regime, whereby a rate is paid on the company's turnover; amounts retained at source by the hirers of services provided by third parties (20% of the amount paid to individual workers and 15% in the case of cooperatives); and amounts retained at source against transfers of federal taxes to the majority of state and municipal governments that had not paid in their social security contributions in the past.

It should be pointed out that this general welfare regime applies to workers with signed work papers, the vast majority being in the private sector plus a few public employees (in the rare cases of local governments that haven't organized a specific regime for them). Rural workers and self-employed professionals get differentiated treatment: with the former, the employer contributes at the rate of 2% of the gross income from the sale of his/her rural products, and workers can retire on a pension of one minimum wage (if they wish to receive more, they can contribute at a rate of 20% of the desired amount, up to a ceiling); in the case of the self-employed, they must pay a higher rate (20%) than wage earners, and this encourages a large proportion of this segment to remain outside the state system.

3.6.2. Other Social Contributions

Another social contribution levied on the payroll and due only from the employer (at a rate of 8%) is the FGTS (Length of Service Indemnity Fund), which brings in the equivalent of 1.8% of GDP, but is of a quasi-fiscal nature: although it is set down in law, its revenue is not included in the public budgets, because it is credited on a monthly basis to the individual accounts of the workers, held at an official lending institution.[23] The majority of the governments have organized their own social security regimes for their public employees (known as the RPPS), but an adequate actuarial assessment has never been performed and the charging of contributions from those covered was only normalized following the constitutional reform approved towards the end of 2003. It is estimated that the contributions, including the employer's portion, yield the equivalent of 1.2% of GDP. In the case of the federal government, active public employees contribute at a rate of 11% – inactive employees also contribute, under special conditions. The lower tiers of government have the freedom to introduce different rates for their own regimes, just as long as these are not inferior to that adopted for the federal regime.

[23] This was introduced in 1966, as a kind of reserve fund, to be drawn down in the event of the worker being dismissed without just cause: in which case the employer would have to pay an additional fine, equivalent to 40% of the balance of the worker's FGTS account, as a way of discouraging a high labor turnover.

3. Other Issues

It might also be worthwhile to address two further issues in order to develop a broader awareness of all the aspects of the Brazilian pattern of taxation: the most recent issues that affect fiscal federalism, fundamental to a full understanding of tax reform; and the taxation system's regressive nature, whose effects are as harmful as they are unknown in domestic literature.

4.1. Dilemmas of Federalism

It is a mistake, commonly made by analysts, to think that the federation is a great hindrance to reform, as if the federative allocation of tax revenues had remained constant since the implementation of the system determined by the 1988 Constitution. In recent years, the Federation has ceased to be a thorn in the side of the so-called economic order, to the point that it has become a factor contributing to the success of short-term macroeconomic policy (at least in terms of managing the debt and surplus targets). However, there is still a long list of issues that need to be faced by the Brazilian Federation over the coming years, including a gradual recentralization of tax control.

In the last few years, important changes have been made in the pattern of financing and public spending, with increasing influence of the central government. Recent taxation measures have taken to the extreme the option of raising unshared contributions, while focusing the granting of benefits on those taxes that are shared with the states and municipalities, thereby throwing the federative structure into disorder (Table 2).[24] Seen from a longer perspective, after four decades, the municipalities have assumed the position of the states as the dynamic force of Brazilian federalism, judging by the changes in the federative allocation of the available taxation revenues. The state governments have had 10 percentage points cut from their share – which fell from 35% of total revenues in 1965, prior to the reform carried out by the military government, to around 25% forty years later. The municipal governments, meanwhile, have seen their share grow from 10% to 17% of the overall revenues. An area in which little or no progress has been made is that of the so-called fiscal war between the states, conducted by manipulating their respective ICMS rates and the granting of benefits (especially the refunding of that portion of the tax that was due to other states) disguised as subsidized loans and even shareholdings. The

[24] Between 2002 and 2005, the overall taxation burden increased by the equivalent of 2.3 percentage points of GDP: state ICMS accounted for 12 percent of this rise, but the effect of the increase in the federal contributions on sales (PIS/COFINS) was three times greater. The allocation of the revenue (after constitutional transfers) shows a significant increase in the federal share, which in the last five years has grown by 1.8 percentage points, from 55.8 percent to 57.6 percent of the total taxation revenue (Table 2).

principal effect has been to reduce the overall effectively available state revenue, and to increase the fiscal pressure of these government tiers on the central government, as well as diluting the historical tendency towards regional economic decentralization. The recent case of the automobile assembly plants is a typical example: given the generalized concession of incentives, the most developed states ended up making the most of their obvious advantages – market location and better economic and social infrastructure, in comparison with the less developed ones. The implications of the ICMS war extend beyond the fiscal sphere, as it has a lot to do with the direction of the industrial and foreign trade policies, essential to a stable upturn in economic growth. In a more open economy, there is less solidarity and more variation in interests and outlooks between the more and less developed regions, especially in terms of trade and industrial policy.

4.2. Taxation Regressiveness

One particularly weighty consideration in the analysis of taxation is the question of its distribution according to the different population strata, but in Brazil this rarely gets much attention in political and technical debate. Recent data reveals one awful aspect of the sheer size and recent increase in the taxation burden in terms of a large and growing level of regressiveness. As has already been mentioned, the taxation burden is largely based on the indirect levying of taxes. This is true even in the case of social contributions, whose effects are possibly even more harmful than those of the taxes.

However progressive may be the levying of taxes on income and assets, the impact is very small in comparison with the enormous weight of the indirect taxes. Studies (FECOMERCIO, 2006) show a direct and continuous relationship between family or household income and the impact on it of indirect taxes: it is estimated that the average burden on a family in the lowest decile, with average monthly income of less than 2 minimum wages, is three times that on those in the highest decile, with a monthly income of more than 30 minimum wages (Table 4). The same estimate shows that the recent increase in the burden, being more strongly backed by indirect taxes than by direct ones, means that this increase proportionally affects the lower income families more.

Table 4 – Impact of Taxation on Total Household Income: 1996 and 2004

Monthly Household Income	In % of the Household Income						Tax Burden Addition (in percentage points)
	Direct Taxes		Indirect Taxes		Global Tax Burden		
	1996	2004	1996	2004	1996	2004	
Up to 2 MW	1,7	3,1	26,5	45,8	28,2	48,9	20,6
2 to 3	2,6	3,5	20,0	34,5	22,6	38,0	15,4
3 to 5	3,1	3,7	16,3	30,2	19,4	33,9	14,5
5 to 6	4,0	4,1	14,0	27,9	18,0	32,0	14,0
6 to 8	4,2	5,2	13,8	26,5	18,0	31,7	13,7
8 to 10	4,1	5,9	12,0	25,7	16,1	31,6	15,6
10 to 15	4,6	6,8	10,5	23,7	15,1	30,5	15,4
15 to 20	5,5	6,9	9,4	21,6	14,9	28,5	13,5
20 to 30	5,7	8,6	9,1	20,1	14,8	28,7	13,9
over 30	10,6	9,9	7,3	16,4	17,9	26,3	8,4

Elaboration: (Zockun, 2006). Primary Sources: POF/IBGE; Viana et. Alii (2000)

MW = Minimun Wage

4. Tax Reform

For years, tax reform has been on the agenda for national political and economic debate, so it is appropriate to provide a personal opinion as to the reasons behind the failure of so many projects and why such an overhaul is becoming ever more necessary.

5.1. Disruptive Adjustment

Fiscal discipline has never been a simple consensual issue in Brazilian history, which has thrown up examples of moratoria: international, in the case of the central government, but also by the lower tiers of government. Concern over the matter, which was ignored by the 1988 reform, only came to the surface with the introduction of the Real Plan: the diagnosis was that inflation masked a structural public account deficit and that, as long as no long-term reforms were put forward and implemented, it would be necessary to effect a provisional fiscal adjustment. This adjustment would involve a temporary increase in the burden of taxation, particularly through social contributions, and the creation of a mechanism for unlinking these revenues, so that additional sums from these same contributions could be utilized for other purposes. Despite being introduced as temporary constitutional rules, their validity has been successively extended and they will continue to be in force until 2007.

At the heart of the concept of fiscal adjustment as a necessary evil are two structural issues that date back to the constitutional reform of 1988: the need to cater for the expansion of social security and, at the same time, try to reduce or even partially reverse the decentralization of taxation. To begin with, federal spending was affected by the increase in pension benefits, within the general regime and also for its own public employees (and much more recently, in welfare benefits), to which it responded by increasing the contributions. Next, the federal accounts, which had been under pressure since the creation of the Real Plan, due to the growing cost of public debt brought about by the extremely high real interest rates, began to require ever greater primary surpluses, following the eruption of the external crisis of 1998. This also led to an increase in the tax burden, although of a different nature and without depending on the unlinking of the federal revenues – now, the sources originally linked to social security were beginning to generate surpluses that were used to finance the burgeoning fiscal spending, not only on retired public employees, but on servicing the public debt. In practical terms, the consequences have been the opposite of those originally intended: a vicious circle has been created, wherein the very emergency measures themselves have led to a relaxing of the federal authorities' efforts and the delaying of the restructuring of public spending; in other words, the measures focused on the continuous increase of the tax burden have ended up provoking imbalance and got stuck in a cycle whereby the adjustment causes maladjustment.

5.2. Reform Proposals and the Reasons for their Failure

The 1988 constitutional reform had been in effect for just a few years when projects to change the taxation system started to appear, advocated in large part by segments close to the taxpayers who were given little elbow room in the Constitutional debates, which, as mentioned before, had focused attention on the federative issue. Among others, one that gained considerable attention was an unusual project with popular appeal that proposed replacing all the taxes with a single tax on financial transfers. The idea was so strongly defended that the federal government ended up proposing and approving the creation of a provisional tax of this kind, which was introduced only in 1994; later, it was to be reintroduced as a contribution to finance health spending (CPMF), also on a provisional basis.

The first important project for reforming the taxation system, proposed by the federal government in 1995, explicitly rejected the idea of promoting the recentralization of revenues. The main objective was to consolidate the national VAT legislation, thwart a fiscal war and create a federal tax that was identical to the state one (same base, justification and legislation), as well as to unify the present social contributions and replace their base, levied on the total sales turnover, with value added, with a view to eliminating its negative impact on the economy's competitiveness. With the prospect of establishing a VAT model with collection shared between the federal government and state governments, the simultaneous application of two rates was provided for, permitting the introduction of the principle of destination in inter-state transactions. This would avoid the evasion stemming from the mere elimination of the charge on the shipping of goods to other states, as well as stopping the predatory fiscal war between Brazilian states. The core of the proposal developed in Brazil, based on what was termed Dual VAT, was to be an ICMS that would be shared between the federal and state governments: it became known as the *little boat model*, due to the innovative treatment proposed for inter-state transactions – according to Varsano (1999).

However, the best opportunity in recent years to push through a sweeping revision of the country's taxes was wasted, because the federal government was afraid of jeopardizing its short-term fiscal efforts, aimed at mitigating the severe external crisis. The government had introduced a program of fiscal stabilization that, in reality, was founded on a sharp and rapid increase in the overall burden of taxation, especially through contributions on turnover, profits and financial transfers that would be altered, merged or eliminated in the reform that was before Congress.[25] The fear of assuming very short-term risks led to the abandonment of the process, on the only occasion that an agreement had been reached to introduce changes in the taxation that were authentically structural and long term – (Dain, 2005). A short time afterwards, alleging once again the lack of tax reform, the government sought and gained approval for the extension of the unlinking of revenues (DRU) and the provisional taxation of bank account transfers contribution (CPMF).

In 2003, the new President of the Republic of Brazil also presented a reform project to Congress, which, essentially, had the same long term objectives. This time, state governors were mobilized, amid much fanfare and it appeared that tax reform would be pushed through, but the proposed constitutional amendment to reform the state ICMS, so as to nationalize the legislation and standardize the rates, was not approved and until today is circulating within the House of Representatives. The same fear of losing control over the short-term adjustments was seen again in 2003, despite the change in government and arguments. In truth, the project only touched, and

[25] In 1999/2000, the federal authorities broke off the agreement that had been made in the House of Representatives, as well as with the state and municipal authorities, regarding what was known as the Mussa Demes amendment, despite the fact that it would bring about an undeniable and deep rooted improvement in the system of taxation and that its implementation would be gradual and the effects only felt in the long term. The federal government feared that this reform would hinder or even cancel out the endeavors it was making in the very short term.

even then only partially modified, the ICMS, but even so it did not get through. Yet again, what was necessary to a more immediate fiscal adjustment was passed unanimously – the extension of the CPMF and DRU, though in enlarged form (the DRU was extended to cover economic contributions and the CPMF rate was constitutionalized) and supplemented by other measures that would lead to a further increase in the tax burden (notably, the contributions on turnover were extended to cover imports). The only consolation is that, during this post-constitution period, though there has been no change in the constitutional framework, significant changes have been made in the supplementary legislation, especially once the economy had stabilized. Following important modifications, such as doing away with monetary correction on company balance sheets and the creation of a simplified system of federal taxation on micro and small businesses (the "Simples"), the federal government supported the changes in the state ICMS forwarded by the Kandir Law and the social contributions on sales (the PIS and, later, the COFINS).

From a federative viewpoint, the measure that had the most direct impact was established by the Kandir Law, a supplementary law of September 1996, which eliminated the direct imposition of ICMS on all exports, including those of primary and semi-prepared manufactured products. The states only agreed to surrender their power to tax exports in return for financial support from the federal government, agreed at the time as a transitory system (for a maximum of twelve years), in the form of a revenue guarantee (with resources passed on only to those states that suffered a reduction in their revenues, and proportional to that loss); this was subsequently converted into a federal transfer (about US$ 2 billion a year), with predetermined apportionment, in the nature of compensation. The Kandir Law has however ended up generating two on-going causes of friction that impair federative relations and economic competitiveness. On the one hand, the transfers are subject to annual renegotiation, during the process of approving the federal budget, because there are no clear principles to govern the determining of the overall amount to be transferred, nor adequate criteria for the distribution of the resources among the neediest states. On the other hand, the fact that exoneration is not automatic (no transfers to third parties or cash indemnification) has meant that, depending on the state authority in question, exporters can accumulate large ICMS credit balances, in contravention of the spirit of that law and even of the Constitution itself (since a partial reform, in 2003, elevated the principle previously declared in the Kandir Law to the Constitutional level). What is more, it has disseminated among state governments the idea that exporting is bad, as it generates no revenues but nevertheless generates expenses: some governors not only hold up or refuse the repayment of credits, but sometimes also resist the granting of incentives and infrastructural support to new projects aimed largely at foreign markets.

5.3. The Need for More Widespread Reform

The Brazilian tax system has become a singular case: it is the only one in the world in which revenues from contributions exceed those from taxes, because it is the only one in which contributions are not levied exclusively on payrolls. According to the law, we have two systems of taxation. In fact, there is a single system in which the contribution is simply a legal short cut to enable the compulsory extraction of resources from society in a manner that is much quicker and easier than the traditional form of taxation. The prolonged use of a strategy for short-term fiscal adjustment based on raising the burden of taxation has hindered economic growth. It is important to make clear that this is not a case of arguing that a high tax burden is, in itself, something that slows down the economy – indeed, if this were the case, then countries of western Europe would not have grown, and would not still be growing. Nevertheless, it cannot be denied that the tax burden became a problem in Brazil as from the second half of the 1990s, breaking with the historical post-war tradition whereby the burden of taxation would rise during the upside of the economic cycle (when the expansion of revenues tended to exceed the rate of GDP growth) and would remain stable during the downside. Despite some oscillations, the economy has grown rather slowly since the introduction of the Real (about 2.2% a year, on average), while at the same time, the average annual growth of national taxation revenues has been close to three times that figure. In such a peculiar scenario, it is inevitable to suppose that taxation has been an important factor in slowing down or braking economic growth, particularly when the taxing of exports has been retained and the charges on capital goods have been increased.

It is time to abandon the strategy of conducting tax reform through a process of gradual change and minimalist projects and face up to the basic issues, which point towards discussion and changes in social security (including addressing the thorny question of pensions) and in the federation itself (whose spending is also on the table for discussion). It is in the area of taxation that the most concrete and effective steps can be taken to curb the growth of public spending and, if such be the case, to initiate a reduction. Restricting the use of provisional measures (temporary laws) in dealing with taxation issues (limited, in exceptional circumstances, to handling the few regulatory taxes), giving the same treatment to contributions and other types of charges as that given to taxes, and beginning the gradual depletion of the CPMF and the DRU,

are the shortest routes to, first of all, slowing down the propagation of spending, and secondly, if possible, starting to reduce it.[26] It is undeniable that the weight of the tax burden has been defined by the amount of spending, but it does not mean that that is the cause. Ever since it became easier, as well as seductive, to create and inflate unshared federal taxes (since the two transitory regulations mentioned earlier came into effect), public spending in Brazil started to grow – and not only pulled up by the increase in taxes and the cost of servicing the public debt.
For this reason, the unlinking of revenues has never been a solution for controlling spending, and as it has changed over the last few years, it has even induced an increase in spending. Budgetary rigidity is merely a symptom of the disease, not the cause of the infection, the origin of uncontrolled spending and finances. It is necessary therefore to reverse the trend, making it harder to increase and use tax revenues, in order to force a review of the pattern of spending.

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[26] Not to mention the CPMF trap, which means that, when real interest rates are finally reduced to a sensible level (the bank rate is presently 6 times the average level for emerging economies), the current rate of 0.38% on bank transfers will discourage financial intermediation, in addition to the other problems associated with this type of charge (Campodonico, 2006).

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3. CHILE UPDATED

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Abstract
This paper is part of a wider research on “Tax Systems and Tax Reforms in Latin America”, carried on at the Department of Public economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. The aim of the paper is to describe and to discuss the Chilean tax system, with reference to its historical development, its present structure and the changes which are now at the centre of the political debate. In this way we want to present an overall picture of the results achieved by Chile in taxation, also in comparison with other countries both of the Latin America and of other world economic areas. From a historical point of view, the Chilean tax system was the outcome of two main laws, passed in 1974 and in 1990, respectively, which are evaluated by going into their details. In particular, it is underlined how these laws were affected by the different political environments inside which they were adopted. The paper then presents the current structure of the Chilean tax system. The main taxes are considered with reference to their institutional features and to their contribution to the total revenue. Particular attention is devoted to the distribution of the fiscal burden, especially though a deep analysis of the implicit rates. The Chilean tax structure is then compared with the tax systems of other countries of the Latin America and of the OECD. This comparison shows the somewhat mixed nature of the Chilean tax system. Some features are similar to those that characterize the most advanced systems, like those of the OECD countries. However, other features are still subject to limitations in the administrative capacity and to severe political constraints. The comparison shows also that Chile fared better than its neighbours in generating public revenue as well as in managing these latter, reaching a macroeconomic stabilisation that is still far from accomplished in the area. The paper ends by discussing the main current topics of political debate concerning the Chilean tax system, especially with reference to the last years reforms and to the programs under way.

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1. Introduction and contents

Stretching from the Antarctic region to the 18th parallel and covering 756,950 squared kilometres, Chile is the seventh largest country in Latin America. It is populated by 16 million people with a high degree of ethnic homogeneity, given that 95% of the population is of "White or White-Amerindian" parentage. With 4408 USD of pro capita GDP, it is the richest country in the region, excluding Trinidad & Tobago and other small-sized countries of the Caribbean. After the PPP adjustment, the above figure reaches 11200 USD, making Chile the second richest Latin American country after Argentina. The same ranking emerges from the Human Development Index. The distribution of such income is extremely uneven: the Gini index is 0.571 while the ratio of the income accrued by the 20% richest part of the population to that accrued by the poorest 20% is 18.7. Such high values are not exceptional within Latin America. However, they are exceptionally high on a global level. Only a handful of African countries present higher values. Chile is thus one of the most uneven countries on the planet. From the sectoral distribution of the GDP (primary 9%, secondary 34%, tertiary 57%) one can see that Chile stands in the middle between rural pre-industrial countries with dominating primary sectors and post-industrial ones where services typically account for more than 60% of the GDP while the primary sector is below 3%.

This paper analyses the most significant features of the Chilean taxation system. The analysis is organized as follows: the second section sketches the history of the taxation system and investigates the recent evolution of the government budget. The third section looks at the present structure of the system from an institutional point of view. The main taxes are described. The fourth section analyses the effect of taxation on Chileans' income distribution via the computation of effective tax rates. The fifth section is concerned with the last interventions and with the current debate on taxation matters. The sixth section concludes.

2. A general overview of the Chilean tax system and its development

2.1 An initial overview of its economic, budgetary and expenditure features

On the wave of booming copper prices, of which Chile is the world's first producer, the general[1] government's (preliminary) net lending reached 4.9% of the GDP in 2005. A year before this figure reached 2.1%. It was a return to the norm, after the 1998-2003 period of net borrowing. In the last fifteen years the fiscal authorities have indeed pursued a policy of tight discipline. The primary result turned negative in 1999 only, when the economy suffered a -1.1% growth as a consequence of the drop in copper prices and the financial turmoil caused by the East Asian and Russian crises. In 2002, the second worst year, the government balance nearly broke even, standing at –0.1% of GDP. Again, low copper prices and extraordinary macroeconomic shocks (the Argentinean crisis) were the causes behind this negative result. Apart from these two years, Chile generated substantial superavits, and used those to reduce its debt from 47.3% to 7.5% of the GDP (see Table 1).

Disaggregating the 2004 total government revenues highlights three main sources: taxes (18.8% of GDP), copper (3.8% of GDP) and social contributions (1.4% of GDP). The copper industry, still partly in public hands after the nationalization by the Allende administration, is the second biggest contributor to government revenues after taxes. A look at Table 1 shows that, while revenues from taxes and social contributions remained fairly stable since 1990, yields from copper were the main cause of the shifts in government borrowing. Social security contributions represent a secondary source of revenues: an unsurprising fact, considering that all but the police's and the armed forces' pensions funds are managed by the private sector. Other headings are of negligible size and have been therefore omitted in the table.

Turning to the expenditures, the bulk of those are made up by three headings: public employment (5.3% of GDP), subsidies and donations (4.6% of GDP) and social security (4.8% of GDP). Regarding the latter, it is worth highlighting the unbalance between social security contributions and expenditures that characterizes the entire period under investigation. This "social security deficit", roughly 3 to 4% of GDP a year, is generated by the costs of transition from a Pay As You Go (PAYG)

[1] Figures for the central government are almost identical (2.2%), which is not surprising since local taxes are negligible in Chile. The fiscal system is highly centralized.

scheme to a Fully Funded (FF) scheme, such as the one introduced in 1981. While contributions were transferred to the new privately owned pension managers, the costs of the old PAYG system kept and keeps weighing on public finances. These costs are mainly the pensions still paid to workers who retired before or after the reform under the PAYG scheme[2], the benefits gained by workers that contributed to the old PAYG system and then shifted to the FF one[3], and lastly, the PAYG scheme still granted to the police and the armed forces (for a detailed analysis of the transition costs, see Arenas de Mesa 2000). To this issue a paragraph is dedicated to it at the end of this paper.

TABLE 1 HERE

2.2 The tax system from the 1990s onwards compared with those of the other Latin American countries

Total fiscal revenues reached a level of 17.1% of GDP in 2004 (last official datum available, see Table 2). Disaggregating the latter gives insight into the contribution of each tax to the bulk of revenues.

TABLE 2 HERE

The last column of the table shows the revenue of each item as the percentage of total fiscal revenues excluding SSC for the year 2004. It is evident from this that indirect taxation dominates direct one: the former accounted for 65.5% of total fiscal revenues whereas the latter for 34.5%. Income taxation yields 4.3% of GDP, equal to 24.4% of total fiscal revenues or approximately two-thirds of direct taxation revenues. The corporate income tax, yielding an amount almost triple that of personal income taxation, is the main source of direct taxation revenues. Second comes the tax on wealth, which contributed a 2.1% of GDP, or 11.93% of total fiscal revenues. Personal income taxation is a minor source of fiscal revenues (6.25% of those). Indirect taxation is based on the VAT. This is the highest yielding tax in Chile,

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2 Workers contributing at the moment of the reform were guaranteed the right to choose between the PAYG and FF scheme.

3 These benefits are paid to the worker via the “Bono de Reconocimiento” (last row in Table 2.1) at the moment of transferral to the FF scheme.

accounting for 8.1 GDP percentage points, 46% of total fiscal revenues and 72.32% of indirect taxation revenues. The remaining 28% is made up mainly by excise duties on tobacco, alcohol and fuels. Import duties and local taxes are all of negligible importance.

Developments of the system from 1970

As highlighted by Bulmer-Thomas (2003), since independence the main source of finance for Latin American governments' had been the taxation of international transactions. This situation, shared by Chile as well, changed abruptly in the following of the first world war: the worldwide recession, together with the drop in prices of Chile's main exports, nitrate and copper, caused a fall in the government's revenues. This rendered a system of internal taxation necessary for the survival of the state (SII 2006a). The process of creating an internal taxation system reached its final step in 1972 when the General Directorate of Internal Revenue is established. This structure then became the Servicio de Impuestos Internos (SII), which is up to now in charge of the administration of the taxation system. Two years later, in 1974, the laws 824 and 825 are passed. These substituted the obsolete system based on the taxation of international transactions with a modern one, based on income and consumption taxation, effectively laying the basis of the system that lasts until today. The system introduced in 1974 was based on five pillars, a corporate tax on all incomes coming from businesses, a unified and progressive scheme of personal income taxation for residents, a flat rate tax on incomes accruing to the non-resident, a general tax on consumption and a set of excises, the most important of whose on tobacco, alcohol and fuel. The current system reflects closely the structure it had back in 1974. Indeed, it has been left virtually untouched since. The only major intervention was the 1990 reform, implemented in concomitance with the return to democracy. In the delicate moment of the transition, it was crucial for the political class to ensure popular support to the frail Chilean democracy. For this reasons, tackling the social problems left by the military rule was vital. The 1990 reform thus aimed at generating the revenues necessary to finance an ambitious program of welfare expansion. The declared target was to increase government fiscal revenues by 3% of the GDP between 1991 and 1993 (see Boylan 1996 for a detailed description of the reform). This was pursued with a quadripartite intervention: an increase in the lowest business tax rate from 10% to 15%, a shift from estimated to actual profits as the base of the above tax for the highest contributors, an increase in personal taxation rates for middle and high-earners (obtained via a widening towards the bottom of higher brackets), an increase in the VAT rate from 16% to 18%. As can be seen in Table 2, the reform accomplished its mission, raising total fiscal revenues of 24.2% from 15.7% to 19.5% of GDP across the 1990-1993 period. Revenues from direct taxation increased by 46%, mainly as a consequence of the sharp increase in business taxation. The latter's yield raised from 1.8% to 3.2% of GDP, a 77% increase. The effects on personal income taxation were instead small. The yield from this increased by around 57%, but considering its very low starting level, the change remains small in absolute terms. Personal income taxation remained exceptionally low in Chile. In the same period, indirect taxation's yield increased by 16.4%, rising from 11.6% to 13.5% of GDP. The first impression is that indirect taxation was subject to a much smaller increase than direct taxation. However, this is not true in terms of GDP percentage: both indirect and direct taxation revenues increased by 1.9 GDP points. Unaffected by the 1990 reform, social contributions' yields remained stable at previous levels.

In 1993 the reform reached its full implementation. The effects of the VAT and business taxation increases had unfolded and the fiscal pressure reached its peak. In the following years these were partly offset by the massive drop in revenues from import duties and other forms of international transactions taxation. In 1993 trade-related revenues equalled 2.3% of GDP. The same figure dropped to 0.4% eleven years later, representing an 82% decrease. Tanzi (2000) shows that the effective tax on Chilean imports, computed as the ratio between revenues from import duties and total value of imports, followed a similar path, dropping from 16.7 to 5.8 in the period 1985-2000, a 65% reduction. The abandonment of the import-substitution model of development and the liberalization of foreign trade determined this drop. Revenue losses from trade liberalization offset the increase generated by the VAT, bringing indirect taxation yields back to pre-reform levels. Fiscal pressure declined and stabilized itself around 18% of the GDP, excluding social contributions. Direct taxation remained instead at higher levels than before the reform. As a consequence, the weight of direct taxation revenues relative to indirect taxation ones increased slightly. In 1990 these generated respectively 26% and 74% of total revenues excluding social contributions, whereas in 2004 the two figures were, respectively, 34.5% and 65.5%.

Since the mid-80s, a remarkable similarity of interventions took place across the Latin American region. With the consolidation of the so-called Washington Consensus[4], the efficiency of tax systems remained high in the agenda of governments in the area. In this light, Latin American countries maintained their attention on reducing the most distortionary elements of their taxation systems as well as simplifying their structure. With this goal, the top rates of personal income taxes were strongly reduced. In 1986, the Latin American average top-rate was 49.5. In 2004 this figure dropped to 28.8 (see Sabaini 2005). Chile followed a similar path, reducing its top-rate from 50% to 45%, 43% and finally 40% in 1997, 2002 and 2003, respectively (see Table 3).

TABLE 3 HERE

A similar phenomenon took place regarding the corporate income tax (CIT): in 1986 all Latin American countries but Colombia had different CIT rates according to the sector of business activity. Since then, Argentina, Brazil, Chile and Mexico among others have introduced a flat CIT. A reduction in the rate accompanied this simplification: the flat CIT rate is often closer to the bottom than to the top rate applied in the early nineties. In Chile, CIT rates were in the range between 10% and 37% in 1986. In 1999 this multi-rate scheme was substituted with a unified rate applied to profits from any sector of activity, currently at 17%. One pillar of the Washington Consensus paradigm was the liberalization of trade and the shift towards the latter as the engine of development. It is then unsurprising that the most notable effect on taxation of this new trend is the reduction of taxes on international transactions. Exports taxes, widely spread in the region at the beginning of the 90's, are negligible now. Similarly, import duties have been substantially reduced due to the signing of various free-trade agreements within Latin American countries as well as between these latter and countries external to the region (e.g. the NAFTA). The notable loss in trade-related revenues, together with the unification and reduction of income tax rates without a widening in its bases, reduced overall tax revenues. To fill

[4]a term that should to be handled with care, see Naim (1999).

this gap, all Latin American governments relied heavily on the VAT: higher rates were introduced and fewer exemptions were allowed. As noticed by Baunsgaard and Keen (2005), various developing countries did not manage to recover from other sources the revenues they lost from trade liberalization. This, however, does not seem to be Chile's case. Looking back at Table 2, one can see that the loss in revenues from trade was almost fully covered by the increase in VAT yields, leaving the level of indirect taxation revenues only slightly reduced from 1990.

3. Some quantitative and institutional features of main taxes

The Chilean constitution imposes taxes not to have a predetermined target. Tax revenues are allocated year by year with the Ley de Presupuesto (Budget Law). It follows that social contributions, defined as those contributions intended to cover welfare costs, are non-existent[5]. The costs of education, health and welfare in general are covered with revenues from direct or indirect taxation, as is the rest of government expenditure. The Chilean taxation system is then based on direct and indirect taxation only, with a few high-yielding headings generating the bulk of the revenues. The high degree of the Chilean republic's political centralization is mirrored in its taxation structure. Local authorities have very little power to levy taxes, while regional authorities have no such power at all. In terms of revenues, the central government virtually corresponds to the general government, the discrepancy between the two revenue levels being relatively small (1.6% of GDP in 2003, equivalent to 9% of general government's revenues). The above considerations all suggest that Chile has a fairly simple taxation system, similar to those diffused in most Latin American as well as OECD countries. An introductory description of this structure follows[6].

TABLE 4 HERE

[5] Since 1981, 10% of worker monthly wages are withheld by the employer and paid to the private pension funds (Administradoras de Fondos de Pensiones, AFP). Strictly speaking, there are therefore social contributions, but they may not be considered "taxes" as their revenue is not accrued by the government.

[6] The following description is based on information available on January 2007. Tax brackets and rates are therefore those applied to the fiscal year ending on December 31st,2006.

Direct taxes

Income taxation was introduced by the law N.824 of 1974. Under this act, residents or persons domiciled in Chile are subject to tax on income derived from any source, either domestic or non-domestic, while non-residents are taxed only on income generated within the national borders. Similarly to that of industrialized countries, Chilean income taxation is based on a flat corporate tax and a progressive tax on personal income. The former applies to all kinds of profits, irrespective of their origin. In a similar way, personal income taxation is subject to a unique progressive tax, irrespective of the origin of that income (the global complementary tax, GCT). As we will see in detail in the next section, this personal income taxation scheme is implemented via a bipartite system: a tax on dependent work (the second category tax, SCT) withheld monthly, and a global tax on total income (GCT) levied annually. The scheme does not apply to income accrued by individuals residing abroad. These are instead subject to a flat rate tax, the additional tax, or AT. All income taxes are charged on the income of the previous financial year, beginning on January the 1st and ending on December the 31st.

Taxes on personal income: resident individuals

The Second Category Tax (SCT): Any person resident in Chile is subject to the Impuesto de segunda categoria (Second Category Tax, SCT). This applies to income from dependent work such as salaries, pensions and other remunerations. Rates follow a progressive scheme, ranging from 0% to 40%. Tax brackets are defined in UTM, which stands for Unidades Tributarias Mensuales (monthly taxation units). These are currency units expressed in Chilean pesos, monthly adjusted in line with the consumer price index behaviour. In practice the UTM scheme defines the tax brackets in real terms. It is intended to eliminate the so-called fiscal drag. In terms of 2005 USD, the SCT rates range between 0% for an individual earning less than 830 USD a month (or 9900 USD a year) to 40% for those earning more than 9220 USD a month (or 110500 USD a year)[7]. As we will see, all progressive taxes in Chile are indexed against inflation as measured by the consumer price index. Table 5 provides the brackets and rate for the SCT as in January 2007:

[7] The conversion to US Dollars is computed using the yearly average value of the UTM and the yearly average Peso/Dollar exchange rate.

TABLE 5 HERE

SCT is computed on total salary and remuneration for work, less social security payments to AFPs. The tax is withheld and paid monthly by the employer. In order to maintain the progressivity of the tax, employees with more than one employer have their rate computed on the gross total of their remunerations.

The Global Complementary Tax (GCT): Any person resident in Chile is subject to the Impuesto Global Complementario (Global Complementary Tax, GCT). As suggested by its name, the CGT is a tax on the global income of the resident, irrespective of its source. The CGT applies to the total of all gross (pre-tax) incomes of the person. It is intended to give a unified treatment to any source of income of the Chilean citizen. Rates and brackets are the same as the SCT ones, translated in annual terms. Annual taxation units (UTA) therefore substitute monthly taxation units (UTM). The former are indexed against inflation in a way analogous to UTMs. Rates are again between 0% and 40%. Substituting UTA for UTM in Table 5, we thus have the brackets and rate structure for the CGT. The changes introduced in recent years on the SCT rates (namely, the reductions of maximum rates) applied equally on GCT's ones.

