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TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA

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A general picture of tax systems and tax reforms in Latin America

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FOREWORD: TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA

by

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Abstract

This paper aims at providing the reader with a broad perspective on Latin American tax systems and on the historical, geographic and structural forces that have influenced and shaped them during the past fifty years. Historical factors, such as cultural links with Europe and the United States combined with structural factors, such as the openness of the countries economies, their degrees of informality, their dependence on the export of natural resources, and the allocation of national income between labor and capital all played major roles in shaping the Latin American tax systems. The paper discusses also the role that the United States played, or attempted to play through various international organizations (especially in the decades of the 1950s and 1960s) in making the tax systems of Latin American countries more elastic and progressive. The paper discusses the major taxes. It provides an explanation of why the personal income tax has not grown into a major source of revenue in Latin America. The main reasons are (a) the large share of national income that does not go to wages and salaries; (b) the high levels of personal exemptions (as compared to per capita incomes) and of deductions; and (c) the fear that higher taxes on incomes from capital sources could lead to capital flight, especially towards the United States. The United States treatment of interest payments to "non resident aliens" gives substance to this fear. Latin American countries were among the first to introduce value added taxes and have been quite successful in the use of this tax. Several such countries collect from these taxes as large a share of their GDPs as industrial countries. However, there is a large dispersion in the revenue productivity of these taxes among the various countries. Zero rating for some categories of goods and services and the use of multiple rates are major reasons for this dispersion in productivity. The paper also discusses issues related to the taxation of enterprise profits and especially problems raised by the use of transfer prices, and by the fluctuation in the prices of products from natural resources. An interesting aspect of the Latin American taxation of enterprises is the taxation of small enterprises. There has been a lot of experimentation related to the taxation of these enterprises. Various reforms have replaced taxes based on accounting with taxes based on presumptive criteria. Finally, the paper calls attention to the growth of tax levels in the past two decades and to the continuing search for new taxes (taxes on assets, taxes on financial transaction, taxes on net wealth, etc.) that could provide revenue in a less painful way. This search for an Eldorado of the tax world seems to be a Latin American characteristic that is likely to persist.

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1. Introduction

Latin America is a huge region containing enormous diversity in culture, natural and human resources, ethnic backgrounds, per capita incomes, and general economic development. This is a region where the populations of all continents converged. Over the past century the Latin American countries have reflected the cultural influence of two outside areas: the United States and Europe. These two areas have exercised strong pulls that have, in part, reflected the backgrounds of the countries' populations and the distance from the two outside areas. Broadly, the more to the south and the East are the countries, the stronger has been the pull coming from Europe. The more to the North and the West, the greater has been the influence of the United States. Naturally, in several of the countries of the region these two outside influences have competed with domestic traditions linked to pre-Columbian cultures that have remained strong in particular countries.

The cultural differences mentioned above have inevitably influenced the role that the governments of the Latin American countries are playing in the economies. Naturally the tax systems are a major instrument, and an important expression, of that role. An aspect that surprises is the very large difference in tax burdens—i.e., in the share of tax revenue into the countries' gross domestic products—between, say, Brazil, where the tax burden is now at European levels (close to 40 percent of GDP) and countries such as Guatemala and Haiti, where it is still close to ten percent of GDP, or about the levels that prevailed a century ago in the now-developed countries. Tax structures also reflect big differences among the countries, again differences that are bigger than those found among European countries.

2. Historical and Regional Factors

The structure of the economies of the various countries has inevitably influenced their tax systems by making certain tax bases more useable while creating difficulties in the use of other tax bases.

For a long time foreign trade taxes, and especially taxes on imports, played an important role especially for countries that had important foreign trade. This trade provided the countries with an easy "tax handle." The ideological attraction for import substitution policies (policies advocated by Raoul Prebish in the 1950s), especially in the three decades after World War Two, encouraged the use of these taxes. However, as predicted by the so-called "theory of tax structure change", with the passing of time, these taxes lost their appeal and their importance. Today, import duties retain some importance predominantly in the island countries of the Caribbean, where imports are often as large as their GDPs. See Tanzi, 1987.

Export taxes had been of some importance especially in the decades immediately after World War Two. At that time policymakers believed that these taxes could be exported, in the sense that they would be borne by the citizens of the countries that imported the commodities from the major Latin American countries. These taxes were used by Argentina and Uruguay, on the export of grain and meat; by Brazil, Colombia, and Haiti, on the export of coffee; by Ecuador, on the export of bananas; and by some other countries. Export taxes almost disappeared in the last two decades of the 20th century but they have reappeared in recent years in Argentina. An export tax, imposed at a given rate of X, is conceptually equivalent to a tax rate of X on the production of the exported commodity, combined with a subsidy of X for the domestic consumption of that commodity. Thus, export taxes discourage production while they stimulate the domestic use of the commodity, by lowering its domestic price. The net effect for the countries that impose them is a loss of foreign exchange earnings. See Tanzi, 1976.

In some cases export taxes have been imposed on the assumption that they would stimulate an increase in the value added of the exported product, by forcing some domestic transformation of the commodity into a more elaborate or refined product. For example Brazil had taxed the export of coffee beans under the assumption that this taxation would stimulate the export of (higher-valued) instant coffee. South Africa has recently introduced export taxes on raw, unpolished, diamonds under the assumption that these taxes will stimulate the domestic polishing and cutting of raw diamonds, thus increasing the value of exports. There is no evidence to suggest that these policies work.

The theory of tax structure change predicted that, with the passing of time, foreign trade taxes would be replaced by domestic taxes and especially by domestic, indirect taxes. This replacement role has been assumed largely by the value added tax. Latin America was an early user of this European idea. Brazil introduced it in 1967 and Uruguay in 1968. The VAT spread quickly in the region and became a major producer of tax revenue. It was introduced in Perú and Bolivia in 1973; in Argentina, Chile, Colombia, Costa Rica, and Nicaragua, in 1975; in Honduras in 1976; and in Panama in 1977. See Ebrill, et Al. 2001. In later years it was introduced in the remaining countries. With the exception of a few Caribbean island countries, all Latin American countries now have a value added tax. In several of these countries the revenue from this tax is at a level comparable to that of advanced industrial countries. This tax has become the workhorse of Latin American tax systems.

Latin America is a major producer of commodities, both agricultural and mineral products. Some countries (Venezuela, Mexico, Ecuador, Trinidad and Tobago) export petroleum while others (Bolivia, Chile, Colombia, Brazil, Perú, Jamaica) export other mineral products or agricultural products. The export of commodities has provided governments with large public revenue that, to some extent, have reduced the need to impose taxes on citizens. This is certainly the case in Mexico, Chile, Bolivia, Ecuador, and some other countries. Two issues are raised by this non-tax government revenue. First, what to do when, as in Mexico and Ecuador, the revenue from petroleum exports are expected to fall in the not too distant future because of the exhaustion of the resources. Second, what to do about so-called commodity cycles that push the prices of exported commodities up and down thus creating significant year-to-year instability in public revenue.

The first situation (the Mexican one) calls for the creation of tax systems that are elastic and broad-based and that lend themselves to rate increases that can be enacted when the time comes to replace the falling revenue from the mineral exports with domestic taxes. The second calls for policies, such as the establishment of stabilization funds, that attempt to provide the government with a kind of permanent income in the face of fluctuating foreign earnings. Chile has established such a fund, to stabilize the share from copper

export earnings that the government is able to spend each year. When the price of copper is high, the fund accumulates resources that can be drawn when the prices fall. Fluctuations in commodity prices have major implications for tax revenue and for tax systems. They make it more difficult to determine the kind of tax system that a countries should have. It is politically difficult for the government to resist the temptation to spend all the revenue during good times and to convince the citizens or the legislatures that the tax system must be reformed to make it more flexible to deal with bad times. See Davis et al. 2003.

The structure of the economy has also implications for income taxes. Mineral resources make it easier for countries to impose taxes on the income of enterprises especially when these are foreign-owned. In Latin America, the revenue from the taxation of the profit of enterprises has been, on average, at a level at least comparable to that of industrial countries. However, taxes on personal incomes have been relatively unproductive. Personal income is the tax base that remains the most unexploited in Latin America. The reasons for this will be taken up more fully later. At this point it should be mentioned that tax experts have often followed Richard Goode's position, argued five decades ago (1951), that maintained that elements necessary for the successful use of personal income taxes are missing in Latin American countries. Some believe that, because many of these economies are characterized by a large informal sector (that often exceeds 50 percent of the economically active individuals), it contributes substantially to the underutilization of personal income taxes. Goode had specifically mentioned the existence of reliable accounting records. Other explanations for the low productivity of the personal income tax will be suggested later.

In the 1950s and 1960s there were various attempts to reform the Latin American tax systems in order to introduce modern income taxes in Latin American countries. Some of these attempts had the strong sponsorship of the American government, at a time when the United States had a lot of leverage in the region and the global income tax was still very popular and generally considered the best tax by tax experts. During the Kennedy Administration, a program called "Alliance for Progress" was created within the Organization of American States, the political international institutions that include all the countries of the Americas. The program continued during the Johnson Administration and

the first years of the Nixon Administration. This program, largely financed by the American government, was endowed with significant financial resources. Its main task was to bring better economic policy in Latin America. A part of this program, the "Joint Tax Program," jointly supported by the OAS, the InterAmerican Development Bank and the United Nations, had the explicit goal of promoting tax reform in Latin America in order to raise more revenue, make taxes more progressive, and make them more efficient and of easier administration. Many tax missions and advisers were sent to Latin American countries and several books came out of these missions. Also two major conferences were held in Quito and in Mexico City. It is difficult to assess how much real success these activities had in establishing modern tax systems in Latin American countries. One area in which they were definitely not successful was in making the personal income tax productive and progressive. There was a continuous process of rejection of this tax on the part of many Latin American countries.

Before moving to the next section, a few words should be added about property taxes and about tax incentives. Especially in earlier decades the Latin American economies were still heavily dependent on agricultural activities. This, together with the fact that in most Latin American countries land ownership was and still is highly concentrated, created pressures to (a) redistribute land through land reform and (b) impose taxes on the potential income of land, or alternatively high property taxes that would force the land owners to use it productively or, alternatively, to sell it. The capitalization of the tax was expected to reduce the market value of land.

There were attempts in some countries at land reform and attempts to establish cadastral values for the land in order to facilitate the imposition of property taxes. However, the fact that many of these countries were experiencing high rates of inflation, and that it takes a long time to establish good cadastral values, especially in places were land records were not kept in an easily accessible way, made this task difficult. Political oppositions from the powerful land owners also played a role. The bottom line is that success in this area has been limited so that property taxation continues to play a very limited role in Latin America. It has not been possible to use property taxes as alternatives to personal income taxes.

In the 1950s there was great confidence in the ability of governments to promote growth. There was also a firm belief, based on work by Harrod, Domar, Rostow and other economists, that investment was the main factor that could contribute to growth. Investment can, of course, be public or private. Public investment could be promoted by increasing the level of taxation while controlling the level of current spending. This led to the great interest in the level of taxation and in its determinants. There were many studies that tried to determine the potential level of tax revenue for developing countries. See Tanzi, 1987. Countries were praised by outside experts for maintaining or achieving high tax levels. See, for example, the report of the Musgrave's Commission in Colombia.

While public investment could be promoted by raising the tax level of countries, private investment could be stimulated through the use of tax incentives. At the time these incentives were supported by many experts, and Latin American governments responded to the prevailing view by introducing incentives for promoting investment for "essential" or "necessary" activities. These incentives became important tools for industrial policy together with the import-substitution policies. With the passing of time the experts' enthusiasm for tax incentives began to fade, but countries have continued to have them. Experts now tend to believe that (a) tax incentives have limited effects; (b) they complicate the administration of taxes; and (c) they are often associated with corruption. Some of these incentives, in Argentina, Brazil, Chile, Perú and other countries have been aimed at regional development. The evaluations of them have generally given negative results.

We shall discuss below some important, specific taxes.

3. Income Taxes

3.1 Personal Income Taxes

Taxes on personal incomes have been remarkably unproductive in most Latin American countries. This is definitely the area where the differences in revenue from industrial countries are greatest. In this section we provide some reasons why this is so. These reasons are somewhat different from those often suggested.

As mentioned earlier, the normal explanation for this result is the importance of the informal sector in Latin America and its impact on tax evasion. To this it is often added that tax administrations are weak so that they tolerates, large tax evasion on the part of taxpayers. Additionally some rely on sociological explanations, such as the presumed dislike on the part of the citizens of many of these countries for income taxes.

Latin American countries are characterized by very uneven income distributions. The Gini coefficients that are estimated for the countries of this region are the highest in the world, at times approaching 0.60. When income distributions are as uneven as that, and governments are chosen through democratic elections, as is now the case in most Latin American countries, one would expect that those with incomes below the mean income for the country, being in the majority, would elect individuals who would support progressive income taxes because these taxes would fall more heavily on the relatively few, rich citizens. The fact that this has not happened in Latin America is puzzling. Economists from DeViti De Marco to James Buchanan feared that in these circumstances very progressive income taxes would prevail thus reducing personal incentives and growth rates. Evidence indicates that their fear was misplaced.

In Latin America the share of total national income that compensates workers employed in official economic activities is remarkably low. For example in Mexico it is only 28 percent. In many places it is less than 30 percent compared to more than 70 percent in many industrial countries. Evidence from industrial countries suggests that revenue from personal income taxes is heavily dependent on the wages received by the employees of especially larger establishments, such as the government and enterprises. These employees are taxed at the source (i.e. their taxes are withheld) so that they would find it difficult to evade paying taxes. The low share of wages and salaries in the national incomes of Latin American countries begins to provide some explanation to the revenue puzzle. In order to collect tax revenue as high as in industrial countries, Latin American countries should (a) tax adequately those who receive wages and salaries as dependent workers and (b) tax adequately the 70 or so percent of national income received as non-wage income. Latin American countries have failed on both counts: wages and salaries

have not been taxed as adequately as they should have; and non wage and salary incomes have been hardly taxed.

An interesting aspect of the taxation of incomes from dependent work (wages and salaries) has been the relatively high level of personal exemptions, accorded by the countries' tax laws to working individuals and families. These levels are especially high when compared to the level of per capita incomes of these countries. In many Latin American countries the level of legally exempted income has been so high, as to wipe out a large part of the income from wages and salaries. Furthermore, the relatively low marginal tax rates are applied at such high income levels that few individuals are ever exposed to them. A few countries (Brazil, Chile and recently Argentina) have managed to get some revenue from personal incomes but the revenue obtained is still very low when compared with that obtained in industrial countries. The prevailing view that higher tax rates would discourage effort and damage economic growth has helped keep these rates down.

While the high level of personal exemptions (combined with the low tax rates and, possibly, the high tax evasion) has reduced the tax revenue that could have been received from wages and salaries, the weakness of the personal income tax, as a source of revenue, owes much more to the low taxation of non-wage incomes which, as indicated earlier, often account for at least 70 percent of the total personal income. The taxation, or better the non-taxation, of these incomes provides a large part of the explanation of why personal income taxes produce so little revenue in Lain America. These non-wage incomes are for the most part returns to capital (rents, interest, dividends, capital gains, profits) and, to a much lesser part, earnings by individuals engaged in informal activities. Given the information on income distributions, it is safe to assume that the share of personal income going to those engaged in non-official and informal activities is low so that their exclusion from taxation cannot be of great consequences for revenue..

Most Latin American countries have been reluctant to tax income from capital sources in part because of the fear that, being mobile, these incomes would emigrate toward that immerse black hole that is the US economy. In spite of the low tax rates imposed by the Latin American countries on incomes from capital sources the U, S. economy exercises a kind of fatal suction for Latin American taxpayers who have transferred hundred of

billions of dollars toward that economy and toward tax havens. Being classified as "non resident aliens" by the US tax authorities they have enjoyed a tax free status in the United States. Because of limited or non existent exchange of information between countries, or because of the territorial nature of several Latin American tax systems, taxpayers have not reported these incomes to the tax authorities of their own countries. The net result has been the low revenue from personal income taxes and the low progressivity of tax systems.

It is not clear how much truth there is in the assertion that an increase in the taxation of dividends, interest incomes, rents, capital gains and profits would lead to a (greater) emigration of capital. However, the non taxation of this capital in the places where it goes (tax havens and the United States) does provide a strong incentive to its exodus. This incentive becomes particularly strong in periods when there is economic and political instability in the Latin American countries. This was the case during the "lost decade" of the 1980s, when huge capital flight from Latin American countries took place. The United States could help by taxing fully these incomes or by providing information to the tax authorities of the countries from which this capital originates. However, neither of these two alternatives is likely. The attempt to reduce the role that tax havens play in tax evasion started a few years ago. It remains to be seen how far it will go. It is also an open question whether the elites of the Latin American countries, who are often over-represented in the governments of these countries, would allow a fuller taxation of personal income. In conclusion, personal income taxes can become productive only if the governments concentrate their efforts on the top 10-20 percent of the population that absorbs much of these countries taxable income. See Tanzi, 1966.

3.2 Taxes on Enterprise Income

As far as the taxation of enterprises is concerned, the issues in Latin America are largely the same as those of industrial countries. Also the rates are broadly similar. These rates have fallen significantly in the past two decades as in the rest of the world. Until the mid 1990s high inflation had created particular difficulties in measuring real profits. Inflation had distorted the measurement of depreciation allowances and, often, the cost of inputs.

Also, by sharply increasing nominal interest rates, it had created strong incentives for enterprises to replace equity with debt. Many enterprises had taken advantage of this possibility. Problems of "thin capitalization" had become significant and because of the deductibility of large nominal interest payments, enterprises had routinely shown losses in their accounts. Several countries (Brazil, Chile, Mexico) had taken steps to index various aspects of the tax system for inflation. Some (Argentina, Mexico, Perú, Colombia, Costa Rica) had also introduced taxes on gross assets or on net worth in order to force enterprises to contribute something to tax revenue. Some of these taxes continue to be imposed today and some countries continue to index the accounts of enterprises for inflation. Mexico, for example, continues to tax only (and to allow a deduction for only) inflation-adjusted interest incomes and payments. These adjustments for inflation introduce administrative complications and raise the cost of compliance for tax payers. Given the now prevailing low rates of inflation in Latin American countries, it is a valid question whether these inflation adjustments are still justified.

As in other countries in the world, the issue of how to value inputs purchased from abroad—the issue of "transfer prices"—is receiving a lot of attention by Latin American tax administrators. In recent years various countries have introduced legislation to establish criteria to deal with this issue. The prevailing principle in this legislation is that of "arm's length", that is the price that the input would command in a competitive market where buyers and sellers were not related. This is a good principle but often it is not sufficient for dealing with the problem especially when (a) the inputs may be purchased from related companies, that is from foreign subsidiaries or branches of the same multinational enterprise; (b) the input are specific to a final product, so that they do not have a market price that can be observed; and (c) the inputs may be trade marks, copyrights, patents, or the output of research done at the headquarter of a multinational company. However, these are not issues strictly limited to Latin America. They worry the tax administrators of other countries as well. See Mercader, 2007.

Other Latin American issues related to the taxation of enterprises are (a) tax incentives; (b) the treatment of foreign enterprises engaged in the extraction of natural resources; and (c) the taxation of small enterprises.

We have already commented on the problems created by tax incentives so there is no need to repeat them. However, a typically Latin American aspect, and one that has acquired importance especially in Central America, is what could be called the process of "tax incentive shopping" on the part of foreign companies. These companies often rely on the competition among countries of the same area (say Central America) to get the best possible deals. For fear of losing an important investment to a neighboring country, that may be willing to offer better tax deals, countries compete in offering incentives that at times are not in their best interest. Countries should be encouraged to coordinate their actions in order to be able to resist requests that essentially put one country against others and that are not in the countries' interest. See Bird, 2007..

The sharp increase in the prices of mineral products (oil, copper, tin, iron, etc) in recent years has brought strong political reactions in some countries (especially Bolivia and Venezuela) against contracts that foreign companies had negotiated in the past, when commodity prices were low. When the prices rose these contracts became very profitable for some companies. Furthermore, there have been reports that some of these foreign companies, exploiting fully the possibilities offered by transfer prices, have paid nothing for years to the countries. As a consequence, royalty taxation has become an important topic in Latin America. Royalty taxation would make companies pay some taxes (in relation to the physical extraction of natural resources) even when the reported profits of the companies are reported to be zero. These royalty taxes can be justified on grounds that the extraction of natural resources by a foreign company makes a country poorer in some basic sense and that this kind of production always causes some environmental damage. It is likely that this aspect of taxation will become more important in future years in Latin America if environmental concerns keep growing.