All the amounts paid for the First and Second Category Taxes constitute a tax credit usable against the CGT. In other words, taxes already paid as FCT or SCT are subtracted from the amount due as CGT. Therefore, this tax can be viewed as a mechanism of ensuring that, whatever their origin, the same levels of income pay the same amount of taxes.

Taxes on personal income: non-resident individuals

Persons neither resident nor domiciled in Chile are not subject to personal income taxation in the form of SCT and CGT. Instead, they are subject to a unique tax called the Impuesto Adicional (Additional Tax, AT). AT is levied on all incomes derived from Chilean sources (generally, when the income is made available from Chile to a person resident in a foreign country). The general AT rate is 35%, although there are several exceptions for various types of income (for a detailed description of such exceptions see SII 2006b). As for the CGT, the tax base is the sum of all pre-tax income. The AT might be seen as the equivalent of the GCT for foreigners. It ensures that any type of income is subject to the same fiscal burden. As for the GCT, the amounts paid for other taxes are indeed reclaimable as a tax credit. Of course, the major difference between the GCT and the AT is that the latter is not progressive.

Corporate Income Tax

Profits deriving from industrial, commercial or any other kind of activity carried out by an enterprise are subject to the Impuesto de Primera Categoria (First Category Tax, FCT). The rate is flat, its level being 17%. All enterprises but those involved in mining activities are subject to this regime. The latter are instead taxed under a progressive scheme. Rates ranges from 0% for mining exploiters whose annual sales are inferior to 12000 metric tons to 5% for those whose annual sales exceed 50000 metric tons. Moreover, it is worth noting that the value of a metric ton (and therefore the boundaries of the tax brackets) is computed according to the average value of that metal in the London Metal Exchange. Apart from being exceptionally low, the tax is then partly protecting the mining sector from fluctuations in metal prices. On top of this, it has been documented that private copper mining companies, representing almost 50% of Chilean production, underreported their profits via transfer pricing (exporting profits disguised as interest payments for debt with subsidiaries, for less tax is usually paid on interest payments than on profits) and paid virtually no taxes between 1992 and 2002 (see Riesgo 2005 and the response paper by Lagos and Lima 2005). This preferential regime is explainable by the central role, both in terms of income generation and employment, played by the mining industry in the Chilean economy.

An important feature of the FCT is that it applies only to profits that are withdrawn from the enterprise or, equivalently, on capital assets that are disposed of. In other words, retained profits are exempt form the FCT and therefore a *de facto* split system is in place, introducing incentives to re-invest profits in the company. Various other incentives similar to the split system just described are also present. A brief list of these follows: a) 14 bilateral Double Taxation Agreements (DTA) are in force and 7 more have been signed and are waiting their implementation. Under these schemes, any tax paid in one country represents a tax credit in the other. b) The Business Platform Law offers favourable fiscal treatments to foreign investors setting up a platform company in Chile for managing investments in third countries. When a company is set up as a "Business Platform", it is not considered to be resident or domiciled in the country. Therefore, it is liable to Chilean taxes only on the income generated in the country. This income is treated as that of a standard non-resident taxpayer, and therefore subject to FCT and AT. c) Instead of standard treatment of the FCT 17% rate and personal income taxation in the form of CGT or AT, capital gains originating from public companies limited by shares are subject to a flat 17% rate. In practice, capital gains pay in this case the FCT only. Furthermore, capital gains from the sale or transfer of shares in SAs are tax-free if these are acquired in the stock market, in a public tender share offer or in an initial public offering by foreign institutional investors. In various cases, capital gains on the sale or transfer of real estate are again tax-free (for a detailed description visit www.sii.cl). d) The most northern and southern regions of the country, denominated Zonas Extremas (Extreme Zones), enjoy an extremely favourable fiscal regime offered to businesses locating in the regions (see World Bank 2005). Its main features are duty-free areas, employment subsidies, and tax credit for investment and sales subsidies.

Indirect Taxes

Impuesto sobre el valor agregado (IVA)

IVA is a general consumption tax equivalent to the VAT. It was introduced with the 1974 reform and is levied on sales of all goods and services. The tax base is the difference between the tax debit (the total sales of goods and total supply of services) and the tax credit (the sum of all purchases of goods and use of services) owned by the taxpayer. A flat rate of 18% is currently applied on this base and must be paid on a monthly basis. Since its introduction, the VAT allowed for various exemptions that cannot be listed in full here (if interested, see Diario Oficial 1976). The two most important are the total exemption of the exporting sector and the VAT reimbursement in the case of acquisitions of fixed assets. Some products are subject to a surtax whose base is the same as the VAT, while the rates vary from case to case. Together, these surtaxes generate almost 11% of total fiscal revenues and 2% of the GDP. Products subject to the surtaxes are: alcoholic beverages (13% to 17% surtax), non-alcoholic beverages with sweeteners, colorants or flavourings: (13% surtax, but retail sellers are exempt), luxury vehicles whose value exceeds USD 18.873 (13.75% surtax on the excess value, going to 0% in January 2007. If the vehicle is imported, the relevant value is the custom one).

Excises

Sales of tobacco products, fuels and luxury goods are targeted with excises. For tobacco products, the tax base is computed on the value of the sale to the final consumer. The rates range from 51% to 60.4% depending on the type of product. For fuels, the base is the value of import or of first sale if produced in Chile. These rates are not expressed in percentage, but instead in UTMs. In 2007, they stood at 1.5 UTM per cubic meter for diesel, 6 UTM per cubic meter for gasoline. Finally, luxury goods such as gold, jewels, furs pay a 15% excise.

Local taxes

Local taxes are of negligible importance in Chile. Regional taxes are non-existent (as noticed above, there are however a number of tax incentives for individual and businesses locating in the extreme regions of the country), while municipal taxation is of minor entity. The collection of taxes is thus highly centralized. Nonetheless, local authorities have notable autonomy in expenditure management. Spending for infrastructures and education is indeed allocated by the central government but managed by local authorities, and in the future health expenditure management might be decentralized as well. Moreover, the Impuesto Territorial and the Patente Commercial are both levied and managed at a local level. The former is a tax on real estates and is to be paid quarterly by the owner to the council in which the estate is located. 40% of its revenues are directed to the council and constitute one of its main sources of income. The other 60% flows into a national "inter-council" fund that is intended to redistribute resources from rich to poor councils. The tax has a progressive feature, as the rates range between 1.2% and 2% according to the cadastre value of the estate. The latter is an annual duty payable to the municipality in which professional, commercial or industrial activities are carried out (See Godoy Ibanez for details).

Other taxes

A stamp duty on documents containing money credit agreements, checks and protests is levied as a percentage of the amount specified in the agreement or as a fixed amount (for checks and protests). Transfers of property in the form of inheritances and donations are subject to a progressive tax. Finally, an 11% tax on the custom value is levied on all imported goods. In the contest of regional integration Chile has signed bilateral agreements with Canada, Mexico and the United States that will eliminate all custom duties in ten years time. Similar agreements have been signed with Colombia, Venezuela, Peru and Ecuador and the Mercosur members and in the contest of the ALADI (Asociaciòn Latinoamericana De Integraciòn, Latin American Integration Association) agreement.

Social contributions

When the Fully Funded (FF), privately-managed pension scheme substituted the previous Pay-as-you-go (PAYG) one in 1981, the armed and security forces called out of the reform, preferring to keep the old scheme for themselves only. This dichotomy is still in place, and the only social contributions present in Chile are therefore the ones paid by the armed and security forces. These account for roughly 1.4 GDP points.

4. The fiscal burden

The distribution of taxation charge

In a region such as Latin America, plagued by extreme income inequality, the issue of redistribution is a debated one. With regards to taxation systems, equity is generally defined in two senses: horizontal and vertical. The former requires that individuals with the same income pay the same amount of taxes, the latter requires that individuals with higher income pay a higher proportion of their income in taxes (i.e. progressivity of the taxation system). The Vertical equity of the Chilean system has been investigated by Engel et al. (1998a). Using data from the CASEN survey[8] of 1996 and computing the before- and after-tax Gini coefficients of income distribution, their paper concluded that the redistributive ability of the system is substantially null. If anything, the system appears to be regressive, the after-tax figure (0.496) being slightly higher than the before-tax one (0.488). Moreover, the authors

[8] The CASEN survey is an household survey with social, economical and demographical information carried out by the ministry of planification (MIDEPLAN) every 4 years. It constitutes the principal source of micro-level data regarding the socio-economical state of the country.

found that the fiscal pressure is equal between income deciles, standing around 15% of income. The Engel et al study thus proves that the Chilean taxation system is vertically unequal. The study had a big effect on the debate, fostering the demand for an increase in direct taxation, (see ARCIS 2001 and Martner 2000). Others, such as the authors themselves, highlighted the importance of considering the distributional effect of public expenditure together with revenues when judging the progressivity of a taxation system. Thus, they suggest to focus on increasing the expenditure directed to the poor instead of increasing direct taxation, which, they argue, is more distortionary than a flat VAT and it is hardly feasible due to the administrative limits still present in Chile. On the other side, conservatory think tanks such as Libertad Y Desarrollo (LyD 2005) and the Centro de Estudios Publicos (Fontaine and Vergara (1997), Johnson 2002) oppose the increase in income taxation on the ground that this latter is distortionary and obstructs economic growth. They propose to drastically reduce the tax rates on the PIT, either lowering the top rate to 20% or introducing a 20% flat rate or even eliminating the personal income taxation and relying exclusively on VAT with a system of consumption subsidies for the poorest strata of the population.

As well as vertical, horizontal equity is debated. The issue here is the split system. Jorratt (2000) underlines the discrimination introduced by the split system against workers, who cannot defer the payment on their incomes. According to SII estimation, an employee with an average income faces a 35% rate of PIT while an entrepreneur with the same income pays 17% (quoted in Serra 1998, p. 24). This fact clearly represents a horizontal inequity and for this reason Jorratt argues for the elimination of the split system. On the other side, Hsieh and Parker (2006) argue in favour of the split system, citing that this is among the principal causes behind the investment boom enjoyed by Chile since then and helps explaining Chilean outstanding levels of corporate savings for Latin American standards.

Another tool for investigating the distributional effect of the taxation system are the implicit tax rates. By comparing the fiscal revenues generated by capital, labour and consumption with their tax bases, the effective rates give an estimate of the actual fiscal burden placed upon the three factors, which can be very different from the one implied by the statutory rates as a consequence of exemptions, deductions, tax credits and evasion. The effective tax rate on consumption (C) compares revenues from VAT and excises with total consumption; the effective rate on labour (L) shows the relationship between revenues from employed work including SSC and the wages and salaries of the employees. Finally, the effective rate on capital (K) compares revenues from taxes on corporate income, capital gains and property with the operating surplus of the overall economy. A detailed description of the implicit tax rates' formulae and the related issues is beyond the scope of this work. If interested, see Mendoza et al. (1994), Carey and Tchilinguirian (2000), or Martner and Tromben (2004) for an application to Latin America.

Figure 1 shows the implicit rates (henceforth IR) on consumption, labour and capital for the period 1993-2002. Unfortunately, data on the reform period 1990-1993 is not available, so that an analysis of the distributional effect of the 1990 reform cannot be carried out. Focusing on the following decade, some stylized facts emerge. Firstly, the burden of taxation lies disproportionately on consumption. The effective rate on the latter, C, floated around 18% for the whole period considered. This should come as no surprise, given the predominance of indirect taxation in Chile. Although the phenomenon is common in Latin America, it's worth underlining that Chile's IR on consumption is exceptionally high for Latin American standards as well: Martner and Tromben (2004) find the Latin American average effective rate on consumption to be around 12% in 2000, 5 percentage points lower than in Chile. It is also worth noting how the trade-liberalization-related loss of revenues was offset by the increase of VAT, leaving C fairly stable across the period.

FIGURE 1 HERE

Secondly, K floated around 7% for the 1993-1999 period, remaining slightly above the Latin American average (estimated at 6%, see Martner and Tromben 2004). This might seem puzzling, given that Chile has the lowest statutory rate on corporate income in the region. However, this might be explained by a higher degree of tax compliance. In general, Chile shows degrees of tax compliance higher than those of its neighbours (see Jorratt 2000 and Bergman 2002). The introduction of a unique 15% rate and the elimination of various exemptions took place in 1999. This intervention's effects can be seen in Figure 1, were the K increased by 2 percentage points in 3 years. One would expect K to decrease after the reduction of all FCT rates to the lowest one. It is then surprising to see that it actually increased after 1999. This is explained by the widening of the taxable incomes due to the elimination of various exemptions and, more importantly, by the fact that the revenues from capital taxation are the sum of FCT and AT revenues.[9] These latter rose sharply in the 1999-2002 period, driving up K. In the following two years the unified rate was increased up to 17%. The effects of this increase on K are unfortunately not computable due to the lack of data.

Finally, employed labour bears an exceptionally low part of the taxation burden. When excluding SSC, the IR on labour is roughly 3%. Not that this phenomenon is peculiar to Chile: the Latin American average IR on employed labour is even lower, staying around 2% (see Martner and Tromben 2004). It would not be an exaggeration to say that income from employed labour is almost untaxed in Chile and in Latin America. Altogether, this analysis confirms the findings of Engle et al. (1998b) that the Chilean taxation system is regressive. The effective rates analysis identifies the source of its regressive nature, which is the dominance of consumption taxation and the almost-exemption of personal income.

5. **Recent tax reforms and future prospects**

After the successful transition to democracy, the stabilization of the macroeconomic environment, the strong reduction of public debt and the covering of revenues loss due to trade liberalization, Chile entered the new millennium in a position to focus on medium-term goals such as enhancing the efficiency of its taxation system, as commonly defined (see Slemrod and Yitkzaki (1996)). In 1998-2000 the SII carried out various inquiries on the state of the system (Serra (1998), Barra and Jorratt (1998) and Jorratt 2000). The documents' aim was to identify its shortcomings and to propose the most appropriate interventions to tackle them. Four areas of intervention were proposed: the simplification of the system, the reduction of its distortionary elements, the reduction of the costs of compliance and the fight

[9] The AT is levied on non-resident individuals. These cannot be employees in Chile. Therefore, I have assumed the AT base to be all profits and therefore I have included AT revenues in the numerator of K. This means I have ruled out by assumption the existence of self-employed workers carrying out their activity in Chile but residing abroad. Although possible it does not appear to be a numerically relevant situation.

against evasion. The main proposals to achieve these goals were the elimination of various exemptions and franchises to the general CIT and VAT treatment; the unification of the CIT rate; the substitution of the complex saving incentive scheme with a split system excluding all withheld profits from the CIT base, the reduction of the PIT top rate and a comprehensive plan to fight against tax evasion.

Judging from recent interventions, the inquiries turned out to be very influential. As we have seen above, in 1999 the split system replaced the previous incentive scheme and the unique CIT rate substituted the multi-rate system while the top PIT rate that was reduced in 2002 and 2003. On the other side, most exemptions and franchises (e.g. to the building sector and to exporters) are still applied to both CIT and to VAT. Remarkable attention has been given to the minimization of compliance costs, defined as the costs in terms of time and money undergone by the taxpayer in order to fulfil her duties. The simplification of the system was indeed accompanied by a noteworthy development in the computerization of the taxation process, which reached in Chile a higher degree than in OECD countries (see Barraza Luengo (2000) for early developments and the SII website for the latest ones). For example, since 2001 the personal income tax is wholly payable on the Internet. The main rationale behind the minimization of compliance costs was to foster the fight against evasion. This issue had attracted the attention of the Chilean authorities since the mid-90s (see Jorratt 1996, Engel et al. 1998b and Trujillo Puentes 1998). According to the Silvani and Brondolo (1993) study, Chile had the highest estimated rate of VAT compliance in all Latin America. Their findings are confirmed by the SII internal study of Barra and Jorratt (1999). Moreover, Chilean citizens appear to have a higher "tax morale" as well as higher respect for the tax authorities than citizens of neighbour states (Bergman 2002). However, with an estimated 20% and 24% of VAT and total evasion (Jorratt 2000) respectively, the phenomenon still represented a significant damage to public finances. In June 2001, the Law n. 19738 launched the Plan de Lucha Contra la Evasion Tributaria (plan against tax evasion, PATE). Its declared goal was to reduce tax non-compliance from the estimated 24% figure to 20% in 2005. In order to achieve this goal, between 2001 and 2004 a number of laws (especially the Tax Procedure Code and the VAT Law) have been modified so as to enhance the enforcement power of the SII, while its auditor staff has been expanded. Penalties for non-compliance have been sharply increased and efforts to better coordinate the tax administration system (the SII, the Treasury and National Customs Service) have been carried out (for a summary of the PATE law see SII 2001). The results of the PATE have been investigated in SII (2005) and they depict a clear success. Estimated tax evasion has dropped to 19.8% or 15.6% of the GDP, depending on the estimation method used. In both cases, the 20% threshold has been passed. Simultaneously, VAT evasion dropped from 19.4% in 2001 to 14.3% in 2005.

The current debate

As outlined in paragraph 2, the privatization of the pension system implemented in 1981 generated a sizeable "social security deficit". Furthermore, the system proved to guarantee adequate pensions only to workers able to contribute constantly over their lifetime. Temporary and "off-the-books" workers (mainly women and low-skilled workers) therefore face serious risks of poverty at retirement age. If they contributed for less than 20 years, they do not have the right to claim the minimum pension guaranteed by the government. Meanwhile, as a consequence of market concentration (the 3 biggest AFPs' market share reaches 75%), low demand elasticity (employees are obliged to contribute to AFPs) and huge marketing costs, the administrative costs of the system are extremely high (2.4% of workers' monthly wage) and AFPs secure themselves outstanding profits (25% on average in 2005). In March 2006, the Chilean president Bachelet appointed a commission of experts to investigate possible interventions to tackle these problems. The commission's report (available at www.consejoreformaprevisional.cl) proposed a vast number of interventions, the most important of which are: eliminating the 20-years-requisite for minimum pension eligibility, equalizing to 65 women and men retirement age (currently 60 and 65, respectively), opening the AFP market to banks (currently forced to set up an ad hoc company to enter), allowing the separation of pension fund and account management services companies and, finally, allocating new workers (220000 a year) to the cheapest AFP via yearly auctions conducted by the social security governmental watchdog. The report, published in June 2006, is currently under scrutiny of the government and the social parties. Discussions for an encompassing reform law should start in 2007.

6. Conclusions

In the last decade the Chilean tax authorities invested relevant energies and resources in reducing the distortionary elements, the compliance costs and the administrative costs of the taxation system. This investment paid off: Chile has now a simple system that generates the highest yields in the Latin American context with relatively low costs of compliance and little distortionary elements. Moreover, thanks to these elements and a firm stand against evasion, it is the Latin American country with the lowest estimated evasion. On the other side, the predominance of indirect taxation and the almost-exemption of personal income make the Chilean system regressive. In a country with such income disparities, this issue cannot be ignored. The other matter of concern is the relevant unbalance that the social security system will produce in the next decades. However, with sound fiscal and macroeconomic fundamentals, strong growth and an efficient tax authority, Chile has the opportunity to tackle these problems. Whether this will happen is a political more than an economic issue.

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Table 1 Structure and development of operations in the general government - Selected figures and years - percentage of GDP

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Revenues	*25.4*	*25.1*	*25.4*	*25.3*	*24.9*	*25.6*	*23.6*	*23.5*	*23.1*	*22.5*	*23.7*	*23.9*	*23.2*	*23.0*	*24.2*
Total fiscal revenues	15.7	17.9	18.6	19.5	18.8	18.4	18.0	17.7	17.9	17.3	18.0	18.1	18.2	17.6	17.3
Copper	4.9	2.5	2.1	0.9	1.5	2.6	1.3	1.3	0.4	0.4	0.9	0.5	0.5	0.9	3.1
Social contributions	1.7	1.6	1.6	1.5	1.5	1.3	1.3	1.3	1.4	1.4	1.4	1.4	1.5	1.4	1.4
Expenses	*20.5*	*20.6*	*20.1*	*20.3*	*19.8*	*18.8*	*17.9*	*18.0*	*19.0*	*20.7*	*20.9*	*20.7*	*20.7*	*19.9*	*18.6*
Public employment	4.7	4.7	4.8	5.2	5.3	5.2	5.0	5.2	5.6	6.0	6.0	6.0	6.0	5.8	5.4
Goods and services	2.9	2.8	2.8	2.8	2.7	2.6	2.6	2.5	2.7	2.6	2.6	2.7	2.6	2.5	2.5
Debt interests	3.3	3.1	2.6	2.4	2.1	1.8	1.4	1.2	1.2	1.3	1.2	1.2	1.2	1.2	1.0
Subsidies and donations	3.7	4.2	4.2	4.3	4.2	4.1	4.0	4.1	4.2	5.0	5.2	5.0	5.2	4.9	4.7
Social security	5.8	5.7	5.5	5.5	5.3	5.0	4.8	4.7	5.1	5.6	5.6	5.6	5.6	5.3	4.9
Others	0.1	0.1	0.1	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Gross operative result	*4.8*	*4.5*	*5.3*	*5.0*	*5.1*	*6.8*	*5.6*	*5.5*	*4.1*	*1.8*	*2.8*	*3.1*	*2.5*	*3.1*	*5.6*
Total Revenues	*25.5*	*25.3*	*25.6*	*25.4*	*25.1*	*25.7*	*23.6*	*23.6*	*23.1*	*22.5*	*23.8*	*23.9*	*23.3*	*23.0*	*24.3*
Total Expenses	*23.0*	*23.3*	*23.2*	*23.8*	*23.4*	*22.2*	*21.5*	*21.5*	*22.7*	*24.6*	*24.5*	*24.4*	*24.5*	*23.5*	*22.1*
Primary surplus/deficit	*5.9*	*5.0*	*4.9*	*4.0*	*3.8*	*5.3*	*3.5*	*3.4*	*1.6*	*-0.8*	*0.5*	*0.7*	*-0.1*	*0.8*	*3.1*
Net lending/borrowing	*2.5*	*2.0*	*2.4*	*1.6*	*1.6*	*3.5*	*2.2*	*2.1*	*0.4*	*-2.1*	*-0.7*	*-0.5*	*-1.2*	*-0.4*	*2.1*
Debt financing															
Financial assets acquisition	0.2	2.2	2.3	0.1	0.8	0.7	0.2	1.1	-0.9	-2.6	-1.4	-0.8	-1.6	-0.4	1.4
Net financial liabilities	-2.3	0.2	0.0	-1.5	-0.8	-2.8	-1.9	-1.1	-1.3	-0.5	-0.7	-0.3	-0.4	0.0	-0.8
Net external borrowing	-0.7	0.6	-0.3	-1.7	-0.7	-2.7	-1.1	-0.6	-0.3	0.5	-0.3	0.6	0.8	1.0	0.2
Net internal borrowing	-2.4	-1.1	-0.4	-0.3	-0.4	-0.4	-1.0	-0.5	-1.0	-0.7	-0.1	-0.5	-0.8	-0.4	-0.4
Bonos de reconocimiento	0.8	0.8	0.7	0.5	0.4	0.2	0.2	0.1	0.0	-0.2	-0.3	-0.4	-0.4	-0.5	-0.6
Sector Gross Debt	*47.3*	*40.8*	*33.7*	*31.4*	*25.5*	*19.6*	*15.1*	*13.2*	*12.5*	*13.8*	*13.7*	*15.0*	*15.7*	*13.1*	*10.9*

Source: Budget Directorate, Ministry of Finance

Table 2 Structure and development of fiscal revenues in Chile as a percentage of GDP, 1990-2005

Source: ILPES elaboration on data from the Ministry of Finance and Internal Revenue Service of Chile.

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005(p)*	*% Tot*
Total fiscal revenues (excl. soc. contrib.)	*15.7*	*17.9*	*18.6*	*19.5*	*18.8*	*18.4*	*18.0*	*17.7*	*17.9*	*17.3*	*17.9*	*18.3*	*18.2*	*17.5*	*17.1*	*18.8*	*100.00*
Direct taxes	*4.1*	*5.6*	*5.8*	*6.0*	*5.8*	*5.6*	*5.7*	*5.6*	*5.8*	*5.5*	*6.0*	*6.5*	*6.7*	*6.4*	*5.9*	*7.2*	*34.50*
Income tax	2.6	4.1	4.2	4.2	4.1	3.9	3.9	3.8	3.9	3.5	4.1	4.5	4.6	4.3	4.0	5.3	23.39
Personal income	0.7	0.8	0.9	1.1	1.1	1.0	1.0	1.0	1.2	1.2	1.2	1.3	1.2	1.1	1.1	n/a	6.43
Corporation income	1.8	3.2	3.2	3.2	3.0	2.9	3.0	2.7	2.8	2.4	2.8	3.2	3.4	3.2	2.9	n/a	16.96
Wealth	1.5	1.5	1.6	1.8	1.7	1.8	1.8	1.9	1.9	2.0	1.9	2.0	2.1	2.1	1.9	1.9	11.11
Indirect taxes	*11.6*	*12.3*	*12.8*	*13.5*	*13.0*	*12.7*	*12.3*	*12.1*	*12.1*	*11.7*	*11.9*	*11.8*	*11.5*	*11.1*	*11.2*	*11.5*	*65.50*
VAT	7.0	7.7	8.4	8.7	8.6	8.2	8.0	7.9	7.8	7.6	7.9	7.9	8.0	8.0	8.1	8.1	47.37
Excise duties	1.9	2.0	2.0	2.0	1.9	1.9	1.8	1.9	2.2	2.3	2.3	2.3	2.3	2.1	1.9	1.9	11.11
Taxes on int'l transactions	2.4	2.3	2.2	2.3	2.0	2.1	2.0	1.8	1.7	1.4	1.4	1.2	0.9	0.6	0.4	0.4	2.34
Other indirect	0.2	0.2	0.3	0.5	0.5	0.6	0.5	0.5	0.5	0.4	0.4	0.4	0.2	0.3	0.7	1.0	4.09
Social contributions	*1.7*	*1.6*	*1.6*	*1.5*	*1.5*	*1.3*	*1.3*	*1.3*	*1.4*	*1.4*	*1.4*	*1.4*	*1.5*	*1.4*	*1.4*	*1.4*	
Total fiscal revenues (incl. soc. contrib.)	*17.4*	*19.4*	*20.2*	*21.1*	*20.3*	*19.7*	*19.3*	*19.0*	*19.3*	*18.7*	*19.3*	*19.7*	*19.7*	*18.9*	*18.5*	*20.2*	
Administrative level:																	
Central government:	15.6	17.3	17.8	18.4	17.6	16.8	17.9	17.6	17.8	17.1	17.8	18.2	18.1	17.4	n/a	n/a	
Local government:	1.1	1.2	1.3	1.2	1.1	1.2	1.4	1.4	1.5	1.6	1.5	1.5	1.6	1.6	n/a	n/a	

% Tot: revenue from item as percentage of total fiscal revenues excluding SSC, year 2004

(p) Provisional

Table 3 Evolution of the Income taxation rates, Chile 1992-2005

	1992		1997		1998		1999		Jun-01		Dec-02		Jul-03		Jul-04		Jul-06	
	Min	*Max*	*Min*	*Max*	*Min*	*Max*	*Min*	*Max*	*Min*	*Max*	*Min*	*Max*	*Min*	*Max*	*Min*	*Max*	*Min*	*Max*
Personal Income	5	50	5	45	5	45	5	45	5	45	5	43	5	40	5	40	5	40
Corporate Income	15	35	15	35	15	35	15	15	15	15	16	16	16.5	16.5	17	17	17	17

Source: ILPES elaboration on data from the Ministry of Finance and Internal Revenue Service of Chile.

Table 4 Chile: main taxes

type of tax	*name of tax*	*acronym*	*rate*
Direct Taxes - Income Taxes	Corporate Income Tax (*Impuesto de Primera Categoria*)	FCT	17%
	Personal Income Tax (*Impuesto de Segunda Categoria*)	SCT	0%-40%
	Global Income Tax for residents (*Impuesto Global Complementario*)	GCT	0%-40%
	Global Income Tax for non-residents (*Impuesto Adicional*)	AT	
Indirect Taxes	Value Added Tax (*Impuesto al Valor Agregado*)	IVA	19%
	Excises taxes (*Impuestos selectivos al consumo*)		13%-60%
	Custom duties (*Impuesto al comercio exterior*)		11%
	Other Taxes (on inheritances and donations, stamps..)		0.25%-1.6%

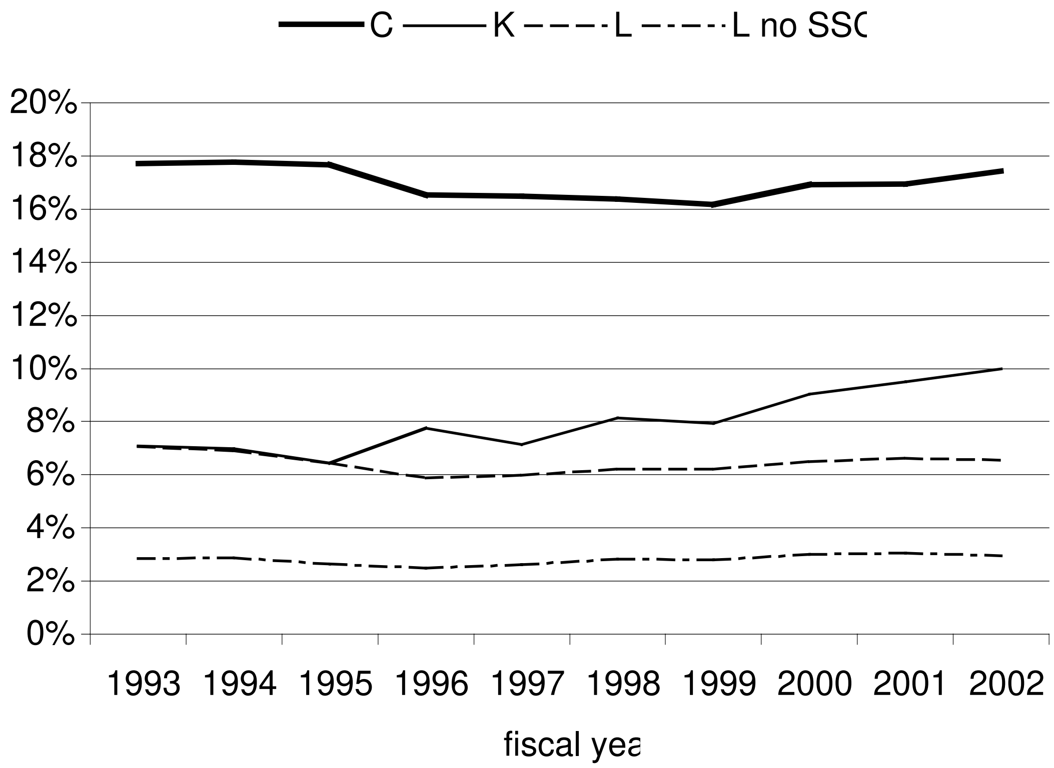
Source: adaptation from SII, Santiago de Chile, Chile.

Table 5 Second Category Tax: brackets and rates

Bracket	*Monthly Income in UTM*	*Tax Rate*
1	0,0 to 13,5	Exempt
2	13,5 to 30	5%
3	30 to 50	10%
4	50 to 70	15%
5	70 to 90	25%
6	90 to 120	32%
7	120 to 150	37%
8	More than 150	40%

Source: Servicio Interno de Impuestos (SII)

Figure 1 Implicit tax rates on consumption, labor and capital, Chile 1993-2002



C: Effective rate on consumption
K: Effective rate on capital
L: Effective rate on labor including social security contributions
L no SSC: Effective rate on labor excluding social security contributions
Source: personal calculations on data from SII, Banco Central de Chile

4. COLOMBIA UPDATED

by

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Abstract

This paper is part of a wider research on “Tax Systems and Tax Reforms in Latin America”, carried out at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. Colombia is a sizeable country in which the social and political environment has not favored, nor currently favors, the structuring and working of the tax system; hence the need for a far-reaching study rather than just a technical analysis. The structure of Colombian taxation is analyzed from the historical, economic and institutional points of view, with a particular focus (updated to take in the December 27th 2006 reform) on corporate tax, income tax, VAT, wealth tax, financial transactions taxation and local taxes. Two specific tax issues are then considered. The first of these is the personal distribution of the tax burden and the redistributive impact of the fiscal system, while the second is the relationships between central and lower Government layers. Finally, we briefly discuss the broad fiscal reforms that were submitted by the Colombian Government to Parliament on July 2006 but subsequently withdrawn. We conclude by discussing this legislative project together with December’s reform within the broader context of the social turmoil and poverty currently plaguing Colombia. We firmly believe that Colombia needs a completely different fiscal reform from the ones passed and/or proposed in 2006, and we outline our own radically alternative proposal for fiscal reform in Colombia.

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At a certain point I realized it was impossible to separate this story from the events in Colombia at that time.

GABRIEL GARCIA MARQUEZ, *News of a kidnapping, 1996.*

1. Colombia's environment, economy and public budget*

Colombia is a historically important country, covering about one million km^2 and inhabited by about 43 million people. It won independence from Spain in 1810, and since then power has been in the hands of two parties, both of whom represent the interests of the country's large landowners and other wealthy citizens. At the outset of the 2000s, Colombia was governed by a conservative, demagogic Government led by A. Uribe and backed by the U.S. Government. Uribe was subsequently re-elected in 2006. Since the 1960s onwards, the country has been plagued by the spread of *guerrilla* warfare involving different groups, and by the Colombian mafia's influence on the trade in agricultural goods, emeralds and, of course, cocaine. This environment was, and remains, unfavorable to the building and working of the tax system and to the tax payer's relationships to this system. This sensitive activity is performed within a context of civil war, crimes, illegal activities, corruption and social deprivation.[1] Further, the substantial size of an informal or illegal economy, together with wide tax evasion, means that high caution should be taken when using economic data.

In 2005 GDP stood at US$ 98 billion (Cia-Factbook), while per capita income was US$ 2,240, US$ 7,900 if adjusted for PPP. Income distribution is very uneven: the Gini coefficient for household income stood at 0.54 in 2005. The share of Colombians living in poverty is nearly 50 per cent. The unemployment rate is also quite high, standing nearly 15 per cent. Colombia's GDP grew at a yearly rate of about 5 per cent in 2005 and 2006. Inflation fell to 4.5 per cent in 2006. Both macro and public budget indicators are forecast to go well in both the short and medium run (IMF 2006; Confis 2006). In 2007, real GDP is forecast to grow by 4.0 per cent, while inflation should fall to 4.0 per cent, values that ought to be maintained in the medium run (to 2010).[2]

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[1] UN data show that about 100,000 people are at war in the mountains together with Army forces and U.S. 'advisors'. A large number of private police forces and Government 'informers' are at work. Kidnappings, assassinations and robberies -the so called '*violencia*'- occur with alarming frequency. The official view (also: IMF 2006), which is not shared by everyone in Colombia, is that the security situation has improved over the past few years, due the fact that some (right-wing) *guerrilla* groups have lain down their arms since 2005, benefiting from a full amnesty as a result thereof.