In Latin America there are many small enterprises. These enterprises have difficulties to deal with complex aspects of income taxes, value added taxes, social security taxes, net wealth taxes, local taxes, and so on. It is very costly for them to acquire the expertise to comply with the tax requirements and to keep the accounts in the way required by the tax authorities. At the same time the tax administrations have had difficulties in verifying the tax declarations presented by these small enterprises. There has thus been a

movement, in several Latin American countries, toward tax simplification for the small enterprises. See Gonzales, 2006. The aim of this simplification is that of combining, in a single and simple tax, all the payments that the enterprise would make to meet the various legal obligations as reflected in the existing taxes. In some way this movement replaces taxes based on formal accounting data with taxes that are, in effect, presumptive taxes.

This movement toward simplification has been pursued by:

- Argentina that in 1998 introduced a Régimen Simplificado para Pequeños Contribuyentes, or "monotributo," a system applied to enterprises with a turnover lower than a well-defined minimum;

- Bolivia, that introduced a Régimen Tributario Simplificado, a Sistema Tribulatio Integrado, and a Regimen Agropecuario Unificado. These three systems apply to three different areas of the economy;

- Brazil, that in 1997 introduced a "simples" system that replaced, for small enterprises, various taxes with a single tax. More recently the "simples" tax has been replaced by a "supersimples" tax that has extended further the scope of the taxes that are replaced by the "simples tax";

- Costa Rica, that has introduced a Régimen de Tributacion Simplificada that has replaced, for small enterprises, the income tax and the value added tax;

- Mexico, that has introduced a Régimen de Pequeños Contribuyentes ("REPECOS") that has replaced various national and local taxes with a single and simple payment;

- Perú, that has introduced a Nuevo Règimen Unico Simplificado (RUS) to replace the income and the value added taxes;

- Uruguay, that has introduced a special tax on small enterprises (IPE) and a monotributo. Both of these aim at simplifying the taxation of small and unipersonal enterprises.

The above reforms have been accompanied by administrative charges that in several countries have created so called "Large Taxpayers Units". These are special units within the tax administrations that follow closely and intimately large enterprises or important individual taxpayers. These large taxpayers, while often small in numbers often account

for as much as 80 or even 90 percent of all income and value added taxes paid. The Latin American countries have realized that small and large enterprises and small and large individual taxpayers cannot be treated in identical ways and cannot be subjected to the same rules. Larger taxpayers require more attention. While large enterprises are expected to report incomes and sales based on modern and formal accounting rules, small enterprises are being subjected more and more to modern versions of presumptive taxes that had been predominant in the past. This is an important conceptual change that can be expected to have a major impact on the tax systems and the tax administrations of Latin American countries.

4. Value Added Taxes

As indicated earlier, value added taxes are now very important in the tax system of Latin American countries. In some of them (Brazil, Uruguay, and Chile) they raise more than 8 percent of GDP in revenue. This puts them among the top countries in the world in terms of tax revenue from value added taxes. Several other countries (Argentina, Bolivia, Colombia, Ecuador, El Salvador, Honduras, and Nicaragua) collect more than 6 percent of GDP, say above the Italian level. There is thus no question that the introduction of the VAT has been a remarkable achievement in the fiscal development of Latin American tax systems.

A VAT imposed with a broad base and with a single rate can be a very effective instrument of economic policy. It is essentially a flat tax on income defined as consumption. Thus, it is a version of an expenditure tax often recommended in the past by Mill, Kaldor, Einaudi and others. By not taxing income saved, it is growth friendly. Because it is collected with a short lag (generally not much more than one month passed between the taxable event and the receipt of the tax payment by the government) it is relatively insensitive to moderate rates of inflation. The revenue impact of a rate change is almost immediate and it is easy to calculate with small margins of error. It does not lend itself easily to social engineering, as happens with income taxes. Furthermore, it can be a useful tool for stabilization policy because it is easy to estimate the impact of a rate change

and to explain the change to members of parliament. A single-rated, broad-based value added tax is also much easier to administer. All these are remarkable characteristics.

Many of these virtues disappear, however, or become attenuated, when VATs are not applied with one rate on broad bases. One of the more contentious issues in Latin American taxation has been whether the VAT should in fact be levied on a broad base and with a single rate. In spite of overwhelming evidence to the contrary, provided by many economists, the politicians of several countries continue to support VATs with much reduced tax bases because of the exclusion or the zero rating of various categories of consumption. Furthermore, in the illusory pursuit of tax equity many countries continue to adopt value added taxes with more than one rate. The reduced rate or rates tax more lightly consumer goods that are presumably more important for families in lower income groups.

Inefficient VATs now exist in Mexico, Colombia, Venezuela, Perú, Jamaica, Argentina and a few other countries. The concept often used to measure the productivity of the value added taxes is the relationship between revenue and rate. Productivity is measured as the revenue share in GDP produced by a unit rate of VAT. In Latin American countries, this index of revenue productivity in 2004 ranged from a low of 24.6 in Mexico and 26-27 in Haiti and Trinidad and Tobago to a high of about 52 in Ecuador and Honduras. Given a high productivity index, a country can raise more revenue without the need to impose a high tax rate. For example, Ecuador and Honduras could raise the same share of GDP in revenue from the VAT with a rate half the rate of Mexico, Haiti and Trinidad and Tabago. Thus a high productivity of the VAT does not automatically implies that the country collects large revenue from the VAT because the revenue collected depends on both the productivity of the tax and the rate (or rates) used.

In some countries, legislatures continue to resist the widening of the base and the elimination of multiple rates, to replace them with a single rate. This has been a particularly lively issue in Mexico that, being a member of the OECD, finds itself in the uncomfortable place of having the least productive VAT in Latin America.

Value added taxes exempt exports and tax imports. In Latin America imports have been a large part of the tax base often providing as much as half of total VAT revenue. When exporters export products, they often present claims for taxes that have been included

in the products that they bought and exported. Two issues have been associated with this process. The first, common in all countries that use VATs, is the possibility that exporters will fake exports and present claims that are not legitimate. The second has been the long delay in getting the rebates. In periods of fiscal stress, countries may tend to slow down the payment of the tax rebates, thus getting a cheap loan from the exporters. In Latin America this second aspect has occasionally become a significant issue.

In particular countries and in particular periods, the faking of invoices to evade tax payments has been a problem. Another has been the sale of services without the payment of the VAT. At times, the users of the services have been given discounts to agree to pay for a service (professional services or services related to construction) without a receipt and without a VAT payment. Naturally these problems are not limited to Latin America but they seem to be more widespread there than in European countries.

V. Other Issues

During the past two decades the level of taxation in Latin America has increased considerably especially in countries such as Brazil, Argentina, Bolivia, Colombia, Nicaragua and a few others. See theTable. These tax increases have reflected both policy changes introduced by tax reforms as well as improvements in the tax administrations that have accompanied the introduction, and subsequently the better use of computers. With the passing of time tax administrators have learned to utilize computers to get more and better information than previously and to be able to follow more closely the compliance of the larger taxpayers. Large taxpayers are now controlled by so-called “large taxpayers units”. The increase in tax revenue has been accompanied, in the more recent years, and for some countries, by larger revenue from government owned natural resources, reflecting the boom in commodity prices. Venezuela, Bolivia, Chile, Mexico and a few other countries have been large beneficiary of this boom. At the same time several Latin American countries have got rid of many small taxes that had created administrative difficulties while contributing little to total revenue.

Over the years there has been a lot of experimentation with new taxes promoted, first, by the countries' revenue needs and, second, by a continuing search for simple solutions to the revenue needs. This in fact has been an interesting characteristic of the policymakers of these countries: the search for the magic solution. In some circumstances, instead of pursuing well traveled roads toward better revenue performance, policymakers have tried novel ways and novel taxes.

TABLE 1 HERE

Some of these ways have included taxes on gross assets, to replace traditional taxes on enterprises, or to establish minimum taxes. This was a tax first proposed by Maurice Allais, the French Nobel Prize winner in economics. Mexico, Argentina and Perú, and some other countries tried this route. Another experiment has been the tax on financial transactions and, especially, on the use of checks. Variations of this tax now exist in Argentina, Brazil, Colombia, Perú, and a few other places. This tax is defended on the grounds that it provides easy revenue as well as useful information on taxpayers to the tax administrations. However, it may, in time, discourage the use of the financial instruments subject to taxation and, indirectly, stimulate underground economic activities.

Hopefully, the reintroduction of export taxes by Argentina will not spread to other countries. Like the tax on checks the tax on exports is easy to administer. In periods of high prices for exports, or after large devaluations, it can have some short term logic. But, in time, it can become a very damaging instrument.

Another issue that continue to affect the tax systems of Latin America is fiscal federalism. Countries such as Argentina, Brazil, Bolivia, Colombia, Mexico and some others have constitutional or other legal arrangements that give significant spending powers to subnational governments or entities. These arrangements have often a large impact on tax systems because they restrict the degrees of freedom that national governments have in reforming their tax systems. For example, in Argentina, foreign trade taxes are not shared with the provinces; therefore they are preferred by then national government even though they are inefficient taxes. In Brazil it has been impossible to reform the badly-structured

value added tax because this tax is the responsibility of the states and not of the national government. In Brazil taxes are such a controversial and constitutional issue that a tax lawyer is essentially a constitutional lawyer. Similar difficulties exist in Mexico where more than 90 percent of all the cases that go to the Supreme Court are tax cases. Clearly, regardless of the merits of fiscal federalism and of fiscal decentralization, they do complicate tax policy and often force on countries tax options that are not the most desirable. This in most evident in Latin America.

What can be called institutional externalities are also in clear evidence in Latin American countries. By institutional externalities it is meant the impact that a public institution can have on another institution. A good tax administration needs a good educational system, to provide the qualified personnel that it will hire. It also needs an efficient justice system that pursues and punishes taxpayers that do not comply with the legal tax requirements. When a tax administration depends on the justice system to punish tax evaders but the justice system is too inefficient or too corrupt to do this rapidly or efficiently, tax compliance suffers and the blame should not be placed only on the tax administrations.

Finally, tax administrations need to be monitored to assure that they remain efficient and objective. However, in several Latin American countries, controls can become political interference when highly placed individuals, within both the executive and the legislative branches, are able to influence administrative decisions for political ends. In some Latin American countries this still happens more than, perhaps, it should.

6. Concluding Remarks

There has been a gradual and continuous evolutions of the tax systems of Latin American countries. Over the years levels of taxation have risen and the quality of the tax administration has improved considerably. The constraints that remain are partly structural, partly administrative, and partly political. This brief foreword has mentioned a few political obstacles that continue to prevent the tax systems from acquiring a more modern look. However, progress has been made and continues to be made. Part of this progress

has been the elimination of many unproductive and nuisance taxes that had been expensive to administer and that gave little in revenue.

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Table 1 Latin America and the Caribbean general government fiscal revenues (as % of GDP), 1990-2005 (including social security and excluding petroleum and natural resource revenues)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina 1/	16.1	18.4	21.5	21.6	21.5	20.3	19.7	20.6	21.0	21.2	21.5	20.9	19.9	23.4	26.3	26.7
Bolivia 2/	8.4	8.9	10.7	18.1	18.4	18.7	20.0	20.0	21.3	20.6	20.4	19.9	19.9	20.7	24.1	25.2
Brazil 3/	28.8	23.3	24.5	25.0	29.1	29.0	28.1	29.0	29.7	31.7	32.6	34.0	35.6	34.9	35.9	37.4
Chile 1/	16.7	18.5	19.1	19.6	18.7	18.0	19.3	19.0	19.3	18.7	19.3	19.8	19.7	18.9	18.5	18.8
Colombia 4/	12.4	13.9	14.0	15.1	15.7	16.7	17.8	18.7	19.2	19.1	18.9	21.0	21.2	21.6	22.3	17.6
Costa Rica 1/	16.5	16.7	17.3	17.7	17.5	17.7	18.2	18.4	18.3	17.6	18.2	19.2	19.4	19.4	19.4	20.5
Dom. Republic 1/ 9/	10.5	11.9	13.9	14.9	14.1	13.9	13.2	14.8	15.1	15.6	15.0	15.9	15.9	14.8	15.3	16.7
Ecuador 1/	10.2	10.8	10.3	10.1	10.2	11.0	9.4	10.5	11.0	11.0	13.2	14.3	15.2	14.3	13.4	14.9
El Salvador 5/	9.0	10.1	10.8	11.5	12.5	13.7	13.2	12.9	13.2	13.2	13.2	13.0	13.8	12.4	13.2	14.2
Guatemala 6/ 9/	6.9	7.3	8.4	7.8	6.8	7.9	8.7	8.8	8.7	9.9	10.0	9.7	10.6	10.3	10.3	9.8
Haiti 6/ 9/	7.3	7.6	5.5	4.8	2.8	5.9	6.7	8.5	8.1	8.5	8.1	7.6	8.3	9.0	8.9	9.7
Honduras 1/ 9/	15.3	16.3	15.8	16.4	15.6	16.9	14.8	14.2	17.2	18.3	17.0	16.9	17.1	17.6	18.2	18.3
Mexico 7/	12.6	n.a.	n.a.	n.a.	n.a.	11.3	10.9	11.6	12.0	12.9	12.1	12.9	13.2	12.6	11.4	11.0
Nicaragua 1/ 9/	9.0	12.4	13.6	13.0	13.7	14.2	14.2	15.7	17.2	17.1	17.4	16.9	16.8	18.4	18.9	21.5
Panama 8/ 9/	14.7	15.3	19.8	18.4	18.6	19.9	19.3	19.2	16.2	16.7	15.0	14.7	14.4	14.7	14.9	14.2
Paraguay 1/ 9/	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	11.2	12.9	13.0
Peru 1/ 9/	11.6	13.1	14.1	14.3	14.9	15.4	15.8	16.0	15.6	14.4	14.0	14.2	13.8	14.7	14.9	15.4
Uruguay 5/	29.5	32.6	32.2	31.1	30.8	32.2	33.6	34.0	32.9	32.5	31.9	32.3	31.7	28.2	29.9	32.2
Venezuela 1/ 9/	4.4	4.8	5.9	7.1	9.4	8.9	8.2	10.1	11.6	11.6	9.4	9.6	10.3	10.4	11.8	12.6

Source: International Monetary Fund, Country Reports. ECLAC-ILPES. IDB studies. Country governments. 2005 data from Martner, R. (2007) 'La política fiscal en tiempos de abundancia,' Documento XIX seminario regional de política fiscal.

Elaboration: IDB, INT/ITD.

1/ Source: ECLAC-ILPES, Database: Estadísticas de las Finanzas Públicas de América Latina.

2/ Source: IMF data, 1994-2004, includes hydrocarbons revenue. Data ECLAC 1990-2, and 2005 excludes hydrocarbons. Social security data from ECLAC.

3/ Source: 1990 Receita Federal; Revenues 1991-2004: SRF - Estudos Tributários / Carga Tributária - elaboration: Amir Khair.

4/ Government data, includes taxes from petroleum revenue (except 2005). Dirección de Impuestos y Aduanas Nacionales (DIAN); Oficina de Estudios Económicos DIAN.

5/ Data from IDB studies and consultancies. El Salvador 2005 data is from ECLAC. Uruguay 2004-5 data is from the IMF.

6/ IMF, Country Reports. Guatemala and Haiti 2005 data is from ECLAC. Haiti data excludes social security.

7/ Data from Martner, R. (2007) 'La política fiscal en tiempos de abundancia,' Documento XIX seminario regional de política fiscal.

8/ IMF, 1992-2002, ECLAC 1990-1 and 2003-5.

9/ Central government data.

1. TAXATION STRUCTURE AND MAIN TAX POLICY ISSUES IN LATIN AMERICA

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Abstract

We provide an overview of Latin America tax systems and tax policies. We analyze the level of taxation, the main features and trends of its evolution, the distributive effects and the main issues under debate. We compare specific features of Latin American tax structure both within the countries of the area and with other OECD countries.

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JEL Codes: H20, H24, H25, H29

1. The regional features and the level of taxation[*]

Latin American countries are strongly characterized by different economic and social indicators within the area, a fact that is crucial for the analysis of their tax systems. Total population is about 540 millions of citizens in 2005 for 19 countries[1], from Brazil with more than 187 millions and Mexico with 106 millions, to Panama and Uruguay, with more than 3 millions of habitants each. Similarly, the level of development differs in the region. The average GDP per capita is estimated about 3750 dollars in 2005, with, on one hand, countries such as Mexico (about 6800 per capita dollars) and Chile (5200 dollars), and, on the other hand, Bolivia (960 dollars), Nicaragua (830 dollars) and Haiti (400 dollars).

The World Bank's Atlas method, which classifies countries according to their income per capita, identifies four groups of countries: in 2005, countries with less than 875 dollars per year are low income, until 3465 dollars per year low-medium income, until 10725 dollars medium-high income, more than 10726 dollars high income. Applying this classification to Latin America we find three low-income countries (Bolivia, Haiti and Nicaragua), ten low-medium income countries (Brazil, Colombia, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Paraguay and Peru) and seven medium-high income countries (Argentina, Chile, Costa Rica, Mexico, Panama, Uruguay and Venezuela).

The three largest countries have however a substantial weight, while the three smallest ones give poor contribution to the production of the GDP of the area. Argentina, Brazil and Mexico contribute for more than 70 percent of the total, while Bolivia, Haiti and Nicaragua all together contribute less than 1 percent of the total. Latin America stretches for more than 20 millions of Km2, of which 42 percent is occupied by Brazil, 14 percent by Argentina and 9 percent by Mexico, while on the other extreme, El Salvador or Haiti occupy only 0.1 percent.

[*]We thank Alberto Barreix for useful comments and Lic. Maximiliano Geffner and Maria Victoria Espada for research assistance.

[1] In this analysis we will not include Cuba, since tax information is not available, as well as English speaking countries, which are not comparable, due to their tax systems, substantially different from the other Latin American countries.

Latin America is also characterized by different sub-area features. Countries have developed their own type of integrations. Argentina, Brazil, Paraguay and Uruguay belong to Mercosur. Venezuela has recently joined them as full member, while Bolivia and Chile as associate members. On the other side, the Andean Community (CAN) is constituted by Olivia, Colombia, Ecuador and Peru. The Central American Common Market (MCCA) groups Costa Rica, Guatemala, Honduras, El Salvador and Nicaragua and, for some specific issues, Dominican Republic.

As we already noticed, differences are enormous. As a consequence, performing a global analysis of the different tax features of the countries is a quite difficult task, which may produce not unambiguous conclusions.

The analysis of the tax situation during the last decades can be conducted following two paths: the first one would imply an effort to compile all the statistical and institutional information of each country in order to analyze the evolution and the results of the changes occurred in each circumstance. The second path, which will be followed in this paper, is more oriented towards stylized facts, exemplified cases, and provide material for subsequent analyses, taking into account the possibility of making mistakes of interpretation or generalizations beyond the necessary.

To build series of data comparable over time and across countries is a difficult task which may lead to mistakes. In particular, we should be very careful in expressing numbers on "fiscal pressure", a well-known concept among economists. A first issue concerns the levels of government which we consider. Most of the Latin America countries are unified: the central government collects the majority of revenue, while municipalities less than 10 percent of it. However in some cases there exist federal governments, such as Argentina, Brazil, Mexico and Venezuela, with their own tax authorities, which may provide, such as in Brazil, significant revenue. Notice that fiscal pressure in 2005 in Argentina was 81 percent in the central government, 14 percent in provinces and 5 percent in municipalities (estimated values). For Brazil, the importance of decentralized governments is substantially higher, amounting to about 30 percent of fiscal pressure.

A part of revenue, on turn, derives from levels, or organizations that have to transfer part or all their revenue to other levels of government without disposing totally of it. This happens for instance with the tax or social funds sharing.

Moreover, although the majority of countries have privatized their manufacturing firms in the last decades, public firms are very important especially in countries which export natural resources (Chile with copper, Venezuela and Ecuador with petroleum, Bolivia with gas) or take advantages from their geographical position (Panama with payments linked to the Channel). In these cases revenues are considered as non-tax revenues, but they may be very high.

Moreover, since one of the functions of the government is to guarantee a social coverage through different instruments, we should take into account also social security revenue. The total or partial privatization of them in some countries in the last decades poses however serious problems on the comparisons of the different levels of this kind of revenue in these countries. Some countries, such as Chile, have a private system with no public revenue. Some other countries, such as Argentina and Uruguay, have a mixed system, so that the government receives lower revenue than the years before the privatization, since part of the current revenue goes to the private sector to finance the current debt, left as a government responsibility. The case of Brazil is again relevant: taxes and contributions to finance social security in 2005 amount to 15.4 percent of GDP, i.e. almost 41 percent of the total tax revenue has been assigned to finance these provisions.

Finally, there are non-tax revenues, such as the inflation tax, the most used complementary instrument during the 1980s. Although the growth of price levels has been reduced during the 1990, the inflation tax is still relevant when we compare the evolution of the levels of revenue over time in many countries and we analyze countries, such as Argentina, Brazil, Uruguay and Dominican Republic, that had a significant inflation in the last years. The application of different types of exchange rates is also another source of revenue which makes it difficult to compare only tax revenue across countries and over time.

GRAPH 1 HERE

Graph 1 shows the level (in percentage of GDP) and the composition of government (central or general, depending on the cases) tax revenues in 2005. In several countries (Argentina, Brazil, Colombia, Costa Rica, Guatemala, Haiti, Honduras and Uruguay) tax revenues are the only source of current revenues of central governments. In others

(Bolivia, Chile, Ecuador, Mexico, Peru and Venezuela) they are complemented by other current revenues originated from natural resources (hydrocarbon and mines). In Nicaragua and, to a much less extent, in El Salvador and the Dominican Republic, bilateral and multilateral donations contribute to raise current revenues with respect to tax revenues. In Panama current revenues from services also complement central government tax revenues.

To find a classification criterion, which, as such, is arbitrary, it seems appropriate to group countries according to the average level of fiscal pressure. We assume that countries with a fiscal pressure of at least 2 percentage points of GDP more than the average of 2005 (18 percent) have a high fiscal pressure. As a result, we have a group of five countries with a high fiscal pressure (Argentina, Brazil, Chile, Uruguay), higher than 20 percent of GDP, other five countries with a fiscal pressure close to the average 18 percent and other five of low fiscal charge (Paraguay, Ecuador, Venezuela, Guatemala, Haiti), with a fiscal pressure lower than 10 percent of GDP.

The evolution of fiscal burden (including social security) between 1990 and 2005 (see table 1) shows that fiscal pressure has, on average, strongly grown in the region from 12.6 percent in the 1990's to 18 percent in 2005. Taking the average during this period as a criterion, we can classify countries depending on whether they overcome by three or more percentage points the regional average or not. As a result, Argentina, Brazil, Chile, Costa Rica and Uruguay show higher levels than the average, while Paraguay, Ecuador, Venezuela, Guatemala and Haiti have lower fiscal pressure.

Argentina and Brazil have significantly raised their taxes, from an initial relatively high level of taxes with respect to the regional average. Starting with a low fiscal pressure, Bolivia, Costa Rica, Colombia, Dominican Republic and Venezuela show a strong increase. Tax revenue significantly increases from 2005 in these countries and in Chile, with an elasticity higher than one, following administrative improvements and full returns of the new taxes. Mexico is the only country where the tax revenue has remained very low, close to 12 percent of GDP.

In the 1990's, the higher growth rates push for a higher tax burden. In general, the elasticity of the tax collection is higher than one (see Martner and Trombe, 2004). In the growing phases, this is due to the fact that growth produces an increase of the formal

economy and generates an increase more than proportional of imports and associated taxes. On the contrary, during recessions, revenues decrease more than proportionally, due to the opposite direction of the above relations and to the significant increase in tax evasion. The relation between inflation and tax revenue is also strong. First, this is because inflation decreases the real value of tax revenues due to delays between the tax generation and their collection. Second, since inflation reduces real revenues, families and firms will try to maintain their disposable real revenue through a lower tax payment. Thus, macroeconomic stability, i.e. high growth combined with low inflation, is the main condition for more tax revenues. In a recession phase with growing inflation, any tax system faces difficulties to avoid the loss of revenues.

TABLE 1 HERE

One of the main goals of taxation is to finance the expenditure of government goods and services. Thus, the choice of the level of taxation indicates, in the medium run, the level of public expenditures. Beyond the traditional recommendations of avoiding taxes that may distort resources allocation, the economic theory provides a very limited guide with respect to the decision on the level of tax burden and tax structure. Some studies find a negative relation between fiscal pressure, or public expenditures, and economic unemployment. To this respect however a final conclusion can not be reached: some countries have grown with a high level of taxation and others have a poor macroeconomic performance with a low fiscal pressure. Causality may even be reversed: as long as countries grow, the tax base enlarges and the system becomes more progressive, creating a virtuous circle between growth, public expenditure, level of taxation and progressivity of the system.

GRAPH 2 HERE

A way to evaluate if the levels of taxation and the tax structures are "appropriate" is to compare the relation between taxes and GDP for a large number of countries. The simple comparison between Latin America and the Caribbean and the other world areas is very insightful (graph 2). In 2005 the fiscal pressure in OECD was 2.2 times the fiscal pressure of Latin America and the Caribbean. In OECD countries, direct taxes and

social security contributions are relatively more important, while the tax system of Latin America and the Caribbean is based on indirect taxation. The levels of fiscal pressure in Latin America and the Caribbean are similar to the ones of East Asia, although the composition is very different. Asian countries show a higher level of direct taxes (especially corporate taxes) and very low social security contributions.
Using panel regressions, some authors estimate the “fiscal capacity” of each country (see for instance Agosin et al. 2005 for Central-American countries), which can be compared to the effective taxation. This type of analysis is out of the scope of this paper. We however show the relation between fiscal and tax revenue in Latin America and the Caribbean and the level of per capita revenue in graph 3.

GRAPH 3 HERE

To conclude, in spite of the general growth of the average fiscal pressure in the last decades in all countries (with the exception of Mexico), in the current situation there still exists potential space (Brazil is the big exception). The level of effective fiscal pressure is below the expected or potential level given the per capita income of the countries and the concentration coefficient of incomes (see Agosin et al. 2004, Perry et al., 2006). This loss of fiscal revenues is about 3 or 4 points of GDP, which implies that, given the level of fiscal pressure of 17 percent in 2005, there exists a loss of revenue which can be estimated between 15 percent and 25percent of the current level.

2. Main features of the evolution of tax systems in Latin America

The composition of the tax structures shows significant changes during the period 1990-2005, following a series of stylized facts which we summarize as follows.

a) First, we observe a lower participation of revenues from external commerce on the total level of tax revenues, in part as a consequence of the abolition of taxes on exports in the area[2], and especially for the substantial reduction of the nominal and effective tariffs on the imports. This trend originates in the 1980’s and it is complemented with the process of generalization and growth of VAT in the all region,

[2] The recent case of Argentina with respect to the withholding of exports since 2002 is an exception to the general rule.

which became the main source of revenues, doubling its value with respect to GDP during the period 1990-2005, as shown in table 2.

b) Second, the weight of taxes on income is also increasing in the same period, but at a lower rate, although in the last years the weight of corporate taxation seems to be larger. To this respect, notice that the information about corporate taxation and taxes on natural or physical persons are insufficient for the majority of countries. In graph 4 we also observe a decreasing trend of top tax rates, both for personal taxes (from 40 percent/60 percent in the middle of 1980's to 25 percent/35 percent now) and for corporate taxes (44 percent on average in 1986 and 26 percent in 2004).

TABLE 2 HERE

GRAPH 4 HERE

c) Third, the VAT tax base has been progressively raising, especially through the inclusion of services. The average level of this tax is also growing, from 11 percent to 15 percent with a maximum level of 23 percent (Uruguay). Although its adoption has been general, VAT shows important differences from one country to another, both in terms of the tax base and of the tax rates (variety and levels) applied in each country. Concerning the first issue, in some countries VAT is generally applied to goods and services, while in others only to goods and some services and, in very few ones, only to goods. Regarding the tax rates, a first difference is between countries with multiple tax rates (applied to different types of consumption) and countries with a unique generally applied tax rate. Argentina, Colombia, Costa Rica, Honduras, Mexico, Nicaragua and Panama use a system of multiple tax rates, while the other countries apply a unique, uniform tax rate.

Tax rates in turn show two basic features. On one side there is a general trend to growth, since between 1994 and 2004 the average VAT revenue in the area raised of almost three percentage points of GDP. On the other side, there are remarkable differences across countries with respect to the size of the tax rates (see table 3). Argentina, Brazil, Chile, Peru and Uruguay apply tax rates higher than or close to 20 percent, while Bolivia, Costa Rica, Ecuador, El Salvador, Guatemala, Haiti, Honduras,

Panama and Paraguay have adopted tax rates no higher than 13 percent, thus lower than the average 14.8 percent. In comparative terms, in 2004 the simple average of VAT tax rates applied in Latin America and the Caribbean was almost five percentage points below the average of the European Union (14.6 percent and 19.6 percent respectively). The differentiation across countries was lower in the European Union than in Latin America and the Caribbean (standard deviation of 3 in the first case and 4.5 in the second one).

TABLE 3 HERE

Moreover, the VAT productivity (defined as revenue in percentage of GDP divided by the general tax) is comparatively low in the region, since it reached a 40 percent in 2005 (notice that the average productivity in developed countries is higher than 60 percent). Even in this case there are important differences across countries, as shown by graph 5. Five countries (Haiti, Mexico, Peru, Panama and Dominican Republic) show a revenue efficacy much lower than the average of the area.

This indicator does not, of course, necessarily reflect administrative efficiency, but the dispersion of tax rates around the general tax. For instance, in Mexico, exemptions for food make the dispersion larger. Thus, this graph only shows the distance with respect to a potential collector in case there would be no exemptions. In a context with growing difficulties to introduce new taxes or higher tax rates, the abolition of exemptions and the limits to tax deductions emerge as significant sources of fiscal revenues in the future.

GRAPH 5 HERE

d) Fourth, there is a raising degree of informality of markets, especially in the labor field and in small firms, which induces the majority of countries to implement several tax measures to adapt to these circumstances: some have adopted alternative systems to integrally treat these groups of taxpayers, some others to exempt taxpayers considered less remunerative for the tax administration, or, in other cases, countries have opted for living with the problem and not comply with the rules.

Fourteen of the seventeen countries analyzed in Latin America have adopted a special regime of taxation of small taxpayers, and only three did not (El Salvador, Panama, Venezuela). Nevertheless these three countries apply an exemption of VAT according to the amount of sales. In the majority of countries special regimes are adopted on voluntary basis. Seven countries apply more than one regime. Chile apply four general regimes and some of them admit sub-regimes with specific features according to the economic activity of the taxpayers[3]. Argentina applies a regime denominated "*monotributo impositivo*" which is a substitute for the income tax, social security contributions and VAT [4]. Brazil has adopted a regime called "*simples*" which is also a way to capture the informal economy through a simplified system.

e) Fifth, "tax expenditure" is a term largely used to refer to exemptions, deductions, credits, delays and returns of taxes. In a wider sense, tax expenditure is the revenue which is left uncollected, due to franchises or special tax regimes, aiming at favoring or stimulating specific sectors, activities, regions or agents of the economy.

In Latin America and the Caribbean, an increasing number of countries provide information on tax expenditure. The amounts are very significant in all cases, with a minimum of 1.4 percent of GDP for Brazil and a maximum of 7.4percent of GDP for Colombia. Concerning the taxes coming from the tax expenditure, notice that in Argentina, Ecuador, Peru and Uruguay incentives related to indirect taxes prevailed, especially VAT, while in Chile the incentives focused more on the income tax. Regarding the destination, in Argentina 80 percent of tax expenditure (2.4percent of GDP) corresponded to treatments established by the laws of the respective taxes and the other part to benefits given to the different regimes of economic, regional and sectoral promotion. In Chile, the tax expenditure (4.2 percent of GDP) is mainly directed to the financial sector (61.3 percent), housing (12.6 percent) and education (7.4 percent).

f) Finally, we notice two additional facts: on one side the significative reduction of the number of taxes, especially selective taxes, which has been limited to not elastic goods and services, such as tobacco, alcoholic beverages, telecommunications, on the other side the emergence of taxes applied to extraordinary bases such as bank debts or credits, tax on financial services and other "heterodox" charges, aiming at establishing a minimum weight of direct taxes.

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[3] Gonzalez, Dario (2006).
[4] Gomez Sabaini, J.C. and Geffner M. (2006).

TABLE 4 HERE

3. Perspectives of the main taxes

The reduction of taxes on external commerce, which started in the past decades, does not seem to be completed, since the current process induced by both the multilateral treatments of commerce (TLC with the European Union and other bilateral treaties of free commerce) and the different areas of regional integration will necessarily have impact on the collection of the import rights. The agreement of the DR-CAFTA for instance, which is a convention of Central American countries, US and the Dominican Republic, establishes a loss of collection for tariffs (see Barreix et al. 2003, and Agosin et al., 2005).

This situation highlights that it will be necessary to recollect resources which will be lost, in order on one side to avoid stopping the process of openness and on the other side to avoid fiscal losses which may affect the country's level of fiscal sustainability, the equity of the tax system and its productive structure. As noticed by Baunsgaard and Keen (2005) "an informal revision of the information also suggests that the countries which successfully recollected the lost revenues of external commerce did it not only with resources coming from consumption tax – a standard recipe - but also with a heavier income tax. This may be somehow due to the fact that the increase of income tax helps to overcome the political economy difficulties concerning a greater weight of the consumption tax, which are perceived (correctly or not) as regressive".

The evolution of tax structure in Latin America however did not follow that direction. It was instead focused on raising consumption taxes, and when these were not sufficient, on heterodox or distortionary resources to strengthen the collection, which is an issue for the future of the tax income.

Regarding tax income, the reduction of marginal taxes of personal and corporate income followed a general international trend, as long as the majority of medium and small countries have adopted competitive measures aiming at stopping the charge of the effects of commercial and financial liberalization of the last two decades.

The strong participation of the society in the total collection of taxes and the high mobility of tax bases under the globalization process make it urgent to include changes

in this field in order to avoid a growing delay in the increase of collection of income taxes. To this respect, many countries still apply tax rules more appropriate to closed economies with controlled financial markets, which is the opposite of the real world.

Many practices are still frequent: the use of the source principle instead of the world income, the absence of rules to control the excessive deductions of interests, the lack of explicit rules to determine transfer prices between international firms, the absence of connection across tax administrations in the field of exchange information, and many other rules aimed at enlarging and strengthening the potential base of charge and avoiding the effects of a dangerous tax competition, through rules frequently used in developed countries and recommended by OECD.

The generous and not always effective systems of incentives to investments, and the favourable treatments of financial incomes also limit tax collection.

Other progressive taxes, such as taxes on the personal wealth, complementary to the income tax, are used in very few countries (for instance Argentina and Uruguay). They however do not have the desired impact due to serious administrative problems, especially of control.

To sum up, we still need a debate on the role of the personal income tax in Latin America, in particular we wonder about the treatment of revenues from any kind of financial assets, both private and public, the role of capital gains, and the best way to effectively control the application of the tax. Given the different goals of personal income tax, on one side, and corporate income tax, on the other side, it is convenient to separately analyze the perspectives of both taxes on equity and investments.

Additionally, as we have noticed, "the diffusion of VAT has been the tax event of the last fifty years, since from being a largely unknown tax outside France, in the 1950's it became adopted by 136 countries, where it usually represents a fourth of the tax collection"[5]. VAT is a continuously developing tax as shown in the agreements of the Andean Pact. The design of the Andean Pact can be summarized as follows: (a) credit method for invoicing with consumption base under the destination principle; (b) possible adoption in the long run of a common list of exempted goods and services, mainly the sensible services – education, health and internal transport of travellers, except flight – and the financial services and (c) the reduction, in case of existence of

[5] Dialogo Fiscal Internacional (2005), Conclusions Conference VAT.

multiple tax rates, to a maximum of two, being the general tax rate equal or lower than 19 percent, while the minimum tax rate can not be lower than 30 percent of the general tax, to ease the VAT administration. The time of adoption of this regulation varies according to the type of measure, with a maximum of 10 years.

Countries have invested a large amount of money to improve tax compliance. There exists a trend toward a reduction of tax evasion, although very few studies analyze this phenomenon. Also, a process of learning and cooperation has started, not only among the countries of the region, but also in relation with the rules followed by the industrialized countries, up to the extent that the rules established by the Sixth European Directive are frequently used in all countries of the region. This is in contrast with the evolution of the tax income.

Although these improvements, there are still questions on the effects of the tax, especially relative to its distributive impact. The best way to address this problem is still a debated issue in these countries. The process of enlarging the tax base however provides alternatives under different grounds, for instance, the treatment of merit goods or goods involving large externalities, the case of financial instruments, electronic commerce, the destination principle in relation with the process of integration at regional level.

On the technical point, there is consensus that the use of a zero tax should be reserved only to exports. However this has not been the behavior of several countries, which have instead applied the same tax to domestic activities to try to limit the effect of taxation on the lower levels of income. These mechanisms are certainly not recommendable and their use should be disincentivated. This opens the question if it is necessary to give some progressivity to this tax or if it has to be as more neutral as possible – enlarging totally the bases— while the progressivity should be left to the income and wealth tax.

As we already noticed, "the choice between a VAT with a unique tax rate or a VAT with multiple tax rates depends mainly on administrative considerations: the application of a unique tax rate is usually preferred when other instruments are available, which are considered more appropriate for distributive goals and whose absence tends to favour a greater differentiation", as it has been remarked by the final document of the VAT Commission. There exists a necessary interrelation between the VAT treatment and the

consumption selective taxes on goods and services. These taxes have been focused almost exclusively on the "vicious" –tobacco and alcoholic beverages. In other words, they have a mere collecting role, with a regressive substantial impact, since these consumptions represent a major proportion of revenue of the sectors with lower resources. On the contrary, although differential VAT tax rates are not recommendable with respect to the application of tax rates higher than the general one, a combination with a selective taxation could be a better option.

To sum up, the role of selective taxes has been decreasing during the last decades. It is thus worthwhile to wonder about a global analysis of selective taxation in the framework of consumption tax and about its role.

4. The effects of taxes in Latin America: equity and efficiency

Many industrialized countries show high ex-ante (before the public intervention of taxes and transfers) income concentration coefficients and better concentration indexes ex-post. On the contrary, in the majority of Latin America countries, as shown by the evolution of the Gini index in graph 6, the distribution of revenues ex-post is more concentrated than ex-ante, meaning that the effect of the tax system is regressive. Unfortunately this happens in one of the extremely unequal areas of the world.

GRAPH 6 HERE

Although it is frequent to mention that the most effective State action takes place through public expenditure, there is still a question on the role of taxes on distributive issues, i.e. if both instruments –taxes and expenditures- should be considered as alternative or complementary ways to reach in the long run more efficiency with more equity. To this respect, in many cases tax rules affect the distributive results, bearing differently on people under the same circumstances, affecting the essential principle of horizontal equity. The doubt should not only be on how to improve vertical equity, but, in particular, on how to avoid horizontal inequities. Although the general level of taxation in the region has increased during the last decades, the importance of personal income tax did not grow, while at the same time the degree of regional inequality has increased.

This situation points out the necessity of rethinking about the role of each tax in the general context of the tax structure of the countries and, as suggested by Bird et al. (2004), to look in details at the directions of ongoing reforms, more than at the past situations. The studies on distributive incidence show, even with methodological and informative limits, that the distributive effect of tax systems is, in a large amount of cases, regressive, since the tax structure is dominated by the indirect taxes, with a smaller weight for taxes on capital and wealth.

In this sense we wonder about the degrees of advance and efficiency of the tax administration, since, as far as they are weak and they can not reach an acceptable outcome, a substantial tax evasion is facilitated, which creates a significative wedge between the legal and effective tax rates. Due to this, the expected goals may not be reached. At the same time, corruption and the low degree of the government institutions also establish a limit to the effectiveness of redistributive measures.

It is difficult to disentangle the importance of the tax incentives by the changes occurred in each time to the degree of commercial openness, since in many countries these tax benefits were either part of the measures to stimulate direct foreign investments and strengthen the process of substitute imports, or they were aimed to build free areas of exports.

The results obtained are not clear, due to the absence of specific analysis, the difficulties of information, or possibly the lack of interest in knowing the actors of this process. The quantification effectuated, following the different alternatives to estimate the "tax expenditures" are clearly significative, although the methodological alternatives do not recommend drawing conclusions from comparisons across countries.

Nevertheless some experience may be revealed. First, we observe that developed countries used largely instruments to sustain tax income, instead of external commerce and consumption. Second, the benefits provided were more authomatic and contained in the general rules of taxes, while on the contrary in the Latin America region they were more discretional and based on independent texts of law referred to special sectors or activities. Third, countries such as EU and Canada have a significant weight in the field of tax expenditure, which indicates an active role of the State in this field, and the benefits allowed are made transparent through their inclusion in the federal budget. In this sense, the available information does not clarify the role of taxes in the process of

moving savings and investments, since, although currently one can have information on fiscal costs, the results obtained are not clear. This opens a series of questions not only relative to the objectives of promoting investments, but also to the better instruments and the capacity of the state in their administrative and managing process.

5. The political economy of the tax reforms in Latin America

It is clear that, for different reasons, the majority of reforms required to raise the level of taxation, to eliminate the problems which make taxes not economically neutral and the effects of inequity on the distribution of tax charge have not been solved yet.