[2] The question of the reliability of these forecasts remains open, however. The said IMF report defines them as 'prudential', but subject to a series of structural reforms and to virtuous Governmental behavior. In the long run, the most critically important trend seems to be the one regarding pension expenditure, notwithstanding the 1993 reform (see below).

Focusing now on the public budget, we first need to distinguish between the Non-Financial Public Sector (NFPS), General Government and Central Government.[3] We shall refer to the NFPS when evaluating the overall financial position of the public sector, whereas we shall consider the General Government level when analyzing tax revenue. Both the total revenue and the total expen-

TABLE 1 ABOUT HERE

diture of the NFPS increased by 75 per cent between the early 1990s and the early 2000s.[4] Taxes constitute just half of the NFPS' current revenue, with the remaining share mainly accounted for by profits from public utilities and the State-owned oil company. This allows Colombia to finance a sizeable welfare expenditure (on education, health and old age pensions) without excessive fiscal pressure.[5] This clearly raises some question marks about the future sustainability of Colombia's public finances, since: *i)* the contribution made by non-renewable resources will inevitably decrease; and *ii)* more than one utility will be privatized. In both cases, non tax-revenue will have to be replaced by permanent structural taxes, and this will not be an easy task.[6] At the beginning of the 1990s, the budget was balanced, but this situation subsequently deteriorated during the years 1996-1999, at which point an adjustment plan was adopted and the financial position of the NFPS improved as a consequence. The overall NFPS balance stood at -1.9 per cent in 2006, and it is forecast to stabilize at -0.4 per cent by 2010. At that time the public debt/GDP ratio should decrease by about ten points (down to about 50 per cent). Half of the funding of Colombia's public debt is forecast to come from internal sources, while the other half is due to be provided by foreign capital.

The rest of the chapter is organized as follows. Section 2 discusses a general overview of the Colombian tax system from the ear1y 1990s onwards. Section 3 describes the main features of the major national and local taxes, updated to include the tax reform introduced in December 2006. Section 4 discusses a couple of significant tax policy issues: the personal distribution of the tax burden, and the financing of lower government tiers. Section 5 provides a brief overview of the broad reform submitted by the Government in July 2006 but subsequently withdrawn in November

[3] These aggregates are given in the ILPES-CEPAL data that constitute the main for this study. The *Non-Financial Public Sector* includes State, Departments, Municipalities, social security, *and* public enterprises. *General Government* and *Central Government* correspond to their counterparts in OECD and EUROSTAT public accounts. Unfortunately, the ILPES data fully cover the NFPS and the Central Government, but just partially the General Government.
[4] The expansion in public spending was largely due to the new 1991 Constitution, which led to a process of expenditure decentralization. This rise in expenditure was also the result of pension reforms, interest payments on public debt, and the salaries paid to public employees. A further contribution to this process was made by the restriction imposed on the Central Bank's power to finance the Government's budget deficit. (Lozano 2002; Jungito and Rincon 2004).
[5] At a first guess (data are not given in IMF 2005) the three said sectors accounted for about GDP 15 per cent by 2005 (education 5per cent, pensions 4per cent, health 6 per cent). Military spending probably accounted for GDP 4 per cent.
[6] For example, the increase in oil prices pushed up the NFPS' current non-tax revenue from GDP 10.3 per cent in 1998 to 18.8 per cent in 2004 (ILPES-CEPAL).

2006, and also outlines our suggestion for a more radical reform of taxation designed to reduce social deprivation in Colombia, but which would probably be met by strong political opposition.

2. A general outline of the Colombian tax system and its development since the ear1y 1990s

2.1 The Colombian tax system from the early 1990s onwards

In the 1960s and 1970s, Colombia's tax system was a relatively simple one. However, from the 1980s onwards the system was subject to repeated reforms of a non-radical nature (Shome 1995).[7] Seven major reforms were introduced between 1990 and 2003 (Gobierno de Colombia 2006)[8], mainly designed to increase revenue (Lozano 2002)[9]. These reforms focused principally on VAT: the standard rate was increased from 10 to 16 per cent, while its tax base was also enlarged. On the other hand, trade liberalization led to a reduction in revenue from customs duties. As far as direct taxes were concerned, the generous allowances of the early 1990s were only slightly reduced, while tax rates as such were not substantially modified either for individuals and for corporations. During the early 1990s, taxation on financial capital was eased to stimulate savings and investment; however, at the end of the decade the Colombian government introduced a wealth tax.[10]

Subsequent to the adjustment plan introduced towards the end of the 1990s, two small tax reforms were made in 2002 and 2003; these were partly designed to finance the battle against *guerrilla* warfare, which was a central issue in the Uribe Government's program. The main tax measure introduced in 2002 consisted of a 10 per cent surcharge on both income and corporate tax, while the 2003 reform increased the rate of the financial transaction tax (introduced in 1998 as a part of the adjustment plan) from 0.2 to 0.4 per cent[11]. Taken together, these two measures yielded approximately 0.7 per cent GDP. However, there was a real problem with the said reforms, they were all introduced as temporary measures, but were subsequently extended (in general to 2006-07), as about 1.2 - 2.0 GDP percentage points of revenue (wealth tax included) was due to evaporate, and this lost revenue had to be replaced in some way.[12] In 2005-06 the increased openness of the econ-

[7] The main reforms were based on studies by highly-qualified tax professionals, such as Musgrave and Gillis, Mc Lure, Bird, and Poterba.. However, politicians repeatedly failed to follow the experts' recommendations.
[8] Taken together these reforms increased fiscal pressure by about 7 per cent (Government of Colombia 2006).
[9] The more theoretically consistent substantial recommendations, illustrated in Shome (1995), were largely ignored.
[10] However, it has been pointed out that there were too many small, short-term reforms granting preferential treatments, and too many tax amnesties, which had the effect of reducing the tax base (MIP 2002).
[11] It also introduced OECD-like transfer price rules.
[12] The Government believes that the removal of the wealth tax in 2007 will be compensated for by the increase of import taxes and VAT, while other observers maintain that the tax gap must be closed by tax reforms (Clavijo 2005).

omy encouraged to introduce a number of specific tax measures (International Law Office 2006), including new legislation designed to avoid double taxation among Andean countries (thus replacing the one in place dating back to 1971[13]), and new tax regimes for Free-Trade Zones and for Low-Tax Jurisdictions. With reference to the latter, a higher withholding tax rate is currently due to be applied to cross-border payments made to beneficiaries located in a list of foreign tax havens. However, the Government has yet to publish the list of those countries acting as such tax havens.

2.2 An overview of the current fiscal structure, and a comparison with that of other Latin American countries

As a consequence of the above-mentioned reforms and of the buoyancy of the tax bases, General Government's total fiscal pressure almost doubled between the early 1990s and the early 2000s, increasing from 10.5 per cent of GDP in 1990 to 20.4 in 2004 (Table 2).[14]

TABLE 2 ABOUT HERE

This substantial increase was generated by direct taxation, and in particular by corporation, property and wealth taxes. Indirect taxation rose by more than three points, and this was entirely accounted for by the increase in VAT. Social security contributions more than tripled, partly as a consequence of the 1993 pension reform (Clavijo 1998), although their point of departure in 1990 was only GDP 0.8 per cent. Thus total fiscal revenue in 2004 consisted mainly of taxes (17.5 per cent of GDP), rather than of social security contributions (2.8 per cent of GDP). The respective weights of direct and indirect taxes were evenly balanced. More than one of the above-mentioned features is characteristic of Colombia, to be found in very few other Latin American countries, and is not to be found in the continental average (see the chapter by Martner and Sabaini).

In the case of direct taxes, up until the late 1990s the most important ones were those levied on large companies and multinationals, whereas the personal income tax burden has been virtually non-existent (0.2 per cent of GDP up until 1999).[15] This remarkable figure may be explained in political-economy terms (see also the chapter by Martner and Sabaini). Very few Colombians actually pay income tax[16], as tax exemptions and deductions are substantial. We believe that the country's

[13] Bolivia, Colombia, Ecuador, Peru and Venezuela.

[14] It is not easy to properly evaluate Colombian fiscal pressure. Tax evasion is deemed to be high (Shome 1995; Ministerio de Hacienda 2006; Clavijo 2005), and yet remains underestimated since the potential tax bases are calculated from national accounts, which in turn allow for the large-scale exclusion of illegal business activities.

[15] We lack figures for subsequent years.

[16] According to CONFIS (2006), these included 515,000 corporations and shareholders who paid 85.9 per cent of taxes on income and profits in 2005, and 830,000 individuals, comprised of 317,000 employees (accounting for 7.7

landlords and its other wealthier citizens deliberately chose to avoid directly taxing the middle classes (and themselves) to obtain political consensus. The most important indirect tax is VAT, while other forms of indirect taxation play a secondary role. Taxation by the various levels of Government is highly centralized.[17] Central Government only grants Departments and Municipalities the power to raise a limited amount of money from property and from specific goods and services.

Total fiscal pressure and tax structure differs substantially from one Latin American country to another (see the chapter by Martner and Sabaini). A quick comparison of taxation in Colombia with that of other Latin American countries must necessarily be deemed to be purely indicative.

TABLE 3 ABOUT HERE

Nevertheless, the few figures shown in Table 3 may provide some insight into the comparative position of Colombia. In the first few years of the 2000s, fiscal pressure in Colombia has been close to the Latin American average; the increase in Colombia's taxes during the 1990s, on the other hand, was a multiple of the Latin American average. Moreover, the data show that Colombia has a relatively high share of direct taxes. If we compare these figures with those in Table 2, the picture becomes more complex. It is immediately clear that up until 2000, the structure of Colombian taxation was not that far removed from the one revealed by the averaged figures for Latin America as a whole. The reforms implemented in the late 1990s and during the first few years of the 2000s were mostly temporary measures, and their impact should not be overestimated. Hence the rise in the share of direct (corporate) taxation can only be seen as a temporary phenomenon.

3. The institutional features of Colombia's principal taxes

The following section illustrates the Colombian fiscal system (IBFD 2006) and includes the changes recently made by the tax reform passed by Parliament on the 27th of December 2006, and which came into force on the 1st of January, 2007 (Congreso de Colombia 2006; Colombian Tax Flash 2007; Parra, Escobar & Cia 2006). At the end of the chapter we shall see that a broader, more ambitious reform had been submitted by the Government to Parliament in July, 2006; but after a heated debate outside of Parliament, the Government withdrew the reform proposal .

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per cent of total tax paid by withholdings) and 513,000 self-employed (6.4 per cent of total tax paid by tax returns). These data pale when compared with the number of the employed, to about 16.2 million, (according to UN data).

[17] 82.9 per cent of total revenue went to Central Government, 6.6 per cent to Departments and 10.7 per cent to Municipalities in 2002 (Lozano, Ramos and Rincon 2004).

3.1 National taxes

3.1.1 Direct Taxes

The income tax system consists of a general tax levied on both individuals and business enterprises. For practical purposes, we distinguish between the tax applicable to individuals (Personal Income tax - PIT) and that applicable to businesses (Corporate Tax - CT).

3.1.1.1 Personal income tax - PIT

Colombian PIT is a global income tax. It is levied at the same rate on the total income of an individual. Special taxation plays a very marginal role and is levied on a few items. The deemed minimum annual net income of individual taxpayers is 3 per cent of their net wealth. Married couples are taxed separately: each spouse is taxed on his/her income, but spouses cannot divide their joint income for taxation purposes. There are separate tax regimes for two specific groups of tax payers: Colombian national and foreign residents pay Individual Income Taxation-IIT, while Non Resident Income Tax-NIT is levied on non residents in the form of a withholding tax.[18] Resident Colombian citizens are taxed on their worldwide income, while resident foreigners who have been living in the country for less than five years are subject to tax on their income earned in Colombia. As of their fifth year of residence, foreigners resident are also taxed on their worldwide income.

Individual Income Taxation - ITT

IIT is based on a broad concept of income that places considerable emphasis on the personality of taxation. The main kinds of income comprised within the tax basis are as follows:

1. wages, and all other incomes from employment, together with retirement, old age, disability and company pensions received after 1998 or, regardless of when received, that amount over and above a certain threshold;
2. capital gains, gifts and inheritances, including any such sums from deceased foreign residents;
3. business and investment income.

On the bass of certain personalized targets, a considerable amount of tax exclusions and exemptions are granted: for example, the following are exempt from income tax:

1. those incomes which do not exceed some thresholds (not automatically adjusted for inflation);
2. the following incomes (up to a certain threshold established by law):

[18] Income originated in countries of the Andean Community is in general taxable only in the source country.

3. 25 per cent of employees' earnings when they are not over (2006) COP 7,033,000[19] per month;
4. pension-fund related payments and life insurance payments and proceeds;
5. accident, sickness, maternity benefits, and sums received as severance or job's end payments.

The IIT is progressive with four brackets and marginal rates, shown in Table 4. Note the high thresholds in a country where the PCI of those not living in poverty and/or the employed is estimated to be about US$ 4,500. Income tax is directly *withheld* monthly by employers from their employees' wages. The 10 per cent surcharge, in force up until 2006, has recently been abolished.

TABLE 4 ABOUT HERE

Non-Residents Income Tax - NIT

NIT is levied on non-residents on the part of their income pertaining to activities located in Colombia, which in principle is subject to taxation at 33 per cent. However, the income paid abroad is *de facto* subject to a final *withholding tax,* which may be levied at a rate of well below the said rate, either at 10 or even at 0 per cent, according to the various incomes in question. The previous surcharge of 7 per cent was abolished by the 2006 reform. Of particular interest is that dividends are exempt from NIT when they are taxed at the corporate level, or are taxed at 33 per cent when untaxed at that level. Interest may be taxed at either 0 or 33 per cent ,depending on its source. All payments to a party of a jurisdiction defined as a tax haven are subject to the 33 per cent rate.

3.1.1.2 Corporate tax - CIT

CT is levied on the following broad categories of tax payer:
1. Colombian corporations or foreign corporations making profits in Colombia;
2. state-owned enterprises and mixed public/private companies;
3. investment funds, mutual investment funds, family compensation funds and so on;
4. cooperative and mutual societies, unions, non-profit-making foundations or associations.

Colombian citizens are taxed on their worldwide income, whereas foreigners on their Colombian earnings[20]. A broad income concept is applied in principle. Total income includes all receipts, unless specifically exempt. Once all proceeds and capital gains have been added up, net income is then given by subtracting cost and expenses from total revenue. Tax losses may be carried

[19] 1 US$ = 2,360 COP; 1 € = 3,013 COP (Forex, average 2006).
[20] Foreign income tax paid by Colombian enterprises may be creditable under certain specific rules. Income from business activities located in the Andean Group countries is in general only taxable within the source country.

forward without any limitations, but no carry-back is allowed. A large number of exemptions are provided for, and their entity was further enlarged by the December 2007 reform. They include:

1. 40 per cent of the value of tangible fixed assets in the tax year the said assets were purchased;
2. all taxes paid as a consequence of the economic activity performed are fully deductible;
3. up to 25 per cent of the Tax levied on financial transaction;
4. placement or transfer to capital reserve of certain items;
5. those incentives granted to business enterprises operating in the Free Zones (Fzs).

The CT tax base is deemed to be the higher of the taxable income, and a 'minimum presumptive income' equal to 3 per cent of a corporation's net worth.[21] Corporate income will be taxed at a flat rate of 33 per cent from 2008 onwards (taxed at 34 per cent in 2007).[22][23]

3.1.1.3 Other direct taxes

Financial income paid to residents

Interest and capital gains received are included in taxable income *i.e.* they are taxed under the ordinary rules, with the exception of a few items which are exempted/subject to special rules. Dividends paid to Colombian residents by Colombian corporations or Colombian branches of foreign companies are no longer taxable (they were taxed at 7 per cent before the December 2006 reform).

Net wealth tax and other taxes on capital and property

Up until the year 2010, net wealth tax will be levied on those tax payers (individuals or enterprises) whose liquid net worth at the 1st January of each year exceeds a given amount (COP 3,000,000 in 2007). The tax rate is 1.2 per cent (compared with 0.3 per cent before the December 2006 reform), and the tax is levied on the net value of wealth excluding shareholdings in nationalized companies.[24] Real estate benefiting from works of local public interest may be subject to the payment of a battlement contribution. Inheritances, bequests and gifts are not taxed as such, but are considered and taxed as capital gains within the income tax framework.

Financial transactions tax

[21] This presumption does not apply to enterprises subject to special regimes or to tax payers operating mainly in financial markets and the public services.
[22] Colombia's is the highest such rate among Latin American countries, and is on a par with that of Paraguay. The Latin American average is 28.3 per cent, while the lowest rate - 15 per cent - is that of Brazil (ILPES-CEPAL).
[23] However, the taxpayers listed under 4 are entitled to pay at a lower rate of 20 per cent. Enterprises operating in FZS are subject to a rate of 15 per cent provided they qualify for it.
[24] The value of the house in which a tax payer usually resides is subject to taxation just for a part. Some non-profitable organizations are exempt from payment of this tax.

This tax was originally conceived as a temporary measure when introduced in 1998: nevertheless, since the 2000 tax reform it has became a permanent feature of the tax system, and the revenue it produces now plays a sizeable role in Colombia's fiscal revenue. The tax is levied at the rate of 0.4 per cent on those financial transactions regarding cashier's checks and savings account deposits. However, transactions between accounts belonging to the same person or company are exempt from financial transaction tax, and a 25 per cent deduction from income tax is granted.

3.1.2 Indirect Taxes

3.1.2.1 Value added tax- VAT

Since 1983, VAT has gradually emerged as a vital source of tax yield, taking the place of the then general sales tax. Certain of its present, important features have only emerged over the course of time, including the gradual increase in VAT rates, its extension to services, the deductibility of machinery, and its being credited against incoming VAT rather than against PIT or CT due (Shome 1995). VAT is levied on the supply and importation of all goods and services, unless those explicitly excluded by law. In the latter case, the goods may be either excluded (*i.e*. not subject to VAT) or exempted (zero-rated, *i.e*. subject to VAT at 0 per cent). The former category of goods includes a basket of essential goods consumed by, among others, poor households. The latter category consists mainly of exports, financial and insurance services and some social services (health, public transport, education). Special rules apply to small taxpayers. A share of the yield is transferred to lower tiers. The standard VAT rate is 16 per cent [25], although certain goods and services are taxed at four different rates: 1.6 per cent (in the case, for example, of cleaning and private security services); 10 per cent (certain foods, health insurance, entertainments, cotton, tobacco, works of art, air freight); 20 per cent (e.g. mobile telephone services, some vehicles and some alcoholic beverages); while other vehicles and alcoholic beverages may be subject to 25 and 35 per cent VAT.

3.1.2.2 Other indirect taxes

Stamp duty

Stamp duty is payable on any public or private document concerning the creation, existence, changes or cancellation of obligations over and above a certain threshold. Pursuant to the 2006 re-

[25] This rate is slightly higher than the LA average (14.7 in February 2006 (ILPES-CEPAL)

form, the tax is due to be gradually phased out. The current rate of 1.5 per cent will be reduced to 1.0 per cent as of 2008, then to 0.5 per cent in 2009, before the tax is abolished altogether in 2010.

Excise duties and agricultural products' taxes

Excises duties are due on petrol, tobacco and alcoholic beverages. Tax rates vary, depending both on the characteristics and type of product in question, but most are relatively high, as they indeed are in other developing tax systems. [26] Exports are exempt from such duties. Other lesser taxes are levied on agricultural products (such as rice, cacao, wheat, barely, maize, sorghum and oats).

Import and export duties

Certain custom duties are levied on foreign products. As a member of the Andean Group, Colombia must abide by a mutual plan regarding external tariffs. According to this plan, the rate levied on those raw materials either not produced in the member countries or scarce therein, is set at zero per cent. Intermediate goods are taxed at 5, 10, or 15 per cent while a 20 per cent rate is applied to final products. The duties on vehicles are the highest of all, and may even be as high as 35 per cent. With the sole exception of coffee, which is subject to several duties, no taxes are levied on exports.

3.2 Local taxes

Taxes may be imposed by Colombia's Parliament, although certain levies may also be introduced by Departmental Assemblies and Municipal Councils. However, the revenue from these taxes constitute but a very small part of the total tax burden and a very small share of the resources needed to finance local spending. If authorized to do so by Parliament, the Departments may establish taxes on alcoholic beverages, cigarettes or tobacco, gasoline, lottery tickets and horse race betting, together with registration duties and social security contributions. The *Unified real estate tax*, together with the *Industry and commerce tax*, represent the Municipalities' main source of revenue. The basis used to assess the property tax is the national cadastre, while the rates are chosen locally from a range set by national law. Public establishments, government departments, state-run enterprises, mixed public/private companies, and companies belonging to Departments, are not subject to the tax. Furthermore, Municipalities may levy road, forestry, gambling and prize-winnings taxes, and benefit from contributions when real estate properties appreciate as a result of public works.

[26] For instance 20 to 40 per cent on alcoholic beverages, 48 per cent on beer; 55 per cent on tobacco.

3.3 Social security contributions

Subsequent to the 1993 pension reform[27] (Clavijo 1998; Rudolph *et al*. 2006), and its following amendments, any public or private sector employee[28] has to contribute to the pension system at a rate of 15.5 per cent of wages, approximately two-thirds of which was charged to the employer, while the rest to the employee. Subsidies are provided to those citizens who are not able themselves to contribute to social welfare funds. Only those taxpayers earning over and above a certain threshold income are asked to pay their social security contributions in full. The health care insurance charge is about 5 per cent for employees and 7 per cent for employers. Payroll taxes are due from employers to cover unemployment insurance, subsidies for families and poor children, occupational accident insurance and technical training, at rates varying from 2 to about 8 per cent for any single item. Hence the total burden of payroll taxes amounts to all of 47 per cent, about 37 per cent of which is charged to employers and about 10 per cent to employees. One may ask why such high rates do not give rise, as is the case in Brazil, to higher revenue from social security contributions than the present figure of 2.8 per cent of GDP (see Table 2 above). One answer may lie in the fact that the present pension system is estimated to cover only about 25-30 per cent of the entire labor force, and in the lengthy term of transition to the new pension system (completion is due in 2013).

4. The principal tax policy issues

4.1. The distribution of Colombia's fiscal burden

The increasing Colombian social expenditure over the last 20 years has not been very effective from the redistributive viewpoint. This has been due to the lack of a valid evaluation system, to the fragmentation of the welfare programs (Perotti 2000), and to the fact that these measures have mainly consisted in funding education and healthcare -expenditures which however appear to be progressive (Ariza and Zapata 2005)-, while no attempt was made to implement a social security safety net. Colombia has merely adopted a targeted program of transfers to the poor (*Familias en acción*) like to those introduced in recent years in other Latin American countries (Clavijo 2005).[29]

It is thus worthwhile analyzing the redistributive effects of taxation. Over the last few years, Colombia's government has made efforts to expand progressive taxation. In particular, from 1998

[27] The main change introduced by the reform was the establishment of a fully funded, privately administered defined contribution pension system running parallel to the existing defined benefit PAYG State scheme. Workers may choose *between* the two systems, but may *not combine* the two. Hence the system ought to be defined as a single pillar system, the main consequence of which being that the contribution rates are the same for both the systems.

[28] Self-employed workers may join either system voluntarily, provided their contributions reach a minimum level.

[29] *'Progresa'* in Mexico in 1997, *'Bolsa-Escola'* in Brazil in1995.

onwards increasing importance was given to the Financial transaction tax; however, it is difficult to assess the impact of this tax on the progressivity of the tax system.[30] At first sight it would seem that income tax has contributed towards the redistribution of income, given its system of progressive rates. In fact, the average value of the PIT quasi Gini coefficient[31] for 1993-2000 (Sanchez and Espinosa 2005) is quite high (0.64).[32]. These values point to a huge concentration in the distribution of the tax burden, whereby the richer quantiles of the population pay the majority of the tax. However, this does not necessarily imply that the tax system significantly levels out the inequalities plaguing Colombian society. To check this effect we ought to look at the post-tax Gini index. A good example is provided by Ariza and Zapata (2005), who calculate the Reynolds-Smolensky index [33] for 2003 and obtain a miniscule value (0.005). The weak redistributive power of the tax can be accounted for by two simple facts. The first is that the above-mentioned series of exemptions substantially narrows the tax base; secondly, we ought not to forget the massive effect of tax evasion in Colombia. To conclude then, even though the legal structure of Colombia's PIT is a progressive one, its equalizing power is quite weak since the incidence of the tax is extremely low.

Standard literature of public finance point out the negative equity effects of indirect taxation, due to taxpayers' decreasing consumption propensity. However, one must take into account the structure of Colombian VAT, whereby many basic goods are VAT-exempt, while certain luxury goods are taxed at higher rates. According to Avila *et al*. (2001), the tax allows for income redistribution for the first 18 ventiles, whereas the situation differs in the case of the last two ventiles where the rates of saving are quite high. Other scholars, on the contrary, believe that the tax is fully capable of improving equity at any stage. Sanchez and Espinosa (2005), for example, consider the contribution of each decile towards the amount of VAT collected by the Government. They show that the tax is a progressive one that it is mainly paid by the rich people.

4.2 The decentralization of government layers

Over the last two decades, Colombia has made substantial efforts to define its fiscal decentralization model. The first step taken towards this goal was the 1991 Constitutional Reform, one aim of which was to assign greater control over welfare expenditure to the lower tiers of government. The process, however, failed to modify the allocation of tax revenue. While taxation remained centralized, a complex system of vertical transfers was set up to allow local governments to maintain high

[30] This would require certain assumptions regarding the transactions carried out by the various strata of the population. Some attempts were made in this direction. Sanchez and Espinosa (2005) conclude that the FTT has a small redistributive effect, whereas Clavijo (2005) holds that it only affects users of bank markets, not the owners of financial capital.
[31] This is the Gini Index calculated considering the distribution of tax on households' incomes or consumption.
[32] The same index computed by Zapata and Ariza (Zapata and Ariza 2005) for 2003 is even higher at 0.89.

levels of spending (mainly on health and education: Lozano 2000). The transfers were granted as a shares of Central Government revenues, and were calculated using revenue-sharing parameters. This way of financing the lower tiers produced a sharp rise in the flow of resources from Central to the lower governments. During the second half of the 1990s, the quantity of transfers grew enormously, and this discouraged tax efforts at the local level (Jungito and Rincon 2004). The ensuing debate pointed out that the main weakness of the existing transfers' system was the imbalance between the revenue raised by local layers and their actual spending. Since local administrations were also able to borrow to finance their expenditure, and could rely on transfers from Central Government, the problem of the moral risk arose (Iregui *et al.* 2001). Local layers did not need to promote efficient spending, since they knew that Central Government could bail them out (Alesina *et al* 2000). However, the entity of resources was not the only factor creating bad incentives. Transfers to Municipalities were established as an average of various indicators, where the percentage of those people with 'unsatisfied basic needs' accounted for more than 60 per cent. While this scheme improved horizontal equity, it also contributed towards the 'soft budget constraint' problem.

The inadequacy of Colombian fiscal decentralization was one of the main concerns analyzed by the 'Alesina mission' (Alesina 2000), a study group whose aim was to suggest institutional reforms. The group's advisors recommended that a few simple changes be made as follows:
i) Municipalities and Departments should not be allowed to borrow;
ii) allocation rules should be changed, not by eliminating transfers but allocating them using a rule ensuring that local tiers benefit from a share of the taxes collected in the local area;
iii) greater flexibility and clarity with regard to spending decisions and responsibilities.

In line with these recommendations, and in an attempt to reverse the trend in public expenditure while at the same time preserving a decentralized system, Colombia witnessed a new reform in 2001 (Sanchez *et al* 2002). This reform set up a new system for the period 2002-2008. A limit was imposed on local tiers' spending. The link between the revenue of Central Government and transfers was removed, and transfers were converted into lump-sum grants. From 2002 to 2005, the upper limit yearly increases in transfers was set at 2 per cent in real terms; from 2006 to 2008, it was due to rise to 2.5 per cent. Finally, as of 2009, transfers will be allowed to rise at the same pace as Central Government's tax revenue. Hence, after 2009, funding to local layers will once again be linked to Central Government's revenue; the consequences of this will depend largely on the degree to which the transition scheme manages to recovery fiscal responsibility (IMF 2006).

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[33] This index gives the reduction in inequality (Gini index) after tax, which combines the quasi-Gini with the mean rate.

5. The latest changes in the Colombian tax system: a lot of work resulting in a limited, unfair reform and an alternative proposal

5.1. Step one: the need for a broad, theoretically coherent tax reform

After the 1998-2001 adjustment plan, clear evidence emerged of the need for a broad reform of the Colombian tax system. A politically accountable, academically authoritative committee was appointed to identify the weaknesses of the existing system, to establish a coherent framework and to set directions for change: the *Mision de Ingreso Publico* (2002), and it drew up these guidelines:

1. both vertical and horizontal equity, as well as efficiency, need to be improved;
2. the Government has to create new taxes that are easy to handle;
3. a good working relationship between central and local governments needs to be built.

Consequently, the implementation of the following measures was suggested:

1. the widening of the PIT basis, by limiting some deductions and abating exemption thresholds;
2. the simplification of para-fiscal contributions, to be also divided according to payers incomes;
3. the strengthening of CIT by enlarging its basis and reducing the existing generous allowances;
4. the widening of the range of goods on which VAT is due, and the reduction of the number of VAT rates. The final proposal was to expand the base so as to cover one half of GDP, and to apply a single 10.4 per cent rate[34] on all goods while preserving the same revenue as before. The negative effects on redistribution could be compensated for by keeping some essential goods tax-free, or by giving poorer households a VAT rebate. In this case the VAT rate should remain at 16 per cent;
5. the reduction of the financial transactions tax;
6. the strengthening of local taxation.

5.2 Step two: the wide-ranging, ambitious program of reforms proposed in July 2006

In July 2006, the Colombian Government submitted a program for a tax reform to broadly modify the existing system. The taxes due for change were as follows (Government of Colombia, 2006).

i) CIT - Exempt incomes to be cut but not fully cancelled out; all fixed investments to become deductible. A rate of 34-32 per cent to be applied from the first to the third and later years.

ii)PIT - The level of exemption to be raised and marginal rates reduced. All allowances, barring the basic exemption, to be repealed.

[34] Apart from some presumed theoretical merits, the efficiency advantage of single-rate VAT is its greater administrative simplicity, ease and lower cists of compliance, especially given the resulting reduction in tax refunds; it may also help limit tax avoidance. Chile is the main example of a Latin American country with single-rate VAT.

iii) VAT - Rates to be greatly simplified (10, 16, 25 per cent). Exemptions not to be completely abolished, but in the main replaced by zero rates. Rebates of COP 236,000 (= US$ 100) to be introduced to in part compensate the poor for the lesser number of essential goods exempt.
iv) Financial Transaction Tax to be kept in force at the rate of 0.4 per cent, while *Stamp duty* and *Wealth tax* to be abolished.[35]

The tax reform package was not at all in keeping with the *MIP*'s recommendations. The exemption thresholds not had to be reduced but raised to the point where total allowances were extended rather than reduced. VAT should continue to be levied at more than one rate, and a dual system of untaxed goods and rebates to poor households established. A number of important issues were not addressed: e.g. the question of decentralized government's revenue, and the reform of para - fiscality. In terms of equity, the reform proposal greatly favored the middle and upper classes, whose incomes were lightly taxed while their wealth was now largely to escape taxation. Colombia's poor citizens, on the other hand, were penalized when it came to taxation on consumption.

5.3 Step three: the minor, unfair 'reform' introduced in December 2006

We have mentioned the changes introduced by the December 27th 2006 reform in the previous description of the Colombian taxes, since these changes will come into force from the 1st January 2007. However, the overall picture shows that once again the few real changes made are to the advantage of the country's wealthier citizens and its large corporations. Income tax has remained almost unchanged. While on the one hand, the lower limit of the top bracket has been brought down, on the other hand no adjustments for inflation have been made as yet. The rate of wealth used to calculate 'presumptive' personal and corporate income has been halved. The wealth-tax rate has been increased, but the tax will be abolished in 2010. A few goods have been exempted from VAT, but in the case of a larger number of goods, the previous rates have been replaced by a higher rate.

[35] According to the Government's estimates, the PIT threshold exempted all tax payers within the first 7 deciles, and the tax would also have been very light when it came to higher incomes. The situation regarding VAT was quite different however. A roughly flat rate of around 5.5 per cent was to be levied on taxpayers within the first 5 deciles (those earning up to approximately COP 16.5 million yearly - about US$ 7,000), above which the tax rate rose and burdened the 10th decile to the greatest degree. To sum up then, only those tax payers with an annual income of at least COP 104 million (about US$ 44,000) were to pay a combined (PIT + VAT) rate of just over 20 per cent.

5.4 An alternative strategy for tax reform designed to benefit the poor rather than the rich

To counter social deprivation, any tax reform would need to be different from the latest proposals & bills submitted. The cornerstones of such a reform should be the extension of PIT to middle incomes at a reasonable mean rates, together with a reduction in VAT charges. Wealth tax should be made permanent, and serious measures should be adopted to combat tax-evasion and smuggling. In our opinion, political forces rather than economic factors are preventing Colombia from substantially increasing both income and wealth taxes. This potential revenue could be added to that recovered by extending instruments such as presumptive assessments and minimum taxes. A surcharge should be introduced on the rents of those large corporations operating within the framework of a natural monopoly or exploiting natural resources, land included. The revenue gathered in this manner could then be used to subsidize the poor of this beautiful, culturally and historically wealthy country; those same citizens who inhabit the shantytowns one sees when landing at Cartagena Airport, or who inhabit the impoverished villages of Colombia's interior.

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http://www.eclac.cl/Ilpes/ - United Nations Economic Commission for Latin America – Latin American and Caribbean Institute of Economic and Social Planning

Table 1 - Structure and development of operations in the Non-Financial Public Sector - Selected figures and years - Percentage of GDP

	1990	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Total Revenue, of which:	*20.0*	*27.8*	*31.0*	*31.3*	*30.5*	*33.9*	*33.7*	*35.1*	*34.7*	*35.4*	*37.5*	*34.9*
Total Taxes	12.6	16.5	17.3	17.8	18.0	16.2	16.0	17.4	17.3	17.6	18.6	18.0
Non-tax current revenue	7.3	9.4	11.4	10.9	10.3	16.7	17.2	17.6	17.2	17.6	18.7	16.9
Total Expenditure, of which:	*20.6*	*28.1*	*32.7*	*34.1*	*34.2*	*38.0*	*37.5*	*39.1*	*38.1*	*38.0*	*38.6*	*35.5*
Current primary expenditure	10.9	15.7	17.6	18.9	20.2	25.8	25.0	25.8	25.5	25.3	26.3	25.3
Interest on Public Debt	3.2	3.3	3.9	3.7	4.6	3.7	4.3	4.8	4.5	4.7	4.5	4.0
Capital expenditure	6.5	9.2	11.2	11.5	9.4	8.3	8.2	8.5	8.1	8.0	7.7	5.9
Primary Surplus	*2.6*	*3.0*	*2.2*	*0.9*	*0.9*	*-0.3*	*0.4*	*0.7*	*1.0*	*2.1*	*3.6*	*3.7*
Budget Balance	*-0.6*	*-0.3*	*-1.7*	*-2.8*	*-3.7*	*-4.1*	*-4.0*	*-4.1*	*-3.5*	*-2.6*	*-0.9*	*-0.3*
Total public debt of NFPS			*29.7*	*34.6*	*39.1*	*50.1*	*57.8*	*62.9*	*71.5*	*67.7*	*62.6*	*60.2*
Total public debt of Central Government	*14.8*	*13.9*	*14.4*	*17.8*	*24.5*	*34.6*	*42.7*	*48.4*	*55.9*	*54.9*	*52.0*	*51.0*

Source: ILPES-CEPAL on Colombian data of Ministerio de Hacienda and CONFIS.
Notes: The figures for 2005 are provisional.

Table 2 - Structure and development of consolidated General Government revenue - 1990 - 2004 - Percentage of GDP

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Total tax revenue	*9.6*	*10.7*	*11.2*	*11.5*	*12.1*	*11.8*	*12.5*	*13.2*	*13.1*	*13.4*	*13.9*	*15.8*	*16.0*	*16.6*	*17.6*
Direct taxes, of which	3.6	4.6	4.9	5.0	4.8	4.7	4.6	5.2	5.2	5.7	5.9	7.0	7.6	7.7	8.4
income and profits	3.2	4.2	4.4	4.5	4.2	4.0	3.8	4.4	4.3	4.2	4.3	5.3	5.2	5.1	6.0
households					0.2	0.2	0.2	0.2	0.2	0.2					
corporations & businesses					3.9	3.8	3.6	4.2.	4.1	4.0					
property	0.4	0.4	0.4	0.4	0.5	0.6	0.7	1.4	1.2	1.4	1.2	1.4	2.0	2.1	2.0
other direct taxes	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.4	0.4	0.4	0.4	0.4	0.4
Indirect taxes, of which:	6.0	6.1	6.4	6.5	7.3	7.1	7.8	8.1	7.9	7.7	8.0	8.8	8.6	9.1	9.2
general taxes on goods and services	2.4	2.8	3.2	3.3	4.1	4.1	4.7	4.8	4.6	4.4	4.8	5.3	5.2	5.7	5.9
specific taxes on goods and services	1.8	1.8	1.8	1.7	1.9	1.8	1.8	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.0
international trade	1.3	1.0	0.9	1.0	1.1	1.0	0.9	1.0	1.2	0.9	1.0	1.1	1.0	0.9	0.9
other indirect taxes	0.5	0.5	0.4	0.5	0.3	0.3	0.3	0.4	0.3	0.5	0.3	0.4	0.4	0.4	0.4
Social security contributions	*0.8*	*1.8*	*1.9*	*2.1*	*2.8*	*3.7*	*4.1*	*4.4*	*3.8*	*3.6*	*2.9*	*2.9*	*2.6*	*2.4*	*2.8*
Total fiscal revenue	*10.5*	*12.4*	*13.1*	*13.6*	*14.9*	*15.5*	*16.6*	*17.6*	*16.9*	*16.9*	*16.8*	*18.6*	*18.8*	*19.21*	*20.4*

Source: ILPES - CEPAL on Colombian data of Ministerio de Hacienda and CONFIS.

Table 3 Central and General Government revenue compared with the Latin America average

	Central Government -2005		*General Government -2004**	
	Colombia	*LA average*	*Colombia*	*LA average*
Total fiscal pressure	17.6	15.2	20.4	21.1
percent increase from 1990	98.0	31.0	94.2	27.1
percent share direct taxes	42.2	27.6	41.1	28.9
percent share indirect taxes	43.2	59.9	45.1	48.0
percent share social contributions	15.6	12.5	13.8	23.1

Source: ILPES – CEPAL.

Notes *Only Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Uruguay. The 2005 figures are provisional.

Table 4 Tax brackets and rates of personal income tax

Net taxable income	Marginal tax rate	Average tax rats at mid- brackets
COP > 0-21,800,000 (US$ 9,2506)	0	0
COP 21,800,000- 34,000,0000 (US$14,400)	19	5.0
COP 34,000,000-82,000,000 (US$34,750)	28	15.5
Over COP 82,000,000 (US$34,750)	Lump-sum payment (COP 15,760,000) plus 33 percent of the excess over and above COP 82,000,000	27.7 percent as example for an income of COP 200,000,000 (US$ 84,750)

5. COSTA RICA

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Abstract
This paper is part of a wider research on “Tax Systems and Tax Reforms in Latin America”, carried out at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. After a general introduction, section 2 shows the structure of tax system in the early 1990s, together with the main reforms adopted during the 1990s, and with reference both to the tax burden and to an international comparison. Section 3 describes the main institutional features of the major taxes. Nevertheless, tax revenue still falls short of the country’s need for public investments and it is well below the expected level in light of the country’s income or the human development level. Since 2002 the country has been discussing a tax reform bill that will amend most of the deficiencies mentioned so far. When and whether there will be a vote on this bill is uncertain.

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1 Introduction and main conclusions

In the early 1990s, Costa Rica's tax system was characterized by its complexity, consisting in a very high number of taxes, a broad use of tax incentives that eroded the tax bases and a poor technical design of the taxes. Tax Administration was weak and lacked appropriate legal instruments to enforce the tax code. Moreover, no interest accrued on tax debts. The Costa Rican government was, in fact, a bank granting interest free loans to taxpayers who did not pay their taxes on time.Since then, systematically but very slowly, the Tax Administration has been strengthened and the tax code improved and simplified; the use of tax incentives has diminished, the sales tax's basis has been broadened while that of excise taxes has been narrowed – conforming to best international practices – while the basis for the income tax has also been expanded, modestly. The tax burden of the central government has been increased from 11.3% of GDP in in 1991 to 13.4% of GDP in 2004 and is expected to reach 14% of GDP in 2007. Nevertheless, tax revenue still falls short of the country's need for public investments and it is well below the expected level in light of the country's income or the human development level.

Both the income and the sales tax still have technical limitations: the income tax is based on Product-Income concept (generically excludes capital gains taxation), a schedular structure and has a significant rates' dispersion. The sales tax, name used in Costa Rica for the Value Added Tax, excludes most services (Costa Rica's fastest growing economic sector) and does not allow credit for goods or services not physically incorporated into the final product.

Since 2002 the country has been discussing a tax reform bill that will amend most of the deficiencies mentioned so far. When and whether there will be a vote on this bill is uncertain. The pace of reform seems to have shifted from slow to glacial and Congress's current top priority is ratification of the free trade agreement between the Dominican Republic, Central America and Unites States.

2 Structure of the tax system

2.1 The tax system in the early 1990s

The Costa Rican tax system, in the early 1990s, had such complexity that an IMF mission lead by Vito Tanzi, stated: "…it will be difficult to find other countries, regardless of size or of economic development – with a more complex system. This complexity is the result of the extremely high number of taxes, the increase of special incentives, the vast number of public sector activities and the disintegration on the performance of those activities" [1]Deficiencies in the design of the principal taxes were summarized as follows. [2]

1. *The sales tax basis* was limited to goods, and only included certain listed services. The tax was based on the principles of invoice - credit of the value-added tax, but recognized credit only for the acquisition of goods and raw material physically incorporated into the final good. On the other hand, the Selective Consumption Tax covered more than 1,000 tariff items, even though most of the revenue came from just a few goods.[3]
2. *The Personal Income tax* had a schedular structure, with different rates for each schedule. Financial income was very lightly taxed. The Corporate Income tax had progressive rate structure based on gross income, with reasonable rates. Mendez (1991, p.8) summarized these features as follows: "The income tax is characterized for imposing different rates on different types of income and on different legal persons. Thus, different rates exist for capital income and labor; for income of dependent employees and independent workers; for small businesses and for other companies, for cooperatives, for the agricultural sector; for the forest sector; for coffee and banana producing sectors"
3. *Foreign Trade Taxes*, in spite of tariff reductions in the 1980s, still represented 30 % of Central government revenue, or 3.4 % of the GDP in 1991.
4. Many laws granted tax incentives to promote investment and exports: Tourism Incentives Law, Free Trade Zone Regime Law, Export Incentives Law, Industrial Production Incentives Law and several laws to encourage the forest development. Thus "We created a system in which the success from the developing of the new model has a negative impact on the public finances. The development of non traditional exports, of tourism, of forest activities ... requires public expenses and investments, but these sectors do not contribute to the revenue of the government"[4]

It is then not surprising that the tax burden of the country was relatively low and the direct taxes' contribution was very limited, as Table [5] 1 shows. Please note, however, that in 1995 the tax burden, for the first time in this period, is more than 12 % of the GDP, which reflects changes in the tax structure and a better tax administration.

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[1] TANZI *et al* (1990), pp.2-3.
[2] This section is based on Cornick (1998), pp. 45 and ss.
[3] See Méndez (1991)
[4] Herrero and Fernando (1994), p. 39
[5] See Cornick (1998 and 2002)

Table 1: Taxes as percentage of the GDP, 1991-1995 per tax period

	1991	1992	1993	1994	1995
Tax Revenue	11.3.%	11.9%	11.9%	11.6%	12.3%
Direct Taxes*	2.2%	2.2%	2.7%	2.8%	3.1%
Income Taxes	1.7%	1.6%	2.0%	2.1%	2.2%
Indirect Taxes	9.1%	9.7%	9.2%	8.8%	9.2%
General Sales Tax	*4.0%*	*4.4%*	*4.2%*	*3.9%*	*4.1%*
Selective Consumption Tax / Excises	*1.4%*	*2.0%*	*1.9%*	*2.0%*	*1.9%*
Foreign Trade Taxes	*3.4%*	*3.0%*	*2.7%*	*2.6%*	*2.9%*

**Includes pension contributions from the national budget.*
SOURCE: Authors' elaboration based on Ministry of Finance and Central Bank of Costa Rica data.

Regardless of these weaknesses, at the beginning of this period the fiscal deficit was reasonable, although it grew in 1994 and 1995, partly as a result of the shutdown of a State bank, since the costs were assumed by the government.

2.2 Tax reforms in the 1990s[6]

During the 1990 several reforms were proposed to increase tax-revenue, improve tax design and strengthen tax administration. At the end of this section we will present some data which illustrate the effect of those reforms on the structure of public sector revenue. Firstly, however, we will present a brief description of the reforms in this period.

*Income Tax***.** In 1992 almost all exemptions from the Income Tax were eliminated, except those for Free Trade Zones and cooperatives. The immediate effect, though, was limited since the "acquired rights" of the taxpayers who were enjoying the exemptions were maintained until the expiration of their contracts. In 1995, the "Tax Justice Law" tried to reduce income tax evasion by independent professionals through the increase of presumptive income standards and created a tax on fixed assets, creditable to the payment of corporate income tax, a type of minimum tax. In 1999 the Costa Rican Constitutional Court declared unconstitutional the main aspects of the law. In 1998 a tax was imposed on the Certificates of Tributary Credit (CAT), the main tax subsidy used as an incentive for exports. In 1991 a tax of 25 % on CAT had been created, but only for those taxpayers who voluntarily elected to pay the tax and in exchange accepted an extension of the incentive period. In 1999 a new reform to the Tax Code modified one of the main deficiencies of the previous system. Tax debts resulting from tax assessments started to bear interest form the moment the debt was incurred in the first place; previously, interest charges started accruing only after the Administrative Tax Court had ruled on the debt, which usually happened several years after the tax assessment. In 2001, with the approval of the "Tax Efficiency and Simplification Law", the additional depreciation expenses caused by revaluation of fixed assets was abolished. This law also increased the applicable rate to certain types of income. Specifically, the income from remunerations, gratuities and salary in kind, previously subject to a 10 % rate increased to 15 % rate. In addition, private universities and "off shore " banking were included in the tax base. In this last case, a fixed annual tax was imposed, similar to an "operational license", and different from the obligation to pay tax on income as other companies. An 8% tax was imposed on revenue form repurchase of securities (recompras y reportos).

*General Sales Tax***.** The tax rate was temporarily increased form 10 to 13% in 1991 and went back to 10% in 1994. In 1995 the rate was increased again, to 15 %, for eighteen months and then returned to 13 %, its current rate. During the 1990s, the tax basis was increased, but the list of exempt goods remained extensive, and included not only final consumption goods but also raw materials and other goods used in the agricultural production.

Selective Consumption Tax. The list of goods subject to Selective Consumption Tax was extremely large in the early 1990´s: 1,500 tariff items in 1995. In 1996 the number was reduced to 700 items. The Executive's authority to increase the rate every six months without legislative approval was abolished on August 2001.

Foreign Trade Taxes. The average tariff level continued to decrease, as did tariff rates' dispersion. All taxes on exports were repealed, except those on coffee, banana, meat and cattle.

Changes in the revenue structure of the Central Government. These changes resulted in a substantial modification of the revenue structure of the Central Government, as shown in Table 2. which includes also the first column from Table 1.

[6] This section is based on Rodriguez-Clare and Angulo (2002).

Table 2. Tax revenue as percentage of the GDP, 1991 and 1996-2004

	1991	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Tax Revenue	11.3%	12.7%	12.5%	12.6%	11.9%	12.3%	13.3%	13.2%	13.3%	13.4%
Direct Taxes*	2.2%	3.0%	3.0%	3.2%	3.6%	3.5%	3.9%	3.9%	4.1%	4.1%
Income Taxes	*1.7%*	*2.2%*	*2.2%*	*2.4%*	*2.9%*	*2.7%*	*3.1%*	*3.1%*	*3.3%*	*3.3%*
Indirect Taxes	9.1%	9.8%	9.5%	9.3%	8.3%	9.1%	9.4%	9.3%	9.2%	9.3%
General Sales Tax	*4.0%*	*5.4%*	*5.1%*	*4.8%*	*4.3%*	*4.5%*	*4.9%*	*4.9%*	*4.7%*	*4.9%*
Selective Consumption Tax and Excises	*1.4%*	*2.3%*	*2.4%*	*2.7%*	*2.7%*	*3.2%*	*3.3%*	*3.4%*	*3.4%*	*3.2%*
Foreign Trade Taxes	*3.4%*	*1.8%*	*1.7%*	*1.6%*	*1.2%*	*1.0%*	*1.0%*	*0.9%*	*0.8%*	*0.9%*

**It includes pension's contributions from the national budget. Author's calculations based on Ministry of Finance and Central Bank data.*

Note that tax revenue of the Central government increased for by about two points of the GDP, from 11.3 to 13.4%, from 1991 to 2004. Of this increase, 1.9 percentage points were due to increased direct taxes' collection, while sales tax collection increased by 0.9 percentage points. In contrast, taxes on foreign trade, which in 1991 were equivalent to 3.4 % of the GDP, in 2004 barely, reached 0.9 %, as a result of the tariff reduction and the elimination of exports taxes. Overall, a slow but steady increase of the tax burden occurred during this period. Preliminary data suggests that this upward trend will continue since 2005 to 2007..However, is this rate of increase enough to satisfy the public expenditures needs of the country? AGOSIN et. to (2005) have argued persuasively that it is not: Costa Rica's tax burden is less than the expected[7], either taking as a reference the level of income of the country or its level of human development.

Distribution of the tax burden The incidence and allocation of the tax burden in Costa Rica has been analyzed in detail in Taylor (1997) and Bolanos (2002) works which updated the previous results and concluded that pre and post tax income distribution is almost identical.[8]. Nevertheless, the distribution of tax burden showed a slight improvement between 1988 and 2000. The gross effective burden in 1998 increased from the first to the third

[7] In the econometric sense of the term: the value expected from the tax burden in Costa Rica, in an econometric exercise taking into consideration variables such as the level of income and the level of human development, is superior to the value actually observed.

[8] Since it is predictable in this type of studies, and to use the words of the author " The results for low income groups are quite sensitive to the situations, particularity the matters related to the transfer of salary taxes."

income decile and it decreased from there on; however in 2000 it did oscillate. The change of the trend was characterized by the Author as a movement from “solid regressiveness” to “moderate regressiveness”.However, there are no great differences in the tax burden by income level: for the first decile the total is 21.9 % of gross income, and for the tenth decile the total is 20.9% of gross income.

2.3 International comparisons

Considering the differences in terms of income levels and human development between Costa Rica and other Central American countries, perhaps it will be surprising that the tax revenue structure, without considering the social security charges, is very similar in all these countries. Naturally, if payroll taxes are included (by judicial fiction, payroll taxes other than the income tax, are not considered taxes in Cost Rica) the Costa Rican tax burden is higher, but nevertheless the basic similarities remain. In the following Table we compared the structure and level of tax revenue (as percentage of the GDP) of Costa Rica and the Central American average for the year 2002. It can be noticed, that the countries with higher tax burden are Nicaragua and Honduras, but this information probably shows an underestimation of the GDP in the abovementioned countries. In any case, the tax pressure in Costa Rica is closer to the Central American average and the structure of the tax revenue structure is also very similar, with low importance on direct taxes and a big burden on indirect taxes. In this Table we do not distinguished between income tax paid by companies and the one paid by individuals, however further on we will disclose some information on this matter for the case of Costa Rica.

Table 3. Central American countries tax pressure per type of tax on the year 2002 (% of the GDP)

Concept	*Costa Rica*	*El Salvador*	*Guatemala*	*Honduras*	*Nicaragua*	*Central America*
Total Tax Revenue	12.8	12.0	10.6	16.1	14.3	12.3
Direct Taxes Income	3.5	3.5	2.8	3.7	2.8	3.2
Income	3.1	3.4	2.8	3.5	2.8	3.1
Families	0.0	0.0	0.0	0.0	0.0	0.0
Companies	0.0	0.0	0.0	0.0	0.0	0.0
Properties	0.4	0.1	0.0	0.2	0.0	0.2
Other Direct Taxes	0.0	0.0	0.0	0.0	0.0	0.0
Indirect Tax Income	9.3	8.5	7.8	12.3	11.4	9.1
Goods and services General tax	4.9	6.3	4.8	5.5	5.9	5.3
Domestic	n/d	3.0	1.9	n/d	n/d	2.3
Imported	n/d	3.3	2.9	n/d	n/d	3.0
Goods and services Specific tax	1.1	1.1	1.5	1.9	3.7	1.5
Petroleum Derivatives	S/d	0.6	0.9	0.7	2.5	0.9
Others	S/d	0.5	0.6	1.2	1.3	0.6
Trade and International Transactions	0.9	1.1	1.2	2.0	1.1	1.2
Other Indirect Taxes	2.4	0.0	0.3	2.9	0.7	1.1

A comparison with the tax structure of Mercosur countries, on one hand, and with the average structure for the European countries, shows different results.

Table 3 - Partial comparison of revenue of the Central government: Europe 1997, Mercosur 2002; Costa Rica 2004 (% of GDP)

	Europe	*Mercosur*	*Costa Rica*
Tax Revenue, from which	29.1	19.8	13.4
Sales Tax	7.3	5.9	4.9
Income Tax	14.5	4.2	3.3

Sources: Costa Rica, Ministry of Finance; Mercosur: Barreix and Roca (2005); Europe: Bernardi (2002)

The tax burden of the Central Government in Costa Rica not only is extremely lower than the European average, but also than the simple average of the countries of the Mercosur. On the other hand, in Europe the income tax collection almost duplicates VAT collection, in contrast both Costa Rica and the Mercosur where sales tax collection is higher than the income tax collection.

3 Structure of the main taxes

3.1 Income taxes

It is customary to classify income taxes as either individual or corporate taxes, depending on who bears the burden of the tax. Due to Costa Rica's scheduler income tax structure, this allocation is not entirely possible in Costa Rica. However, taxes on personal and corporate profits and on wages can be anyway classified. This is done in Table 4. However, some clarifications are needed: salaried workers in Costa Rica do not file a tax return and the tax is withheld at source. Only independent workers must file a tax return. Therefore, in Table 4 the total contributed by individuals is the sum of the withholdings from the salary of employees and pensions of retirees more than income tax from independent individuals. In any case, it is clear that still adding the withholdings from employees and the income tax from individual, (the sum totals 25.9 per cent of the collection related to this tax) the Corporate Income Tax contribution is much higher, equivalent to 49.5 per cent of the entire collection of personal direct taxes, or almost the double of the tax paid by individuals. The contrast with the European case, in which the individuals pay almost three times more taxes than companies, is clearly remarkable. This schedular income tax structure represents an important challenge to the tax reform currently in discussion and it will be described further on this chapter. The fact is that there is a strong internal and external pressure, in the sense of reducing the corporate income tax and compensates this revenue loss. This compensation requires a broader corporate income tax base and a constant raise on individual income tax collection, and both efforts are substantially challenging.

Table 4: Percentage distribution of the income tax collection 1998-2004

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Salary and Pension's Contribution	25,6%	23,1%	27,8%	24,4%	27,6%	26,6%	23,8%
Other withholdings - a)	25,0%	21,1%	23,5%	22,3%	27,3%	24,8%	23,4%
Individual and Corporate contribution, from which	45,0%	45,1%	46,4%	40,3%	43,8%	45,5%	51,6%
Corporate	43,2%	43,6%	44,7%	38,6%	41,9%	43,0%	49,6%
Individual	1,8%	1,5%	1,8%	1,6%	1,9%	2,5%	2,1%
Others - b)	4,4%	10,7%	2,2%	13,0%	1,3%	3,1%	1,2%

a) It includes securities withholding
b) It includes non domicile financial institutions tax

Income taxation in Costa Rica, ruled by Income Tax Law 7092, of 1988, has three main features: it is "Schedular" which means it is formed by several different income taxes; it is based on a territorial principle; it is based on the Product-Income concept. A "*schedular*" system imposes different tax rates on different sources of income. The classification of the income is structured according to different criteria chosen by the legislator: for example, if income is obtained for personal services rendered in the capacity of dependent employee or as an independent worker, if it comes from labor or from capital and, related to this one, if it comes from regulated financial market transactions or not, etc.. The so called Income Tax, then, comprises several different taxes:

a) *a tax on profits of both corporation and independent workers*. These tax payers file a tax return and pay their own taxes;
b) *several withholding taxes* on: dividend income, interest, salaries, pensions, payment remittances to non-residents.

On the other hand, Costa Rican income tax system is based on territoriality: only income of Costa Rican sources is taxed. Finally, under "Product-Income", only income from capital or labor services is taxed, while capital gains generally are not taxed.

3.1.1 Profits (or Net Income) Tax

This tax is imposed on some net income obtained by some individuals and corporations[9]. The types of taxable income are: income from services rendered by practicing professionals (since there is a specific tax in the Law for the income from dependent labor) and corporate income; capital income from real estate and movable property, and from the disposition of capital, through secured financing transactions different from financial market transactions, since the law includes a schedular tax on financial market profits under article 23. As a general rule, capital gains are not taxable. However, there are two exceptions from that rule:

a) habitual capital gains: defined under article 6 d);
b) depreciable assets: defined under article 8 f), when the taxpayer sells them for a price higher than their book value.

The tax is calculated on net income, defined as gross income minus all costs and expenses necessary to produce said income. In general, depreciation of tangible assets is recognized, however, revaluation is not. In regards to amortization of intangibles, it is recognized for software and invention patents, and it is not authorized for a restrictive list that

[9] A tax is imposed on permanent establishments and branches of non domiciled entities. Additionally other collective entities with no legal personality.

includes goodwill, trademarks, manufacturing procedures, copyrights, intellectual property rights, or formulas or other similar intangible assets.

The difference between the tax treatment for individuals and for corporations gives the applicable rates. For individuals, marginal tax rates from 0 % to 25 %[10] apply as follows:

i) For income below and up to $3,584[11] annually 0%;

ii) Income between $3,584 and $5,313 annually, 10%;

iii) Income between $5,313.01 and $8,928 annually, 15%;

iv) Income between $8,928.01 annually and $17,890 annually, 20%;

v) Income over $17,890 annually, 25%;

Minor deductions for family charges are allowed.[12]

The general corporate tax rate is 30%. However, businesses with up to up to $53,637 pay a 10% tax and those with gross income up to $107,894 pay 20%. As shown in Table 4, most of the collection comes from corporations, while collection form independent workers is quite smaller. Salaried workers pay roughly half as much income tax as corporations.

3.1.2 Withholding taxes

a) Dividends for private corporations are taxed at 15%, but are exempt when paid in stock or to another corporation. The rate is 5% for publicly traded corporations, cooperatives and "*asociaciones solidaristas*".

b) Interest bearing instrument are taxed at 15%, except those traded in the Stock Exchange, which are taxed at 8%. Securities issued in foreign currency are exempt when issued by the Government or a State owned bank. All securities issued by the "Banco Popular y de Desarrollo Comunal" and the National Housing Financial System are also exempt.

c) *Salaries, wages and executive compensation.* In case of the income of regular personnel (employees and officials) of the company and of the income from retirements and pensions of all regimens, the applicable rate is a progressive scale that starts at 0 % for income up to $ 809, then 10% (from $819 to $1,213) and finally 15 % (on the excess of $1,213). On the other

[10] Applicable rates for the period 2006, starting on October 1, 2005. Established by Executive Decree No. 32693-H from September 19th, 2005. La Gaceta 198 from October 14, 2005.

[11] Tax Brackets are defined in colones (local currency). Currency conversion used was the official average as of September 5th, 2006 (¢518.5 = $1)

[12] $18 annually per dependant child. The credit is available only if the child is under age or can not attend his or her own necessities or is physical or mental disabled, or is studying and is not older than 25 years. If both spouses are taxpayers, only one can claim the credit. The credit for a depending spouse annually is $27. If the spouses are legally separate, the deduction can be applied only by the spouse that supports the other, according to the law. If both are taxpayers, only one will be able to credit it.

hand, the applicable rate to executives remunerations and income in kind is a flat 15 %, without any exempt amount.Minimal family allowances are permitted to be deducted from income to which the progressive rate is applicable: for children ($0.89 monthly per each child) for the spouse ($1.60 monthly). In case of income received from periods longer than a month, a deduction from income is allowed for every month. The employer is the withholding agent.

d) Foreign remittances tax. Income from Costa-Rican sources received by non-domiciled individuals or corporations is taxed at varying rates: 10% for wages, salaries and pensions, 15% for independent personal services, 25% for technical assistance, royalties, patents, 15% for interests and dividends, except for interest paid to a "first order entity", declared as such by the Central Bank, 5% for transportation services and communications, 5.5% for insurance, 20% for movies, recordings, discs and the like, 30 % for the rest. If the income recipient cannot claim a credit for the remittance tax paid, Costa Rica exempts him. Also, it includes some exceptional cases of Costa Rican source: technical assistance, financial and other advisory services although clearly rendered in a foreign country in favor to a Costa Rican company.

3.1.3 Other income taxes

a) Special tax for non domiciled banks and financial institutions controlled by or related to local banking or financial group. This tax substitutes the foreign remittances tax and it consists on a flat annual amount of US$125.000. The Costa Rican institution is the withholding agent.

b) Investment funds regime ruled by the Securities Market Law. Except for profits subject to the tax imposed on the financial market interests, all other incomes received by the funds is levied by a return-auto liquidation tax of 5 %, including habitual & non habitual capital gains.

c) the amount referred as "others" in Table 4, includes the collections from non-domiciled banks and financial institutions. However, the current information does not allow us to do a precise calculation of the collection in each situation.

3.2 General Sales Tax

The general sales tax is based on the value added tax model, consumption type, and allows a complete and immediate credit for the taxes paid for purchases of fixed assets.The sales tax in

Costa Rica adopts the consumption tax method. Therefore, there is an exemption of the instrumental assets, only when the final destination is not consumption. Thus, in order to obtain the credit, it is enough to acquire a capital asset that will be used in an activity subject to tax, although it is exempt. Even, if it is anticipated that in three months the tax credits will not be absorbed, it is possible to claim compensation or return. Hence it is not a requirement to hold the capital asset related to the activity until the end of the useful life in order to obtain the right to claim the total amount of the credit for the tax paid in the acquisition. In regards to the criteria applied to allow a credit, the Costa Rican tax does not follow the international trend, since it follows the "physical deduction" method and not the "financial deduction" method, due to an administrative and judicial interpretation. The tax credit is allowed only for inputs that are physically incorporated to the manufacturing process, as well as capital assets that are directly related to the production phase.

All goods are taxed, except those explicitly exempt. In contrast, all services are exempt, except those explicitly taxed. Consequently, the inclusion in the list determines if certain activity is subject to tax, or not. The Attorney General Office has accepted this limited and restrictive characteristic. In contrast, the inclusion of goods is presumed. Consequently, according to the method, first you have to disregard the possibility that the good is excluded from the definition of "goods" stated in the law and regulations, and second you have to discard the possibility of an exemption listed under article 9 of the Law or in some another legal norm. There are two basic forms of the taxable events: imports and local operations and exports. In the first case, each isolated input is taxed. In the second case, each transaction is taxed but in the context of periodical tax returns. The taxpayer description follows the typical system in the value-added tax based on the combination between a special type of taxpayer, the figure of the seller or service provided in each phase of the productive chain.

Although the General Sales Tax is technically characterized by its "multiphase" coverage, under the "Special System of determination and payment of the tax by factories and customs" taxes are assessed on the basis of estimated retail prices and collected from factories, wholesalers and customs. To apply this Special System the Tax Administration must issue resolution that sets the parameters to be applied and other information needed by the taxpayer. As the Costa-Rican tax is based on the destination principle, exports are in practice "zero rated" even though this precise terminology is not used in the Law, while imports under the Free Trade Zone Regime, established by Law 7210, are exempt.

The current tax rate 13 %, except for the consumption of residential energy which is taxed at a 5 % rate. The tax bases of the three basic forms of the taxable event (imports, sales of goods and rendering of some services) are the following:

a) in the selling of goods: the net selling price including the total of the consumption selective tax. There are deductions for the following items:

- *Discounts,* whenever they are commonly used and are separated from the selling price in the invoice;

- *The value of the services* rendered in the selling of goods, whenever they are provided by third parties, invoiced and taken into account separately. It refers to services which value is included in the price of the goods, and as a basic condition a third party has to render the service and the financial expenses have to be invoiced and accounted separately.As special rule, in the case of leases with call option, the base will be the market value of the goods. Aside from this specific provision, the General Sales Tax does not contain any extensive rule related to market valuation between independent parties.

b) In rendering of services, the tax base is the sales net price, determined deducting the amounts described for the sale of goods.

c) In the case of imports, the sum of the Costa Rican customs -CIF value-, and the amount effectively paid for tariffs, economic stabilization tax, consumption selective taxes or specific and any other tax that affects the imports, as well as other charges that appear in the insurance policy or in the customs form.

Credit cards companies should withhold a sales tax advanced payment on electronic payment transactions. The processing company withholds a percentage with a ceiling of 6 % on the total amount of the transaction, excluding that of the sales tax. These withholdings constitute an advance payment to the account of the taxpayer’s monthly liquidation.

3.3 Selective Consumption Tax and other excise taxes

The consumption selective tax is generated either when a good is imported, or when the local manufacturer sells it Different rates apply depending on the product and its basic features:

a) It is a one-phase tax: this means it taxes only the importation or the sale of product by its producer. Further sales are not taxable.

b) It taxes consumption products only. If an item is taxed and then used as an input in the production of taxable goods, a credit equal to the amount paid for taxes on the input is allowed. Therefore, this tax does not have “cascading” effects.

When the manufacturer produces by order of the distributor and the distributor supplies the raw material, the distributor, rather than the manufacturer, becomes the taxpayer. The Tax Administration can modify the tax base so that prices between related companies reflect “arms length” prices. Additionally, the following goods are subject to excise taxes:

*a) Alcoholic beverages***,** based on alcoholic content;

b) Non alcoholic beverages (except milk) by consumption unit**.** For tax purposes, consumption units for all beverages are defined 250 milliliters and for sodas 39,216 ml.. For containers with different contents the tax will be imposed proportionally. The tax applies to national production and the imports.

***c)** Toilet soap:* approximately US$ 0.00015 per gram at the current exchange rate. The tax, in Costa-Rican currency, is updated quarterly according to changes in the Consumer Price Index.

d) Single tax on fuels (oil derived): tax established on fuel either of national production or imported. This tax excludes the application of the sales and consumption selective taxes. The taxable time occurs for the national production at the moment of the manufacture, distillation or refinement. For this purposes national production means the moment in which a product is ready for sale (excludes the reprocessing), and for imports when the customs declaration is accepted. The taxpayer of this tax is Costa Rican Oil Refinery, Corporation (RECOPE), either as producer or as importer. For each type of fuel, the update of this tax is also quarterly, in accordance with consumer index prices determined by National Institute of Statistics and Censuses (INEC), however, the quarterly adjustment cannot exceed the three per cent (3 %).

4 Recent Tax reforms

4.1 Comprehensive Tax Reform

The ad hoc Committee of Former Secretaries of the Treasury was created with the mandate to design a fundamental fiscal reform, including, naturally, tax reform. The Committee’s final report was presented on April 2002[13] and it recommended a substantial transformation of the Income and Value Added taxes. The Secretary of the Treasury issued instructions to the Tax Administration to prepare a bill based on the Committee’s recommendations. The bill, under the name “Fiscal Order Law” was introduced in Congress on April 10, 2002, discussed for

[13] The report: “*Transformación Fiscal para el Desarrollo”. President of the Republic. Dr. Miguel Ángel Rodríguez Echeverría*, San Jose, April 2002.

almost 4 years, had its name changed to "Fiscal Pact Law" and was finally approved on its February 2006[14], but the legislative procedure was declared unconstitutional by the Constitutional Court and the bill was sent back to Congress. A new government took office in May 2006 and it sent a separate bill for the Value Added Tax, two minor reforms comprising and excise on luxury homes and a fixed $200 fee on registered corporations and has indicated that it will send other bills to Congress, including an Income Tax Bill. In sum, four years of discussion and a project neither approved nor rejected, seem to indicate that Costa Rica lacks an agreement on the need of the reform and the technical characteristics that should guide it. Let's now discuss the reform proposed so far.

4.2 Income Taxes

There are two mayor taxes for residents: one for individuals and one for corporations, but some sources of income are taxed separately (schedular system) and only national source income is taxed. As a consequence:

a) The taxed paid on a certain amount of income will be different depending on whether the income was made up from salaries, honoraries for independent professional services, bonds or stock;

b) Major loopholes leave certain sources of income untaxed:

- non - recurrent capital gains are not taxed;
- foreign source income – or national source income "placed" abroad – is not taxed at all;
- it does not tax all incomes of a resident in Costa Rica. This is contradictory to the idea that everyone pays taxes according to his financial capacity, since one is more or less wealthy according to the total of its wealth.