We may identify some reasons for that: on one side, several elements intrinsic to the political reality of the countries which condition their economic decisions; on the other side, the weakness of the institutional development of tax administrations required to apply measures which need a high degree of efficiency and managing capacity. The two elements are not independent and it is not by chance that the countries where the "élites" are stronger the tax administrations are weaker.

First, it is widely accepted that Latin America is the area with the highest degree of inequality of revenues, a fact that has been accentuated during the past recent years, although the region is showing a growing GDP per capita and a decreasing index of poverty[6]. In this sense some authors have developed the thesis that the extension of inequality of revenues in the region has affected the design and implementation of the tax system. This generates a vicious circle of inequality of revenues and tax regressivity, instead of a virtuous circle which may correct the large disequilibrium of revenue through the tax system.

From the political perspective, social inequality may result in the generation of "élite groups", which try to minimize their relative fiscal burden, by controlling the legislative process or inducing tax laws with these effects, in order to translate a major percentage of the fiscal burden to sectors with fewer resources. It is also feasible to expect a raise in pressures for the same "élites groups" to control the process of implementation and fiscal rules, and also to design administrative rules which would have a more beneficial effect for them, such as laundering, moratorium and other

[6] Sokoloff and Zolt (2005).

similar measures. Under these circumstances, the design of a progressive fiscal structure is more difficult.

Similarly, in economies with a large poor class it is feasible to find high levels of informality both in labor and in goods markets and under these circumstances the design of tax systems with a certain degree of equality is not simple, since the informal economy makes it difficult to have an efficient administration of tax instruments.

To sum up, the absence of a substantial middle class is a critical limit for the development of a personal income tax which would account for at least 20 percent of the main revenues, and would make it in a large and general way with respect to any type of rent.

It has also been observed that while developed countries have enlarged and extended the tax bases having as a consequence an increase of the tax collection, the joint or simultaneous movement of reduction of taxes and enlargement of bases had not an equivalent correspondent in Latin America taxation. The expansion of tax bases, eliminating exemptions, special deductions and preferred treatments in fact did not happen in the majority of these countries[7].

In this sense we should notice, once again, the preferential treatment received in the past and also currently by the rents generated by the financial sector in the majority of countries, due to legal rules which have protected them, and due to inefficient control mechanisms, which render a large part of these financial rents in practice not taxed.

The debate on the openness and mobility of the financial market in all countries of the region, and the fact that a good percentage of the personal saving portfolios and of the firm benefits are collocated outside – both in developed countries which are not available to apply retention mechanisms of taxes at the source and in fiscal heavens – has as effect that, in the majority of cases, the financial rents escape all types of taxation, both at the source and at the taxpayer residence.

The insufficient development of tax administration did not have the success which was desirable to reach the sectors "hard to tax", such as informal sectors, agricultural sector, professional sectors and small firms. These economies have also experienced a substantial growth of services, which delivers new and more difficulties for an efficient control of the tax administration.

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[7] To this respect see the analysis by Keen and Simon (2004).

As a consequence, the design of tax policy in developing countries should especially consider the administrative issue, without implying that the political economy objectives would be subject to a certain level of administration, while using other mechanisms to improve this level. In this sense, the objective would be to reach and adequate balance between a better distributive equity, the reduction of economic distortions and the consideration of the tax administration, in each particular circumstance. It seems that in the last decades in Latin America the "adequate balance" has not been like that, while the directives in the tax field have been largely influenced by efficiency goals with a lower weight for distributive issues.

As noticed by Sokoloff and Zoltls (2005) the evidence suggest that the large history of inequality in the region is a central element to understand the distinctive features of tax systems in Latin America, and at the same time that the élite groups have bearded a light tax burden during the years.

All together these factors indicate the enormous problems which oppose changes of the tax system. An appropriate "political environment" seems necessary to complete the required changes and adopt the required measures.

On one side in the last years there was a significative improvement in the knowledge and transparency of the information to the beneficiaries of the differential incentives allowed by the system. This information was not available in the past. The efforts employed in realizing a better transparency pushed by the international environment set the issue in various countries of the region at a legislative level. The publication of the complete and ordered texts of the law, the diffusion of the "tax expenditures" which quantify the amount of benefits allowed, the public knowledge of the name of the main fiscal debtors, the elimination of the financial and stock-market secrets in almost all countries, the diffusion of the failures of the fiscal and stock-market courts, all these are factors which contribute to the change. On the other side, it is evident that the current technological level allows the tax administration, if correctly applied, to convert into a tool of enormous value which was not available before. Currently, through the computers it is possible to manage big external database on the behavior of the taxpayers which, allow the same tax administration to make the declaration in behalf of them, as it is happening in some countries of the region, such as for example Chile.

Equally, the systems of source retention may be currently generalized without big difficulties for the tax administration, which receives the information from those who have retained the tax at the source without more complexity, while this mechanism – very used in developed countries- had an enormous problem of information. This allows to capture data in real time and to know in a general way the transactions between different economic sectors.

Similarly, the countries have found it convenient to agree on exchange information, which shows a cooperation effort among them, since, through it, it is possible to increase their own efforts and the possibility of applying these taxes.

To sum up, the experience shows that three elements are essential to improve the efficiency of tax administration in each country:

1. the political will of effectively implement the tax rules voted by the policymakers;
2. an administrative strategy clearly defined and continuous during the time in order to reach all the proposed objectives;
3. a flexible endowment of resources, personal and financial, which are necessary to reach these objectives.

The observed experience in the countries turns out to be ambiguous in this field, since while the objectives are changing, the strategies followed by the tax administrations are also constantly changing in each of the directions in which they develop, and there is a systematic insufficiency of resources to comply with the proposed goals. However it should also be mentioned the existence of "political interferences" in the fiscal management which often condition their activity.

6. Some features which may help the implementation of tax reforms in Latin America

Mahon (1997) analyzes some circumstances related to the reforms in the Latin America tax structure and consider four possible events which make them possible:

a) as a result of situations of economic crisis;
b) as the action of governments recently elected;
c) as a consequence of the existence of authoritarian regimes;
d) as a result of international pressures, either due to the external context or to existent conditions.

Additionally, as a fifth determinant operating on the tax structure of the last decades, we may mention the weakness of tax administration, an issue that we have discussed in the previous section. To strengthen this is a central element for the application of the tax reforms.

a) The more substantial changes in the structure of countries are usually possible during the period of crisis, since in these circumstances it is feasible to overcome the political opposition and the administrative inertia which usually stop the relevant changes. In this sense, there are many examples of crisis in Latin America which have facilitated the application of deep reforms, both in the tax field and in other public policies. An example are the economic emergency laws in Argentina in 2002, which make it possible to approve tax measures which were rejected by law not many years before. This is especially important when tax changes have to be implemented with serious redistributive implications, which would be strongly rejected if proposed in situation out of crisis. Again, various reforms contained in the laws approved in Argentina in December 1999, especially for personal income taxation, have found support in this situation.

b) Similarly, electoral cycles can also be considered as a vehicle which facilitate the adoption of significative changes. In many countries tax reforms take place in the first months of a new government, when it enjoys the support of the citizens which voted it. Many reforms took place in the first year of government, and then the debate around them takes place in a larger time.

c) Last, we should mention the external pressure exerted as consequence of economic programmes subject to conditions of political economy, as well as the pressure exerted by the external trends in the field. In the tax field, as in few other economic ones, the effect of "doing as the neighbour" finds a large space and so the tax systems of the region have been subject to different trends, one of the major is the application of a generalized VAT in all countries.

d) As we already noticed, the weakness of tax administration has also affected the directions of many tax changes in some countries in the last years. These changes had the purpose of translating part of the responsibilities of an efficient tax administration on the taxpayers themselves, using systems considered as "imperfect substitutes" to the design of an appropriate tax system. We refer to taxes such as the tax on "active

entrepreneurs” or “tax on financial activities”, as well as other proposals that put the financial sector at the centre of the tax collection.

e) Given the legal and administrative difficulties to raise tax collection on corporate rents, it is a general fact in the region to adopt different methods of determination, complementary or substitute, to improve the obtained results. They have been based on the application of a tax which determined the “presumed base” in order to determine a minimum amount of tax, much beyond the effective result which would be obtained as a consequence of the tax on the “net rent” of firms. Some countries use for this purpose as a presumed tax base the active value, or, in other cases and more recently, the amount of the gross sales, or revenues, before deducing costs and expenditures. The so determined taxation is considered a minimum amount to pay. When the determination of the tax amount taking into account the net rent leads to higher amounts, the taxpayer should pay the exceeding amount. In the opposite case the tax on actives or on gross sales remains as a ceiling under which it is impossible to go. In facts, the application of these taxes is the result of the limits of the countries, from both a legal and an administrative point of view, to apply a tax structure in which the nominal or legal taxes used would correspond to the effective taxes. These systems however would *de facto* lead to the elimination of corporate income tax, and would convert the taxation in non tax revenues with cumulative effect, worsening the problems of economic efficiency.

f) The use of taxes on bank debts and credits basically replied to the urgencies of obtaining fast collections, translating the responsibility of its revenue to the financial institutions, taking into account the weakness of tax administration, which assumes a smaller role in its capture. Although they were introduced with the specific purpose of improving resources in the short run under emergency, more than as an instrument to remain in the tax structure, the successful reply in some countries is making difficult to replace them without affecting the level of revenue. Tthe evidence show that they have proved effectiveness in obtaining revenue in the short run while, at the same time, as indicated by Coelho, Ebrill and Summers (2001), the reaction of the market to the tax impact shows that there exist adverse effects, including in particular a significant degree of financial disintermediation. Baca-Campodonico, de Mello and Kirilenko (2006) however confirm this trend and indicate that this source of revenue may not be too sure in the long run.

To sum up, the current tax systems have been the result of a series of compromising decisions adopted under different circumstances, going from the possibility of a crisis, to the limits of the institutional capacity of collecting taxes. These limits, in one or another scenario, were not equal in all countries and the results observed for the tax structure of each country are the consequence of specific facts which have to be evaluated analyzing each specific case.

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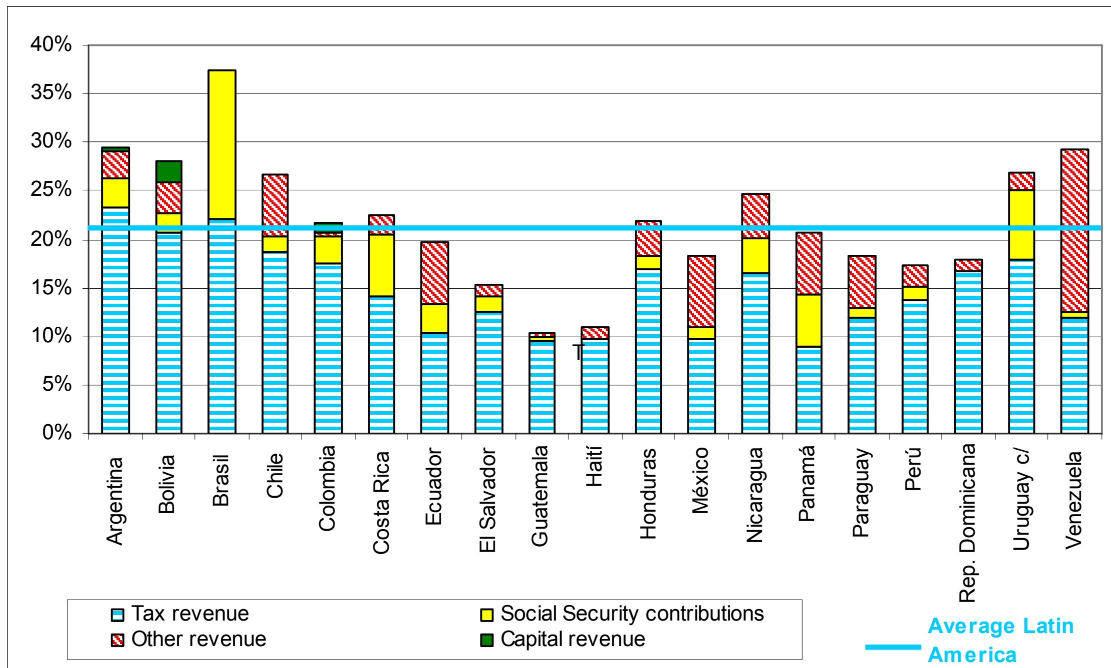
Graph 1

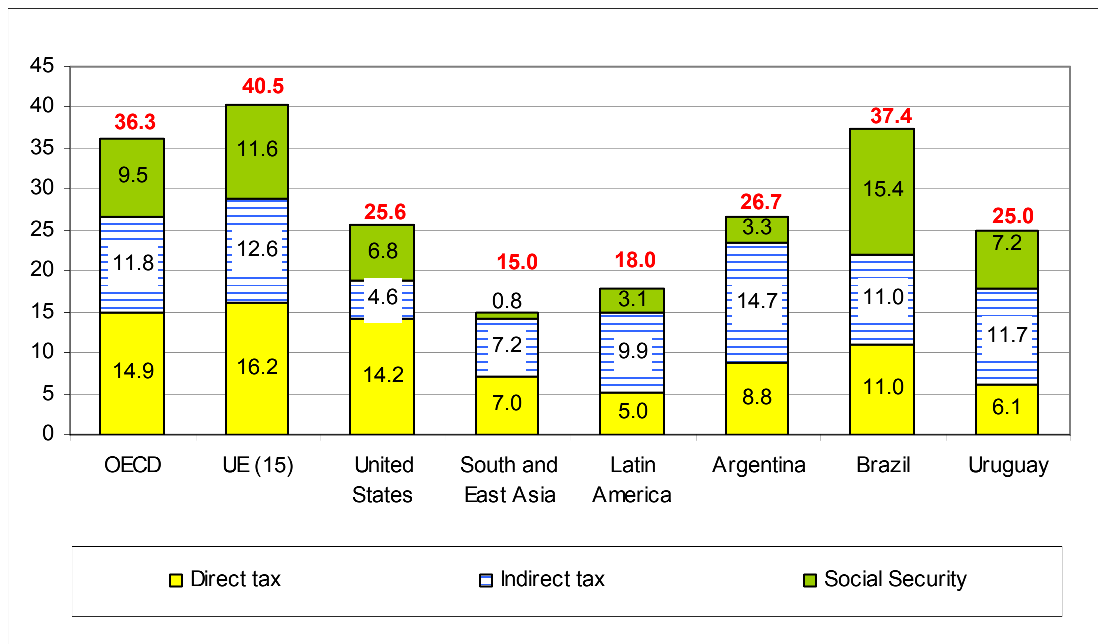
FISCAL BURDEN IN LATIN AMERICA AND THE CARIBBEAN (AS PERCENTAGE OF GDP, 2005)



Source: official numbers of ILPES, CEPAL.

Graph 2

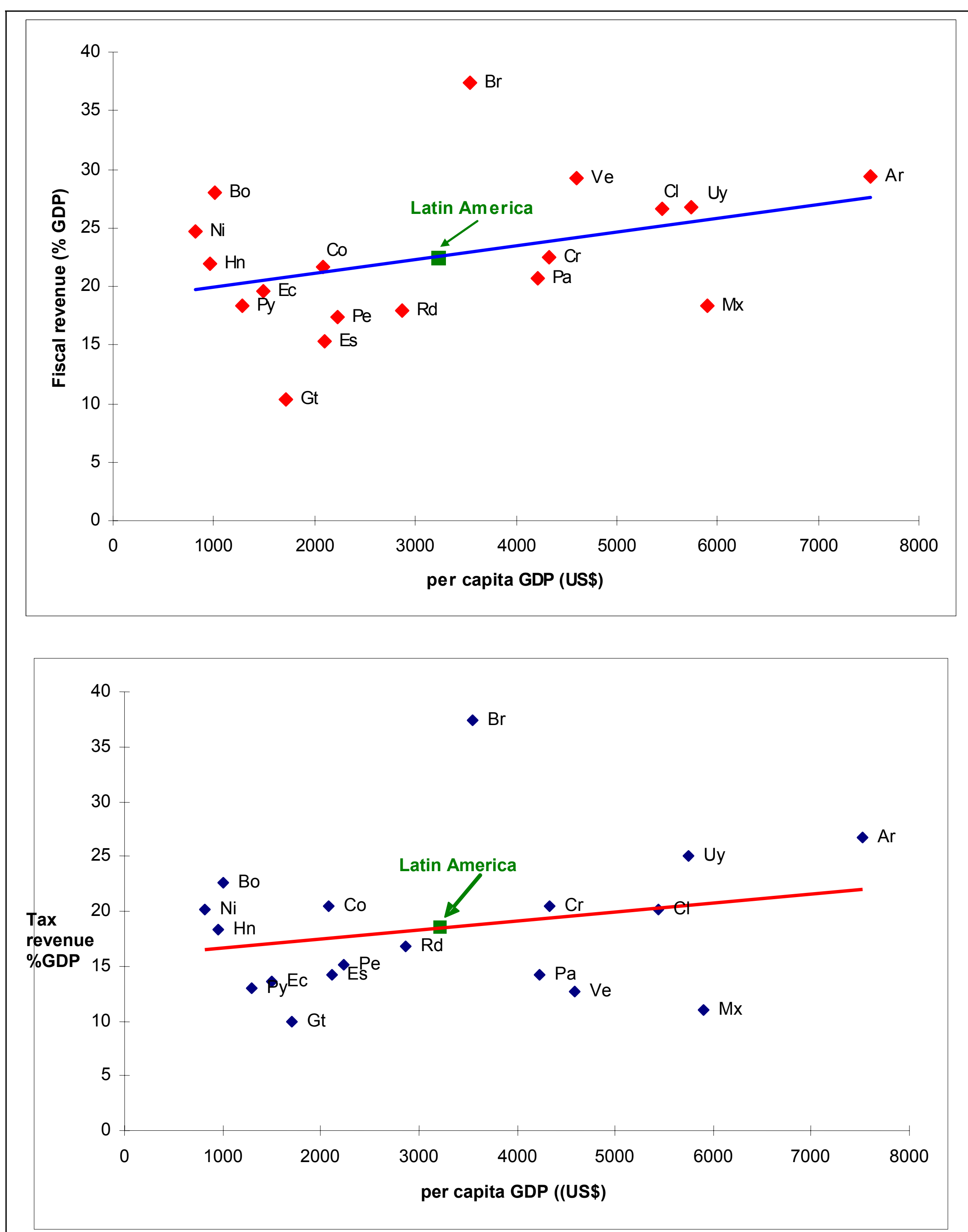
International comparisons of the fiscal burden (2005)



Source: authors' calculations on official data of each country.

Graph 3

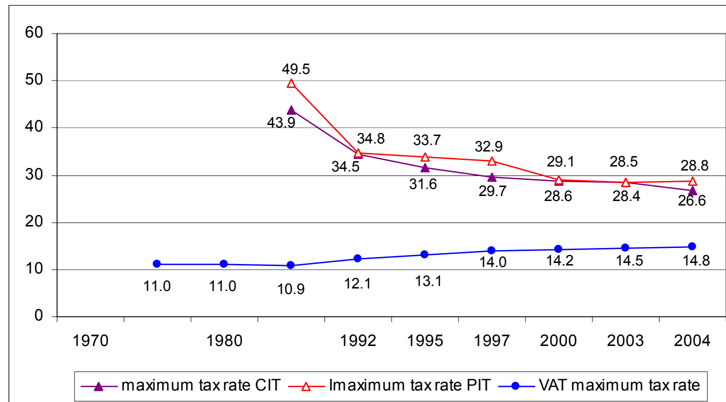
Fiscal and Tax revenue and per capita GDP, 2005



Source: CEPAL.

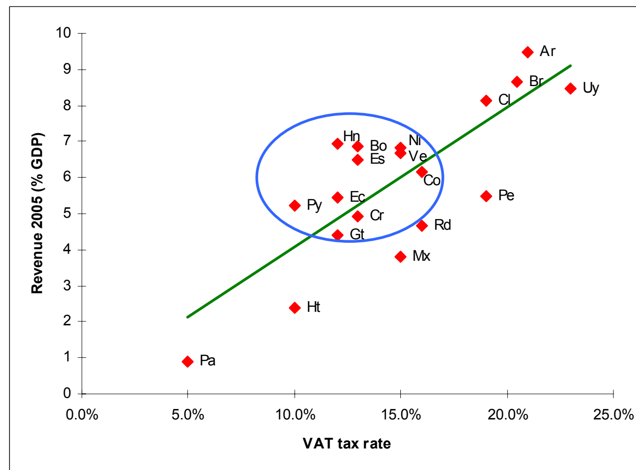
Graph 4

Evolution of average CIT, PIT and VAT in Latin America



Graph 5

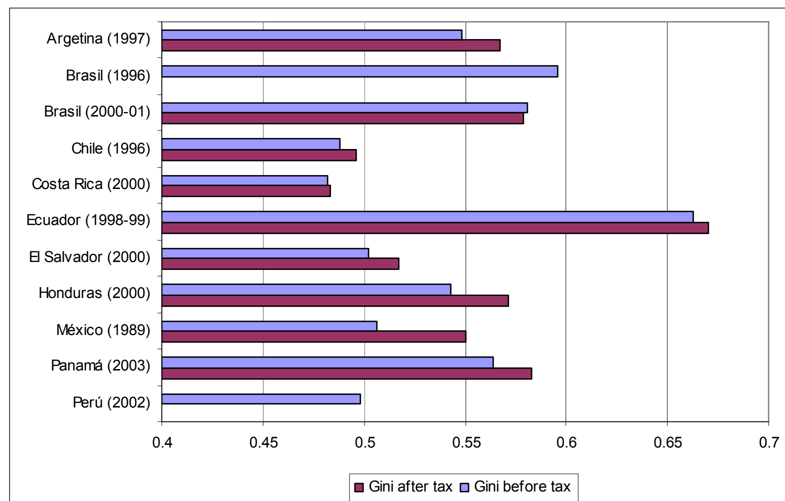
VAT productivity (2005)



Source: CEPAL

Graph 6

Latin America: distributive effects of the tax policy (Gini coefficients ex - ante and ex - post)



Source: Gómez Sabaini (2005b)

Table 1

Central Government: Tax revenue (with social security contributions, % of GDP)

	1990	2000	2005p	Average 90-05
GROUP 1	**20.7**	**23.2**	**26.0**	**22.8**
Brazil	30.5	32.5	37.4	31.0
Uruguay	22.4	23.6	25.2	23.6
Argentina	16.1	21.5	26.7	21.3
Chile	17.4	19.3	20.2	19.4
Costa Rica	16.9	18.9	20.5	18.7
GROUP 2	**11.3**	**15.0**	**17.0**	**14.6**
Honduras	15.3	17.0	18.3	16.6
Colombia	10.5	16.8	20.4	16.1
Panamá	14.7	16.0	14.2	15.7
Nicaragua	9.0	17.5	20.1	15.6
R. Dominicana	10.5	15.0	16.8	14.5
Perú	11.6	14.0	15.2	14.5
Bolivia	8.2	14.0	22.6	13.2
México	12.6	12.1	11.0	12.4
El Salvador	8.9	13.0	14.2	12.4
GROUP 3	**7.7**	**10.1**	**11.7**	**9.6**
Paraguay	9.9	12.0	13.0	11.7
Ecuador	10.1	11.6	13.4	11.0
Venezuela	4.4	9.4	12.6	9.1
Guatemala	6.9	9.7	9.9	9.0
Haití	7.3	7.9	9.7	7.2
Simple average	**12.8**	**15.9**	**18.0**	**15.4**

1: It corresponds to the Central Government. In other countries the information may be different from other sources on the social security contributions, such as for Uruguay.
2: Data correspond to 2004.

Table 2

Structure of tax revenue in Latin America (% of GDP)

	1990	1995	2000	2005 (p)
Total tax revenue	10,5	12,2	13,0	15,0
Direct tax revenue	2,9	3,5	3,9	5,0
Rent and capital gain	2,1	2,8	3,1	3,9
Property	0,6	0,6	0,7	0,9
Other direct	0,1	0,1	0,1	0,2
Indirect tax revenue	7,6	8,7	9,0	10,0
General on goods and services	2,9	4,4	5,1	6,0
Specific on goods and service	1,9	1,9	2,0	1,8
Commerce and international transactions	2,0	2,0	1,6	1,5
Other indirect	0,7	0,4	0,4	0,7
Social Security	2,4	2,9	2,9	3,0
Total	12,9	15,1	15,9	18,0

Source: CEPAL, United Nations.

Table 3

Latin America and the Caribbean: tax rates of VAT

	1994	2000	2005
Argentina	18	21	21
Bolivia	14,92	14,92	13
Brazil	20,48	20,48	20,48
Chile	18	18	19
Colombia	14	15	16
Costa Rica	8	13	13
Ecuador	10	12	12
El Salvador	10	13	13
Guatemala	7	10	12
Haití	10	10	10
Honduras	7	12	12
México	10	15	15
Nicaragua	10	15	15
Panamá	5	5	5
Paraguay	10	10	10
Peru	18	18	19
R. Dominicana	6	8	16
Uruguay	22	23	23
Venezuela	10	15.5	15
Average Latin America	11,7	14,2	14,8
Standard deviation Latin America	5,1	4,6	4,4

Source: CEPAL, on the official numbers of each country

Table 4

Tax expenditures in selected Latin America and OECD countries

Country	Year	Total fiscal pressure	Tax expenditure Total	Direct Taxes	Indirect taxes	Total tax expenditure / total fiscal pressure
		(% GDP)	(% GDP)	(% of total)	(%of total)	(%)
AMÉRICA LATINA						
Argentina	2004	22.6	2.4	27.4	72.6	10.5
Brazil	2004	16.5	1.4	68.6	31.4	8.5
Chile	2002	18.1	4.2	74.0	26.0	23.2
Colombia	1998	14.4	7.4	35.0	65.0	51.4
Ecuador	2000	11.6	4.9	47.0	53.0	42.1
Guatemala	2000	9.7	7.3	28.0	72.0	75.2
México	2003	12.6	6.3			50.0
Peru	2003	14.7	2.5	34.0	66.0	17.0
Uruguay	2000	23.6	5.3	11.0	89.0	22.3
OECD						
Australia	1999-2002	24.2	4.3			17.8
Canada	1999-2002	17.6	7.9			44.9
US	2001-2004	18.5	7.5			40.5
Netherlands	2002	39.2	2.4			6.1

Source: Gómez Sabaini (2005b)

2. AN OUTLINE OF TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA

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 give a brief look at tax systems and tax reforms in some Latin American countries over the last two decades. The paper presents evidences of the structure and evolution of tax systems, focusing on tax ratios and on the allocation of revenues across levels of government; then it illustrates common features of current tax systems. In the 1980s and until the mid-1990s Latin American countries began to implement a set of tax reforms, that were significantly influenced by international financial institutions. The first goal of these reforms was to enhance revenue collection and provide more stability in the revenue systems. Although not fully implemented, these reforms have generally increased the efficiency of tax systems and their revenue raising capacity. However, they have come at a price: other issues have been driven and kept off the tax policy agenda, including mainly considerations of tax equity and redistribution. With few exceptions Latin American countries do not rely widely on direct taxes and social security contributions. At present, after two decades of tax reforms, there is still the issue of raising more tax revenue, but the main challenges for next years seem to be: broadening tax bases, especially in the field of direct taxes, reducing reliance on the more distorting taxes, such as those on financial transactions, foreign trade, enterprise turnover and payroll, and improving tax administration.

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1. Introduction and main conclusions*

In the mid-1970s and until the mid-1990s Latin American countries began to implement a set of tax reforms, involving the simplification of tax structures and the removal of exemptions and special privileges, the replacement of trade taxes by value-added taxes and an emphasis on improved tax administration (Shome 1992; 1995; 1999; Tanzi 2000; Lledo *et al.* 2004). Reforms were significantly influenced by foreign experts and by international financial institutions that promoted a fairly homogeneous set of tax changes, often in the context of macroeconomic stabilization programs. The first goal of these reforms has been to enhance revenue collection and provide more stability in the revenue systems (OECD 2006a).

A number of exogenous determinants influenced tax reforms (Tanzi 2000). A first set of determinants concerned the precarious macroeconomic situations of many countries and the inflationary context that compelled many countries to look for short-term tax measures and to rely more heavily on indirect taxes over direct taxes. A second set of determinants came from trade and capital liberalization; the consequence, similar to what has been experimented elsewhere in the world (Bernardi 2004; Bernardi *et al.* 2006), has been twice: a reduction in revenues from foreign trade taxes and its compensation with other revenue sources (brad-based consumptions taxes and partly also direct taxes); secondly, a rapid reduction in personal income tax rates and in corporate income tax rates. In this context during the 1980s and 1990s all the Latin American countries (following Brazil where valued added taxation dates 1967) introduced the VAT which represents the most important innovation in Latin America's taxation during last decades.

Although not fully implemented, these reforms have generally increased the efficiency of tax systems and their revenue raising capacity (Shome 1995 and 1999). However, they have come at a price: other issues have been driven and kept off the tax policy agenda. One of the main excluded issues deals with considerations of tax equity and redistribution and the financing of social security programs. With few exceptions Latin American countries continue to be allergic in taxing incomes and collecting social security contributions. Thus revenues from income taxes continue to be low compared with international levels. Many reasons contribute to explain this result (Tanzi 2000): very large personal exemptions and deductions; reluctance to tax financial incomes; falling in tax rates; low efficiency in tax

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administration. At present, after two decades of tax reforms, there is still the issue of raising more tax revenue (OECD 2006a), but the main challenges for next years seem to be: broadening tax bases, especially in the field of direct taxes, reducing reliance on the more distorting taxes, such as those on financial transactions, foreign trade and enterprise turnover and payroll, and improving tax administration (OECD 2006a).

The paper is organized as follows. Paragraph 2 discusses main issues in tax reforms enacted in the last decade and main perspectives for next years. Paragraph 3 presents some indicators of the macro structure and evolution of the tax systems over the last decade, focusing on tax ratios by legal categories. Paragraph 4 gives an overview of the main institutional features of the present tax systems in Latin American countries, focusing on personal income taxes, corporate income tax and consumption taxes.

2. Tax reforms during the last decade: main issues and perspectives

Over the past two decades, tax reforms in Latin American countries have been significantly influenced by foreign experts and by international financial institutions that have promoted a fairly homogenous set of tax reforms, often as a pre-requisite for the disbursement of loans and in concert with structural adjustment programs (Shome 1992; Tanzi 2000). The reforms have been intended in particular to increase the tax-to-GDP ratio, to make tax systems more neutral and compatible with market economy, international trade integration and financial liberalization (Lledo *et al.*, 2004; Perry and Herrera 1994; IDB 1996; CEPAL 1998; Shome 1999).To provide more stability in the revenue systems (Jenkins 1995) a greater reliance has been placed on value added type taxes and on a reduction in the top statutory income tax rates for individual and corporation income taxes. A necessary, even if not sufficient, condition, to achieve macro-economic stability had been to build a tax system that could be administered and yield an adequate level of revenue to the public sector. This has been the focus of the main tax reforms in most of the countries in the Latin America region during the last two decades (OECD 2006a). Thanks to these reforms since the early 1990's many countries in the region had made substantial progress in consolidating their public finances adversely affected by the financial crises at the end of 1990's. Fiscal adjustment has taken place against a background of volatile growth, continued disinflation and strengthening external positions, facilitated by improvements in the terms of trade in some cases. At the same time, given that

in the last two decades many Latin American countries were facing a precarious fiscal situation, policy makers were often deterred from pursuing deep tax reforms in the face of uncertainty about revenues in the short and medium run (IDB 2006; OECD 2006a).

Based on these goals, tax reform proposals in the region have tended to include the following elements (Jenkins 1995): (i) Implementation of broad-based and uniform VAT systems to replace taxes on foreign trade and cascading turnover taxes; (ii) Reduction of the highest statutory tax rates and simplification of the personal income tax system; (iii) elimination of preferential treatment for particular sources of corporate income and particular economic sectors; (iv) Modernization and strengthening of the institutions involved in tax administration. The reforms in tax administration that were promoted and supported by international organizations have been implemented more consistently than other reforms (Lledo *et al*. 2004). A proliferation of programs included staff training, introducing modern information technology, and revising procedures and internal organization. Collection of taxes through banks was adopted everywhere, as well as internal organization by functions instead of the traditional tax base by tax base approach (IDB 1997).

In other areas successful reforms were implemented: the reform of foreign trade taxation and the reduction in high marginal income tax rates. During 1980s tax reforms also reflected development policy strategies; the policy of import substituting industrialization, that was common until the early 1980s, implied high tariffs and tax incentives for selected growth-promoting sectors. The latter narrowed the corporate tax base and led to the creation of multiple corporate income tax rates (Perry and Herrera 1994). From the mid 1970's taxes on foreign trade have been replaced by domestic broad base consumption taxes. In this context all the Latin American countries (following Brazil where valued added taxation dates 1967) introduced the VAT which represents the most important innovation in Latin America's taxation during last decades. In the same years the rate of decline in highest marginal PIT rates and corporate income tax rates has been more rapid than in the OECD countries (Shome 1999). Some areas of tax reform in the Latin American region represent interesting examples and experimentations in tax policy and tax institutions (Tanzi 2000). For instance during 1990s several countries in the region introduced business taxes on gross assets that performed well in the inflationary environment (Tanzi 2000). Such a tax was first adopted in Mexico in 1988 and subsequently introduced in Argentina, Colombia, Costa Rica, Paraguay and Uruguay (Shome 1999). The business asset tax has been used as a minimum income tax or sometimes as a complement to it. At present Mexico continues to operate the gross assets tax as a minimum income tax. A second example of experimentation is in the field of small

business taxation. Almost all Latin American countries have introduced simplified taxation schemes for small firms. The aim has been twice: reducing the administrative burdens and increasing tax compliance. A third example of tax experimentation is the tax on banking transactions, mainly on debits, that was originally introduced in Argentina in 1983; it was reintroduced there in 1988 and 2001, and implemented in many other countries (for instance in Brazil in 1994 and 1997, in Colombia in 1998). As was the case with other tax policy innovations, governments' urgent revenue needs have been the major reason for the adoption of BDTs in Latin America. The tax has also proved to be very popular and easy to administer given the consolidated and satisfactory role of banks as collection agents (Tanzi 2000). Bank debits are still taxed in Brazil, as well as in several other countries in the region, discouraging financial intermediation in most cases.

At present, after two decades of tax reforms, there is still the issue of raising more tax revenue (OECD 2006a). Brazil's tax-to-GDP ratio is already closer to the OECD average than that of the other Latin American countries. But in some countries, such Mexico and Paraguay, government revenue is much lower. This reflects the inability of the governments to bring the more dynamic sectors of the economy into the tax net. Other than increasing tax revenues, the main challenges for next years seem to be: broadening tax bases, reducing reliance on the more distorting taxes, such as those on financial transactions, foreign trade, enterprise turnover and payroll, and improving tax administration in many countries (OECD 2006a). The reform of foreign trade taxes and their gradual elimination has still to be completed along the progress in regional and international integration (Martner and Tromben 2004); the lost revenues of external commerce have to be recollected with resources mainly from consumption taxes and income taxes. By far Latin American countries need to improve the system of personal income taxation and social contributions. The present pay-as-you-go social security systems in Latin America are basically bankrupt. The high payroll taxes used to finance these schemes create a major distortion in the labor market and are subject to a high degree of evasion. With a few notable exceptions, the income tax has performed badly in Latin America during the last two decades. Income taxes, both personal and corporate, suffer of large erosion of tax bases, mainly as a consequence of generous incentives for investments, favorable treatments of capital income (Shome 1999) and large tax exemptions. The main challenge is thus to broaden tax bases (Tanzi 2000; OECD 2006a), especially in the field of personal income taxation, but also in field of business taxation. Tax evasion in the field of direct taxes shows a decreasing trend in more recent years, even if additional measures seem essential for the effective collection of the income tax.

An additional area that is likely to see increased tax policy activity is the use of taxes to control pollution. Moreover the property tax that has been implemented by some local governments, it is a source of revenues that Latin American countries should consider carefully as a way to finance the maintenance costs of their urban infrastructure. Finally, in the field of banking transactions, there is consensus that despite their revenue raising capacity bank debts taxes have to be reformed because of their inefficiencies: the cumulative and cascading nature of their base; and their potential to cause disarticulation in the banking system, reduce market liquidity, and generate economic distortions (Tanzi 2000).

3. Tax systems: structure and developments

Historically Latin American tax systems have been characterised by (a) a low tax-to-GDP ratio; (b) a tax structure weighted towards indirect taxes with narrow tax bases, multiple rates and many exemptions; (c) under-taxation of income, wealth and property; (d) a limited tax administration capacity; (e) a mild redistributive impact; and (f) a highly centralised tax assignment with tax revenues transferred to sub-national governments in the form of ad-hoc negotiated block grants (Lledo *et al*. 2004; Bird and Oldman 1990; Shome 1992, 1995, 1999; CEPAL 1998). Based on data made available by ILPES-CEPAL (2006), Table 1 provides information on tax revenues as shares of GDP for eight Latin American countries in the last decade (1995-2005). The table gives also some information about the way these countries provide arrangements between the central and the sub-central levels of government. Broadly speaking there are large differences in tax rations between Latin American countries and the OECD or EU countries. In Latin American countries there is considerable diversity in the size and the scope of governments which are typically much smaller than in the OECD or EU area (OECD 2006a). The total fiscal pressure in Latin American countries is less than half than in the OECD countries and even lower than in the EU countries (OECD 2006a and 2006b; Bernardi 2004; Gandullia 2004). Also the composition of tax revenues shows very different approaches, where OECD countries collect a larger share from direct taxes and from social security contributions. In terms of total taxation, but not of revenue composition, Latin American countries show patterns similar to those of the countries in the South and East Asian area (Bernardi, Fumagalli and Gandullia 2006).

A number of factors help explain the level and structure of Latin American tax systems: for instance, colonial heritage, political institutions and regimes, economic structure and income inequality (Lledo et al. 2004). In particular, historically the region shares a number of characteristics of transition or developing countries: a larger share of agriculture in total output and employment, a large informal sector, and limited technical capacity of the tax administration reduce the feasibility of direct taxes as reliable sources of revenue, and limit the total tax revenues (Tanzi 1993). In Latin America in particular, high income inequality concentrates both political and economic power, and undermines tax capacity and the political feasibility of direct taxation (Lledo *et al*. 2004; IDB 1998). Almost during the 1990s the limited capacity of Latin American tax agencies was reflected in a large tax gap – the difference between what revenue authorities would collect if everyone paid the tax legally due and what is actually collected. The gap can be attributed to avoidance, evasion, and tax expenditures (CEPAL 1998). During the 1990s the share of tax revenues to GDP increased significantly in Latin American countries (Tanzi 2000) as a consequence of economic growth and of the design of more efficient tax systems (Martner and Tromben 2004). Also in more recent years (2000-2005) the tax-to-GDP ration of the region continued to increase on average, by about 1.5 per cent of GDP, reaching the average level of 21.4 per cent.

In the last decade the increase in the tax ratio of the eight selected countries reached 2.3 per cent of GDP. The expansion was particularly high in the last few years, when the strengthening of revenues seems to have contributed to significant improvements in the whole fiscal position of the Latin American region (Clements *et al.* 2007). This results from different patterns of individual countries. On the one side in some countries (Argentina, Brazil, Costa Rica and Colombia) the tax burden has increased significantly (6.2 percentage points in Brazil and 6.5 percentage points in Argentina). On the other side in other countries (Chile, Mexico and Paraguay) it has remained quite stable. Uruguay is the only country that in the last decade has registered a decrease (from 25.3 to 23.5 per cent) in the tax –to-GDP ratio. These patterns can be explained by different factors. In Argentina and Colombia the increase in the tax burden has been caused by the expansion of tax revenues (both direct and indirect taxes), partly offset by the reduction in revenues from social security contributions. On the contrary in Brazil the increase in tax burden is mainly explained by the expansion of social security contributions and to a less extent by direct taxes. In general the increase in the tax burden of the region is mainly explained by the expansion of direct taxes and to less extent of indirect taxes and value added taxes, while social security contributions has remained stable on average.

Both at the beginning and at the end of the period Latin American countries show the considerable range in these tax ratios with Brazil collecting around 36 per cent of GDP while Chile and Colombia collecting only around 20 per cent.[1] Taking into consideration only taxes collected by the central government, the highest fiscal pressure is found in Brazil and Uruguay (around 23-26 per cent) and the lowest in Mexico, Paraguay and Costa Rica (around 11-13.6 per cent). Argentina, Chile and Colombia occupy an intermediate position (around 17-19 per cent). At the end of the observed period (2005) the difference between the high fiscal pressure countries (Brazil and Uruguay) and the low fiscal pressure countries (Mexico, Costa Rica and Paraguay) is larger than in the middle of the 1990s. Among the Latin American countries the share of individual taxes in GDP shows large differences. The lower tax burden that can be found in the Latin American countries compared with the international standards is due to the lower incidence of both tax revenues and social security contributions. With the exception of Brazil, which collects from social security contributions a level of revenues as a percentage of GDP comparable with the EU average, in general social security contributions generate less than 6 per cent of GDP and in several countries much less than that (1.2-1.4 per cent in Chile, Mexico and Paraguay).