The proposed income taxation imposes a burden on income from labor, professional activities, businesses and capital, either personal or real property, tangible or intangible obtained by a taxpayer on the tax year. Therefore, the project proposes a shift towards global income and unified taxation. This system accumulates all income in one tax basis; it establishes exemption thresholds for individuals and families; medical expenses, rents and residential mortgage interest payments are deductible. Tax rates range from 0 to 30%.

A special tax basis is created for capital gains and losses, which can be compensated and would pay at a 10 % tax rate. This special treatment is justified by the economic capacity principle, due to the irregular characteristic of these gains that normally are generated during

[14] Under Costa-Rican law, the bill has to be approved on two separate votes before it becomes law.

several tax periods. Hence, this special basis was created in order to avoid an excessive effect over the progressive scale during the realization year. No special base is retained in the corporate income tax, which becomes truly global. This is reasonable since at corporate level the capital gains are closely tied to the economic activity. In the case of family corporations whose sole purpose is the tenancy of real estate and values, a pass-through regimen is suggested, which means that the individual shareholders could file the tax returns, therefore allowing the special tax base.

Special treatment is give to income from the financial market and from Real Estate Investment Funds. In these cases, a withholding of 10 % could be imposed. Nevertheless, the income will be included in the general basis in order to determine the average in the progressive rate, though it can be deducted an amount resulting from multiplying the total income by the above mentioned average, and not exceeding the total of US $55.000. It is a solution that wants to mitigate the concern of the easy reallocation of this type of income, justifying certain favorable treatment, compatible with a progressive system. At a corporate level, the basic rule applies. Nevertheless, the favorable treatment of 10 % ends at the threshold of US $55.000, since the corporate rate is proportional and not progressive. This rule does not apply for financial intermediation institutions.

The proposal includes the worldwide income taxation model, including some features for the capital gains treatment, according to two distinctions:

a. The source of income, Costa Rican or foreign: if the source of income is Costa Rican it will be taxed on accrual basis. If it is foreign the income will be taxed on cash basis, both for individuals and for corporations. The presumptive income regime provides that the income is presumed as being Costa Rican sourced, except if the taxpayer proves the opposite; it is not possible to defend and unjustified net worth increase with the foreign source income;

b. The registration and filing of offshore capital: its timely compliance allows an identical regime to the one applied to income from the financial market. The lack of compliance allows the general treatment in order to encourage the filing of income from foreign source. This regime applies also the corporations, except in case of financial intermediation institutions, for which the general treatment applies.At a corporate tax level, in case of corporations that own other corporations with a trade or business (not portfolio income) in countries with a corporate income tax, double taxation is avoided by exempting the dividends received by local corporations from foreign corporations.

When dividends are distributed to individuals in Costa Rica, they pay Income Tax on them. Dividends to non residents are exempt, unless they reside in a “tax heaven” .The exemption method is applicable to avoid international double taxation and includes a prior resignation of the resulting collection between the lower foreign rate and the higher local one, in contrast to the imposition method. In general worldwide income system is usually combined with the imposition method: Spain and Canada, reserve it for business income; France reserves it for corporate income. In theory, this method promotes capital import neutrality, which means equal treatment to local and external investments in the internal market. If the country is a net capital importer, it will guarantee the avoidance of internal discriminations between foreign and local investment. Nevertheless, if the exporting country taxes capital based on residence, the source country cannot guarantee this neutrality. Due to this, if the country is a capital exporter, it might be interested in encouraging this neutrality so that its companies could compete with the local companies on equal conditions in the source country. If it is like that, worldwide income with the exemption method is the instrument to encourage this neutrality from the country of the residency.

In regards to the integration between the income tax on individual and corporations, as of today dividend income has double taxation, and imposes a 40.5 % total rate: 30 % at a corporate level; 15 % on individuals. This generates a problem of horizontal equity for other incomes: for example, interests can be taxed at 8 % or 15 %. Also, capital gains from the non habitual sales of stock are not taxed. It creates a strong incentive towards debt financing that has been criticized. The reform proposes that dividends received by individuals should be part of the global income in order to keep the applicable average in the progressive scale, and then it excludes them, since at corporate level the dividends already paid 30 %. If the rate decreases to 25 %, or in cases of a favorable treatment regime (pioneers, minor relative development zones, which would pay 15 %), the payment at corporate level would have a credit in the individual income tax. In the same line, capital gains from the sale of stock would have the same treatment.

It is also important to mention the effect in equity of the potential reduction of the Corporate Income Tax at a 25 % rate. Due to this fact the comparison between the current situation is fundamental. The 30 % of the income tax is applicable to a limited tax base: of the financial or accounting income of a company, one part is taxed at 8 % and the other one at 0 % (except for income from foreign source or non taxable capital gains). With the proposal, the 25 % would be applicable to a wide and uniform base including the income that as of today is excluded. Additionally, it is important to mention that the dividends distribution or the capital gains received by individual shareholder would be taxed in the progressive tax rate on their individual income.

In order to strengthen tax collection, and to compare the situation of the different types of taxpayers with regard to the effective application of the tax, the global imposition on income includes the withholdings on incomes, to guarantee the compliance control. Accordingly, the income payers have the obligation to withhold a tax percentage and then pay it to the Tax Administration. This percentage operates as a tax credit applicable to the taxpayer's obligation at the end of the period, either by compensation against the tax debt or by claiming a return, if the withholding was higher than the tax obligation. The current income tax legislation contains this system, limited to few hypotheses, such as governmental or other public entities suppliers, with a 2% rate of advance payment.

4.3 Value added tax

The proposed bill taxes goods and services unless specifically exempt, in contrast to the current system under which goods are generally taxed, but services are not. As for tax credits, the concept of "financial deduction" is substituted for "physical deduction", while only exports are zero rated. The most contentious issues under discussion are the list of exempted goods and services as well as the introduction of the preferential rate of 6% for certain goods and services. The tax rate, currently at 13%, is not modified.[15]

4.4 Tax administration

The proposed tax reform includes the creation of the National Tax Direction that would integrate under a unique technical authority Customs, Internal Taxes and Tax Control Police, allowing higher coherence in global the tax administration. In addition special human resources regime for the Tax Administration is proposed.

Several amendments to the "Tax Code" are proposed: executive tax debt collection and precautionary measures would be transferred from the judiciary to the administration, to prevent the disappearance of assets while a company is being audited or tax assessments are being challenged. These reforms have created concern in the private sector over potential abuses of the Tax Administration. To allay theses concerns, a Taxpayer Bill of Rights has been included in the bill. In addition, the amendments to the main taxes facilitate and require sound improvements of tax management and collection. In this light, it is argued that the introduction of the worldwide income system reinforces the role of the presumptive income

[15] Nicaragua has 15%, Chile 18%, Island 22%, Spain 16%, Peru 17%, Mexico 15%.

based on unjustified net worth increase included in the project. These combined mechanisms would facilitate the tax audits when the external signs of wealth of the taxpayer do not coincide with its tax returns amounts, lacking the plausible justification on the foreign sourced income. This line of argumentation points to the revenue potential of worldwide income taxation, a subject that has been questioned by other skeptical experts. Also it is argued that worldwide income taxation should be an obstacle to current tax planning that openly promotes the reallocation of territorial income in low tax jurisdictions in order to facilitate the future repatriation of tax free income. We reiterate that the arguments in favor of the residence or worldwide principle face questions and criticism on its effectiveness against the tax practices of sophisticated taxpayers, specially in light of the deferral system finally introduced in the Bill. This debate is still open and it is safe to say that has been one of the tangible factors that has complicated the final approval of the comprehensive tax reform.

In contrast, there is a widespread consensus that the systematic effort by the Tax Administration on the implementation of transfer pricing audit techniques according to the international best practices should have an undeniable impact on the revenue, specially in the context of an economy with a growing weight on its export oriented activities. Even the Value Added Tax, generally applicable to consumer goods and services introduces a taxpayers internal control network by promoting that they demand invoices among each others in order to be able to claim input tax credits. This simultaneously should strengthen the cross-control network for income tax purposes.

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6. MEXICO

by

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Abstract
This paper is part of a wider research on "Tax Systems and Tax Reforms in Latin America", carried out at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. The purpose of this paper is to present the underlining features of the tax reform process in Mexico during this period, the main components of the current tax system, and the reform agenda pending for the future. After a general introduction, section 2 is devoted to the structure of the tax system and its development from the 1970s. Section 3 covers some of the quantitative and institutional features of the main taxes collected in Mexico. Section 4 displays information regarding fiscal federalism as far to its features and discussing the difficulties originating by the low fiscal accountabilities of lower layers. Finally, section 5 presents some of the tax reforms implemented in Mexico since the 1990s. Also it will discuss the desirable features the Mexican tax system should adopt in the near future.

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1. Introduction and contents*

The current tax system prevailing in Mexico is the result of a long and unfinished process of reform. During the last 35 years, the tax system has been subject to substantial overhauls aimed at achieving efficiency, neutrality, competitiveness, and equity goals compatible with the development of the Mexican economy and the international economic setting. Even though some of this objectives have been accomplished, the tax ratio is still insufficient to meet the social and infrastructure needs at the onset of the 21st century. The purpose of this paper is to present the underlining features of the tax reform process in Mexico during this period, the main components of the current tax system, and the reform agenda pending for the future. To give a broader perspective of this process, it will cover some of the main domestic and external circumstances surrounding each stage of the tax reform, and a comparative view with other Latin American countries.

Section 2 will be devoted to the structure of the tax system and its development from the 1970´s. It will discuss the current tax structure of Mexico, its composition, an outlook of the macroeconomic framework, and some of the main features underlining the economic policy strategy followed by the current administration. It will go on to summarize the reform development path followed by the tax system in the 1970-2005 period, and the policy making objectives pursued along the way. Section 3 will cover some of the quantitative and institutional features of the main taxes collected in Mexico: Corporate and Personal Income Tax, Asset Tax, Value Added Tax and Excise Duties. Special sections are designed within this chapter to expose the tax treatment of income derived from financial capital, and property taxation. As a salient feature of the Mexican tax system, this section will also present a brief description of the *Maquiladora Industry* (inbound manufacturing) tax regime, designated to cost centers facilities built along the border with the U.S., and also some policy and administrative issues of the transfer pricing regime adopted by Mexico, following the OECD guidelines as a member country.

Section 4 will display information regarding Mexican fiscal federalism. The institutional feautures of it are presented, together with the financing tools existing for intermediate and loser layers. The mai question which emerges is the fact that the main share of resources go to noncentra level of Government as transfers from this last. So that States and Municipalities suffer because of a decoupling between financing sources (external) and expenditures' decisions (in their own power). Finally, Section 5 will present some of the tax reforms implemented in Mexico since the 1990s, an important period of efforts pursued to adequate the tax legislation to an increasingly open and modern economy, and to the admission of Mexico to the OCDE, introducing competitiveness, stability and predictability into the system. Also it will discuss the desirable features the Mexican tax system should adopt in the near future to overcome the revenue-insufficiency aspects still embedded in the main broad-based taxes, as a necessary condition to meet mid-term budget commitments.

2. The structure of the system and its development from the 1970s

2.1 The current structure of taxation

Notwithstanding the series of tax reform efforts carried out by the Mexican Government geared towards modernizing its tax system and to adopt it to a more competitive economic scene, the overall level and structure of taxation Mexico has not changed substantially over the last 25 years. In fact, total tax revenues have decreased in about half percentage points of GDP. VAT collection is the only tax source which has improved during this period, though at an insufficient pace compared with other Latin-America nations (see below 4.1). Income taxes have been the most important revenue source in Mexico, with the corporate income tax holding steady at around 2.5 percent of GDP. Import taxes are low and declining due to NAFTA and, in general, to a wide trade liberalization economic strategy. From 1980 to 1994, total revenue as percentage of GDP showed a steady behavior. During this period, total tax revenue showed a slight increase mainly as a result of the indirect taxation overhaul. Nevertheless, the slowly increasing trend was curbed by the sharp reduction of main tax sources as a result of the 1995'seconomic crisis. The pre-crisis tax revenue collection level, in terms of GDP, was not reached again until 1999.

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Table I
México: Federal Government Revenue
(% of GDP)

	1980	**1990**	**1994**	**2000**	**2005**
Total	14.9	16.2	15.5	15.8	16.9
Tax Revenues	10.8	11.1	11.3	10.6	9.7
Income	5.5	4.9	5.1	4.7	4.6
VAT	2.7	3.5	2.7	3.4	3.8
Excises	1.0	1.3	2.0	1.5	0.6
Import	1.0	0.9	0.9	0.6	0.3
Others	0.5	0.5	0.6	0.3	0.4
Non-Tax	4.5	5.1	4.2	5.2	7.2

Source: Ministry of Finance of Mexico

Oil related revenues contribute with a relatively large, though highly fluctuating, share of the government revenue. Oil fees paid by PEMEX contribute to total revenue from different sources: (1) duty on oil extraction, designed as a cash flow tax levied on total revenues accrued by PEMEX, and consisting of three components: ordinary, extraordinary, and additional; (2) gross revenue tax, levied on PEMEX from its gross revenues; (3) price cap, which applies whenever crude oil export prices exceed annual budget; (4) excise tax on gasoline and diesel levied on consumers, calculated as the difference between the consumer price fixed by Government, and the producer price equivalent to the spot price, plus transport costs and quality adjustment, and (5) income tax, based upon a tax structure similar to that applicable to other corporations. The oil-related component of non-tax sources have fluctuated sharply since 1980. However, higher international oil prices during the last years have resulted on a substantial increase of non-tax revenues. In 2005, the contribution of non-tax sources to the total Federal Government revenue has reached 42 percent, from less than 30 percent a decade ago. The overall oil revenue take, which includes excise tax on gasoline and diesel, has contributed annually to 25 - 35 percent of total revenue. The relatively high reliance on oil - related sources, especially during high oil prices periods, produces significant and undesired effects on macroeconomic policy, budget allocation, and on revenue-enhancing tax reform sense of urgency.

2.2 Developments of the system (from 1970 to 2000)

The current Mexican tax system barely resembles the structure prevailed forty years ago. Over the past four decades, developments of the tax system have been guided by the social and economic objectives pursued by the Mexican Government in different development stages. Before 1970, taxation in Mexico followed a highly pragmatic view. In response to the need to raise revenue with the least administrative burden, the tax system was integrated by numerous levies on industrial production, natural resources and international trade. Yet, as a result of important tax efforts to streamline administration and the introduction of a more efficient scheme to tax gross income, tax collection increased to 10 from 6.5 percent of GDP during the 1940-70 period. This substantial increase on the tax burden also responded to a gradual move towards an economy based on manufacture and service sectors, from traditional non-mineral primary activities.

In order to keep up with the economic strategy prevailed at that time towards industrialization and internal-market orientation, a set of tax reforms were approved by Federal Congress during 1955-1972. On the income taxation structure, a "cedular system" was replaced by general regimes for individuals and corporations based on "net global income". For corporations, an accelerated depreciation scheme applicable to equipment was introduced as a mean to foster investment in key industrial sectors. The new tax regime also featured special tax regimes for small taxpayers in primary sectors, such as agriculture, livestock and fishing activities, in such a way that fiscal authorities collected fixed amounts of tax, without regard of income, cost, and investment performance. Also, these reforms included an overhaul of the indirect taxation structure. A number of production and sales tax were substituted by a simpler scheme based on a single turnover tax. In the administrative sphere, a national taxpayers' registry was created for the first time.

Between 1978 and 1981, another important set of tax reforms was introduced, basically aimed at adapting to a rampant inflationary environment. Previously, during the 1971-1975 period, public expenditure increased to 30 from 20.5 percent of GDP as a result of an significant expansion of state-owned enterprises. New findings of oil fields fed favorable expectations on oil revenues. As a result, the federal government decided to finance public expenditure with foreign credit resources and with inflationary taxation. In 1975 fiscal deficit reached 10 percent of GDP. As a result of the second oil price shock and concomitant increases on oil revenues extracted form *Petróleos Mexicanos*, or PEMEX - the national oil monopoly -, President López-Portillo decided to further expand the number of state-owned enterprises under an ambitious program of public investment. Consequently, public expenditure reached 41.1 in of GDP by 1981, whereas inflation aroused to almost 30 percent. Income tax reforms carried out during this time addressed the inflationary adjustment as one of the main objectives. The tax schedule for personal income tax was corrected for the effects of inflation to prevent undesired distribution effects associated with "bracket-creeping". Also, the capital gains assessment mechanism was revised to allow cost adjustment for general price increases. Though partial and incomplete, inflation adjustments paved the way for further reforms intended to fully recognize the effect of inflation on tax bases. The indirect taxation structure was object of a deep reform. In 1980, a value added tax replaced the turnover tax, 30 federal excise taxes, and about 400 local taxes, under the policy objective of reducing typical distortions, such as the "cascading effect", associated with a turnover tax system.

Starting in 1982, the administration of President De la Madrid faced a profound macro-economic crisis as oil prices collapsed, and external credit lines were depleted. In spite of the implementation of an aggressive economic adjustment through drastic reduction on public expenditures and the privatization of several state-owned enterprises, the Mexican economy fell into deep recession and inflation rates reached three-digit levels. As part of the economic package, excises tax rates increased and the VAT was reformed to introduce a multi-rate structure. By the end of the 1980s, the tax system structure proved to be insufficient to address revenue, efficiency and equity concerns. At that time, the tax system contained a set of rules conceived for a different development strategy, such as uncompetitive tax rates, rampant tax credit allowances, and an uneven distribution of the tax burden among sectors. The new development strategy based on economic openness, deregulation, and privatization demanded a new tax structure compatible with the modernizing of the economic structure, to the adoption of the *North American Free Trade Agreement (NAFTA)* with the US and Canada, and to the entrance of Mexico in the OECD.

In due regard to these circumstances, the administration of President Salinas embarked on a profound overhaul of the tax system during the 1989-1991 period. In perspective, the tax legislative initiatives approved by Congress in this short period of time are reckoned to be the most substantial effort undertaken by the Mexican Government in modern times to streamline its tax system. As part of this set of reforms, income tax rates applicable to corporations were reduced to 35 from 45 percent, in an attempt to set a competitive level against trading partners: US (38.3 percent) and Canada (43.3 percent). To facilitate international trade and investment by reducing the capital cost of firms increasingly doing business in Mexico, officials form the Ministry of Finance started negotiations with partner countries aimed at reaching income tax treaties.

The maximum personal income tax rate was brought down to 35 from 50 percent. Full integration between corporations and individuals was allowed. In an attempt to foster compliance and increase tax revenues the Congress approved a new 2 percent asset tax, totally creditable against corporate income tax. The CIT structure was adjusted to fully incorporate the effects of inflation. PIT brackets were also adjusted for inflationary purposes. For small enterprises, a new simplified tax system based on cash flow was devised to comply with tax obligations with fewer accounting records burden. An important element of this reform endeavor was the overhaul of some deductions and exemption items included into the tax codes supported by weak economic rationale. Some tax incentives were trimmed, such as the accelerated depreciation scheme for investment projects carried out outside the areas of Mexico City, Guadalajara, and Monterrey. In others, deductions linked with executive meals and automobiles were curbed. Finally, special tax bases applicable to firms and individuals engaged in primary sector and other activities which usually conveyed a small or nil tax base for taxpayers, were eliminated. Finally, VAT rates previously settled at 6.15, and 20 percent, were replaced by a single tax rate of 10 percent.

From a broad perspective, the tax reform effort carried out during the 1970 - 1990 period showed mixed results. The reduction of tax rates, the elimination of some unjustified preferential regimes, full integration of income tax between individuals and corporations, the total recognition of inflation effects into tax bases, and rationalization of the indirect taxation structure, provided a more efficient, fair, and competitive tax system. Nevertheless, those reforms fell short to provide the Mexican Government with an adequate source of non-oil tax revenues. By 1990, tax collection as a percentage of GDP of 11.1 percent compared unevenly with other Latin-American countries such as Chile (18.6 percent), Brazil (17.6 percent), Argentina (14 percent), or Colombia (12.2 percent). The severe financial crisis underwent by the Mexican economy at the end of 1994 resulted in a substantial curtail of tax revenues. In fact, this reduction turned out to be even more severe than the contraction of national income. Tax-ratio decreased by 23 percent from 1994 to 1995. This effect was explained by the credit crunch experienced by economic agents, so that they financed short-term debt payments with tax withheld from income tax and VAT.

As part of the economic package put forth by the President Zedillo administration, VAT general rate increased to 15 from 10 percent along with a substantial increase of real prices of goods and services provided by public entities. At the same time, and in order to ease the effects of the financial crisis, the Government announced a set of temporal tax incentives, such as the reduction of the tax on assets general rate for small and medium enterprises, the immediate expense of marginal investments carried out during 1996, and also tax credits to foster employment. The emergent tax policy measures probed to be efficient to achieve the desired effects. The Mexican economy activity resumed relatively fast. By 1996, real GDP grew by 5.1 percent. However tax collection increased by only 0.8 percent due to the effects of the corporate operating losses carried forward. The downward tendency was not reverted until 1997, when tax collection increased to 9.8 as a percentage of GDP, from 8.9 per cent in 1996. During the post-crisis period of 1997-2000, the tax reform agenda addressed again some issues pending after the 1989-1991 overhaul of the tax system. Clearly, its limited capacity to raise revenue scored high again in the Government priorities. In 1999, the tax-ratio reached only 11.3 percent of GDP, which turns out to be the same level of 1994 before the financial crisis. Yet, the plural composition of the Congress observed in 1997 for the first time in the modern history of Mexico, resulted in poor agreements to reach consensus upon a revenue enhancing reform. This lack of agreements in Congress over one of the most pressing and unaccomplished issues in Mexico, still lingers as of today.

3. Some quantitative and institutional features of main taxes

3.1 The Personal Income Tax (PIT)

The general regime for resident individuals is applicable on a global and worldwide income basis. Therefore, taxable income includes all kind of realized income, in cash or in kind, accrued from wages and salaries, personal services, business income (e.g. partnerships, sole proprietorship), capital gains, interest, exchange rate fluctuations gains, rents, dividends, or any other source. Nonresidents are also subject to this regime for their personal income sourced in Mexico. An individual is resident of Mexico when she establishes her home or center of vital interest in the country. Following mainly economic and administrative reasons, the Mexican PIT regime excludes from its base items such as financial interest income, imputed income from owner-occupied housing, proceeds form the sale of home ownership, gifts and bequest, gains from sale of stock exchange-listed shares, authorship rights income, and fringe benefits. Exclusion of fringe benefits from taxable income, stands out not only as a major base-erosion and a low revenue-elastic concept in the Mexican PIT regime, but also as a source of inequity among wage earners with the same income position, but different composition. Qualified fringe benefits granted under a very broad definition, and usually valued and apportioned on arbitrary basis, have traditionally been used by employers as a tax planning tool to reduce average tax rates. As a result, policy-makers were forced to further push down tax rates, especially for mid-level income earners, arising concerns about the ability of the PIT to incentive work, savings and human capital formation.

Individuals are allowed to deduct from taxable income the following personal itemized-deductions: medical, dental and funeral expenses (including dependents), charitable contributions, real mortgage interests, child school transport, contributions to qualified individual retirement accounts (up to the equivalent of five minimum wages, approximately Ps 88,000 per year), and health insurance premiums for themselves and their dependents. Once taxable income is defined, the PIT regime establishes a system of marginal tax rate and subsidy schedules to compute for the individual income tax. Despite insufficiencies of efforts pursued to broaden the PIT base, the highest marginal rate has decreased from 40 percent in 2002 to 28 percent effective as of 2007, driven by the need to achieve efficiency goals and a more competitive tax environment in Mexico. For the 2006 fiscal year, the highest marginal tax rate arises to 29 percent (Table 2.)

Table 2
Personal Income Tax 2006

Income brackets (Ps)		Tax Rate %
0.01	5,952.84	3
5,952.85	50,524.92	10
50,524.93	88,793.04	17
88,793.05	103,218.00	25
over 103,218.01		29

Individuals are entitled to a marginal nonrefundable subsidy up to 50 percent (Table 3) of the tax obtained from the application of the marginal tax rate schedule. Introduced into the PIT regime back in 1991, the subsidy mechanism is designed to overcome inequities among wage earners with same level but different kind of remuneration. The subsidy mechanism is designed to phase out as the proportion of exempt fringe benefits from total remuneration increases. Further on the,

Table 3
Subsidy Schedule 2006

Income brackets (Ps)		% Subsidy over marginal tax rate
0.01	5,952.84	50
5,952.85	50,524.92	50
50,524.93	88,793.04	50
88,793.05	103,218.00	50
103,218.01	123,580.20	50
123,580.21	249,243.48	40
249,243.49	392,841.96	30
over 392,841.97		0

PIT regime allows low wage earners to claim a tax credit as a relief measure aimed at increasing their disposable income. The wage tax credit varies from Ps 2,611 to Ps 4,884, depending on the level of wage income up to Ps 88,588 annually.

The Mexican Income Tax Law (ITL) establishes individual rather than familiar filing unit. All resident taxpayers are required to fill an annual tax return, except for those cases where salary is the only source of income and it does not exceed an annual threshold of Ps 300,000. As of 2006, most individual taxpayers are required to fill an annual tax return on electronic basis and pay the tax due through electronic transfer of funds. For nonresident individuals with source of income in Mexico, the PIT regime establishes an almost uniform 25 percent flat rate, striving towards a more neutral and simple treatment for inbound operations. This rate is applicable to independent personal services, fees paid to members of boards of directors, lease of property, and most capital gains. Mexican residents or non-residents with a permanent establishment in Mexico are required to withhold the tax when payments are made to non resident individuals. For wages sourced in Mexico and received by non-residents, the ITL sets marginal rates of 15-30 percent.

3.2 The Corporate Income Tax (CIT) and the Asset Tax

Mexican corporations are taxed on their worldwide income. CIT statutory rate is as of 2007. Corporations are deemed to be residents if they are incorporated under the provisions of Mexican corporate law, or if the principal center of administration, or the effective place of management, is located in Mexico. Despite substantial decreases on inflationary levels during the last decade

(3.3 percent in 2005, from 35 percent in 1995), mechanisms to adjust the CIT base for inflation still remain enacted as a mean to enhance business income measurement. Yet, for simplification purposes, an annual adjustment has replaced an old one calculated on monthly basis. This adjustment was originally conceived to include into taxable income, inflationary gains and losses accrued by corporations due to monetary liabilities and assets holdings. In terms of capital cost allowances, buildings generally depreciate at a rate of 5 percent, and automobiles at 25 percent, whereas other machinery and equipment depreciate according to the type of assets and the industry use, ranging from 5 to 50 percent. Immediate expensing is allowed for pollution abatement and control engineering assets, as well as for special adaptations to taxpayer facilities designed to allow the access for handicapped individuals. Only straight line depreciation method is allowed. An accelerated depreciation incentive is granted for corporate investments on assets located outside of the areas of Mexico City, Guadalajara and Monterrey, or within these regions, if corporations probe their operations are not water intensive, and comply with environmental standards.

As of 2005, the CIT law allows for deduction of inventory cost under standard accounting principles, using LIFO, FIFO, average cost, retail, and identified cost (when the value of merchandise sold exceeds Ps 50,000) as valuation methods. Net operating losses are allowed to be carried-forward to offset future tax liabilities over a ten year period, adjusted for inflation. Similar to other corporate income tax codes around the world, as of FY 2005 the Mexican CIT system contains a thin capitalization rules to restrain corporations from using excessive debt payments as a tax shelter mechanism. Thus, interest paid by taxpayers on certain debts deemed on excessive to their equity (over a 3:1 ratio) are non-deductible. A tax credit is available for research and development (R&D) expenses. Taxpayers are required to submit an application to an ad-hoc inter-institutional committee disclosing detailed information about each R&D project. Tax credit is granted only to qualifying investments on R&D expenses for approved projects. A fixed amount of tax credit is granted every year, as approved by Congress. For the 2006 FY, an equivalent of Ps 4,000 million is assigned for R&D approved projects.

CIT regime allows for a full integration system. Dividends distributed from after-tax earnings, (previously recorded in the *Net Tax Earnings Account*, or CUFIN, by its initials in Spanish) have no further tax liability effect both at corporate and individual levels. Dividend paid from the CUFIN account is not subject to withholding tax when distributed. Individuals are required to include grossed-up dividends in their taxable income, but at the same time, they claim a credit for the income tax paid by the corporation. The Mexican CIT regime allows for group taxation. A single consolidated tax return may be filed on behalf of a group of Mexican resident corporations (holding and subsidiaries), under a detailed set of rules, consolidated corporations accrue mutual tax benefits such as full profit-losses offsetting, and tax deferral on inter-company flow of dividends. Following capital-export neutrality standards, Mexican CIT Law unilaterally grants a tax credit for taxes paid abroad in order to prevent, or ameliorate, double taxation effects. Normally, foreign source income is taxable until it is distributed as dividends to the Mexican resident holding corporation. However, the CIT regime sets forth an anti-deferral scheme based on effective tax rates, whereby foreign source income from investments in low-tax jurisdictions (*Preferred Tax Regimes*), is includable into taxable income of the Mexican parent corporation at the time of realization, regardless of the time of distribution.

An Asset Tax (AT) is applicable in Mexico as a supplement minimum income tax. From its introduction in 1989, the AT scheme was designed as a control devise for those taxpayers that permanently reduce or eliminate their tax liability by engaging in accounting manipulation or aggressive tax planning. By assuring a tax payment based on a minimum presumptive return on assets, the AT has also embedded efficiency features as it incentives corporations to allocate their fixed assets to its highest productivity use. AT is payable at a rate of 1.8 percent on the value of assets held by individuals or corporations engaged in business activities, except on their first four years of operations (preoperative, initial, and two subsequent periods), when it exceeds income tax liability. Some non-financial debts are allowed to be deducted from the asset tax base.

3.3 Taxation of income from financial capital

The Mexican ITL allows for different treatment on the disposition of shares of stock issued by corporations. Exemption is granted for residents and non-residents income form the disposition of shares listed and traded on authorized stock exchange market, regardless of whether the issuing corporation is Mexican resident. However, sale of unquoted shares, or quoted shares not traded through authorized market, is taxable under the PIT regime. For this purpose, an income averaging mechanism is set forth, along with a detailed procedure to determine the average cost of shares, which includes an adjustment for inflation and for changes in the CUFIN account computed by the issuing corporation (see 3.2) through the stock holding period. Non residents are subject to either a 25 percent gross withholding rate, or the PIT statutory rate applicable to net income, provided certain rules are complied with.

Real interest income received by individuals is taxable, except for those interest paid by banking institutions originated from checking accounts or payroll accounts, pensions and retirement or savings, provided the average daily balance is less than the equivalent of Ps 88,820. Domestic law provides for a general withholding rate of 0.05 percent (annual rate) on interest paid by financial institutions. In general interest payments to non residents are subject to the following withholding rates: 4.9 percent to interest payments on debt instruments placed in recognized local markets or placed abroad through financial institutions resident in countries which Mexico has a signed treaty with; 10 percent to interest paid to foreign government financial institutions, or derived from debt instruments placed through financial institutions in countries with no treaty with Mexico; 15 percent to interest paid to reinsurance entities, and 21 percent in some other cases. Interest payments to non residents are exempt, provided they are derived from loans to the Mexican Federal Government, or to the Bank of Mexico.

As said below (see 3.2) the income tax regime in Mexico follows a full integration system, in such a way that dividends are usually free of tax liability to the recipient, provided they are originated from the CUFIN Account. Statutory withholding rates could be reduced, or even eliminated, by applying tax treaty provisions. Mexico has pursued an active policy to engage in trwaties to prevent double taxation and allow free exchange of information. Currently, over 30 treaties have been enacted with countries from diverse geographic location.

3.4 Property taxation

Taxation on land and property in Mexico is levied and administrated at the sub-national level of government and the revenue collected from this source accounts for the main tax income for municipalities. Property tax is levied through an *ad valorem* rate applied to the appraisal value of property. State Congress approves every fiscal year changes into base and taxes, upon proposals made by municipalities. Municipal authorities keep track of cadastre records on location, size and ownership of each parcel of land. However, municipalities usually lack of adequate cadastre register, as well as administrative and enforcement capabilities. Part of this insufficiencies are explained by the relatively high rotation of personnel in charge of this duties, given the fact that the municipal government term in Mexico lasts only three years, with no reelection. Property tax base tends to lag behind market values in most municipalities. In addition, preferential treatments are granted for some extensions of land, particularly to rural areas and some urban areas devoted to social needs. As a consequence, despite the clear advantages offered by this source of income in terms of revenue raising capacity, as well as on efficiency and equity grounds, taxation of land and property is largely underdeveloped in Mexico. Municipalities collect only around 0.2 percent of GDP, well bellow OECD (1 percent), and Latin America (0.7 percent) averages. No bequest, inheritance or gift tax is imposed in Mexico.

3.5 Value Added Tax

The Mexican VAT system stands out for its low revenue yield capacity, complex structure, and high levels of evasion. The multiplicity of tax rates, along with broad preferential treatments granted to a variety of goods and services, not only undermines revenue collection, but also distorts relative prices and falls short to meet the distribution objectives intended to pursue. A general 15 percent rate is applicable to most goods and services traded domestically, as well as imported. A reduced 10 percent rate is levied on the consumption of goods and services along the border with the United States of America, to address undesirable distortions effects that could arise in the economic activity carried on in this region with a higher rate. As a result of the comprehensive zero-rating and exemption treatment, (Table 4), VAT tax expenditures represent almost 2 percent of GDP, approximately one third of total tax expenditure budget for 2005[1]. Yet, 50 percent of total benefit is received by the wealthiest decile of the Mexican population, whereas the lowest income families only receive 3 percent of total tax expenditure[2]. Thus, the application of a narrow-based VAT structure arises serious concerns for policy-makers, and consequently scores high in the tax reform agenda for the near future.

A salient feature of the Mexican VAT is its cash flow basis time of supply rule. Introduced as a measure to alleviate the financial stand of small and medium firms suppliers of large corporations, as of 2002 a taxpayer is liable of VAT upon receipt of payments from customers, whereas input credits are claimed at the time of payment to suppliers of goods or

[1] *Tax Expenditure Budget*, SHCP, 2005.

Table 4 Mexican VAT Preferential Treatments	
Zero Rating	**Exemptions**
Exports, including in-bound *maquila* and *sub-maquila* exports Food products, medicines, magazines and newspapers published by the taxpayer, gold and jewelry; farm and livestock products and services, sale or lease of agriculture machinery, and domestic water supply.	Medical and education services, residential construction, books, magazines, and newspapers published by third parties, public transportation, lease of residential property, shares, bank interest payments, life insurance, author copyright, sale of participation certificates on real estate investment trusts, temporal imports by a corporation endorsed by the m*aquila* or similar export-oriented program, or by a the automobile industry.

services. However, VAT imposed on interest payments by households on final consumption is still levied on accrue basis. Taxpayers are required to compute VAT on a monthly basis. Excess of VAT input-credits is either fully refundable or carried forward to offset future liabilities.

Small business are eligible for simplified procedures to calculate tax liability on presumptive basis. Under this scheme, tax authorities pre-estimate the monthly value of turnover and input tax credits, based on a variety of parameters typical for each type of taxpayers, such as inventory levels, machinery and equipment, and overheads. Tax liability is obtained by applying the tax rate to the estimated output value, reduced by the estimated input credit. Corporations are required to withhold VAT paid to individuals performing professional activities, ground transportation of goods services, lease of tangible property, as well as to commissioners. VAT withholding is also required on payments to non residents with no permanent establishment in Mexico, for the sale or lease of tangible assets. Finally, in-bound *Maquiladoras*, Temporal Import Program for Export companies (*PITEX,* by its initials in Spanish), and automobile industry firms with bonded warehouse facilities are required likewise for their payments to domestic suppliers.

3.6 Excise Duties

The Special Tax on Products and Services (*IEPS*, by its initials in Spanish) is levied on the sale or import of selected products such as gasoline, diesel, tobacco, soft drinks, concentrate syrups,

[2] *Integral Fiscal Reform Project*, Fiscal Research, No.1,3rd Stage, SHCP, 2001.

beer and spirits, as well as services related to the commission, mediation, agency, and distribution activities related to these products. Generally, IEPS tax liability calculation follows a credit mechanism similar to VAT, so it is collected at the import, producer, and wholesale levels. Retail sales of IEPS products are usually exempt, so the IEPS levied at the wholesale level is usually passed on to final consumers. Tax withholding is required on taxable sales from producers or importers to taxpayers engaged on mediation or distribution activities. A differentiated ad-valorem rate schedule is applicable to taxable sales. Beers and sprits are taxed at rates ranging from 25 to 50 percent, depending on the alcoholic content embedded on each type of beverage. A 20 percent rate is levied on soft drinks and concentrate syrups, 110 percent to cigarettes, and 20.9 percent to cigars. Taxation on the sale of gasoline and diesel products follows special rules. According to the IEPS Law, tax rates levied on these items are calculated monthly through a detailed mechanism based on international prices. Monthly rates are assessed and published by the Secretariat of Treasury and Public Credit on the Federal Official Gazette. IEPS tax on gasoline and diesel is collected on a single stage basis at each *Petróleos Mexicanos* (PEMEX, by its initials in Spanish) sale point. For FY 2006, the Federal Congress approved amendments to the IEPS Law to introduce an environmental incentive. A new ruling allows beer producers, importers and bottling companies to apply a tax credit when using recyclable containers.

3.7 *Maquiladoras tax regime* and Transfer Pricing issues

Maquiladoras, or inbound cost centers, are Mexican assembly plants capable of maintaining equipment, machinery and inventories provided by their foreign-owner corporation, for their transformation into semi-finished and finished goods destined for export to the US market. Parent corporations also grant *maquiladoras* free use of patents and technology to carry out the manufacturing process. Ever since its initial stages dated back in the late 1960s, the *maquiladora* industry has contributed to the expansion of Mexican manufacturing exports. However, this contribution reached meaningful levels in the decade of the 1990, especially since the adoption of the North American Free Trade Agreement (NAFTA) with the U.S. and Canada in 1994. The contribution of the *maquiladora* industry to the Mexican economy has been substantial. For 2005, the value of total *maquiladora* exports was US$ 96.75 billion, equivalent to 55 percent of total manufacturing exports, and 45 percent of total exports, mainly to the US market. The number of *maquiladora* plants has risen to 2,811, from 1,703 in 1990, mainly located along the border zone with the US. Currently the industry employs 1.17 million. Part of the expansion of this export sector is explained by the tax incentives granted by the Mexican Government to assembly plants carrying on *maquiladora* activities, as defined and recognized by the Secretariat of Economy. Capital required to perform *maquiladora* activities in Mexico is considered in-bound for their export. Therefore, duty free and VAT exemption to the temporary imports of machinery, equipment, parts and material are granted, provided they are designated to be transformed into export products, according to the Maquiladora Program regulations. Also, inventories considered to be in-bound for export are exempt from Asset Tax.

The income tax treatment to the *maquiladora* activities has spurred special attention to policy-makers and members of the industry for the last decade, especially since 1995 when Mexico joined the Organisation for Economic Co-operation and Development (OECD). The continuous set of reforms introduced to the *maquiladora* regime since then, has responded to the changing economic conditions surrounding their activity, in Mexico and abroad, and also to the develop of the transfer pricing practice in Mexico. The continuous coordination and mutual agreement between tax authorities from Mexico and the US has played a key role in shaping the *maquiladora* tax regime. Before 1995, the Mexican Income Tax Law offered no special treatment to the *maquiladora* activity. Thus, *maquiladoras* constituted a permanent establishment of foreign residents, subject to the general regime of corporate income tax in regard to their business activities carried out in Mexico. Also, the income tax legislation required *maquiladoras* to charge foreign corporations a profit-margin from 2 to 5 percent above operation cost as transfer price.

By the mid- 90s, as a response to the need to enlarge the income tax base for the *maquiladora* industry, the Mexican tax legislation developed for the first time special rules applicable to their activities. The key issue was the exemption of the permanent establishment status for the foreign residents owners of Mexican-based *maquiladoras*, provided that they comply with income tax requirements, either by adopting a *safe harbor* rule of 5 percent on all assets, or by abiding to an *Advance Price Agreement* (*APA*) ruling. However, the economic dynamism shown by the sector during the past decade, threatened the ability of these transfer pricing rules to adequately reach the tax base originated by the *maquiladoras* activity in Mexico. To address this concern, *maquiladora* rules were modified as of FY 2000 following the *Mexico-US Mutual Agreement on the Tax Regime applicable to Maquiladoras* (MAP agreement), reached in October, 1999, allowing the exemption of permanent establishment status to *maquiladoras* owned by foreign residents, when satisfying one of the following requirements: (1) Adopt a *safe harbor* rule, whereby *maquiladoras* consider a taxable income by the amount greater between 6.5 percent of total cost and expenses, or 6.9 percent of total assets used in connection with their operation, or (2) Apply and obtain an *APA* , following procedures set forth by the Mexican Fiscal Code. By 2003, the Mexican Congress approved reforms to the Income Tax Law, including some additions to the rules applicable to the *Maquiladora* activity. This reform was important for two reasons. Firstly, the addition of the applicable tax rules, including the permanent establishment exemption assumption, into the text of the law provided a sense of certainty to the business community. Previously, those rules were subject to annual confirmation. Secondly, a wider set of methods was offered for the *maquiladora* industry to comply with Mexican transfer pricing regulations, in accordance with OECD Transfer Pricing Guidelines (Table 5).

Table 5
Current options for Maquiladoras to comply with transfer pricing requirements

I. Arm´s length principle, plus fixed assets net value
Declare income and deductions according to prices determined by arm´s length methods described by the Income Tax Law, in accordance to OECD Guidelines, plus 1 percent of the net value of the machinery and equipment owned by foreign residents, devoted to the maquila activity (APA is not mandatory, but transfer pricing study records should be kept).

II. Safe Harbor
Declare as taxable profit the greater of: (a) 6.5% of total cost and expenses, and (b) 6.9% of total assets used in the maquila operation.

III. TPM Predetermined Methodology
Declare taxable income as resulted from arm´s length prices obtained following the Transactional Profit Margin (TPM) Method, considered within the transfer pricing methods allowed by the Income Tax Code, in accordance to OECD TP Guidelines, accounting for the machinery and equipment transferred by the foreign resident to the maquiladora to carry out assembly activities. (APA is not mandatory but transfer pricing study records should be kept).

In an effort to adequate the *maquiladora* tax rules to a relatively recessive economic period in the export market, by the end of 2003 President Fox signed a tax relief decree granting *maquiladoras* a partial exemption, equivalent to 50 percent of the taxable income assessed upon the current rules. This tax benefit has been enacted without time limit.

4. Taxation by levels of government and fiscal federalism

The Mexican United States is organized as a federal and democratic republic consisting of 31 free and sovereign States, unified by a Federal Government rested in the capital city sited in the Federal District (a.k.a. *Mexico, D.F. or Mexico City*). The Federal Government is divided in three autonomous powers: Executive, Judicial and Legislative. This scheme is replied in every State Government. Further on, each State is conformed by a number of municipal governments ruled by an autonomous Executive Branch, but without legislative powers. Fiscal relationships among the three level of government is ruled out by the Fiscal Coordination National System (FCNS). The FCNS Law was enacted in 1980, jointly with the introduction of the VAT, in response to the need to harmonize vertical and horizontal distortions emerged by the existence of multiple local turnover and excise taxes. Under the FCNS arrangement, the Federal Government is exclusively empowered to impose broad-based taxes, meanwhile state governments share part of a pull of federal revenue collection, formally denominated Revenue-Sharing Fund (RSF), according to a distribution formulae constructed upon two elements: population and tax capacity.

Also, state governments share total collection from both sales tax for new cars (*ISAN*) and the annual automobile registration fee (*tenencia*), both imposed at the federal level, but collected and enforced locally. By disposition of the FCNS Law, part of the revenue-sharing transfers received by each state is passed on to municipalities. Besides the revenue-sharing mechanism, the FCNS also defines rules to transfer spending responsibilities to state and municipal governments on itemized areas, such as education health, and local infrastructure. For this purpose the FCNS establishes seven appropriate funds for earmarked expenditure, transferred every fiscal year to local authorities. As a result of the FCNS revenue-sharing and spending decentralization mechanisms, the Mexican federal government transfers up to 60 percent of federal revenue collection to local governments, compared to an average of 22 percent in OECD and Latin American countries. Due to an increase in the bulk of federal revenue integrated into the RSF, transfers to sub-national governments have increased from 2.8 percent of GDP in 1990, to 3.3 percent in 2006.

Table 6
Revenue Sharing Fund (RSF)
(% of GDP)

	1995-2000	**2001-2004**
Average	11.9%	13.2%

Source: Ministry of Finance and Public Credit

In terms of local revenue sources, the Mexican Constitution grants limited taxation powers to states and municipalities. Indeed, state governments rely on the local payroll tax as their major tax source. Additionally, states raise revenue from some additional sources such as the real estate transfer tax, tax on motor vehicles older than 10 years, and some fees and licenses for public services. At the Municipal level, property tax is the single most important source of revenue, followed by local fees and licenses, water fees and real estate transfer tax. The combination of limited local taxation powers with a vast transfer of fiscal resources originated from the FCNS revenue-share mechanism, has created an undesirable local dependency on federal transfers. On average, federal transfers currently account for 90 percent of total state revenue. As a result, local governments find few incentives to enhance local tax effort. Property tax is a case on its own, as municipalities collect only 0.2 percent of GDP, compared to an average of 0.7 percent in Latin America countries or 1 percent in other OECD countries.

The high centralization of taxation in Mexico, combined with a substantial decentralization of spending responsibilities induces distortions in the efficient provision of public goods. Lack of correspondence between the level of government in charge of collection and that responsible for spending, results in a sub-optimal allocation of resources. Furthermore, unbalanced fiscal responsibilities affect local governments to adequately held accountable for their tax and spending decisions. During recent years, the Mexican Congress approved reforms geared towards correcting some of the distortions induced by the FCNS fiscal arrangement. As of 2004, state governments are empowered to legislate and implement low-rate cellular taxes on individual income obtained from the following sources: professional services, lease of fixed property, dispose of property, and business activity. Nevertheless, by 2006 only three state governments -, Chihuahua, Guanajuato, and Oaxaca - have already implemented some form of local cellular tax. Arguably, unless deep reforms on the Mexican fiscal federalism system are carried out, local governments would perceive cost-ineffective both from economic and political perspectives, to incur into new tax responsibilities or to enhance current sources of revenue collection.

5. Tax reforms in the 2000´s and those currently planned

The fiscal policy during the 2001-2005 period contributed to achieve the public finance objectives estimated by the Mexican government. The public deficit as a percentage of GDP decreased from 1.1 in 2000 to 0.2 in 2005. Also, the Public Sector Borrowing Requirements (PSBR), a broader measure of the amount of money needed by the government to cover any deficit in financing its own activities, followed suit reducing from 3.3 to 2.3 in the same period. (See Table

Table 7
Public Finance 1997-2005
(% of GDP)

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Public Deficit	0.7	1.2	1.1	1.1	0.7	0.6	0.4	0.2	0.2
PSBR	4.5	5.9	5.9	3.3	3.0	2.6	2.5	1.8	2.3

Source: Ministry of Finance and Public Credit

7). As a result of the combination of tax administration efficiency gains and a reorientation of public expenditures, the public sector has increased capabilities to mobilize resources towards social needs. Public expenditure allocated to social development increased to an average of 10.1 percent of GDP during the 2001-2005 period, from 9.3 percent registered in 1998-2000.

5.1 Tax reforms already passed

Tax reforms approved by the Mexican Congress geared towards a more efficient and competitive system. In general terms, the reforms pursued four basic objectives: competitiveness, simplicity, revenue capacity enhancement, and fiscal federalism.

Competitiveness

Similar to other small and increasingly open economies, globalization and international tax competition poses challenges to the Mexican tax system. Consequently, the new Income Tax Law recently enacted introduced reforms to attain a competitive framework for individuals and corporations in Mexico. During the last few years, the CIT rate has been reduced by 30 percent to reach 28 percent effectively from 2007, increasing the competitive stance of the tax system. Effective CIT tax rate is reduced even further as of 2005 considering the new deduction of the employee profit-sharing item(*Participación a los Trabajadores en las Utilidades de las empresas, PTU*), which is expected to reduce CIT rates by 4.4 percentage points. In order to foster investment and employment, an immediate deduction applicable to fixed assets was introduced into the Income Tax Law. This tax incentive was restricted for investment in new fixed assets utilized outside the metropolitan areas of Mexico City, Guadalajara, and Monterrey, unless corporations prove the employment of sizeable labor force, the utilization of clean technologies with respect to the emission of pollutants, or the engage in production processes not incentive in the use of water. Also, a 30 percent tax credit on R&D investments and expenses was enacted for corporations.

Aimed at promoting the Mexican real estate market, a tax incentive was granted to real estate investment trusts by allowing investors a tax deferral scheme. For the *maquiladora* industry, a 50 percent reduction of the CIT base was granted as a response to short-term economic impacts, such as US economy contractions and strong competence from China. The Congress also approved measures for individuals to deduct medical insurance premiums supplementary to or separate from health services furnished by social insurance institutions, and also to deduct real interest paid on home mortgage loans granted by a bank or auxiliary credit organization. On a move to introduce equal competing conditions for domestic corporations seeking funds in the domestic financial markets to finance investment projects, PIT reforms were introduced to tax previously exempt interest government bonds. Parallel to the CIT rate reduction, the maximum marginal tax rate applicable to individuals gradually reduced form 40 to 28 percent, effectively 2007, introducing incentives to work, save and invest. As a measure to promote the tourism industry, the Congress introduced discretionary changes into the VAT consisting on expanding the 0% export rate to tourism services rendered to international tourists in connection to their attendance to seminars, congresses, or any other similar events taking place in Mexico.

Simplicity

During the last half decade, several simplicity measures were introduced into the tax system. As part of a major effort to modernize and enhance operations, the Tax Administration Service (*SAT*) has implemented IT solutions aimed at encouraging voluntary compliance and lower compliance costs. One of the salient features of the recent reform efforts has been the widespread introduction of electronic means to file returns, pay taxes, and comply with information requirements. Nowadays, more than half of total taxpayer obligations are fulfilled through the Internet, accounting for the total universe of corporate return filing. The SAT web page registered 115 million visits/transactions in 2005, from 1.1 million in 2000. Besides administration efficiency gains, several tax policy initiatives were taken in order to simplify calculations and reduce compliance costs. The corporate income tax was reformed to eliminate the tax differential scheme previously introduced to account for the reinvested profits, and the mid-year adjustment of installment payments. Also, the calculation for inflation adjustment to real interest was greatly simplified, by introducing an annual mechanism to adjust for monetary position (assets and liabilities), combined with a nominal deduction and inclusion of interests.

The most important reform of the PIT regime towards simplicity, was the implementation of cash flow regime to individuals engaged in trade and business, and professional activities. This new regime allows individuals to include taxable income and deduct expenses on cash flow basis, to wave inflationary adjustment calculations, and also to keep a single and simple accounting record. For taxpayers with limited administrative capacity, a new *intermediate regime* was also designed. Under this new scheme, individuals and corporations with annual income bellow a 4 million pesos threshold, are allowed immediate expense of investment on fixed assets, following a simpler set of rules to comply with the Income Tax Law. The VAT law was reformed accordingly. A new supply rule was introduced in such a way that the tax levied upon the sale, rendering of services and the temporary use or enjoyment of property is due at the time of collection. Also, tax credit is allowed at the time of payment. Accordingly, in those cases where an obligation to withhold arises, tax is collected on the amount actually paid. In terms of administration ease, it was eliminated the obligation for taxpayers to file an annual VAT return, leaving only monthly tax returns. Towards simplification of the withholding tax rate structure devised for non-residents with source of income in Mexico, the Congress approved reforms to levy a single general withholding rate of 25 percent applicable to almost all sources of income.

Fiscal Federalism

During the last few years, initiatives towards increasing the availability of revenue sources to sub-national governments were approved by the Congress, in two different ways: share of federal tax bases and new local taxing powers. Considering the relatively less mobility of individuals engaged in small business activities, reforms were introduced to allow State governments to share with the Federal Government part of the income tax collection sourced in their territory. Same sharing arrangement was established for the proceeds of the sale of immobile property. Operation and administrative rules were needed for local governments to expand capacities in order to receive tax returns, collect part of the provisional installments paid by taxpayers every month, and to grant tax credits against federal tax due. Besides administration and collection duties, inspection powers were granted for sub-national tax authorities to oversee the appropriate compliance behavior of small taxpayers operating locally. As discussed above, in terms of new taxing responsibilities for local governments, the Federal Congress approved legislation to empower State governments to implement cellular taxes on income obtained by individuals from independent professional services, lease and dispose of fixed property, and business activities. To avoid distortions on location decisions, state congresses are constrained to impose tax rates beyond an interval of 2 to 5 percent.

5.2 Tax reforms under way and planned

During the last 25 years, the Mexican tax system has been subject to a permanent reform process geared towards providing a more competitive fiscal environment to economic agents. As a result, the tax legislation includes some salient efficiency features, such as full integration of dividends, recognition of inflationary impacts, and relatively competitive statutory tax rates. Facing the need to adapt to an increasingly open and modern economy, the tax system has successfully adopted international best practices, such as standard transfer pricing guidelines. Also, the Mexican tax system has adopted a wide network of tax treaties to avoid double taxation and exchange of information, with more than 30 partner countries. The membership of Mexico to the OECD and NAFTA has greatly contributed to the tax system modernization process. Nevertheless, the pursue to a more competitive and efficient tax system has not get through along with parallel reforms to strength its revenue capacity. The tax system is currently limited by its own structure to yield adequate collection levels. Therefore, the key issue on the reform agenda is to bridge the gap between actual and potential tax capacities, primarily by broadening tax bases while keeping tax rates to competitive levels. By doing so, it is expected not only to attain revenue targets, but also to alleviate horizontal inequities currently originated by unjustified preferential treatments, as well as to ease compliance and the administrative costs.

Several efforts have been attempted in the recent past to overcome some of the revenue insufficiencies embedded into the tax code. The Executive Branch of the Mexican Government has recurrently sent to Congress diverse reform initiatives with the explicit objective of closing loopholes and to level field ground for all economic sectors and productive activities. For its depth and potential consequences to attain revenue collection goals, it stands out the *Integral Fiscal Reform Bill* (IFR) introduced to Congress in the early stages of President Fox term. Though some of the proposals contained in the IFR were actually approved and implemented, the core part of it, which basically included a broad-based new VAT structure, is still pending. Given the immediate and unavoidable fiscal pressures faced by the Mexican Government in the short term, it is expected that new tax reforms initiatives, covering similar issues proposed by the IFR, will be introduced again to Congress by newly elected Federal Government authorities. In this section, some of the main IFR proposals pending, along with some considerations about under way efforts to modernize the *SAT* operational system, are laid out.

Value Added Tax

As discussed along the present study, the wide and numerous exemption and zero-rated goods and services items considered in the VAT law, have resulted in a significant reduction of the potential consumption base. The narrow-based structure has also contributed to low compliance levels, as taxpayers have found the way to arrange transactions in such a way that they appear either exempt or zero-rated. The IFR proposed a new VAT legislation, though keeping intact a substantial part of the current law articles in order to facilitate compliance. Zero rate was only granted for export activities, under destination principle considerations. For control purposes, the initiative required taxpayers to engage in electronic transfer of funds when arranging for the export transaction payment, to be eligible for VAT refund. The proposed VAT base included most items currently zero-rated or exempt, such as food, medicine, books, magazine, education, and transport. Exempt treatment was only granted to those transactions that, by their intrinsic nature, do not represent consumption expenditure, or entail difficult to tax goods and services, such as the sale of land, hard currency, stocks, gold, jewelry, art objects, and financial services, except for interest paid on individual final consumption. Lease or sale of housing construction was also proposed to be exempt from VAT.

The general tax rate proposed by IFR was equal to the current 15 percent, maintaining the reduced 10 percent rate for transaction of goods and services along the border with the US. The rationale behind proposing to leave the dual tax rate system was to avoid market price distortions in the referred area, given the considerable influence of the US southern economy in the living of residents in the Mexican border states. However, the reform proposal maintained the current exclusion of the reduced border rate to the taxable sale of fixed property. Some of the IFR original proposals for VAT reform where adopted in an effort to streamline the current structure. The obligation for taxpayers to fulfill an annual tax return, besides provisional monthly payments, was repealed. Nowadays, a monthly taxable period prevails, easing tax administration and compliance costs. Also, in an attempt to simplify tax assessment, facilitate inspections, and allow neutrality respect to the decision of firms to handle commerce practices with suppliers and clients, the VAT time of supply rules switched to pure cash flow basis.

Personal Income Tax

Besides low revenue-yield capacity, the Mexican PIT structure shows serious deficiencies in terms of efficiency, equity and simplicity. The adoption of broad exemptions grounded on poor social or economic justifications, promotes low personal saving rates and productive investment disincentives. Consequently, the PIT system has unnecessary adapted relative high marginal tax rates to medium level income individuals, along with arbitrage opportunities to evade the tax burden. The IFR addressed most of these insufficiencies by followed a basic approach: to broaden the tax base and reduce marginal tax rates. To achieve these objectives, the IFR pursued to wide up the tax base, along with a decrease of marginal tax rates which included the introduction of the zero percent marginal tax rate for the lowest income end.

One of the top priorities of the PIT in the future reform agenda is the tax treatment of fringe benefits into the wage earners tax base. As discussed before, the exclusion of this item from taxable income, which accounts for an estimate of one-third of total wage remuneration, biases the distribution of the tax burden among individuals at the same level of wage income, but with different composition. Full taxation of fringe benefits would not only bring revenue and equity benefits to the PIT structure, but also simplicity. The inclusion of this item into the wage earners taxable income makes no longer necessary to sustain the fiscal subsidy system, arranged for those individuals receiving a smaller portion of their salary by fringe benefits. By applying a single marginal tax schedule, instead of two, the PIT regime will get rid off one of its most administrative complex features. Therefore, a single effective rate could be applicable to each level of income. Part of the extra revenue collection expected form the inclusion of fringe benefits could be used to reduce marginal tax rates to medium income level individuals, and so effectively increasing incentives for work and capital formation. Pursue to streamline the PIT structure, widen its tax base and further contribute to achieve horizontal and vertical equity, the reform agenda should also eliminate the exemption granted to authorship rights.

Corporate income tax

The current CIT structure allows preferential treatments for taxpayers in specific economic activities, regardless of their size, ability to pay, or administrative capabilities. Through a combination of tax incentives granted by the *simplified regime*, such as immediate expense of investments, partial exemption of tax liability (about 45 percent for agriculture), and administrative facilities to fulfill deduction requirements, taxpayers carrying out land transport and agriculture activities afford comparatively lower effective CIT tax rates. As a result, medium and large-sized corporations dedicated to agriculture and transport activities, pay little or no CIT. Preferential regimes granted on an indiscriminative way to a broad range of sectors in Mexico not only seriously erodes the tax base, but also promotes economic inefficiency, horizontal and vertical inequity among taxpayers, evasion and elusion opportunities, as well as complications to the tax administration. The limitation of non-neutralities within the CIT structure represents a necessary condition towards a more transparent and efficient system. Thus, the reform agenda should consider to cancel the *simplified regime* as a mean to eliminate preferential treatment for medium and large firms engaged in transport and agriculture activities. As for small scale taxpayers, it is desirable to allow them to comply with the income tax either through the *small taxpayer´s regime* or the *intermediate regime*, already applicable to individuals engaged in small business activities.

Reform on tax administration

A profound reform on the SAT´s operation and infrastructure is currently underway. The drive to change is oriented towards increasing tax compliance through a comprehensive broadening of the taxpayer universe, and a thorough simplification of payments and tax filing processes.One of the basic components of the ongoing reform effort is the redesign and computerization of key process. In the recent past, SAT operations relied on fragmented information systems, excessive procedures and lack of integration between operating areas. SAT reforms aim at shifting form an organization based on functions towards a different one operating by processes. To achieve this goal, an improved TI platform is currently under design in order to support newly designed tax administration operating processes, either in substantive areas such as taxpayer services, auditing and collection, or support functions such as human, financial and material resources management.

Also, some different efforts to improve tax administration are currently underway, such as a comprehensive fiscal census geared towards improving registration and control of individuals and enterprises engaged in trade or business, the *Advanced Electronic Firm* which allows taxpayers to fulfill obligations and file tax return by electronic means, and the implementation of the risk management program. Towards the future, important steps should be taken to grant autonomy status to the SAT agency. The wave of autonomy reforms undertaken by tax administrations of different countries during the last decade, have proven to be relatively successful to provide an institutional framework capable of enhancing operation in developing countries. Besides improving corporate governing and allow mid and long term strategic planning scenarios, an autonomous SAT would empower managers with greater control over personnel, funding and budgeting to achieve highest standards of efficiency and quality. A constitutional reform should be passed by Federal Congress for SAT to achieve autonomy.

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7. PARAGUAY UPADTED

by

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Abstract

This paper is part of a wider research on "Tax Systems and Tax Reforms in Latin America", carried out at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. After a brief introduction to the country economy, section two presents basic data on public finances and compares the Paraguayan tax system with other Latin American systems. Section three details the main taxes and their features. Finally, section four evaluates recent tax reforms. The chapter closes with a critical evaluation of the initiatives taken and those still needed to contribute to improve the country's social and economic present status.

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[1] I wish to acknowledge very helpful comments from Andrew Nickson, even though I remain solely responsible for the contents of this chapter.

1. Introduction and contents

Paraguay is one of the smallest South American countries, both in terms of area and population. This landlocked country covers an area of about 407 million sq. km. and has a population of about 5.5 million people. The Republic of Paraguay's political history, beginning with independence from Spain in 1811, has been shaped by three post-colonial dictatorships (from 1814 to 1870), followed by a period of high political instability, which ended in 1954, when General Alfredo Stroessner assumed the Presidency after a military coup. Mr. Stroessner's authoritarian and corrupt regime lasted until 1989. In June 1992 a new democratic Constitution was adopted, establishing Paraguay as a Presidential Republic, which is divided into 17 departments and 231 municipalities. Since 1989 all Presidents have come from the Colorado Party, the most powerful party, which has ruled uninterruptedly since 1947. In 2003 Nicanor Duarte Frutos, leader of the reformist faction within the Colorado Party, was elected President with an ambitious program of State reform. Among the actions taken, with encouragement from international organizations (primarily the IMF), was a major tax reform approved in 2004, but with implementation partially delayed to 2006.

This chapter analyses Paraguay's tax system and its recent reforms. After a brief introduction to the economy contained in the remainder of this section, section two presents basic data on public finances and compares the Paraguayan tax system with the other Latin American systems. Section three details the main taxes and their features. Finally, section four evaluates recent tax reforms. The chapter closes with a critical evaluation of the initiatives taken and those still needed to improve the country's social and economic conditions.

From an economic perspective, Paraguay lags behind the other Latin American countries under many respects. It is one of the poorest and most uneven countries, both in terms of income and land distribution; it is also one of the least developed and least industrialized countries in the region. The informal economy is wide (Nickson 2004b) and the perceived corruption index is one of the highest registered (TI 2005). Paraguay is a middle-income country. In 2004 GDP per head was 1,205 US dollars, approximately one quarter of that of Argentina and Brazil, and below the Latin American average of 3,815 US dollars. Furthermore, income distribution is very unequal, as measured by the Gini index (0.58 in 2002, the third highest value in Latin America, after Brazil and Guatemala; UN 2005), and 16.4 per cent of the population lives on less than one US dollar a day (1990-2003 average), in a country were unemployment and underemployment are high (EIU, 2006). Inequality extends also to land ownership. Most of the land is owned by a few large landowners, through which a traditional elite retains significant economic power. In 2002, 62 per cent of total agricultural production came from as little as 1 per cent of total landholdings

(EIU 2006). Economic activity is also unequally distributed on the national territory and is centered around Asunción and Ciudad del Este (EIU 2006). Official figures are biased by the existence of a large informal sector, comprising 24 per cent of GDP according to recent estimates (IMF 2000). It occupies approximately half of the urban labour force, and includes both illegal and not registered legal activities (Sohn 2005, EIU 2006).[2]

Within this framework, economic growth is strongly hindered. Over the last 15 years the economy has gone through a few years of growth followed by years of stagnation and recession (in 1998-2002 GDP growth was negative or zero). The export-led growth driven by agricultural products is encountering serious difficulties, due to extreme vulnerability to the effect of weather conditions on agricultural output and to international price fluctuations. Exports have also suffered as a consequence of the recent economic downturns of Paraguay main trading partners, Argentina and Brazil. In addition, since 1995 the economy has been plagued by repeated banking crises and political uncertainty has discouraged private investment. Since 2003 the economy slowly recovered, thank to improved macro-economic management. In 2004, GDP grew by 4.1 per cent and per capita income by 2.8 per cent, levels not reached since 1995. However, per capita income in 2004 was still slightly lower than in 1991 and remains among the lowest in Latin America.

The poor economic performance has been accompanied by minimal structural changes. The economy still relies primarily on agriculture, whose contribution to total GDP grew from 27 per cent in 1990 to 31 per cent in 2003. The industrial sector is underdeveloped. Its contribution to total GDP is limited and declining (from 16 per cent in 1991 to 14 per cent in 2003) and is mainly limited to agricultural products processing and to the production of basic consumer goods for the internal market. In addition, the major companies remain in public sector ownership, despite repeated attempts to privatize State assets (EIU 2006)[3].

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[2] It is estimated that half of Paraguayan imports are illegally re-exported to Brazil and Argentina. Attempts to fight thee phenomena have been carried out in recent years, but laws are often weakly enforced or not applied (Nickson and Lambert 2002). Further, with reference to the public sector, the 1970 and 2001 civil service reform (law 200/70 and law 1626/01) were approved but not implemented. The 2001 law compelling Government to propose balanced budget is generally ignored. In addition, a 1997 anti-money laundering law is not rigorously enforced (EIU 2006).

[3] Llimited industrialization dated back to the Stroessner regime, but it is also due to the landlocked geographical position, the lack of significant mineral resources and might have been influenced by the two powerful neighbors, Argentina and Brazil, with an interest in Paraguay as a market for their products and as a cheap energy supplier from its enormous bi-national hydroelectric power plants (Itaipú with Brazil and Yacyretá with Argentina), which provide Paraguay with the second World's highest per capita energy resource availability after Nepal. The output from the power plants is almost entirely exported to Brazil and Argentina, although Nickson (2004a) highlights that a viable economic development strategy would be to use this enormous energy endowment to become a regional hub for energy-intensive industries.

2. A general overview of the tax system and its development since the early 1990s

2.1 A first view of budgetary, revenue and expenditure features

Since 1989, economic policy has focused on monetary and fiscal stabilization and on regional integration to boost economic growth. The high inflation rates of the late 1980s and early 1990s have been brought under control since 1995.[4] Balanced budgets have been pursued throughout the 1990s, but in the late 1990s the fiscal deficit widened. Public finances are negatively affected by economic stagnation and the significant extent of informal economy, illegal trade, and corruption. Furthermore, tax collection is deemed inefficient and tax evasion is widespread (Villela *et al*. 2005). Finally, the low level of industrialization limits the extent of the tax bases.

During 2003 a large fiscal imbalance had led to weeks long arrears in salary payments to public sector workers, and Paraguay was at the brink of external default when the first repayments on a US$ 400 million loan from Taiwan became due. In December 2003 the IMF approved a US$ 73 million Stand By Arrangement, giving the government access to loan disbursements from the World Bank and the Inter-American Development Bank, to be used to regularize external debt servicing. In 2005[5] the Non-Financial Public Sector total revenues were 34.9 per cent of GDP[6], while total expenditures were 33.3 per cent of GDP, of which 28.3 made up by current expenditures. The year closed with a budget surplus of 1.5 per cent of GDP, lower than in 2004 (2.3 per cent) but confirming a reversal from the repeated deficit registered until 2003 (Table 1).

Due to the lack of disaggregated data, a detailed analysis of public sector finances is possible only with reference to Central government[7], which, in 2005 amounted to approximately 85 per cent of General government revenues and expenditures. Central government revenue (Table 2) in 2005 amounted to 18.3 per cent of GDP, the main sources being tax revenues (11.9 per cent of GDP), non tax revenues – primarily revenues from the bi-national hydroelectric plant Itaipú (4.7 per cent of GDP) and social security contributions (1.2 per cent of GDP). Tax

[4] The national currency is the Guaranì (PYG), since 1989 under a single free-floating exchange rate. In 2005 the average exchange rate with the US dollar was 6,178 PYG = 1 US$ (IMF, International Financial Statistics).
[5] 2005 data are provisional.
[6] The non-financial public sector (NFPS) budget reflects the relevant weight of State companies on the overall economy, due also to the very limited privatisations undertaken. State companies make up nearly half of the NFPS revenue/expenditure.
[7] Detailed official statistics by the National Statistic Institute (DGEEC), by the Treasury (Ministero de Hacienda) and by the Economic Commission for Latin America and the Caribbean (CEPAL) exist only for the Central Government, less detailed data are provided for General Government, no data for decentralised Governments.

revenues are mainly revenues from indirect taxes, which yield 82 per cent of total tax revenues (9.8 per cent of GDP), primarily made up by VAT (5.2 per cent of GDP), excise duties and custom duties (respectively 2.2 per cent and 1.8 per cent of GDP). The direct tax yield is significantly lower, at 2.1 per cent of GDP, comprising almost entirely revenues from the corporate income tax (99.5 per cent of total direct tax revenues).