TABLE 1 HERE

Also the composition of fiscal revenues differs across Latin American countries and in comparison with the OECD area. The tax structure by legal categories, measured as the distribution of tax revenue among major taxes (direct taxes, indirect taxes and social security contributions) has changed over time (see Table 2). In Latin American countries the tax mix shows a general preference for indirect taxes over direct taxes and social security contributions. With the exception of Brazil, that gives the same weight to direct and indirect taxes, about half or more of total fiscal revenues comes from indirect taxes in most part of Latin American countries (Argentina, Chile, Costa Rica, Paraguay and Uruguay). Social security contributions account on average for around 18.9 per cent of total revenues, with Brazil and Costa Rica much over the average (41.2 and 31.1 per cent respectively). During the last decade the tax mix has changed between taxes and social security contributions. In all these countries with the exception of Brazil and Uruguay the importance of social contributions has decreased in favor of taxes. In the same period the role of direct taxes has

[1] Mexico and Paraguay show even lower levels (11 and 13 per cent respectively), but available figures refer only to taxes collected by the central government.

increased, while the incidence of indirect taxes has decreased mainly as a consequence of the reduction in the revenues from import and export duties.

In 1995 the broad fiscal structure of Latin American countries was composed by social security contributions (22.5 percent), indirect taxes (52.8 percent) and direct taxes (24.7 per cent). At the end of the period (2005) the tax mix changed as effect of the reduction in indirect taxes (1.4 percent) and social security contributions (3.6 percent), compensated by the increase in the share of direct taxes (5 percent). The decrease in indirect taxes is due to the large reduction in import and export duties (2.8 percent), partly offset by the increase in revenues from the VAT (1.4 percent).Among individual countries the tax structure is considerably different. At one side Brazil has a tax structure based for about 41 per cent on social contributions and for the remaining 59 per cent on both direct and indirect taxes. In Chile and Paraguay the share of tax revenues is much higher (91-93 per cent), while the share of social contributions is significantly low (7-9 per cent of total revenues). The variation in the share of individual taxes between Latin American countries has continued to be considerable. For instance, in 2005 the share of direct taxes ranged from a low 15.8 percent in Paraguay and 20.3 percent in Uruguay to 41 percent in Colombia and 43.5 per cent in Mexico. The share of personal income tax ranged from 12.6 in Uruguay to 41.9 in Mexico. Among indirect taxes the share of the VAT ranged from 23.3 percent in Brazil to 40 percent in Chile and Paraguay.

In the region revenues from the VAT have grown significantly over the past decade. Argentina, Brazil and Chile collect a large share of their total tax revenues from VAT. In these countries value-added taxes generate revenues levels comparable to those of the European countries. On the other hand, Mexico collects relatively little from the VAT (3.8 per cent on GDP), mainly because of a significant erosion of the tax base.

TABLE 2 HERE

Selected Latin American countries also differ in the way they provide arrangements between the central and the sub-central levels of government. Historically, Latin American governments have been highly centralized, but in the last two decades, several countries have devolved and begun to share important responsibilities with sub-national governments. For most of the region, however, the assignment of tax bases still reflects the former centralized governance pattern. Tax policy, administration and revenue collection are, for the most part, concentrated at the central government. As a result, Latin American sub-national governments

widely depend on intergovernmental transfers for their financing, and have little capacity to mobilize their own resources (Lledo *et al.* 2004). Table 2 shows for some of these countries the attribution of tax revenues to the central and sub-central layers of general government. The degree of (tax) decentralization is still very different between selected countries. The share of central government receipts ranges from 64 percent in Argentina to 84.6 per cent in Colombia and 92.9 percent in Chile where almost all taxes are legislated, collected and assessed by the central government. During the last decade the tax structure is not changed on average, with some countries (Chile, Colombia and Costa Rica) increasing their degree of decentralization and other countries (Argentina and above all Brazil) moving in the opposite direction.

4. Institutional features of current tax systems

4.1 Personal Income Tax

The degree of experience and practice in the field of personal income tax (PIT) varies a great deal across Latin American countries. Income taxes range from relative well-established ones as in Brazil to the last born PIT in Paraguay (2006). The present personal income taxes are the result of tax reforms implemented from the late 1990s with different patterns across countries. On the one hand, in order to reduce the most distortion elements of the tax systems and following a general international trend, the number of tax brackets has been reduced and marginal tax rates have been decreased in some countries such as Argentina, Chile and Mexico (Bès 1996; Boylan 1996; Gil Dìaz 2002). On the other hand, other countries have experienced initial forms of scheduler PIT (Paraguay and Uruguay) and most of them have increased the lowest marginal rates, even if just at a marginal level, as part of broader tax reforms (Martner and Tromben 2004; Shome 1999). As a consequence of still ongoing reforms, the PIT schedule is piecewise-linear in most of the countries (see Table 3) due to the structure of the tax brackets and rates and quite high thresholds of exemption. However, such a structure does not imply that the general effect is necessarily redistributive. Latin American countries collect little from taxes on income due to the structure itself of the PIT, large personal allowances and deductions, limited number of taxpayers and weak tax administration

(Shome 1999; Tanzi 2000). Recent evidences show that the PIT in most Latin American countries does not have any significant redistributive effect (Engel *et al.* 1999; Goni *et al*. 2006). Such a little help of the taxation system in reducing inequality is an important shortcoming in an area that shows one of the highest income inequality in the world. Any further reform of the fiscal systems should consider both an increase of the volume of the direct tax revenue (Colombia and Mexico) and a change in the structure of the tax and transfer system (Brazil) to get a more progressive overall fiscal system.

The number of brackets varies from 2 in Paraguay to 8 in Chile. In most of the countries (Brazil, Chile, Colombia, Costa Rica and Uruguay) a zero tax rate has applied to the first tax bracket and it reduces substantially the coverage of the PIT. The exemption thresholds are quite high if compared to the relevant income distribution: in Brazil 90 percent of income reported in a recent national survey is below such a threshold and in Colombia the average per capita employment income is about half of the upper limit of the first bracket. The highest marginal tax rate (40 percent) is applied in Chile: the other top marginal tax rates range from 6 percent in Uruguay to 35 percent in Argentina. Paraguay and Uruguay still apply separate schedules to different sources of income but they seem to represent an exception in the area. Paraguay distinguishes between taxation of farmers income, traders income and a personal income subject to a new PIT from the year 2006. In Uruguay the PIT is an incomplete schedular system with different rates and exemptions applied to wages, pensions and non professional services.

TABLE 3 HERE

In all countries the tax unit is the individual; however in Brazil, Chile and Colombia spouses may file a joint tax return in order to get full benefit of personal and family allowances. Standard personal relief is implemented in most of the countries through tax allowances in the form of fixed deductions from the PIT base. Family allowances can be found for instance in Argentina, Brazil, Costa Rica and Paraguay associated with the presence of spouse and dependent children and the expenses related to the mortgage paid for the taxpayer house (Chile, Colombia and Mexico). Moreover some personal allowances, in particular related to employment status as civil servants and employee have been recently introduced in order to deal with the high degree of informality in the economy in Argentina, Brazil and Mexico. Nevertheless the exclusion of fringe benefit from the PIT tax base in

Mexico is one of the main causes of horizontal inequity since these benefits represent about one-third of total earnings for some categories of employees.

Following the most recent reforms, tax bases are quite comprehensive, including worldwide income and, in most countries, capital incomes. The main structural link with the corporate income tax is through the exemption of the domestic-source dividends from the PIT in Argentina, Brazil, Colombia and Mexico; in others countries they are offset against taxes to be paid (Chile) or subject to a 15 percent final withholding tax (Costa Rica). Confirming the peculiarity of Paraguay and Uruguay, in both these countries, only domestic-source income is subject to taxation, a practice not consistent with the ongoing globalization process (Baunsgaard and Keen 2005). In Brazil, Chile, Colombia and Costa Rica the PIT is withheld and employment incomes and other regular sources of income are taxed at source. As a consequence, tax returns have only an adjustment purpose. In countries traditionally subject to high inflation rates, the indexation of tax brackets should play an important role as part of stabilization and equity issues. On the one hand, in order to cope with the fiscal drag, in Chile, Colombia, Paraguay and Uruguay tax brackets are defined in taxation units. It means that the tax structure is expressed in real terms rather than in monetary amounts. On the other hand, in Brazil the monetary readjustment is sporadic and always below the price indices. Finally, there is a high level of centralization of the income tax, in particular in Argentina, Mexico and Paraguay.

4.2 The Corporate Income Tax

A number of approaches to taking company profits may be observed in Latin American countries, especially in the determination of taxable income, in the integration of the corporate and personal income taxes, in the treatment of small firms and finally in the taxation of business gross assets. In general terms, two main trends have characterized the last decade: the reduction in statutory corporate tax rates and the tendency towards unification in the CIT tax rates. The process of reduction in CIT rates started during the 1980's and continued in the following decade. According to Shome (1992 and 1999) during the 1980's the unweighted average of CIT rates in the Latin American area had diminished from 44 per cent to 36 per cent. In our sample of eight Latin American countries the simple average of CIT rates has diminished from 31.25 per cent to 25 per cent in the last 15 years (1990-2005). In four countries (Brazil, Chile, Mexico and Paraguay) the reduction has been quite significant, while

two countries (Argentina and Colombia) have moved in the opposite direction. The result of this process has been to move the CIT tax rates on average considerably under the top personal income tax rate (Shome 1999). During the 1980’s the most part of selected countries had progressive CIT rates and also different rates depending on the economic sector. The progressivity of the corporate tax was intended to pursue redistributive goals, while the use of a differentiated tax structure for economic sector was intended by governments as a way to influence the resource allocation in the economy. During the last decade the situation has been reverted, with the reduction in the number of rates applied in each countries and a tendency towards unification in CIT rates (Martner and Tromben 2004). At present among the selected countries only Costa Rica continues to keep a differentiated structure of CIT rates (10 and 30 per cent). In the Latin American area the dispersion between the highest and lowest rate continues to be high; at one side Paraguay applies the rate of 10 per cent, while the CIT rate is 35 per cent in Argentina and 34 per cent in Colombia. Present corporate taxes in Latin American countries are mainly linear and centrally collected. As illustrated in Table 4, currently statutory CIT rates are moderate; the statutory average tax rate of the Latin American area is 28.25 per cent, compared with 25.04 per cent in the EU and 29.99 per cent in the Asia and Pacific area (KPMG 2006). Similarly to EU countries, the reduction of corporate tax rates has been particularly relevant during the second half of the 1990s (Shome 1999).

The selected countries apply different systems of integration with the personal income tax. Many countries apply a system of dividend exemption (Brazil, Colombia, Paraguay and Uruguay). Chile and Mexico apply the tax credit method in taxing dividend income. Shareholders may credit a percentage of dividends against their PIT liability. The credit is calculated by applying the rate at which dividends were taxed at the corporate level to dividends paid out of income already subject to the corporate income tax. Taxpayers entitled to the credit must include the credit in their taxable income and in the amount eligible for the credit. In Costa Rica dividends paid to individuals are subject to a 15 per cent final withholding tax. The final withholding tax is levied at a reduced rate of 5 per cent in the case of dividends distributed by stock corporations whose shares are registered on an officially recognized stock exchange, provided the acquisition and subsequent sale of the shares are effected through a stock exchange. In Argentina a different approach is followed. Dividends paid to resident individuals are taxable or not taxable, depending on the amount of distributions by the paying entity. Dividends are normally not taxable in the recipient's hands, provided they are paid out of income that has been reported by the distributing entity.

Corporate tax bases appear lower than their potential because of extensive exemptions and tax incentives (IBFD 2006). Historically special tax treatments and incentives were given to the agricultural sector and to some specific industries (Shome 1999). The degree of tax erosion caused by preferred tax treatments is still considerable, even if decreasing in recent years (CEPAL 1998).In Argentina a number of tax incentive schemes aimed at industrial promotion have been removed during the 1990s. These schemes have be replaced by more efficient ones, targeted for instance to promote R&D projects or investments in new capital assets. R&D projects benefit of a tax credit up to 50 per cent, while investments in real capital may benefit of an anticipated refund of the input VAT or of an accelerated depreciation system. Brazil, Chile, Colombia, Mexico, Paraguay and Uruguay still make an extensive use of tax incentives targeted to promote export-oriented firms or R&D investments or regional development (IBFD 2006). For instance in Brazil several tax incentives are granted to encourage technological qualification of domestic industrial and farming enterprises; these incentives include a tax credit equal to 15 percent of R&D-related expenses and a special depreciation (at twice the normal rate) for new equipment used in the R&D activities. The government has also used incentive programs to stimulate development of the economically less developed areas of the country, namely the north-east and Amazon regions. These programs include a number of tax incentives in both direct and indirect taxes field. Regional incentives have proven to be the most elaborate and successful group. Also in Colombia regional development is promoted through tax incentives (in terms of reduction in the income tax rate) for companies located in certain free zones. Similar schemes are still present in Mexico, Paraguay and Uruguay. Almost all the selected countries make large use of incentives for export promotion. However a gradual elimination of these schemes is expected in all countries in order to comply with WTO rules

As reported in Table 4, in taxing corporate profits a number of approaches can be observed, especially in the determination of taxable income. In the calculation of the tax base buildings may be depreciated in all selected countries. The straight-line system is the compulsory method used in almost all countries. In the evaluation of inventories two main methods are applied. Costa Rica, Mexico, Paraguay and Uruguay permit the last-in, first-out (LIFO) method, while Brazil allows the option for the weighted-average cost method. None of the selected countries allows a carry-back of losses; the carry-forward is allowed in all countries, subjected to restrictions. Losses can be carried forward only for 3 years in Paraguay and Uruguay, for 5 years in Argentina and Costa Rica, and for 10 years in Mexico. The carry-forward is unrestricted in Chile and Colombia. A number of Latin American countries have

implemented since many years presumptive taxes for small business taxpayers that (a) are levied on gross corporate revenues and (b) substitute either for VAT or income tax. Other Latin American countries such as Argentina and Brazil went further by creating a unique tax levied on small enterprises that replaces more than one of the major taxes, such as VAT, income and social security taxes (Tanzi 2000). Finally, it should be noted that Latin America countries have a long and sometime successful experience of business taxes on gross assets (Shome 1999). Such a tax has proved to operate well in inflationary environments (Tanzi 2000). It was first adopted in Mexico in 1988 and subsequently introduced in other countries, such as Argentina, Costa Rica, Paraguay and Uruguay (Shome 1999). In Mexico the business tax on gross assets is still in force. It was introduced with the aim of improving the fairness and efficiency of the tax system; it is levied at the rate of 1.8 per cent and operates as a minimum income tax for those enterprises reporting no income tax liability in their annual tax return (IBFD 2006).

TABLE 4 HERE

4.3 Consumption-based taxes

Indirect taxes, in the form of taxes on domestic and internationally traded goods and services, represent the bulk of Latin American tax revenues. The contribution of domestic taxes on consumption has increased in the last two decades. As shown in Table 2, Latin American countries rely heavily on indirect taxes which account for about 50 per cent of total tax revenue (in 2005) with the exceptions of Brazil (30 percent) and Paraguay (75 percent). Value added taxes have been introduced during the 1960s in Brazil and Uuguay followed by the other countries in the 1980s and the 1990s. They have become an important component of consumption taxes, replacing cascading turnover taxes (Martinez-Vazquez and McNab 2000; Shome 1999) and compensating for poor income tax collections and decreasing taxes on foreign trade. VAT revenue covers the main share, ranging from 23 percent on total taxes in Brazil to 40 percent in Paraguay. Over the last decades, the standard rate has increased with few exceptions (Chile and Paraguay) and a remarkable effect on the total revenue in Mexico and Uruguay. However, the increase in the VAT revenue compensate only partially the revenue reduction due to the trade liberalization (Martner and Tromben 2004): trade tariffs and import and export duties decreased by 50 percent in the last ten years, in particular in Argentina, Chile, Colombia, Costa Rica, Mexico and Paraguay (Tanzi 2000). The VAT

structure is predominantly dual- or (more frequently) multiple-rates (see Table 5). The standard VAT rate ranges from 10 percent in Paraguay to 23 percent in Uruguay. Most countries apply one or two reduced rates, ranging between 1.6 (Colombia) and 14 percent (Uruguay), and most countries applies a zero-rate on particular goods (or leave they exempt at all). Finally, many countries apply also an increased rate on some goods and services. The reason of multiple-rate structures in the selected countries can be found in the heritage of the past multiple-rate turnover taxes and in the attempt to mitigate the regressive burden distribution of the VAT. The rate differentiation is decreasing over time as a consequence of a simplification process. However, it still appears to be an ineffective and ill-targeted instrument. It causes high administrative costs and incentives tax evasion and elusion phenomena (Martner and Tromben 2004).

The range of activities exempted from VAT or subject to reduced tax rates still appears to be wide and differentiated across countries. However, the observed trend is aimed at getting a wider tax base. In Latin American countries, VAT is generally a national tax with the main exception represented by Brazil whose three government tiers, federal, state and municipal, are granted the right to administer distinctive VATs. As known, independent and simultaneous VATs applied by overlapping jurisdictions have widely been considered to be either undesirable or infeasible (Bird and Gendron 1998). Nevertheless, it has been argued that a dual VAT - with sub-national VATs integrated with a national VAT and a high control over inter-jurisdictional trade - or even two levels of VAT in a single country can be a solution also to the issue of cross-border trade (Bird and Gendron 2001).

In Brazil, the federal and the state taxes are ruled by different legal norms among states (Afonso, 2001). At federal level, only manufactured products are subject to the value-added tax (i.e. IPI). At state level, a value-added tax on goods and selected services (i.e. ICMS) is collected on an origin basis and managed with the invoice-credit mechanism (de Mello 2007). Rules and rates differ from state to state. A number of proposals to reform the VAT system have been discussed in the last years in particular to share the ICMS between federal and state governments, to unify the legislation and standardize the rates and to define the treatment for inter-state transaction (Varsano 1999).

On average, the VAT compliance, given by the ratio between collected and potential VAT where it is the VAT average rate multiplied by final private consumption, is about 53 percent in 2002 and it has not increased significantly over the last decade (Shome 1999; Martner and Tromben 2004) with very low values in Mexico (34 percent) and Colombia (40 percent).

Focusing on excise taxation, Latin American countries show wide differences in the way they levy excises on alcoholic beverages, on tobacco products and on fuels. Most of the excises rely on *ad valorem* rates with great variability across countries, while in Chile, Colombia and Uruguay fuel and cigarettes (Uruguay) are subject to specific rates. On the other hand, the gradual equalization of rates applied to domestic and imported products is common across countries.