In 2005 current expenditure was 12.3 per cent of GDP, mainly salary payments, which grew from 3.4 per cent of GDP in 1990 to 7.2 per cent in 2005, due to increased public employment in education and health services (Nickson 2004a)[8]. Capital expenditure was not very limited (4.1 per cent of GDP in 2005) but Paraguay still lacks significantly of public infrastructures (EIU 2006). In 2005, interest payments on public debt were 1.2 per cent of GDP, mainly repayments to external sources (90 per cent of total financing). Due also to the country's low credit rating and to its limited access to international capital markets (Sohn 2005), Paraguay debt stock is one of the lowest among Latin American countries and has been reduced in recent years (from 41.7 per cent of GDP in 2004 to 34.7 per cent in 2005).

2.2 Tax system and its structure since the 1990s and a comparison with that of other countries

Paraguay's current tax system was established in 1992 (Law 125/91, approved 9th January 1992). The 1992 fiscal reform aimed to rationalize and modernize an obsolete system, based on about 150 specific taxes with widespread exemptions. The resulting tax system was based on nine main taxes and rested primarily on indirect taxation. Since its approval, numerous incentives, deductions and exemptions were introduced, eroding the tax bases and tax revenues (Alarcón 2004). This system lacked a net wealth tax and an inheritance and gift tax and, until recently, it was characterized by the absence of a personal income tax (a feature that Paraguay shared with Bolivia and Uruguay). The Administrative Reform and Fiscal Adjustment Law approved in June 2004 (Law 2421/04) introduced some amendments to the system: it broadened the tax basis of VAT and of the corporate income tax, introduced a more effective tax regime to large producers, eliminated some large exemptions, and, finally, it brought in a new personal income tax. However, after hot protests, the application of this law was partially postponed to 2006.

In 2004 Central government fiscal pressure, as a percentage of GDP, was the sixth lowest among 19 Latin American countries (12.9 per cent), below the regional average of 15.5 per cent

[8] Public sector employment grew by 50 per cent between 1989 and 2004 (Nickson 2004b). This trend is the opposite of that which was registered in most Latin American countries, but it is due to the relatively limited number of public officials, especially in the health and education services, which were understaffed during the Stroessner years.

(Table 3). However if we exclude social contributions and take into account tax revenue only, Paraguay is the country with the ninth lowest Latin American level of revenue (11.9 per cent of GDP against a regional average of 12.9 per cent).

When compared to other Latin American countries (Martner and Tromben 2004), the Paraguayan tax system displays a number of similar features, but also some peculiar traits. First, similarly to other Latin American countries, Central government tax revenue as a percentage of GDP increased since the early 1990s (+26.3 per cent from 9.4 per cent of GDP in 1990 to 11.9 per cent in 2004). However Paraguay tax-performance was weak in relative terms: its growth rate was lower than the regional average of +34.6 per cent, and its ranking worsened up to 2003, to recover in 2004. In addition, Paraguay well reflects the regional trends as regards the contribution of different taxes to this increase: VAT revenues grew significantly (+25 per cent from 3.7 per cent of GDP in 1993 to 4.7 per cent in 2004), and revenues from indirect taxes increased by 23.5 per cent over the same period (Table 2). Second, similarly to other Latin American countries, the revenues from income taxes are very low, 2.1 per cent of GDP in 2004, and this is the lowest recorded value, half of the regional average of 4.2 per cent of GDP (Table 3), while indirect tax revenues (9.8 per cent of GDP) are slightly above the regional average of 8.6 per cent (Table 3). Furthermore, Paraguay displays a peculiar performance over the period 1990-2004: both the direct and indirect tax revenues' growth was below the mean Latin American value. Indirect tax revenues grew by 23.5 per cent against an average of 25.7 per cent, the growth in revenues from direct taxes was 41 per cent against an average of 57 per cent. In conclusion, Paraguay has not managed to increase its tax revenues, in particular those from direct taxes, as much as many other Latin American countries. Economic stagnation and decline in foreign trade, the extent of the informal and illegal economy, the inadequacy and inefficiency of tax administration, the diffuse corruption, may have contributed to this outcome.

3. Institutional characteristics of main taxes

The Paraguayan tax system partially reflects the three-tier government structure (Central government, Departments and Local governments). Central government has the power to levy the main taxes and duties, such as: corporate income tax (*IRACIS – impuestos a la renta de actividades comerciales industriales o de seguros*), Single Tax (*Tributo Unico*), farming and cattle-ranching income tax (*IMAGRO – impuesto a la renta agropecuaria*), value added tax (*IVA – impuesto al valor agregado*), excise duties (*impuesto selectivo al consumo*), custom duties (*impuesto al comercio exterior*), registration and stamp duties (*impuesto a los actos y* *documentos*), and, from the year 2006, the personal income tax (*impuesto a la renta personal*). Local governments levy taxes on immovable property (*impuesto immobiliario*) and other minor taxes, while Departments may charge fees for the licenses, concessions and other services they offer. According to the Constitution, the power to introduce, abolish or change fiscal laws rests only with the Central government. Local governments may only set local tax rates (except for the Municipality of Asunción, which may apply some surcharges). The following sections describe the most important institutional features of the main taxes as they were in 2004, this is followed by the description of the main innovations introduced by the 2004 reform, where applicable.

3.1 Direct taxes

3.1.1. Corporate income tax

IRACIS, the corporate income tax, is an annual levy on income of resident[9] legal bodies. A specific category of businesses, that of individual entrepreneurs are chargeable when their total revenues exceeds a maximum limit defined each year[10] (otherwise they are subject to the Single Tax). Taxation is based on the source principle and taxable income is made of all incomes of Paraguayan source. A flat tax rate of 30 per cent applies to total yearly gross revenues, net of allowed deductions, but exemption is granted to a wide number of heads. Tax exemption is also granted to a selected group of companies and to free zone activities located in the international free zone near Ciudad del Este, which include trade (introduction of goods from abroad or from national custom areas), industry (manufacturing and processing of goods for export) and services.

The 2004 tax reform (Law 2421/04) introduced some significant changes to this tax both with regard to the tax rate and the tax basis. First, in order to reduce incentives to tax evasion and promote a higher 'formalisation' of the economy, it lowered the tax rate from 30 per cent to 20 per cent during its first year of application (2005) and to 10 per cent from the second year onwards (2006). An additional rate of 5 per cent is charged on dividends distributed to residents, a higher rate of 15 per cent applies to dividends distributed abroad. Secondly, the law extended the tax basis by limiting exempted heads, by reducing allowed deductions, by constraining the list of exempted bodies and by abolishing special regimes. Finally, it extended the definition of

[9] An individual has the status of 'resident' if s/he stayed in Paraguay for a minimum of 180 days during the previous 12 months. A company is 'resident' if established in Paraguay according to Paraguayan law (excluding its branches or agencies abroad) or if it is a branch, agency or plant owned by non residents but established in Paraguay.

[10] The 20,400,000 guaranis (approximately 15,394 US$) threshold, set by law 125/91, was to be adjusted every year according to the variation of the Consumers' Price Index published by the Paraguay Central Bank. In 2004 this threshold reached 52,389,833 guaranis (approximately 8,805 US$).

taxable income, and interests from capital investments abroad are included as revenues of Paraguayan origin.

3.1.2. Single tax / Small Business Tax

The Single Tax is charged on individual entrepreneurs, resident in Paraguay, whose revenues are below the IRACIS threshold. Those chargeable by the Single tax are exempted from the Value Added Tax. The tax basis is made up by the revenues from commercial, industrial or service activities. The tax is levied at a rate of 4 per cent, and the taxable income is either gross revenues or an imputed gross income given by the sum of: salaries and wages; rent, utility bills, purchases of goods, raw materials and other expenses, excluding financial expenditures (these expenditures are increased by a 30 per cent profit mark-up, according to the concept of a presumptive profit). A tax credit of 50 per cent of documented VAT paid during the fiscal year is allowed up to the taxpayers' Single Tax liability. The 2004 reform abolished this tax from 2007 and substituted it with a Small Business Tax (*impuesto a la renta del pequeño contribuyente – IRPC*), that differs from the Single tax in three main respects: the tax rate, the definition of the tax basis and the threshold for its application. The Small Business tax is charged at a rate of 10 per cent, the same of the IRACIS. The taxable basis is the net income, calculated as the difference between revenues and expenses, or an imputed income equal to 30 per cent of gross revenues. Compared to the Single Tax, this tax is charged upon a wider range of businesses: the upper limit for its application was raised up to 100 million guaranis (approximately 16,738 US$ in 2004). Furthermore, the tax credit for VAT paid does not apply anymore. The Small Business tax has the potential to reduce the distortions favored by the previous regime, primarily the incentives for tax evasion by large companies due to the existence of two different tax rates for small and big businesses.

3.1.3. Farming and cattle-ranching income tax

IMAGRO, the farming and cattle-ranching income tax, is an annual tax on income from farming and cattle-ranching activities carried out in the national territory. The tax is charged at the flat rate of 25 per cent on the land owner, unless a written contract proves that the land is used by third parties. The taxable income is the imputed gross income from the land, equal to 12 per cent of the fiscal value of the land defined by the National Land Register Service (*Servicio Nacional del Catastro*), which is notoriously way below the commercial value of land, and this partly explains the tiny the tax yeld from IMAGRO. Exemption is granted to the first 20 hectares of any landholding of less than 100 hectares and to those parts of landholdings occupied by forests and permanent lagoons. The basis for taxation is the gross income after deduction of selected allowable deductions. The 2004 reform overhauled this tax, with effects from the year 2005. It reduced the allowed deductions and introduced a distinction between large and medium-sized landholders[11] both with regard to the taxable income and to the tax rate. While large landholders are taxed on their net income (total revenues net of expenditures linked to the activity), except when less than 30% of their property is used for farming activity, medium-sized ones are taxed on presumptive income, calculated on the basis of productivity coefficients defined by law. Similarly to the previous regime, small landholders are exempted. The reform reduces the tax rate, from 25 per cent to 10 per cent for large landholders and to 2.5 per cent for medium-sized landholders.

3.1.4. Personal income tax

The 2004 reform introduced a personal income tax (*impuesto a la renta personal*), to take effect from 2006. The tax is charged at a rate of 10 per cent on individuals whose annual income exceeds 120 minimum monthly wages.[12] The taxable basis is the gross income from Paraguayan sources, defined as: employment income; 50 per cent of dividends and profits distributed to shareholders of companies subject to IRACIS; capital gains from the transfer of buildings or land; interest payments received. The basis of taxation is gross income net of deductions: social security contributions, donations to the State or other bodies, expenditures and investments related to the contributor's job or profession, as well as personal and family expenses supported by VAT receipts. This latter provision aims to reduce tax evasion. However it significantly cuts potential revenues and will likely increase the costs of administering the tax (IMF 2005).

3.2 Indirect taxes

3.2.1. Value Added Tax

In 1993 Paraguay was one of the last Latin American countries to introduce a value added tax. However the VAT is now the pillar of the fiscal systems, generating more than 40 per cent of

[11] Large landholders are those with a property larger than 300 hectares in the Eastern Region and larger than 1.500 hectares in the Western Region. Medium- sized ones are those between 20 and 300 hectares in the former region and between 100 and 1500 hectares in the latter one. Small landholders are those whose property is smaller than 20 hectares in the Eastern Region and smaller than 100 hectares in the Western Region

[12] In 2006 120 minimum wages amounted to 130 million guaranis (approximately 23,000 US$).

total tax revenues. The tax follows the consumption type and it applies the destination principle. The value added tax is levied at a rate of 10 per cent on the sale of goods and services and on the import of goods. The tax is charged on professional activities; on resident individual entrepreneurs with an income above the IRACIS threshold, and on all other legal bodies and importers, regardless of their income. Exports are not liable to VAT and exporters can recover the VAT paid on inputs through a system of fiscal credits against any kind of tax. Originally a tax characterized by a wide basis, the VAT basis (and therefore tax revenues) has been eroded by the introduction of preferential regimes and exceptions for some types of transactions (e.g.: tourism and transport) and of various exemptions of selected goods or bodies. The 2004 reform broadened the VAT base and partially revised the tax rate as to 1st January 2005. First, the reform eliminated exemptions under special regimes and introduced the tax on services, rentals, transports and on previously exempted goods (such as basic foods and oil products). Second, basic goods are subject to a maximum tax rate of 5 per cent, pharmaceuticals and financial services are charged at 5 per cent for a transition period of two years, afterwards the tax rate will increase each year of one percentage point, up to 10 per cent.

3.2.2. Excise taxes

A single stage excise tax is levied on some selected goods: fuel, beverages, alcohol, oil and tobacco, either produced in Paraguay or imported. Domestic goods are charged at the first stage of the distribution process, while foreign goods are charged when imported. Tax rates vary depending on the type of good charged, and increased in recent years due to the deterioration of the national fiscal scenario and the consequent need to easily and quickly increase fiscal revenues. The 2004 reform set new maximum rates, in some cases higher, in other lower, than the existing ones. It also introduced a rate of 5 per cent on luxury goods and of 1 per cent on electronic items. With the exceptions of fuels, the maximum rate is fixed at 12 per cent.

3.2.3. Custom Duties

Custom Duties are levied according to the Custom Code and the MERCOSUR Common External Tariffs (in effect since 1st January 2005). With few exceptions, goods originating from MERCOSUR countries[13] are exempted, and common external tariffs are applied to imports originating from outside the area. Depending on the type of imports, the tax is levied according to

[13] Argentina, Brazil, Paraguay and Uruguay.

four different systems: general system; tourism (the tax is calculated on a reduced value of goods); minor imports (applied by taxpayers, only up to a maximum amount and with immediate cashing); limited value goods (applied to the introduction of personal goods, up to a maximum amount and with immediate cashing); franchises.

3.2.4. Registration and Stamp duty

The registration and stamp duty is applied to transactions and contracts completed or fulfilled through the production of written documents, such as financial intermediation activities. Many exemptions apply, in particular transactions subject to value added tax are exempted from stamp duty. Tax rates differ widely according to the nature of the transaction.

3.3 Local taxes

3.3.1. Property tax

The property tax is the main tax levied by Municipalities, and there are two surcharges: on not built-up sites and on empty urban buildings. It is charged upon the owner or tenant of the property as of the start of the fiscal year. The tax base is the value of buildings within the national territory, according to the National Land Register Service.[14] The tax rate of 1 per cent is reduced to 0.5 per cent for rural landholdings of less than 5 hectares used for farming activities. Total or temporal exemptions apply to buildings owned by selected bodies or used for special purposes. In case of natural calamities, partial exemptions up to 50 per cent of the tax amount may be allowed. Assessment and collection are autonomously regulated by each municipality, which retains 70 per cent of total revenues and transfers the rest, on a 50-50 basis, to their Departments and to less resourced Local Governments. No data are available on revenues from this source, which are estimated to be extremely low (Martner and Tromben 2004) due to limited local tax administration competencies and efficiency and to obsolete and incomplete cadastral data. IN addition, fiscal values on which the tax is levied are way below the market value.

3.4 Social contributions

[14] The National Land Register fiscal values were revised by decree n. 1267/03, in effect from the 2004.

A compulsory social security system covers all hired workers and their families. The general social security system is administered by the Social Security Institute (*Instituto de Previsión Social*) and covers illnesses, maternity, disability and industrial accidents for all the minors of 60 years whose only mean of subsistence is the wage. In addition, six institutes provide social security to employees of selected bodies. Social security is financed by employers, employees and the State. Employees' monthly contributions range between 2.5 per cent and 9 per cent of net monthly wage – excluding family allowances and thirteenth month's payment. Employers' monthly social contribution range between 2.5 per cent and 16.5 per cent of gross wage.

4. Tax reform

Paraguay is generally regarded as a country that lags behind other Latin American countries in terms of modernization of the public sector and of the economy in general. Sohn (2005), referring to the situation in 2001, notes that "as we enter the 21st century, Paraguay, a country of 5.2m people, is only 'reluctantly' and at 'glacial speed' making tentative moves to put in place the necessary ingredients to promote sustained growth and development". This comment is true also with regard to tax reform: compared to other Latin American countries, Paraguay was a late mover and introduced reforms only after the fall of the Stroessner's regime, the main ones being those contained in Law 125/1992 and Law 2421/2004.

The 1992 reform pursued the simplification of the tax system by reducing the number of taxes, rearranging tax legislation and introducing a value added tax. However, it failed to tackle the problem of tax administration efficiency and disregarded the introduction of a personal income tax, limiting income taxation to legal bodies. In 2003, the incoming government of President Duarte Frutos faced a fiscal crisis and tried to fight against it through an ambitious program of State's reforms addressing the long term weaknesses of Paraguay's public sector and private economy, and aiming to place the country on a path of sustainable growth. This program included the modernization of the Public Administration and the establishment of a favorable economic environment for foreign investors (Duarte Frutos 2003). A number of initiatives in fiscal policy were taken to address the problems highlighted above. In 2003 arrears on public debt were cleared, the custom code and the social security system were reformed, new public procurement procedures were introduced and a reform of tax administration began. In 2004 a Stand by Arrangement with the IMF was signed and the tax reform was approved under Law 2421/04 (Duarte Frutos 2004 and 2005). Improvements include a substantial broadening of the tax basis of VAT and of corporate income tax, the introduction of a new personal income tax for high earners, the elimination of numerous exemptions and a more effective tax regime to large farmers.

Overall, these measures have the potential to increase fiscal revenues and reduce public sector expenditures. They may have already impacted on the 2004 and 2005 (provisional) public sector budget, which show a reversal of the previous years' trends of increasing expenditures and declining revenues. However, the reform impact on the equity of the system is limited, due to the over reliance on regressive indirect taxation and the restricted number of citizen chargeable under the personal income tax (which, in addition allows significant deductions and is proportional). Furthermore, total revenues are still below their potential (Villela *et al*. 2005) due to corruption, tax evasion and the informal economy. Therefore, if fiscal policy is to be effective, these "corollary" problems have to be tackled with determination, through additional initiatives, some already approved by the government (Nickson 2004b). One main issue still to be tackled is the improvement of the tax administration, to make it more honest and efficient. A long due civil service's reform would favor this change, but it seems far from happening, especially after the failure to implement the civil service reform approved in 2001. This is a worrying sign of the persistence of widespread interests protecting patronage in public administration and maintaining a 'privatized' clientelist and politicized public sector, whichfor many years has provided both an opportunity of employment for activists of the Colorado party and also a source for party funding (Nickson and Lambert 2002; Nickson 2004b).

5. Conclusions

Paraguay lags in Latin America for its limited industrialization, widespread poverty, high unemployment and underemployment, income and land distribution inequality, as well as for its delay in implementing needed policy reforms. The weight of the Paraguayan public sector has been traditionally limited, and public finances inadequate to tackle the social and economic problems of the country. Taxation relies extensively on indirect taxes, which are easier to collect, but are regressive. Recent tax reforms have the potential to increase available resources. Surely these reform may be improved, however the major challenge for this country is not that of designing a better tax reform, rather that of fully implementing the existing one. In addition, only if Paraguay is able to reduce tax evasion and erosion of the tax base, can the approved tax reform become fully effective, as regards both the increase of tax revenues and the reduction of income inequality. In order to fight tax evasion, tax administration has to be improved and the competencies and commitment of tax inspectors have to be strengthened, through a long over-due civil service reform. Furthermore, the corruption that affects the Paraguayan economy and society, as well as its public sector, has to be tackled. Under the Presidency of Nicanor Duarte Frutos, a number of initiatives have been approved since 2003 and more are planned, which should help Paraguay to move towards the directions traced above. It is not an easy task, especially as the problems of the country are not limited to the tax system and the civil service, nor solely to corruption, but they extend to a wide array of social and economic issues. In addition a main obstacle to any reform is the strong and powerful opposition of the rich and the limited political mobilization and representation of the mass of impoverished and underemployed citizens – two factors that have meant that until now the pressure for reform has come almost exclusively from external sources.

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Table 1 Structure and development of operation in the Non-Financial Public Sector, 1990-2005, percentage of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total Revenues, of which:	*27.2*	*25.7*	*27.0*	*27.8*	*30.0*	*28.5*	*29.6*	*32.6*	*33.6*	*33.0*	*34.4*	*35.7*	*32.7*	*31.9*	*33.9*	*34.9*
Current revenues	26.4	25.4	26.6	27.1	29.5	27.7	28.9	31.6	32.9	32.2	33.1	35.0	32.6	31.8	33.9	34.7
Capital revenues	0.7	0.3	0.3	0.7	0.6	0.8	0.6	1.0	0.7	0.8	1.2	0.8	0.1	0.0	0.1	0.1
Total Expenditures, of which:	*21.3*	*23.7*	*26.8*	*26.1*	*26.8*	*27.4*	*28.5*	*33.5*	*33.2*	*36.1*	*38.4*	*35.9*	*34.6*	*30.8*	*31.6*	*33.3*
Current expenditure	18.1	19.0	21.3	21.0	22.2	21.2	23.1	23.9	24.5	23.6	30.5	29.3	28.9	26.2	26.6	28.3
Capital expenditure	3.2	4.7	5.6	5.1	4.6	6.2	5.4	9.6	8.7	12.5	7.9	6.5	5.8	4.9	5.2	4.9
Budget Balance	*5.8*	*2.0*	*0.1*	*1.7*	*3.2*	*1.2*	*1.0*	*-1.0*	*0.4*	*-3.1*	*-4.0*	*-0.1*	*-1.9*	*1.1*	*2.3*	*1.5*
Total Public Debt of NFPS	*30.3*	*25.7*	*18.2*	*19.0*	*15.1*	*17.6*	*16.5*	*23.2*	*23.5*	*33.5*	*35.3*	*44.0*	*63.0*	*46.9*	*41.7*	*34.7*
Total Public Debt of Central Gov.	*14.0*	*12.8*	*9.5*	*11.1*	*8.3*	*13.4*	*11.9*	*20.3*	*20.5*	*30.4*	*32.6*	*41.1*	*59.2*	*44.4*	*38.0*	*31.4*
Total Debt of Public Sector	*34.7*	*29.2*	*22.5*	*20.9*	*18.1*	*18.4*	*17.3*	*23.9*	*24.3*	*34.2*	*35.9*	*44.7*	*63.9*	*47.4*	*42.1*	*35.0*

Source: ILPES-CEPAL 2006.

Note: the figures for 2005 are provisional.

Table 2 Structure and development of Central Government fiscal revenues and expenditures, 1990-2005, percentage of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenues	13.3	12.7	14.3	14.9	17.0	17.5	16.5	17.1	17.6	18.0	17.2	18.8	17.5	17.0	18.4	18.3
Total fiscal revenues, of which	*9.9*	*9.8*	*9.9*	*10.2*	*12.0*	*13.6*	*12.7*	*12.7*	*12.6*	*11.8*	*12.0*	*12.0*	*11.2*	*11.3*	*12.9*	*13.0*
Total tax revenues	*9.4*	*9.1*	*9.1*	*9.3*	*11.0*	*12.5*	*11.5*	*11.6*	*11.5*	*10.5*	*10.8*	*10.8*	*10.0*	*10.3*	*11.9*	*11.9*
Direct taxes	1.5	1.5	1.8	1.6	2.3	2.6	2.5	2.2	2.2	2.4	2.0	1.8	2.0	1.8	2.1	2.1
Income and profits	1.2	1.2	1.5	1.6	2.3	2.5	2.4	2.2	2.2	2.4	2.0	1.7	2.0	1.7	2.1	2.1
Individuals	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Corporations	1.2	1.2	1.5	1.6	2.3	2.5	2.4	2.2	2.2	2.4	2.0	1.7	2.0	1.7	2.1	2.1
Property	0.3	0.3	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Indirect taxes	7.9	7.6	7.3	7.6	8.8	9.9	9.1	9.3	9.3	8.1	8.8	9.0	8.0	8.5	9.8	9.8
General sales (VAT)	0.0	0.0	1.4	3.7	4.5	4.9	4.5	4.9	4.9	4.6	4.7	4.6	4.3	4.4	4.7	5.2
Excises	1.1	1.1	1.3	1.2	1.3	1.3	1.5	1.4	1.4	1.4	1.8	2.2	1.8	2.0	2.4	2.2
Custom duties	2.3	2.1	1.8	1.9	2.2	3.1	2.5	2.5	2.4	1.8	2.0	1.9	1.7	1.9	2.2	1.8
Other	4.6	4.4	2.7	0.8	0.7	0.6	0.5	0.5	0.5	0.4	0.4	0.4	0.2	0.3	0.5	0.6
Social security contributions	0.5	0.6	0.8	0.9	1.0	1.1	1.2	1.2	1.1	1.3	1.2	1.2	1.2	1.0	1.1	1.2
Total Expenditures, of which:	10.1	12.9	15.0	14.4	15.8	17.9	17.8	18.6	18.6	21.8	21.7	20.0	20.7	17.4	16.8	17.5
Current primary expenditure	7.3	9.0	11.1	11.3	12.1	12.7	13.7	13.3	14.0	14.7	15.5	15.2	14.8	12.6	11.8	12.3
Interest on public debt	1.6	1.0	1.0	0.9	0.8	0.8	0.6	0.5	0.8	0.8	1.2	1.4	1.5	1.3	1.1	1.2
Capital expenditure	1.2	2.9	2.9	2.3	2.9	4.4	3.5	4.8	3.8	6.2	4.5	3.5	4.4	3.7	4.0	4.1
Primary Surplus	*4.8*	*0.9*	*0.4*	*1.3*	*2.0*	*0.4*	*-0.6*	*-1.0*	*-0.3*	*-3.0*	*-3.3*	*0.2*	*-1.7*	*0.9*	*2.7*	*2.0*
Budget Balance	*3.2*	*-0.2*	*-0.6*	*0.4*	*1.3*	*-0.4*	*-1.2*	*-1.6*	*-1.1*	*-3.8*	*-4.6*	*-1.2*	*-3.2*	*-0.4*	*1.6*	*0.8*

Source: ILPES-CEPAL.

Note: the figures for 2005 are provisional.

Table 3 Central Government revenues compared with the Latin America average (19 countries)

	Paraguay					Latin America		
	1990		*2004*		*1990-2004*	*1990*	*2004*	*1990-2004*
	%GDP	*Rank**	*%GDP*	*Rank**	*% increase*	*%GDP*	*%GDP*	*% increase*
Total fiscal pressure	9.9%	8th	12.9%	6th	30.9%	11.6%	15.5%	33.5%
Tax revenues, of which	*9.4%*	*10th*	*11.9%*	*9th*	*26.3%*	*9.6%*	*12.9%*	*34.6%*
Direct taxes	1.5%	3rd	2.1%	1st	41.1%	2.7%	4.2%	57%
Indirect taxes	7.9%	15th	9.8%	13th	23.5%	6.9%	8.6%	25.7%
Social security contributions	*0.5%*	*5th*	*1.1%*	*5th*	*121.8%*	*2.1%*	*2.7%*	*28.5%*

Source: ILPES-CEPAL.

* For each type of revenue, the lower the country rank, the lower its revenues. Thus a country ranking first, has the lowest level of revenues.

8. URUGUAY

by

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Abstract
This paper is part of a wider research on "Tax Systems an Tax Reforms in Latin America", carried out at the Department of Public economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. Uruguay is one of the oldest democracies in the world. This paper is dedicated to a description of the economic and fiscal evolution since 1970s, with special emphasis on the tax reform of 1974 –the only one of the last 30 years-. It analyzes the macroeconomic frame of the tax changes; the proposal for dual taxation *"Uruguayan style"* and its impact on equity; the new tax secrecy to fight evasion; the abolition of the employer's contributions to social security; and the simplification of the tax system proposed by the elimination of eleven low-revenue taxes and/or those with a high cost of administration and compliance.

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JEL Codes: H20, H24, H25, H29

1. Introduction, content and main conclusions

Uruguay is one of the oldest democracies in the world. Since its independence, in 1830, it has been a democracy for 138 years. Situated between Argentina and Brazil, the country has a total land area of 180.000 km^2 and a population of 3.4 million inhabitants, of which 15% is older than 65 years old. The Uruguayan GDP per capita is approximately US$5.200 (US$9.050 at parity of purchasing power). The domestic economic structure is based on its agriculture (12% of the GDP and more than 50% of exports), manufacturing --basically agricultural related— (18% of the GDP), tourism services (6% of the GDP), and the rest is composed of public and private services.

Uruguay has a difficult fiscal stance characterized a public debt of 2.5 times its GDP – 180% of GDP of pension liabilities and 75% on foreign denominated bonds--, a tax burden slightly above 30% of GDP but has more than 60% affected to pensions and interest payments --5% corresponds to interest payment and 14% of GDP on pensions— that leaves a small margin (11% of GDP) to provide for all public services. Additionally, in spite of a extraordinarily positive phase of the cycle –low rates and weak dollar, quite favorable terms of trade and booming trade partners--, it still runs fiscal deficits.

The second section of this paper is dedicated to the brief summary of the economic and fiscal evolution since 1970, with special emphasis on the tax reform of 1974 –the only one of the last 30 years-- and the tax system's evolution in the 90's.

The third section presents a description of the characteristics of the main taxes of the current tax system, including its main problems. Lastly, this paper describes the tax reform recently approved. It analyzes the macroeconomic frame of the tax changes; the proposal for dual taxation *"Uruguayan style"* and its impact on equity; the new tax secrecy to fight evasion; the abolition of the employer's contributions to social security; and the simplification of the tax system proposed by the elimination of eleven low-revenue taxes and/or those with a high cost of administration and compliance.

2. General view of the tax system and its development since the 70's

2.1. Brief review of the economic and budgetary evolution

In 1973, after 50 years of uninterrupted democratic rule, there was institutional breakup in Uruguay, resulting in a military dictatorship. The economic changes were also significant, led by abandoning the substitution model of imports, strictly speaking useless since 1955, opting for an export promotion model. Since 1974, this was translated in a deep financial liberation, followed by a progressive commercial opening that was accompanied by a monetary and fiscal reform.

The fiscal reform of 1974, the only tax reform of the last 30 years, was design for a combined strategy of export promotion model and a financial center. Its main features were: (i) the introduction of a VAT abolishing a traditional sales tax; (ii) the abolishion the personal income tax (PIT), which had been pioneered in Latin America in the early 60's, with a cedular design too complex for the level of the tax administration, thus, it never ended up collecting more than 0.3% of the GDP; and (iii) the simplification of the system, eliminating a slew of minor taxes, including those of Estate and Inheritance.

Table 1

URUGUAY - EVOLUTION of REVENUE and SPENDING OF PUBLIC SECTOR
in % of GDP

	1975	**1980**	**1985**	**1990**	**1995**	**2000**	**2004**
Total Expenditures, separated in	**23.5%**	**20.9%**	**27.0%**	**31.1%**	**32.7%**	**34.0%**	**29.6%**
Current Expenditures	13.2%	6.8%	6.7%	17.4%	15.1%	15.1%	11.9%
Interests	0.9%	0.5%	6.5%	1.7%	1.4%	2.0%	4.9%
Public Investment	1.8%	5.3%	3.5%	1.8%	2.1%	1.8%	1.5%
Social Security	*7.5%*	*8.1%*	*10.0%*	*10.2%*	*13.8%*	*15.0%*	*11.2%*
Total Taxes	**19.5%**	**22.0%**	**20.4%**	**28.2%**	**30.2%**	**29.8%**	**27.7%**
Total Taxes	13.8%	17.5%	15.4%	17.9%	19.0%	21.0%	22.1%
Social Security Contributions	5.7%	4.5%	5.0%	10.3%	11.2%	8.8%	5.6%
Total Deficit	**-4.0%**	**1.1%**	**-6.6%**	**-2.9%**	**-2.5%**	**-4.2%**	**-1.9%**

Sources: IMF, Vallarino (2005), De Haedo et alter (1987), BCU, BPS y CGN.

The period from 1975 to 1985, the year when democracy was recovered, was marked by the exchange rate crisis of 1982. This crisis was the result of the incompatibility between an expansive fiscal policy and an overvalued domestic currency. In terms of spending, the dictatorship reduced the salaries and public loans, but invested in large infrastructure projects of doubtful social profitability, which concluded in high deficits (*see Table 1*).

The first democratic administration, 1985-1990, increased public spending, including high debt services, a by-product of the debt crisis of the early 80s. To finance this, the government implemented extremely harsh and continuous tax adjustments[1] with the

[1] Those "adjustments" included, among other measures: (i) the increase of the general VAT rate from 20 to 22%; (ii) the rise of the corporate income tax rate (CIT) from the 30 to 35%; (iii) the implementation of the

subsequent upsurge in the tax burden, which jumped from 20.4% to 28.2% of the GDP between 1985 and 1990 (see Table 2).[2]

Table 2

URUGUAY -TAX BURDEN
in % of GDP

	1975	1980	1985	1990	1995	2000	2004
Direct Taxes	**2.4%**	**3.2%**	**1.9%**	**2.7%**	**4.0%**	**5.7%**	**5.8%**
Corporate Income Tax	*1.1%*	*2.4%*	*1.1%*	*0.9%*	*1.8%*	*2.3%*	*2.5%*
Personal Income Tax (Shedular)	*0.0%*	*0.0%*	*0.0%*	*0.6%*	*1.1%*	*2.1%*	*1.4%*
Net wealth and property taxes	*0.4%*	*0.8%*	*0.8%*	*0.3%*	*0.4%*	*0.7%*	*1.0%*
Indirect Taxes	**8.6%**	**12.7%**	**11.9%**	**13.0%**	**12.1%**	**12.3%**	**13.0%**
VAT	4.0%	6.2%	5.7%	*6.7%*	*7.8%*	*8.2%*	*9.1%*
Excises	3.5%	3.4%	3.6%	*4.0%*	*3.3%*	*3.4%*	*3.1%*
Trade taxes	0.7%	2.4%	1.8%	*2.3%*	*1.0%*	*0.8%*	*1.3%*
Local Taxes	**2.9%**	**1.6%**	**1.6%**	**2.1%**	**2.9%**	**3.0%**	**3.3%**
Total Taxes	**13.8%**	**17.5%**	**15.4%**	**17.9%**	**19.0%**	**21.0%**	**22.1%**
Social Security	**5.7%**	**4.5%**	**5.0%**	**10.3%**	**11.2%**	**8.8%**	**5.6%**
Total Taxes	**19.5%**	**22.0%**	**20.4%**	**28.2%**	**30.2%**	**29.8%**	**27.7%**

Sources: De Haedo et alter (1987), Vallarino (2005), DGI y CGN

2.2 The tax system and its structure from the '90s

As it had happened in the late '70s, Uruguay fell again, twenty years later, in an inconsistency between the foreign exchange regime and the fiscal policy. In the '90s decade, the country made two interrelated errors: i) it created a large deficit to finance the growing public spending on social security --doubling total public debt which includes transfers to the unfunded pension system and the foreign denominated long-term debt--, and ii) it allowed an overvalue of the domestic currency that exacerbated the loss of competitiveness as Uruguay's productivity lagged the one of its trade partners.