TABLE 5 HERE

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Table 1 Structure and development of fiscal revenue in selected countries as % of GDP (1995-2005)

	1995								*2000*								*2005 p*							
	AR	*BR*	*CL*	*CO*	*CR*	*MX*	*PY*	*UY*	*AR*	*BR*	*CL*	*CO*	*CR*	*MX*	*PY*	*UY*	*AR*	*BR*	*CL*	*CO*	*CR*	*MX*	*PY*	*UY*
						c	*c*											*2004*		*2004*		*c*	*c*	*c*
Direct Taxes. of which	*3.9*	*8.6*	*5.7*	*4.7*	*2.4*	*4.2*	*2.5*	*5.3*	*5.7*	*9.0*	*6.0*	*5.9*	*3.3*	*4.9*	*2.0*	*6.2*	*8.8*	*10.4*	*7.2*	*8.4*	*4.1*	*4.8*	*2.1*	*4.7*
Income	2.5	4.8	3.9	4.0	2.2	4.0	2.5	1.8	4.0	5.4	4.1	4.3	2.7	4.7	2.0	2.3	5.5	6.2	5.3	6.0	3.4	4.6	2.1	2.9
Personal income	-	3.4	1.0	0.2	-	2.0	-	-	-	3.9	1.2	-	-	1.9	-	-	-	4.1	-	-	-	-	-	-
Corporate income	-	1.4	2.9	3.8	-	2.0	2.5	1.8	-	1.5	2.8	-	-	2.8	2.0	2.3	-	2.1	-	-	-	-	2.1	2.9
Property	1.4	1.5	1.8	0.6	0.2	0.2	0.0	3.5	1.7	1.3	1.9	1.2	0.5	0.2	0.0	3.9	3.3	1.5	1.9	2.0	0.7	0.2	0.0	1.8
Others	0.0	2.3	-	0.1	0.0	0.0	0.0	-	0.0	2.3	-	0.4	0.1	0.0	0.0	-	0.0	2.7	-	0.4	0.0	0.0	0.0	-
Indirect Taxes. of which	*11.6*	*11.2*	*12.8*	*7.1*	*9.6*	*5.1*	*9.9*	*11.5*	*12.4*	*11.0*	*12.0*	*8.0*	*9.2*	*5.8*	*8.9*	*11.4*	*14.6*	*10.7*	*11.5*	*9.2*	*10.1*	*4.9*	*9.8*	*13.1*
VAT	8.8	7.8	8.2	4.1	4.6	2.8	4.9	7.7	8.8	8.0	7.9	4.8	4.9	3.5	4.7	7.9	9.5	8.4	8.2	5.9	5.5	3.8	5.2	8.5
Excise duties	1.8	2.1	1.9	1.7	1.9	1.4	1.3	3.1	2.5	1.7	2.3	1.9	3.2	1.6	1.8	3.2	2.0	1.3	1.9	2.0	3.3	0.7	2.2	2.6
Import and export duties	0.4	0.8	2.1	1.0	3.0	0.6	3.1	0.5	0.5	0.8	1.4	1.0	1.0	0.6	2.0	0.2	2.7	0.5	0.4	0.9	1.2	0.3	1.8	1.4
Others	0.6	0.5	0.6	0.3	0.1	0.3	0.6	0.2	0.6	0.5	0.4	0.3	0.1	0.1	0.4	0.1	0.4	0.5	1.0	0.4	0.1	0.1	0.6	0.6
Total Tax Revenue	15.5	19.8	18.5	11.8	12.0	9.3	12.4	16.8	18.1	20.0	18.0	13.9	12.5	10.7	10.9	17.6	23.4	21.1	18.7	17.6	14.2	9.7	11.9	17.8
Social Contributions	*4.7*	*9.9*	*1.3*	*3.7*	*5.9*	*2.0*	*1.1*	*8.5*	*3.4*	*12.5*	*1.4*	*2.9*	*6.3*	*1.5*	*1.2*	*8.4*	*3.3*	*14.8*	*1.4*	*2.8*	*6.4*	*1.3*	*1.2*	*5.7*
Total Fiscal Revenue	20.2	29.7	19.8	15.5	17.9	11.3	13.5	25.3	21.5	32.5	19.4	16.8	18.8	12.2	12.1	26.0	26.7	35.9	20.1	20.4	20.6	11.0	13.1	23.5
Administrative level																								
Central government	12.9	20.5	18.4	13.4	12.3	11.3	13.5	23.1	13.1	23.0	17.8	14.1	12.3	12.2	12.1	23.6	17.1	25.8	18.8	17.3	13.7	11.0	13.1	23.5
State - local government	7.4	9.3	1.4	2.1	5.7	-	-	2.2	8.3	9.5	1.5	2.7	6.6	-	-	2.4	9.6	10.0	1.4	3.1	6.9	-	-	-

Source: ILPES-CEPAL (2006)
p) preliminar; c) central government

Table 2 Tax mix in selected countries as % of total taxation (1995-2005)

	1995							
	AR	*BR*	*CL*	*CO*	*CR*	*MX*	*PY*	*UY*
						c	*c*	
Direct Taxes. of which	*19.5*	*29.0*	*28.6*	*30.2*	*13.4*	*37.1*	*18.9*	*21.0*
Income	12.4	16.2	19.6	25.9	12.4	35.6	18.6	7.2
Personal income	-	-	4.8	1.4	-	18.0	-	-
Corporate income	-	-	14.7	24.5	-	17.6	18.6	7.2
Property	7.1	5.0	9.0	3.6	1.0	1.5	0.2	13.8
Others	0.0	7.8	-	0.7	0.0	0.0	0.1	-
Indirect Taxes. of which	*57.1*	*37.6*	*64.6*	*45.7*	*53.8*	*45.2*	*73.2*	*45.2*
VAT	43.3	26.3	41.7	26.1	25.7	25.0	35.9	30.3
Excise duties	8.8	7.0	9.4	11.2	10.7	12.3	9.9	12.3
Imports and export duties	1.9	2.5	10.5	6.7	16.8	5.4	22.9	2.0
Others	3.1	1.8	3.0	1.7	0.6	2.5	4.5	0.6
Total Tax Revenue	76.6	66.6	93.2	75.9	67.2	82.3	92.1	66.2
Social Contributions	*23.4*	*33.4*	*6.8*	*24.1*	*32.7*	*17.7*	*8.0*	*33.7*
Total Fiscal Revenue	100	100	100	100	100	100	100	100
Administrative level								
Central government	63.7	68.9	93.2	86.5	68.6	100	100	91.3
State - local government	36.3	31.1	6.8	13.5	31.4	-	-	8.7

	2000							
	AR	*BR*	*CL*	*CO*	*CR*	*MX*	*PY*	*UY*
Direct Taxes. of which	*26.2*	*27.7*	*31.1*	*35.0*	*17.7*	*40.2*	*16.5*	*23.9*
Income	18.5	16.7	21.1	25.6	14.4	38.9	16.4	9.0
Personal income	-	-	6.4	-	-	15.9	-	-
Corporate income	-	-	14.7	-	-	23.0	16.4	9.0
Property	7.7	4.0	10.0	7.1	2.8	1.3	0.0	14.9
Others	0.0	7.0	-	2.3	0.5	0.0	0.1	-
Indirect Taxes. of which	*58.0*	*34.0*	*61.5*	*47.9*	*49.0*	*47.2*	*73.4*	*43.7*
VAT	41.1	24.7	41.0	28.8	26.0	28.5	38.6	30.5
Excise duties	11.6	5.2	11.7	11.2	17.0	12.9	15.0	12.2
Imports and export duties	2.5	2.4	7.0	5.9	5.4	4.9	16.6	0.7
Others	2.8	1.7	1.8	2.0	0.6	0.9	3.2	0.3
Total Tax Revenue	84.2	61.7	92.6	82.9	66.7	87.4	89.9	67.6
Social Contributions	*15.8*	*38.4*	*7.4*	*17.0*	*33.2*	*12.6*	*10.1*	*32.3*
Total Fiscal Revenue	100	100	100	100	100	100	100	100
Administrative level								
Central government	61.2	70.7	92.1	84.0	65.2	100	100	90.8
State - local government	38.8	29.3	7.9	16.0	34.8	-	-	9.2

	2005 p							
	AR	*BR*	*CL*	*CO*	*CR*	*MX*	*PY*	*UY*
		2004		*2004*		*c*	*c*	*c*
Direct Taxes. of which	*32.8*	*29.0*	*35.7*	*41.0*	*19.7*	*43.5*	*15.8*	*20.3*
Income	20.6	17.4	26.2	29.3	16.5	41.9	15.8	12.6
Personal income	-	-	-	-	-	-	-	-
Corporate income	-	-	-	-	-	-	15.8	12.6
Property	12.2	4.1	9.5	9.6	3.2	1.6	0.0	7.7
Others	0.0	7.5	-	2.1	0.0	0.0	0.0	-
Indirect Taxes. of which	*55.0*	*29.8*	*57.0*	*45.2*	*49.1*	*44.5*	*75.2*	*55.5*
VAT	35.6	23.3	40.2	28.8	27.0	34.7	40.0	36.2
Excise duties	7.6	3.6	9.5	10.0	15.9	6.0	17.1	11.0
Imports and export duties	10.2	1.4	2.2	4.3	5.7	2.9	13.5	5.9
Others	1.6	1.5	5.1	2.1	0.5	0.9	4.6	2.4
Total Tax Revenue	87.8	58.8	92.7	86.2	68.8	88.0	91.0	75.8
Social Contributions	*12.3*	*41.2*	*7.1*	*13.8*	*31.1*	*12.0*	*9.0*	*24.4*
Total Fiscal Revenue	100	100	100	100	100	100	100	100
Administrative level								
Central government	64.0	72.1	92.9	84.6	66.1	100	100	100
State - local government	36.0	27.9	7.1	15.4	33.9	-	-	-

Source: ILPES-CEPAL (2006)
p) preliminar; c) central government

Table 3 Structure of Personal Income Tax

Country	*Tax unit*	*Number of brackets*	*Minimum tax rate*	*Maximum tax rate*	*Highest rate applies from*	*Tax base*	*Main exemptions*	*Main reliefs*
AR	Individuals and undivided estates. Spouses file a separate tax return	7	9	35	39,215 $	Worldwide income from real estate, capital business income and personal services	Gifts, inheritances and legacies Domestic-source dividends from registered shares Public and private bonds and other financial sources	Family (spouse, dependent, life insurance and private pension contributions) and personal (basic, employment and self-employment) allowances decreasing with income. Deduction of maintenance payment and social security payments.
BR	Individuals. Spouses file a joint tax return if they are not married under a separate property regime	3	0	27.5	12,000 $	Worldwide income from salaries, capital, raffles and personal services	Domestic-source dividends Interest on savings accounts	Family (dependent) and personal (basic; medical and education expenditures) allowances. Deduction of Social security payments
CL	Individuals. Spouses must file a joint tax return in some cases	8	0	40	110,500$ (tax brackets defined in taxation units)	Worldwide income from any source	Domestic-source dividends as tax credit	Deduction of instalments paid for mortgages and gifts
CO	Individuals. Spouses taxed separately	4	0	33	34,750$	Worldwide income from salaries, pensions, capital gains, gift, inheritances and business income	Domestic-source dividends	Deduction of interests paid on loan for the taxpayer home
CR	Individuals	5	0	25	17,890$	Domestic-source income only	Dividends subject to a 15% final withholding tax	Family (spouse, dependent) allowances
MX	Individuals. Spouses taxed separately	5	3	29	9,245$	Worldwide income from any source	Domestic-source dividends Financial interest income, gifts and bequest	Personal (medical) allowances and deduction of charitable contribution, real mortgage interests and contribution to retirement and health accounts. Tax subsidy (i.e. tax credit up to 50% of tax, decreasing with income)

PY	Individuals and individual enterprises (individual farmers are subject to a tax on farming income at the rate of 25%)	2	8	10	Income over 120 monthly minimum wages (23,000$)	Domestic-source income only: employment income, 50% of dividends and the profit distributions from companies subject to CIT, capital gains derived from the transfer of property and interest income	Pensions in general and social security benefits	Personal and family allowances.
UY	Individuals on their units of monthly national minimum salary (NMS)	5	10	25		Domestic-source income only: wages, salaries and pensions	Capital income taxed separately (10%)	In addition a rate of 2% (and a surcharge of 0.25%) is payable by employers

Source: IBFD (2006)

Table 4 Structure of Corporate Income Tax

Country	*Statutory tax rate (%)*	*Treatment of dividends*	*Depreciation of assets*	*Valuation of inventories*	*Carry forward of losses (no of years)*	*Tax incentives*
AR	35	Generally exempt. However they are taxed (35%) when exceeding taxable profits (equalization tax)	Straight-line (different %)	Market cost at the end of the year	5	R&D Tax credit
BR	15 (+ surtax of 10% above 110000$) and 9% of social contributions	Exempt	Straight-line (10%)	Weighted average, FIFO	Unlimited (up to 30% of taxable profits)	R&D Tax credit; export tax credits; regional development tax incentives
CL	17	Taxed with full tax credit	Straight-line (different %)	Earlier direct cost or weighted average	Unlimited	Investment tax credit; export tax incentives; regional development incentives
CO	34	Generally exempt. However they are taxed when exceeding taxable profits	Fixed yearly % (different %)	Average and specific identification methods	Unlimited	Export tax incentives; regional development
CR	10 - 30	15 final withholding tax (reduced to 5% for dividends from quoted companies)	Straight-line (different %)	FIFO or LIFO	3 - 5	Export promotion
MX	29	Taxed with full tax credit	Straight-line (different %)	FIFO, LIFO or weighted average	10	Export promotion; job creation tax credit; R&D tax credit
PY	10	Exempt	Straight-line (different %)	FIFO or LIFO	3	Export promotion; industrial investment; free zone
UY	30	Exempt	Straight-line (different %)	FIFO, LIFO or weighted average	3	Export promotion; free zone

Source: IBFD (2006)

Table 5 Tax rates for selected consumption-based taxes

Country	*VAT*					*Excises*		
	Standard rate (%)	*Increased rate (%)*	*Reduced rate (%)*	*Import*	*Export*	*Cigarettes (%)*	*Unleaded gasoline (%)*	*Diesel fuel (%)*
AR	21	27	10.5	Included	0	60	62 - 70	19
BR	Inter-state: 12 Intra-state: 17	Intra-state: 25-35	Inter-state: 7 Intra-state: 7	Included	0	Federal excise tax (IPI) from 0% to 365%		
CL	19	36		Included	0	60.4	6 tax units per cubic metre	1.5 tax units per cubic metre
CO	16	25 - 45	2 - 10	Included	0	55	0.15$ per gallon	
CR	13		5	Included	0	100	Different %	
MX	15		0 - 10	Included	0	110	Different %	
PY	10		5	Included	0	8	34	34
UY	23		14	Included	0	0.5$ per unit	0.64$ per liter	0.06$ per liter

Source: IBFD (2006)

3. POLITICAL ECONOMY ISSUES OF TAXATION IN LATIN AMERICA

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.

The political economy of Latin America is a crucial issue. In the last decades many Latin American countries have experienced a democratic transition, but poor economic performances. In particular, contrary to the predictions of the political economy literature on democracy and economic development, fiscal pressure has remained low, especially income taxes, despite the democratic transition. This puzzling evidence can be reconciled with political theories, if we include the role played by vested interests, financial sector and populist economic policies.

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JEL Codes: H20, O54

1. Introduction

Most of Latin American countries have only recently experienced a transition towards democracy. With the exception of "old" democracies such as Costa Rica or Colombia, while in the 1950s only a minority of Latin American countries could be considered democracies, in the 1990s a large majority of them accomplished the transition to a democratic political organization, although with several specific features.

The democratic transition has relevant implications for economics. The recent political economy literature has analyzed the double link between democracy and economic development. On one side, countries should become more democratic as they become richer (Lipset 1959). As pointed out by the "modernization" theory (see Boix (2003), Barro (1996), Giavazzi and Tabellini (2005), Acemoglu *et al.* (2004-5), Acemoglu and Robinson (2006)) markets can prosper only in a political framework characterized by constitutional liberties and democratic practices[1]. On the other side, democracy affects the economic outcomes, and, in particular, it may affect public policies: Boix (2003) suggests that in democratic regimes taxes and public spending should be higher than in autocratic regimes, since in these last ones a substantial part of the electorate is excluded from the decision-making process. Boix (2003) also shows that under the same level of per capita income, when modernization starts, the government is larger in a democracy than in an autocracy, because redistributive welfare expenditures, such as pensions, health care and unemployment benefits, rise after the introduction of a democratic regime. This is particularly true in countries characterized by high ex-ante income inequality: in a democracy, the larger is the group of low-income individuals, the higher are the votes in favor of redistributive public policies (in the spirit of the Meltzer and Richard's seminal paper (1981)), and thus the higher are taxation, especially on labor income, and public expenditures.

Recently, Persson and Tabellini (2006) have deeply analyzed the double link between democracy and economic development, identifying a new crucial variable, 'democratic capital,' which is a measure of the persistence of democracy in a society: democratic capital stimulates growth, which in turn

[1] See Cacciatore *et al.* (2006) for the problematic evidence in this theoretical context of South and East Asia.

contributes to consolidate democracy creating a virtuous circle of democracy and development.

The predictions of this literature however are at odds with facts in the Latin America context. In general, the economic performances of Latin American countries have been rather poor and disappointing in particular in the years right after democratization: on average the lowest growth rates are in the 1980s, that is during the transition period. This poor economic performance is difficult to be explained according to the "modernization" theories. Focusing in particular on taxation, contrary to the predictions of Boix (2003), the democratic transition in Latin America has not been associated with a growing fiscal pressure, nor with a rebalancing of tax composition in favor of more labor and less consumption taxes. We find that countries where fiscal pressure is increasing show this raising path even before the democratic transition. This suggests that there is no systematic relation between the democratic transition and an increase of fiscal pressure[2]. In other words, since the level of fiscal pressure depends on many factors (per capita income, macroeconomic variables, etc.) the democratic transition does not appear to have *ceteris paribus* a crucial positive impact. This result can not be explained if we represent the functioning of a democracy through a standard median voter model, which aggregates voters' preferences: in this area, among the most unequal region in the world (see Gómez-Sabaini and Martner (2007) and Barreix *et al.* 2006), the popular demand for redistribution is very high. Following Meltzer and Richard (1981), we would expect significant increases of taxation with the democratic transition. This is not what happened in Latin America and thus a puzzle emerges.

Rodriguez (2001) suggests that other political factors have to be included to account for Latin America's overall poor economic outcomes: political instability, inequality in the distribution of political and economic power, corruption and rent-seeking, vested interests.

In this paper we focus on taxation and we investigate into this "puzzling" evidence: enormous changes in the political organization of these countries, mainly the democratization process, have not been associated with a raise in the fiscal pressure.

[2] Notice that we focus on tax revenue. However in countries such as Chile, Colombia and Mexico, non-tax revenues, related to the exports of non-renewable resources, are also important and they have considerably increased in the last years (see Jiménez and Tromben 2006).

After assessing this evidence, we make an effort to provide possible explanations of this "puzzle". This is not an easy task. All possible arguments that we will mention have perhaps a role in this complex evidence and the best explanation has to be thought as a combination of them. We argue that specific elements which characterize Latin America may have played a role in keeping the fiscal pressure low despite the democratic transition: (i) the quality of democracy, with a low level of representation and a relevant weight of lobby, elites, interest groups; (ii) the development of financial institutions; (iii) the heritage of populist economic policies.

We should also remember that international organizations, such as IMF and World Bank, have played a crucial role in the design of fiscal systems and fiscal reforms in many Latin American countries. The tax systems in place thus strongly reflect the plans of these external organizations, not necessarily in line with the preferences of their democratic societies.

The paper is organized as follows: next section focuses on democracy and summarizes the main facts of the democratic transition for a sample of Latin American countries (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay and Uruguay). Section three shows the existence of a puzzle comparing fiscal and political data. Section four provides alternative explanations of this puzzle. Section five concludes.

2. Democracy in Latin America

In the 1980s and 1990s, with the exception of Costa Rica and Colombia, all Latin American countries of our sample experienced a democratic transition. This happened in 1983 in Argentina, in 1985 in Brazil and Uruguay, in 1989 in Chile, in 1991 in Paraguay and in 1994 in Mexico. In each country the democratic transition, which has represented the defeat of the armed forces' political power, has been characterized by specific features.

In Argentina (see Bès 2007), serious economic problems, mounting charges of corruption, public denunciation of human rights abuses and, finally, the 1982 defeat by

the UK in the Falklands War, all these facts contribute to discredit the military regime that was in power since the coup against Isabel Perón in 1976. On October 1983, Argentines went to the polls in elections found by international observers to be fair and honest and the large turnouts for mid-term elections in 1985 and 1987 demonstrated continuous public support for the new strong and vigorous democratic system. As for Brazil (see Afonso and Barroso 2007), the military maintained power from 1964 until March 1985 because of political struggles within the regime and local elite. In 1984 many public demonstrations held in the main cities made clear that military rule could not continue and that Brazilians were starting to require changes in the electoral system to directly elect their president. So, after the end of the military dictatorship, Brazil went into a troubled process of re-democratization, with the New Constitution in 1988 and the first direct presidential election won by Collor de Mello. In Uruguay (see Barreix and Roca 2007), the unpopularity of the *de facto* military government emerged in 1980 with the "no" in the referendum proposing a change in the constitution. In 1984, after massive protests against the dictatorship, national elections were held and the new administration, led by Sanguinetti, started to implement economic reforms and to consolidate democracy. The Chilean military regime instead (see Cominetta 2007) lasted until 1988, when in a plebiscite 55 percent of the voters denied a second term to General Pinochet, the chief of a junta established by the army in power since 1973. Paraguay (see Ferrario 2007) was progressively isolated from the world community during Stroessner's 34-year reign, characterized by severe limitations of political freedoms and persecution of the opponents. In 1989, Stroessner was overthrown in a military coup headed by General Rodríguez that easily won the presidency in elections, instituted political, legal, and economic reforms and initiated a rapprochement with the international community. A democratic system of government was then established by the 1992 Constitution. As for Mexico (see Alvarez 2007), since 1929 the Institutional Revolutionary Party (PRI) monopolized all the political branches. It was only through the electoral reforms started by president Salinas de Gortari and consolidated by president Zedillo, by the mid 1990s, that the PRI lost its majority in Congress and the democratic transition started.

Despite these specific features that gave birth to the democratization process in each country, a common element of the successive development and, to a certain extent, of

the current maturity of democracy in Latin America relies in its economic foundations. Latin American citizens seem to support democratic regimes mainly because they are convinced that these are beneficial for their economies. 72 percent of Latin Americans believe that democracy is the only political system which can contribute to economic development (Latinobarometro polls 2004 in Santiso 2006). Interestingly, this value increases up to 84 percent in Uruguay and 79 percent in Argentina, the countries which have experienced the most dramatic shocks and financial crisis in the area. In other words, as noticed by Santiso (2006), it seems that Latin American citizens are becoming "politically mature". They can distinguish between democracy as a political system, which they consider the best environment for growth (on average, according to the poll on Human Values 1995-2000, again in Santiso 2006, more than 80 percent of Latin Americans approve of democratic ideals), and the economic outcomes reached by the functioning of their democratic governments and political leaders, which may fail to satisfy their expectations. In fact the average rate of satisfaction about the accomplishments of democracy does not exceed 62 percent.