During this period an explosive growth in spending was verified in social security that went from 10% to 15% of the GDP between 1990 and 2000 (Table 1). In the same period, the deficit of the social security system went from 4.5% to 10.8% of the GDP. As a result of the abuse of the mechanism of indexing retirement pensions by less than the inflation

Taxes on Bank Assets (IMABA) --which burdens bank loans at differential rates according to length of the credit, similar to the debit tax but on loans-; (iv) strong rise of the excise tax on petroleum products, which collected almost 2% of the GDP; (v) a significant increase of the employer's contributions to social security; and (vi) a jump of almost 2% of the GDP in the property and net wealth taxation --punishing the agricultural sector with a fivefold increase in the assessment value of the land--.

[2] This increase on fiscal burden was complemented with heavy price hikes that increased the surpluses of state-owned energy, water and telecommunications monopolies to more than 2.5% of GDP.

rate during the dictatorship, through a referendum in 1989, it was established in the Constitution the obligation of adjusting them in function of the index of the last evolution of wages. Therefore, through the increase of public wages independently from their productivity, the Uruguayan governments "create" in productivity by decree, and the Constitution multiplies it.

Also, the continuous growth of public spending forced a great fiscal effort larger than the revenue capacity to cover it[3], moving the tax system away as the instrument for the integration and development strategy, for which it was designed. Therefore, in the last decade a "tax spiral"-continuous tax adjustments as answers to the growing expense- has ensued, with two main consequences:

1) It "muddied" the tax system with the creation of several distortionary taxes, which affected competitiveness but at the same time, relatively easy to collect, [4]Indeed, at least thirteen new taxes were created in Uruguay, exactly at a rate of one per year[5].
2) It increased the regressivity of the system. Since it is difficult to tax the mobile factor --the capital--, the load should necessarily fall upon consumption and/or salaries. Between June 1984 and May 1995, the general rate of the VAT ("basic rate") increased almost 30%, moving from 18% to 23%, which is the current rate. Additionally, in May of 2001 the COFIS was created, a wholesale VAT, with a rate of 3%. Added together, VAT and COFIS impose a tax of more than 26% on consumption.

3. Features of the (current) main taxes

3.1. Direct taxes

3.1.1. Personal income tax (PIT)

Contrary to what is usually claimed, Uruguay has a personal income tax. It is an incomplete cedular system, it is a variety of taxes that burden some sources of income at different rates but exempting others. For example, the Tax to the Personal Retributions (IRP) is imposed on wages and pensions, the Tax to the Commissions reaches a great

[3] This point will be carried out later on.

[4] Rezende (2005) complained on the emergence of a new tributary principle based in the easiness to collect by the tax administrators.

number of non-professional services (custom and currency exchange brokers, salesmen, etc.), sole proprietors are burdened by the corporate income tax, but other types of income –such as interests, real estate rents, capital gains and professional services-- are not taxed.

Next, we describe the main characteristics of the different taxes of this incomplete cedular system.

Tax on Personal Retributions –wages, salaries, and pensions-- (IRP)

The IRP taxes wages, salaries, and pensions on a monthly basis. The nominal income of each of the three categories[6] is taxed according to the quantity of *Bases de Prestación y Contribución* (BPC)[7] perceived at 0, 3 and 6. The IRP, which collected 1.2% of GDP in 2004, is applied on the whole income, not on the margin, but the income obtained from different jobs is not cumulative, on the contrary, it is taxed separately.

Additionally, there is a *Tax on Commissions* that levies on the income of commissions and brokerage services, which collected in 2004 some 0.10% of GDP.

3.1.2. Corporate Income Tax (CIT)

The Corporate Income Tax --CIT-- collected in 2004 US$274 millions, approximately 2% of the GDP, 9.5% of the total tax revenue[8]. The nominal rate of the tax is 30% and the income is determined in the traditional form, on real basis (inflation adjusted) and with the accrual method.[9] Although the nominal rate of the corporate income tax in Uruguay is 30%, the effective rate it is significantly smaller. The country does not escape to the traditional "*dichotomic model*" in which numerous incentives are granted without a development strategy. For example, they include from the industrial promotion to

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[5] Actually, the tax on Sales of Agricultural Goods (IMEBA, January 1996) and the tax on Insurance Companies (February, 2001), also were created.

[6] In fact, four income categories are considered, as towards the inside of the public sector the income of the employees of the judicial power taxed to a minimum rate are considered as a separate category.

[7] The current value of BPC is UR$1,482, approximately US$63. Until December 2005 the tax fringes were determined in minimum wages (SMN). The expressed intent of the government raising gradually the SMN has taken the same to use the BPC to determine the tax brackets and thus not to lose revenues.

[8] The revenue of the Tax on Farming Income –IRA- did not reach one million dollars. The producers with a volume of sales lower to a certain limit can choose to pay the IMEBA, a tax on the sales of farming goods at differential rates. This tax collected US$42 million, 0.3% of the GDP in 2004.

[9] It is important to point out that in Uruguay, like in most Latin American jurisdictions, the entrepreneurial income carried out in personal societies, including the sole proprietors and the limited liabilities partnerships, are taxed with the same tax as the corporations.

forestry, plus 8 foreign trade zones on services. This makes the effective rate significantly smaller to the nominal one.[10] Also, at a macro level, from the total collection of the corporate income tax (2.5% of the GDP) 48% was paid by state-owned corporations in 2004. Consequently, the burden of the Uruguayan private sector by CIT is the lowest in Latin America, except for Haiti.

Tax on Small Enterprises

The firm or individual, who carries out economic activities and whose sales are not higher than certain annual limit should not pay the corporate tax -IRIC- but the Tax on Small Enterprises which is a fixed sum to be paid monthly. In the year 2004, this tax collected US $12.2 millions, approximately 0.09% of the GDP.

Taxing non-residents

Currently, the following rents are taxed: (i) income derived from the lease, use, or alienation of trademarks, patents, etc. carried out by taxpayers subject to the corporate tax –IRIC-- to non residents; (ii) technical assistance paid by firms subject to the CIT to non residents; (iii) dividends credited by firms subject to CIT to non residents, when they are taxed in the home country and it is entitled to tax credit; and (iv) income derived from the lease, use, or alienation of the copyright on literary, artistic or scientific works carried out by taxpayers subject to CIT to non residents.

In 2004, for these items US $14.6 millions, approximately 0.11% of the GDP were obtained in revenues.

3.1.3. Net Wealth Tax

Uruguay is one of the few countries in the world that levies on net wealth. The collection of the net wealth tax at company level was of US $124 millions, almost 1% of the GDP, in 2004 and the one on individuals reached only 0.1% of GDP. Approximately half of this revenue comes from state-owned enterprises. The tax burdens the assets located in the country, it is allowed to deduct bank debt and the credit from suppliers. As there is no intention to burden the investments on productive assets, it presentes a great deal of exemptions --for example, the land and livestock in agriculture and 50% of the fiscal

[10] For example, for the period between 1993-1997, a sample of 2.368 companies that represented more than 30% of the total output, paid an effective rate average of 21%.

value of the manufacturing equipment-- which determines that the tax burdens almost exclusively on the personal goods. The general rate is 1.5%, 2% for financial institutions and 2% for withholding on the principal of non-resident‘s loans.

Additionally, the net wealth tax can be credited to the corporate income tax with a limit of 50% of the former. On the other hand, the collection of the net wealth tax levied on individuals is insignificant: in 2004 it was of only US$8 millions, 0.06% of the GDP. The tax burdens the local assets disregarding the national bank liabilities, with a minimum exempt of US$85.000 progressively, with rates that go from 0.7% to 3%. In the same pattern as in the case of the net wealth tax levied on corporations, practically only the real estate is taxed.

3.2. Indirect taxes

3.2.1. Value Added Tax (VAT)

As it was stated, Uruguay was one of the first countries of Latin America on introducing the VAT, in 1974. Their revenue was US $1.200 millions in 2004, 9.1% of the GDP, more than 40% of the total tax revenue. Approximately 40% is captured in customs (VAT on imports). The productivity of the VAT in the last three years, amid a very favorable economic cycle, has been lower to 0.40 if it is estimated according to the GDP and it is lightly higher than 0.40 if the consumption is considered. According to estimates carried out for 1999, VAT tax expenditures were 4.5% of GDP, almost 80% of the total tax expenditures (Rossa and Roca, 2001). Also, Cobas, Perelmuter and Tedesco (2005), estimated that VAT evasion reached 25% of the real revenue. Nevertheless, if we exclude the calculation of the state-owned enterprises, which are not supposed to avoid taxes, evasion would reach 38.5%.

The Uruguayan VAT is consumption-based using the indirect method (all tax purchased are credited) and applies the destination principle. The general rate (“basic rate”) is 23%, however, certain goods and services are taxed at a reduced rate (“minimum rate”) of 14% --medicines and goods of the basic needs basket--. The main exemptions are health and education services; real estate leases; fuels --diesel oil is taxed--, food staples of the basic needs basket; and books, magazines and newspapers. Tobacco and cigarettes and the sale of real estate, currently exempted, will be burdened by the proposed reform.

Regarding the financial transactions, the VAT only taxes interests of loans that finance consumption. It is distinctive of the Uruguayan VAT, the regime in "suspense" for the sales of the agricultural sector, similar to that of the internal community operations in the European Union.

Problems of the VAT

Uruguay has the highest VAT rate in the world: 26,1% (including the cumulative effect) --23% of basic rate plus 3% of COFIS, which has also cumulative effect on services--. Broadening the base would allow a substantial discount of the rate of the VAT, strongly diminishing the reward of evasion. According to Barreix and Roca (2006b), a uniform VAT at 17% with only five exemptions (education, financial intermediation, and health services, real estate lease and gasoline) would obtain the same revenue. However, in the tax reform the government resisted the inclusion of this proposal for fairness purposes, and decided to reduce the rates of VAT to 22% and 10% and to eliminate COFIS.[11]

3.2.2. Excise taxes

The excise taxes –IMESI-- collects 3.1% of the GDP, approximately 15% of the total tax revenue, of which the tax on gasoline, diesel, and fuel oil represents 38% of the total.

The excises in Uruguay reach the traditionally taxed goods, that is: (i) goods with negative externalities: tobacco products and cigarettes, alcoholic beverages; (ii) as substitutes of user charges: fuels[12], oils and lubricants, and automobiles; and (iii) other luxury goods, as non- alcoholic beverages, cosmetics, and perfumes. *Table 7* shows the specific tax per unit on selected products.

[11] Nevertheless, with the broad base VAT at 17%, the poorest decile --the only loser-- could be easily compensated with targeted public expenditures. A 17% flat VAT implies a reduction of 35% of the rate and is highly superior in competitiveness, neutrality, political enforcement and administrative simplicity. This is even more relevant regarding the global impact of the reform determines that the seven poorest deciles end up the winners.

[12] By a recent modification, the excises on fuel in Uruguay -and their uses- became a fixed amount per liter. A fraction of the excise revenues are transferred to municipal governments.

Table 3

Excise Taxes on Selected Products	
Tipe of Product	**Tax**
Cigarettes	US$ 0.50 p/20 cigarettes
Gasolines	US$ 0.64 per liter
Diesel	US$ 0.06 per liter
Whiskies	US$ 4.00 per liter
Beer	US$ 18 per liter

Source: Government Decrees

3.2.3. Trade Taxes

Trade taxes mainly charge on imports since export levies were practically eliminated since the mid 80's. The revenue was 1.3% of the GDP, nearly 6% of the total tax revenue in 2004. This fall that was accentuated with the advances of MERCOSUR.

3.3. Local taxes

Uruguay is a unitary state constituted by 19 departments, of which the capital, Montevideo, concentrates 42% of the population. Property taxes, user charges and automobiles licenses constitute 80% of the local revenue.

The rate of the rural property levy is fixed by the national government, which is collected for and by the departmental governments. Municipalities have a high autonomy in the determination of the taxable base and in the arrears collection on this local tax.

In 1990, the central government's transfers hardly represented 11% of total revenue of the municipalities, growing to 17% in 2000. These transfer as a share of local revenues are quite low comparing not only for the region but also contrasting with developed countries. The types of transfers are: (a) revenue sharing of selected national taxes; (b) reimbursement of specific infrastructure investment costs; and (c) subsidies to transportation infrastructure.[13] The transfers of shared taxes represent approximately 36% of the total resources transferred to local governments.[14]

[13] Approximately, 3.5% of the excises collection (IMESI) on gasolines and fuels, and 5% of the IMESI on tobacco products are transferred to the municipalities and distributed among them according to their area and population –distributive approach--. Furthermore, 20% of the IMESI on the diesel oil is transferred to the local governments and the distribution criterium takes into consideration the origin of the revenue --devolution approach--. .

[14] Finally, the central government pays the employer contribution to the social security for municipalities' employees , except for the capital –Montevideo--.

3.4. Social Security Contributions

In 1996, Uruguay implemented a pension reform adopting a mixed system with two pillars: (i) the one of "intergenerational solidarity" (pay as you go), of allotment, obligatory, with defined benefits which is administered by a public decentralized entity, Social Security administration --BPS--; and (ii) the "individual savings", financed by an obligatory contribution after certain wage threshold (approximately US$1,000 dollars per month to a limit of approximately US$3,000), based on individual capitalization, and managed by four funds –of which the state-owned fund represents 50% of the market--.[15] Finally, the employers only contribute to the allotted pillar –Employer's Social Security.

Table 4

Social Security Contributions (in % of gross wages and salaries)			
	Total	**Workers**	**Employers**
Commerce and Industry	21.04	15	6.04
Construction	17.77	15	2.77
Civil	31.53	15	16.53
Rural	15.00	15	0.00
Domestic services	27.50	15	12.50
Total	24.38	15	9.38

Source: BPS (Social Security Administration)

Issues on the Employer's Social Security Contributions

As can be seen in *Table 8*, the employer's social security contributions --approximately 2% of the GDP-- present a great and unjustified scattering among the different sectors. In the tax reform, the government has proposed a 7.5% uniform rate that is revenue neutral. It must be pointed out that a country with high unemployment --stabilized near 10% for more than 30 years--, sub employment estimated in more than 15%, a weak employment to GDP elasticity (0.33), and a public workforce of more than 20% of total employment, there are no doubts that these "employer's" social security contributions, truly fall on workers reducing wages and/or employment.[16]

[15] The personal contributions to the first pillar are 15% of the salaries up to the aforementioned limit (US$1,000) and to the pillar of individual capitalization the same rate to the income between this figure and a new. The contribution for the wage surplus is optional.

[16] Additionally, regarding coverage, estimates of Buchelli et alter (2006), only 28% of the active workers would receive pensions at the age of 65 (minimum age of retirement for both men and women). Within this percentage, the public employees represent 57%, which reinforces the hypothesis of a very informal labor market as well as the high protection offered by the immobility —cannot be fired-- of public employees. In fact, 85% of the public servants will fullfill the condition (35 years of work) to get a pension at 65 years old.

4. The Tax Reform

4.1. Economic and tax perspectives

Then fiscal alley of Uruguay

Revenue collection in Uruguay surpasses its tax capacity and, therefore, taxes should not be increased. The current tax burden is slightly above 30% of the GDP.[17] On the other hand, Uruguay cannot diminish it because the high level of welfare (mainly pensions) that the country has being enjoyed for the last forty years. Assessing the level of the government's degrees of freedom to provide public services, Villela, Roca and Barreix (2005) have defined the *disposable fiscal income* as the tax revenue minus the social security spending and the interest payment of the public debt --the committed spending--.

Table 5

MERCOSUR: Disposable Fiscal Income 1994 and 2003

	1994				**2003**			
	Total Revenues(1)	Public Debt Interests	Social Security Expense	Disposabl eFiscal Income(*)	Total Revenues(1)	Public Debt Interests(2)	Social Security Expense	Disposable Fiscal Income(*)
Argentina	21.6	1.4	5.4	14.8	24.4	3.5	6.8	14.1
Brazil	28.7	2.9	4.7	21.1	35.5	9.3	11.2	15.0
Paraguay	17.5	0.7	2.4	14.4	16.4	1.7	5.9	8.8
Uruguay	30.8	1.2	16.3	13.3	31.2	6.2	14.8	10.2
Average	**24.7**	**1.6**	**7.2**	**15.9**	**26.9**	**5.7**	**9.7**	**12.0**

(*) It is not considered the possibility of incurring in deficit.
(1) It includes net results of Public Companies, Sales of Assets and Donations. For Paraguay the net estimated result of Itaipú y Yaciretá is included.
(2) For Argentina, the interests of the public debt where estimated considering the exchange offer.

[17] There are three estimates to be considered: 1) Piancastelli, M. (2001). He considers a sample of 75 countries, in the period 1985-1995 and the income of Central Government. The coefficient of tax effort estimated for Uruguay is 1.411. 2) Teera, J.M. (2001). This sample is of 122 countries, developed and under-developed, in the period 1975-1998. The resulting coefficient for Uruguay is 1.236. 3) Cobas, P., Perelmuter, N., and Tedesco, P. (2004). Evasion in Uruguay: a study on VAT. Research paper. FCEA – UDELAR. Unpublished. They work with the income of Central Government with a sample of 17 Latin American countries, in the period 1990-2000. The estimated coefficient for Uruguay is 1.707.

Therefore, the *disposable fiscal income* is the residual flow after paying social security benefits and debt interests, that is to say, before paying any public services or employees. This will be the government's budgetary restriction to assign resources to the remaining public spending categories[18].

In *Table 5*, it can be observed that the *disposable fiscal income* for Uruguay was only 10.2% of the GDP for the year 2003. Of the 31.2% of GDP, approximately 15% were destined to the payments of Social Security benefits and 6% to the public debt interest payment. This *disposable fiscal income* is lower to the Central American average (11.2%) and less than half of that of the OECD (23.6%). The reduction of the *disposable fiscal income* --fell 30% between 1994 and 2003-- is explained by the increase of the interest payment of the public debt, which more than compensates the slight drop on social security spending and the increase of the fiscal income.

Some consequences could be drawn, which have been included when designing the current tax reform:

(i) The need to maintain a tax burden of approximately 30% of the GDP determines that the indirect taxation (approximately 15% of the GDP) will continue to play a high role in the tax structure. This is highly regressive and so, makes it necessary to introduce a global personal income tax to counteract the negative effects on equity[19].

(ii) There is consensus that the most suitable instrument for income redistribution is social public spending. Nevertheless, fiscal situation of Uruguay determines that close to 10% of GDP are available, once benefits of the social security and interests of the public debt have been paid. This fact, again, show the need of introducing a personal income tax that will help to correct the inequality of the income distribution.

Furthermore, it must be established that, according to several studies, the public spending in Social Security is regressive and pro-rich, this is, it concentrates on the strata of higher income[20]. The reason is that such a spending has certain co-lending character for the

[18] Uruguay has a stock of total public debt of more than two and a half times its GDP (it includes social security and financial public debt, not including contingencies). The conditionings imposed on its flow but not performing a sustainability analysis are considered.

[19] The regressivity of the overall tax system in Uruguay, and in particular of the consumption taxes, are presented in Barreix y Roca (2006).

[20] Planning and Budget Office (OPP, 2003).

contributions during the working life span of those whose activity was developed in the formal sector of the economy, but it doesn't reach those who have worked in the informal economy, who obvioustly are the poorest.

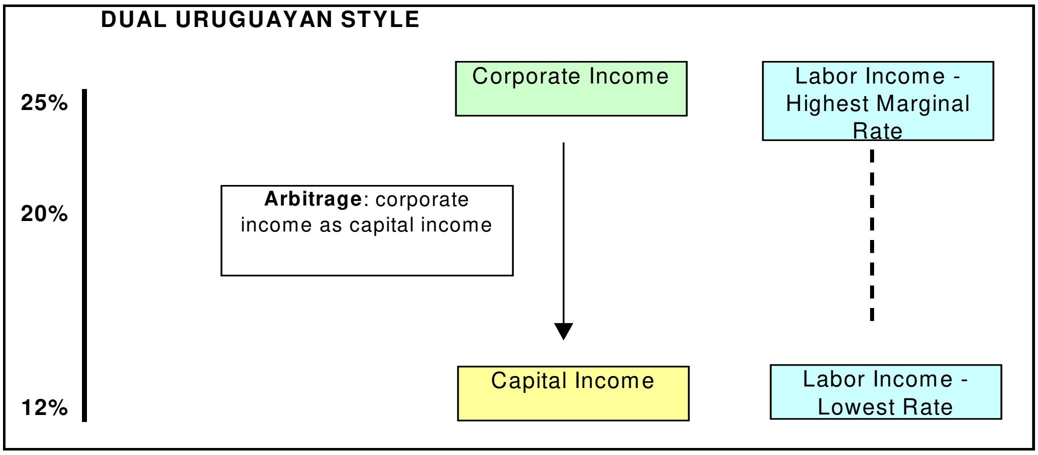
(iii) Finally, a very low *disposable fiscal income* to finance low quality public services coupled with a high tax burden, incentives the informal sector and weakens voluntary compliance, increases the risks on fiscal sustainability, and hinders the level of services of physical and social infrastructure necessary for economic development.

4.2. The tax reform [21]

4.2.1. The Uruguayan dual income tax

The dual income tax *Uruguayan style* takes from the Nordic dual the central idea of levying personal income –at progressive rates-- and the capital income –at a proportional rate-- separately. On the other hand, it establishes a lower tax rate for capital income (interests, dividends and profits, rents, capital gains), is almost the same to the lowest marginal rate that taxes the labor income. These rates constitute the “anchors” of the income tax system, the minimum rate at which you begin to tax. Besides, the highest marginal rate which taxes labor income is very close to the rate that levies on the (net) corporate income.

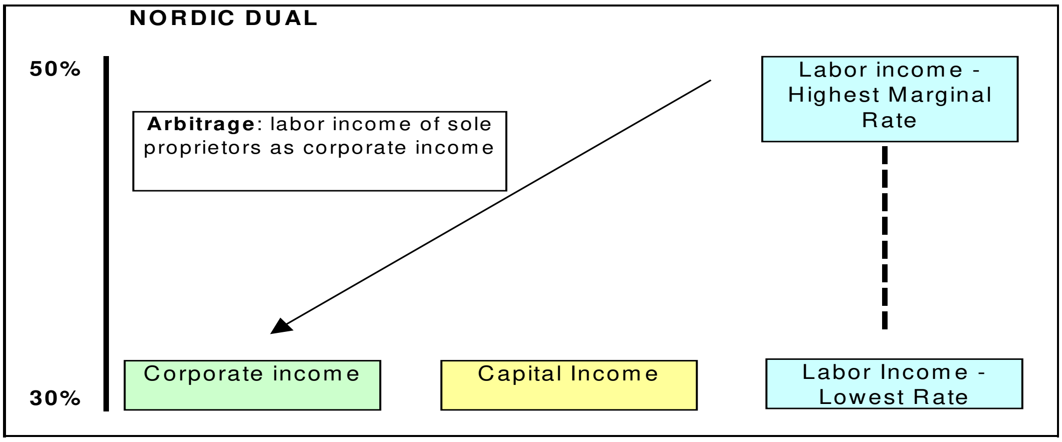
Figure 1



[21] In July 2005, the government formed a Tax Reform Commission. The authors were members (pro bono) of the Commission, which worked until January, 2006. In August 2005, they presented a report to the Government, which was considered the “Base Report” of the reform, which introduced the dual income tax *Uruguayan style*.

Therefore, the main difference with the Nordic dual, which is reflected in the previous figure, is that it "anchors" at the rate that taxes both the corporate income and the capital income (close to 30%), which in turn is the lowest rate to labor income that is levied progressively until rates reach close to 50%. Thus, the Nordic dual provides an arbitrage opportunity for the income of sole proprietors disguising it as corporate income.

Figure 2



Many experts consider this as its "Achilles' heel". Something similar occurs in Chile - which applies a synthetic PIT--, where CIT's rate is 17% and the marginal highest rate that taxes the labor income reaches 40%.[22] On the contrary, the dual *Uruguayan style* limits the possibility of arbitration to the point that the taxpayer can choose to pay corporate or individual income tax. However, it does not solve the possible arbitrage between corporate income and capital income. This can be solved through ordinary rules of the corporate income tax, of much easier implementation than the controls the Nordic dual imposes. For example, the arbitrage in the dual *Uruguayan style* between interests -- taxed, as it will be seen, at 12%-- which are deducted from the CIT at the rate of 25% can be solved adjusting the deduction to the proportion between the capital income tax rate and that of corporate income (12/25 in this case)[23].

[22] For this reason, Chile has a tax expenditure --individual income disguised as corporate income-- of more than 100% of what is received as revenue. Indeed, the tax expenditure originated in the CIT is estimated 2% of the GDP when it is revenues for PIT are slightly less than 2% of the GDP.

[23] Another more complex way to avoid this arbitrage is using the paid credit of the retained capital income and simultaneously apply thin capitalization rules for interests or limitations of other kind of capital income in the determination of the company's profits.

It is interesting to point out that the new Spanish PIT follows a dual model closer to the "Uruguayan" than to the "Nordic" dual. Indeed, capital income is levied at a uniform rate of 18%, labor income is taxed from 24% to 43%, and CIT reaches a 30% rate.
Additionally, the dual *Uruguayan style* takes from the uniform (*flat*) income tax[24]: (a) it limits the number of deductions and credits that erode the base of the PIT, especially in Latin America; and (b) it sets a non-taxable minimum threshold high in order to leave out of PIT almost 60% of the population.

Personal income tax (PIT)

The new PIT levies capital income at 10% and, in turn, the labor income in five brackets, with a lower marginal rate of 10% and a highest marginal rate of 25%. The proposed rate design has four characteristics:

i) It avoids the arbitrage between the different types of income and/or the taxpayers' juridical nature. Therefore, the incentives for avoidance decrease, and also do not alter taxpayer's choice of portfolio.

ii) Moderate taxes --marginal highest rate is 25%-- assure that, given the high contributions to the social security in Uruguay (approximately 25% of the labor cost[25] on average), the PIT does not diminish the disposable income of the middle class significantly and, with it, do not affect private saving and/or the labor supply and do not incentive evasion.

iii) There is an administrative reason to apply a reduced rate to the capital income: it avoids "delocalization" of savings in a financially integrated world. In general, the richest individuals are those that have capital returns and, they are captured by the highest marginal rate when applying the integral method[26]. Therefore, it generates an incentive to avoid it, mobilizing the savings to jurisdictions where they are not taxed and do not exchange information with other jurisdictions[27].

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[24] A modified model of the theoretical version developed by Hall and Rabushka (1995), was enforced recently in more than a dozen countries, especially in ex Soviet block economies.

[25] It includes all the social security charges (health insurance, unemployment, employers and workers contributions, etc.).

[26] In Barreix and Roca 2006b, it is argued about the inconvenience of introducing an income tax of the integral type in Uruguay.

[27] Contrasting with our proposal, the new dual income tax approved in Spain, considers that lease are less prone to *delocalize* and consequently, are taxed in the labor income basket at progressive marginal rates.

iv) Lastly, the most relevant argument, that is efficiency, which prescribes that the capital returns should be taxed at lower rates than those from labor (or even, not to be taxed at all)[28]. In theory, to tax the capital income with reduced rate is equivalent to apply different weights between the current and future consumption (Boadway, 2005)[29]. Actually, almost all legislations that apply the integral type of income tax protect savings by exempting: a) pension contributions, which are usually taxed at retirement (pensions), b) the income (consumption) provided by durable goods, and c) the deduction of the mortgage interests and, simultaneously, not taxinng the inputed income generated by the consumption of the individual's own home.

Equity in the PIT

Some observations related to the progressivity and redistributional incidence of the new dual PIT, in particular comparing it with the current IRP, should be made[30]. In Table 6 the average effective rate for the IRP (currently applied) and the proposed PIT for each decile. As it can be observed, the highest Kakwani index in the PIT (0.3887) in connection to the IRP (0.1973) show the higher progressivtiy of the former.

Two observations become relevant: (i) as it will be seen, our proposal to tax all capital rents at a lower rate does not only take into account the possible delocalization but also its efficiency; (ii) it is worth noting that the Spanish CIT taxes real estate capital gains (and loses), at the capital income rate (18%) while including rental income in the labor basket.

[28] Although academics tend to recognize that income derived from savings must be taxed at lower rates due to efficiency, there are opposed viewpoints. For example, King (1980), answering the Meade Report (U.K., 1978) conclusions, proposed that the income tax is similar to levy on individual consumption and sustained that there is little difference in efficiency between both systems.

[29] Boadway summarizes the following arguments favoring preferential treatment on capital income: 1) the positive externality of investment linked to the innovation on the literature about endogenous growth; 2) the systematic tendency to save below optimum, which seems irrational (in practice, it can be that individuals act strategically anticipating the government or a philanthropist will help them when in need); 3) that the capital income at an individual level will discourage innovative projects as being inherently risky (the disadvantages of these market investments are originated in significant externalities developed in asymmetric information), and 4) to tax the capital income discriminates against households whose income fluctuates, thus savings operate as a way of "smoothing" their consumption.

[30] Actually, a correct comparison should consider, besides the IRP, the taxes which the PIT will substitute and which are paid by individuals (for example, certain percentage of the Tax on Commissions), but have not been taken into account in this estimate.

Table 6

PIT versus IRP - Progresiveness and redistribution						
	Average Effective Rates by Decile				Percentage paid by each decile	
	IRP	IRPF	IRPF - IRP		IRP	IRPF
Decile 1	0.23%	0.10%	-0.13%	**Decile 1**	0.27%	0.05%
Decile 2	0.70%	0.22%	-0.48%	**Decile2**	1.27%	0.18%
Decil e3	1.05%	0.48%	-0.58%	**Deci e3**	2.37%	0.47%
Decile 4	1.36%	0.91%	-0.45%	**Decile 4**	3.50%	1.02%
Decile 5	1.60%	1.31%	-0.28%	**Decile 5**	4.72%	1.69%
Decile 6	1.84%	1.89%	0.04%	**Decile 6**	6.36%	2.82%
Decile 7	2.13%	2.73%	0.60%	**Decile 7**	8.55%	4.76%
Decil e8	2.51%	3.94%	1.42%	**Decile 8**	12.53%	8.53%
Decile 9	2.89%	6.22%	3.33%	**Decile 9**	19.13%	17.80%
Decile 10	3.21%	11.23%	8.03%	**Decile 10**	41.28%	62.69%
Kakwani	*0.1973*	*0.3887*		*20% + vs 40%*	*8.1*	*46.9*
Reynolds-Sm	*0.0047*	*0.0222*		*40% -*	*7.4%*	*1.7%*
				20% +	*60.4%*	*80.5%*
Source: Barreix and Roca, 2006						

A first evidence of the superior redistributional capacity of the PIT (in connection to the IRP) is appreciated in the previous table: the five poorer deciles are better of with the introduction of the PIT, the situation of the decile 6 remains practically unchanged, the decile 7 will pay slightly more PIT that IRP, and the significant collection increase is on population's three richer deciles (in particular the 20 % richer), the losers of the reform[31].
The highly superior progressivity of the PIT over the IRP can be shown comparing the collection by decile.[32] In turn, the 20 % richer population will contribute with 60.4% of the IRP and they would pay 80.5% of the PIT. It should be stressed that while the IRP collects 0.87% of the GDP while the PIT will collect 2.5% approximately.
Finally, more technically, the Reynolds-Smolensky (RS) index has to be considered as global indicator of the redistributional capacity. The highest RS associated to the PIT (0.0222) in connection with the associated to the IRP (0.0047) shows that the PIT causes a improvement in the distribution of income of more than 2 points of the Gini, superior to the one of the IRP, of half a point of the Gini, which would allow the IRP to be identified

[31] Another way of determining the winners and losers is to compare the participation in income of each decile before and after the reform.

as (almost) neutral. From a different viewpoint, the introduction of the PIT determines a transfer of 2.2% of the total income (after the PIT) of 20% of the richest households to the poorest 80%.

Corporate and International Income

The reform introduces international taxation in Uruguay levying with a uniform final withholding[33] on interests, royalties, technical assistance, and capital gains remitted or credited abroad at 12%. Dividends, including those paid to residents, will be tax at 7%. Also, a battery of traditional instruments is introduced such as transfer prices, definition of permanent establishment, tax haven regulations, etc., as key elements of the fiscal pyramid[34].

Finally, the territorial approach will be applied. until the administration improves, a network of information exchange agreements will be in place, and MERCOSUR consolidates as a common market. Fulfilling those conditions, the country will be able to compete for investments, and then, to implement worldwide income taxation.

4.2.2. A new tax secrecy

The dual system allows the country to maintain a tax secrecy on financial savings instruments, and at the same time, to tax the capital returns by final withholding (12%). Consequently, the country cannot be considered a tax haven[35] according to the regulatory scheme of the OECD. Indeed, for a jurisdiction to be considered a tax haven by the OECD the country must have low or no taxation on capital income. Uruguay would not fulfill the criterion as it taxed at least at 12% rate through a similar system to the one defined by EU Saving Directive[36].

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[32] Indeed, currently 40% of the poorer households pay 7.4% of IRP, and they would contribute only 1.7% of the dual PIT revenues.

[33] The effective withholding in the source has a definitive character and it is not necessary to fill and identify the taxpayer.

[34] In Barreix and Roca 2003, it is argued that the tax system must be organized in a *pyramidal way*, being the tip of the pyramid the international taxation, to which the most specialized actions correspond.

[35] Null or insignificant taxation is the first criterion for which a country can be considered a tax haven. Uruguay levies at 12% on all capital income, however, it has great difficulties to fulfill the three subsidiary criteria for which a tax haven is defined: transparency, exchange of information and deadlock.

[36] The EU Directive on Savings is compatible with tax secrecy regime proposed by Barreix and Roca, 2006b.

Nevertheless, to fight evasion there is a proposal to lift the tax secrecy only on the banking operations for "transaction motive" -current and savings accounts- and to maintain it for "accumulative motive" (savings) --bank deposits, bonds, etc.-- (Barreix and Roca, 2006a).

4.2.3. Tax simplification

The revenue of the dual PIT can substitute eleven taxes that compose the current incomplete cedular income tax and so, simplifying the tax structure. The are two main reasons to abolish these taxes:

(i) eliminate taxes which compete with the new income tax system and collect 1.26% of the GDP --IRP, Tax on Commissions, IMABA (tax on bank assets) and Tax to the Granting of Sportsmen--; and

(ii) remove seven taxes of high administration and compliance costs and/or low yield (0.84% of GDP in 2004) in order to simplify the system –COFIS (wholesale VAT), ITEL (excise on telecommunications), ICOSIFI on some bank transactions, tax on the forced auctions, tax on credit cards, tax on lotteries, tax to the sales in public auctions--.

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