A crucial implication of this trend is that Latin American citizens are particularly sensitive to the economic performances (especially in terms of growth and inflation) accomplished by their leaders, and they are ready to punish those leaders who do not achieve the expected economic goals. At the same time, this implies that economic reforms are a main platform proposed by political parties to gain votes. This is especially true in the context of taxation, where reforms may represent a politically feasible and optimal strategy to gain support, since there still exists potential space for both increasing the fiscal pressure and rebalancing the composition of the tax revenue, currently mainly dominated by indirect taxes (see Gómez-Sabaini and Martner 2007). However, fiscal policies do not really follow this suggested path.

3. Taxation and democracy: a puzzle?

Contrary to the predictions of the literature, and also contrary to what we would expect in a democratic context with essential economic foundations, after the democratic transition Latin American economic policy has not given a priority role to taxation and redistributive policies. In the period 1980-2004, while the democratization process

develops, the tax burden in percentage of GDP remains quite low (in 2004 the average value for Latin America countries is 16.6 percent (ILPES CEPAL 2007) compared with an EU(25)-average of 39.3 percent (EUROSTAT 2006)) and quite stable. The tax structure remains dominated by indirect taxes, with a low weight of income and capital taxes.

Figure 1 shows for each country the evolution of a democratic index and of the tax revenue in the period 1980-2004. Data on tax revenue as percentage of GDP come from ILPES CEPAL statistics and the democratic index is POLITY2 from Polity IV dataset (2005). This dataset contains many information on political regimes characteristics and transitions of a variety of countries from 1800 to 2004 and it is largely used in the most important political economy studies. According to some specific political features, such as political competition, political freedoms, constraints on the exercise of power by the executive and guarantee of civil liberties, each country is related to a one-year democracy (DEMOC) and autocracy (AUTOC) index, both ranging from 0 to 10 (strong democracy or strong autocracy). POLITY2 is a combined polity score, computed by subtracting the AUTOC score from the DEMOC score and so ranging from -10 (strong autocracy) to +10 (strong democracy)[3].

FIGURE 1 NEAR HERE

According to Figure 1, there is no systematic relation between the evolution of democracy and the evolution of taxation. A part from Colombia, which experienced a significant increase in tax revenue/GDP in the period 1980-2004 (the democratic transition here happened much earlier, in 1957), this ratio slightly raises over time in some countries (Argentina, Paraguay, Uruguay, Colombia, Costa Rica) and is almost unchanged in others (Mexico, Chile). Notice that for the first group of countries this slight increasing path of tax revenue in percentage of GDP seems to start even before the democratic transition, and it should thus be explained by other factors (for instance per capita income, macroeconomic performances). The timing of the transition seems to have no relation with changes in the tax burden. In other words, it is very difficult to

[3] Actually, POLITY2 is a revised combined polity score that differentiates from POLITY (see Polity IV Project Dataset User's Manual (2005) for more details).

argue that tax revenue increase after the democratic transition, as we would expect from the theories.

Concerning the tax structure, notice that indirect taxes (consumption) are more important than direct ones (income and capital). According to ILPES CEPAL Statistics from 1990 to 2004, in Mexico in 2004 direct taxes amount to 4.6 percent of GDP while indirect taxes reach 5.3 percent of GDP. The difference in the relative weight of direct and indirect taxes is much more evident if one considers the tax structure of Paraguay and Uruguay. In Paraguay, during the analyzed period, the ratio between indirect taxes and GDP is generally more than four times that of direct taxes. In Uruguay, the importance of consumption taxes is confirmed by the fact that their revenue in 2004 are 14.3 percent of GDP against 4.3 percent of GDP of income and capital tax revenue. In Costa Rica, direct taxes increase from 2.2 in 1990 to 3.8 percent of GDP in 2004, but indirect taxes are much more important, reaching in the same years 8.6 and 9.2 percent of GDP respectively. In Chile, direct taxes/GDP and indirect taxes/GDP stay around 5 and 11 percent respectively during the 2000s. Argentina's tax structure is becoming more balanced: in 1990 the difference between the revenue of consumption and income taxes was 5 points of GDP while in 2004 it decreases to 3.3. Even in Colombia, we observe a similar trend: in 2004 direct and indirect taxes amount each to 7.2 percent of GDP. Brazil represents the only exception. In this country taxes on income and capital are always higher than consumption taxes.

Given the high ex-ante inequality that characterizes Latin American countries (see Barreix *et al.* 2006), this structure of taxation with a prevalent weight of indirect taxes implies a high degree of regressivity[4], and thus an even more unequal ex-post income distribution. This is exactly the opposite of what predicted by a standard median voter's model (*à la* Meltzer and Richard 1981), which would suggest that, in a democratic country, when ex-ante inequality is higher, a poorer median voter votes for higher taxes and redistributive policies and thus ex-post inequality is reduced.

How can we reconcile this puzzling evidence with political theories? We try to address this question in the next section.

[4] Notice that the recent introduction of multi-rates VAT may alleviate this regressivity result (see Sabaini and Martner 2007).

4. Possible explanations of the puzzle

In this section we propose possible explanations of the puzzling evidence on taxation and the democratic process in Latin America. These explanations can be grouped in three types: (i) the quality of these democracy suffers from low levels of representation, while vested interests, or lobbying and interest groups play a crucial role, leading to economic outcomes rather different than median voter's choices; (ii) financial institutions, which are crucial for tax enforcement, have typically provided a low value added to Latin American firms which use them, and thus a high degree of "disintermediation" characterizes these economies; (iii) the economic policies suffer from the heritage of populism, which in previous political regimes was keeping taxation very low in order to maintain the support of the mass, even at a cost of increasing debt[5].

4.1 The quality of the democracy and the role of vested interests

One of the main issues of democracy in Latin America concerns the quality of these democracies. The POLITY2 index captures some fundamental characteristics of a democracy. However, to what extent these democracies have a substantial rather than a formal character? This would help explaining why the economic outcomes are somehow different from the ones that would emerge in a true democracy.

In a democracy, a small and homogenous number of elected individuals are in charge to represent the large variety of public opinion and preferences. The quality of a democracy can thus be judged, at least in part, by the level of representation. In a democratic context, representation matters for the durability and stability of the democratic regime itself. However, the relation between representation and durability is not unambiguous. On one side, Diamond (1996) argues that under-representation may affect citizens' support for the system and thus increase the likelihood of a reversal to non-democratic forms of government. On the other side, as noted by Huber and Stephens (1999), in countries where poverty and inequality are prevalent, such as in Latin America, a lack of political representation may be associated with democracy

[5] Notice the opposite experience of New EU Members, in which the transition from an autocratic regime to a democracy is associated with an increase of taxes and public expenditures, in line with the heritage of the former socialist regimes.

consolidation, because if subordinated classes are not represented, the elites can keep their interests more secure and reduce the possible threats of breakdown. However, once the economy develops, representation may increase without affecting the stability of the democracy.

The level of representation in a democracy may also play a crucial role in explaining economic policies. We expect that a democratic transition will not induce a significant increase in taxes, even in countries with high income inequality, when low-income groups are not enough represented, i.e. the representation level is low. Our countries lack of representation, a fact that may help to reconcile the evidence on taxation and formal democratic systems. Luna and Zechmeister (2005) build an index of "mandate or issue representation". Using data for 1997 and 1998 and considering the correspondence between party elites and party electorates on a variety of issues grouped in five areas (economic, foreign investment, religion, regime, law and order), they find the highest scores of this index in Chile and Uruguay, followed by Argentina. Colombia and Costa Rica stay in the intermediate range and Mexico and Brazil are the less representative countries. The old democracies, Colombia and Costa Rica, seem to be characterized by only a shallow connection between elites and citizens (see in particular the experience of Colombia until 1974), but there is room for a significant improvement in the effectiveness of political representation in the young democracies too. In other words, there is room for these new democracies to acquire a more substantial character.

While in Latin America democracies political parties weakly represent voters' political preferences, they are largely influenced by the action of lobbies, elites and interest groups. In scarcely representative democracies, the government shapes policy more to the pressures of special interests than to the preferences of the general electorate. The role of lobbies in the political process has been emphasized by Grossman and Helpman (1994). They argue that once solved their internal free-rider problems, special interests groups can provide political contributions to influence the government's policy. The lobbying process can be seen as a two-stage non cooperative game. Each interest group gives the government a contribution schedule that maximizes the aggregate utility of its members in which all possible policies are linked to specific contributions. Then the government chooses a policy and collects from each group the

related contribution. The increasing ability to contribute and to deliver blocks of votes improves the position of special interests in the eyes of the government.

Following this reasoning, taxation in Latin America may be seen as the result of the pressure of interest groups, which lobby to keep taxes low. In particular, the elites in power are generally near the rich. They are interested in keeping down taxes not only for themselves, but also for middle classes, in order to obtain their support in the political competition (see also Bernardi *et al.* (2007) and Gómez-Sabaini and Martner (2007)).

4.2 Financial institutions

In a democratic system electoral terms and mandates impose a radical transformation of the temporal horizon. In a shorter time horizon, which depends on electoral terms and mandates, the appropriate time management becomes a top priority for the government. Financial institutions are developed in this direction, since they may allow governments to act as though they had infinite horizons at their disposal.

Once introduced and developed, financial institutions may also play a crucial role for tax enforcement. According to Gordon and Li (2005a), this role becomes very important to understand why poor and rich countries have different tax revenue as a percentage of GDP and different composition of the tax burden. In poorer countries firms receive a low added value (i.e. benefits) from using the financial sector than in richer ones. This affects the threat of "disintermediation". When firms rest on the financial sector, the government can obtain many information about the scale of the firm's economic activity and use them to improve tax enforcement. Thus, the modest value added coming from the financial sector reduces the poor government's ability to collect tax revenue[6].

[6] Cash transactions are used here as a synonym of informal economy, difficult to control and to tax. Firms that are not strongly dependent on financial sector can rely on cash transactions, which do not leave paper trail, in order to avoid (high) taxes (i.e. the cost of using the financial sector). This may increase the shadow economy.

Following this reasoning, a possible explanation of the low tax burden in poor countries is that the under-development of the financial sector, bringing about "disintermediation", may be responsible for low tax enforcement and thus low revenue collection.

Moreover, if the benefits from using the financial sector are low, the design of the tax structure will be oriented towards a more intensive use of corporate income taxes, and tax collection will be focused on capital intensive firms. This narrow tax base in fact depends more heavily on the financial sector and has very low chances of "disintermediation". In this context, countries may use an inflation tax as an instrument to raise the costs of cash transactions and create efficiency and revenue gains by improving the capital and labor allocation between taxed and untaxed sectors and shifting new firms to using banks as intermediaries.

The results of Gordon and Li (2005a) are consistent with the Latin America context, which shows a low tax burden and a still relevant inflation tax (see Gómez-Sabaini and Martner 2007). As a consequence, a democratic transition may not induce a significant increase in tax collection, if it is not joined by a significant economic development, which would induce a further development of a well functioning financial sector and, in general, of efficient fiscal institutions.

Gordon and Li (2005b) claim that this most intense use of taxes on corporate income in poor countries can also be justified using the lobby model of Grossman and Helpman (1994). Capital intensive firms are interest groups actively lobbying to keep a low level of corporate taxation. When these firms are not numerous, such as in poor countries, they are not able to lobby effectively and, as a consequence, the level of CIT in the tax structure increases. However, contrary to the evidence, this would suggest that the overall level of taxation is also higher in poor countries, where only few firms actively lobby.

4.3 Populism

During the 1980s in Latin America land owners exercised political monopoly that does not allow the political system to start fiscal and economic reforms to create a sufficiently high tax base. After the World War I and the great depression of the 1930s

this political monopoly stopped giving way to political parties and military leaders, supported by urban labor union and import-substituting industrialists. Political scientists named this alliance between labor and capital owners against land owners “populism”. It concretizes in a set of economic policies designed to achieve specific political goals such as mobilizing support within organized labor and lower-middle-class group (Kaufman and Stallings 1991). Among the different experiences of Latin American populism we can mention the Péron regime in Argentina from 1973 to 1976, the Echevarría government in Mexico from 1970 to 1976 and the five years of Sarney governance in Brazil from 1985 to 1990. Populist politics gave rise to populist policies oriented for example to keep taxation very low in order to maintain the support of the mass, even at a cost of repeated cycles of growing budget deficits and increasing debt.

The heritage of these populist economic policies is our third argument that may help explaining the low level of tax burden observed in the young Latin America democracies. As mentioned in section 2, the democratization process is perceived by citizens as an improvement and a way to attain economic development. In this sense, it could be difficult for politicians elected in a sufficiently free and fair context to increase taxes with respect to the previous political regimes. In particular, the political cost of increasing income taxes in these low-income countries, in terms of loss of support from the population, may be so high that the government prefers to tax corporations (and provide a system of incentives for them, see Marenzi and Maffini 2007).

5. Conclusions

Latin America suffers an “excess of inequality” (World Bank 2005). The high levels of inequality have been quite stable over time. Thus, they are not affected by economic or political changes that characterized the last decades in this area of the world. Inequality ex-post is not much better than inequality ex-ante. This suggests that taxation does not have a redistributive impact. Fiscal pressure is in fact quite low and indirect taxes dominate direct ones in many countries’ tax structure.

Though the high ex-ante and ex-post inequality may sound consistent with the non-democratic phases of the XX century, it is quite surprising that they remain similar after 20 years of democracies. Political economy median voter’s theories would predict an

increase of taxation and redistributive policies, which, instead, has never started. We have suggested that other political factors are still relevant in Latin American democratic decision making, which may help explaining this apparent puzzle: a low level of representation of political parties, large power of lobbies and interest groups, high "disintermediation" from the financial sector which reduces tax enforcement, the heritage of populist economic policies. Reducing the role of these factors seems to be essential to a democratic increase of fiscal pressure and redistribution which, lastly, would reduce inequality. This in turn may also have an important positive impact for growth and the overall development of Latin America (see Aghion *et al.* 1999).

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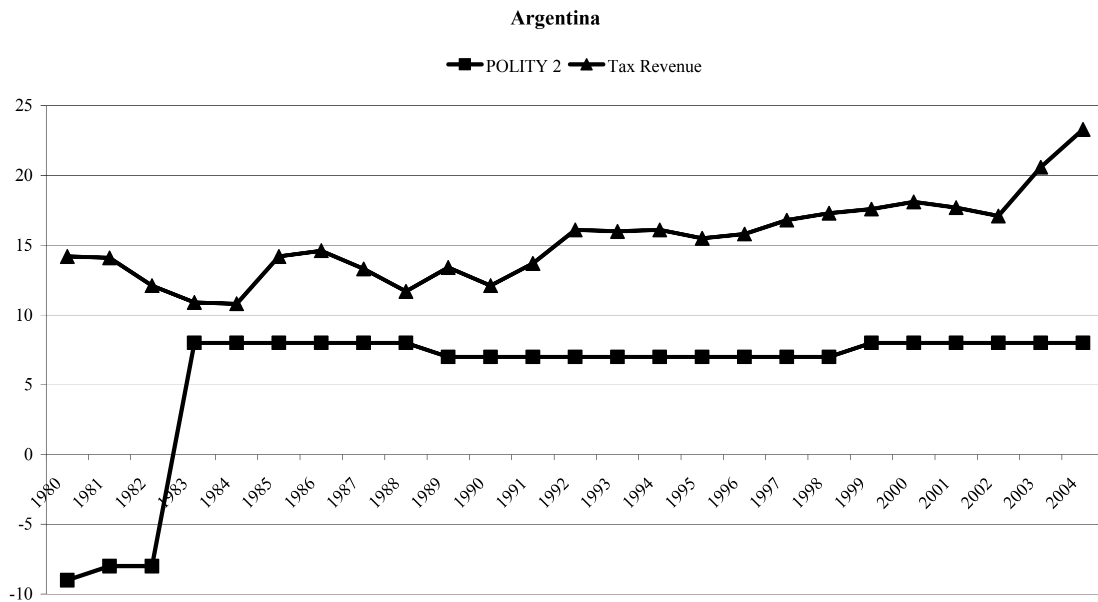
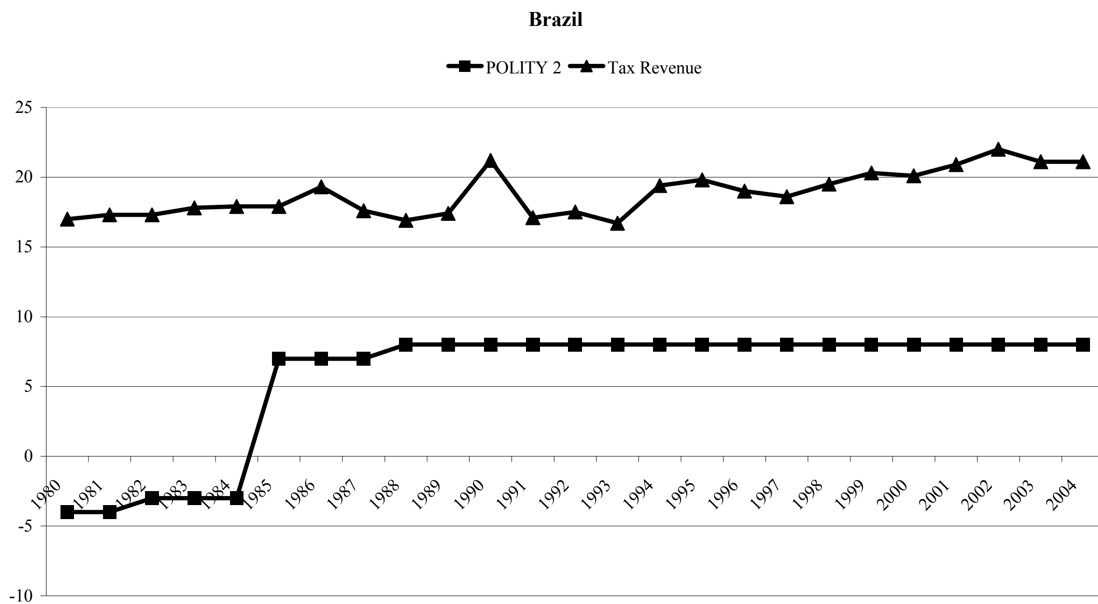
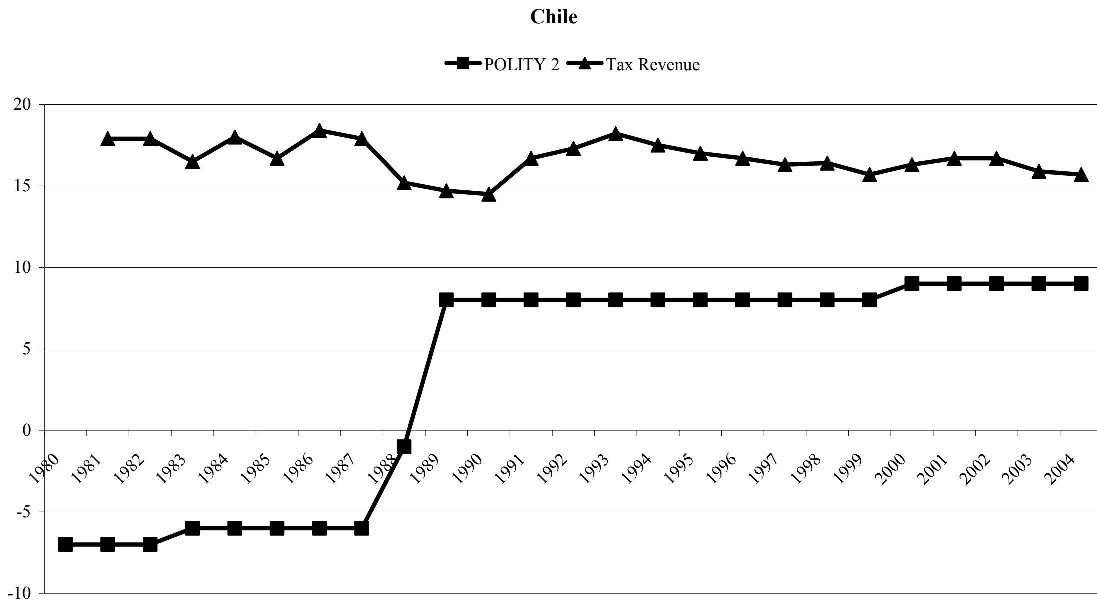
Figure 1 The evolution of POLITY2 and Tax Revenue in Latina American countries



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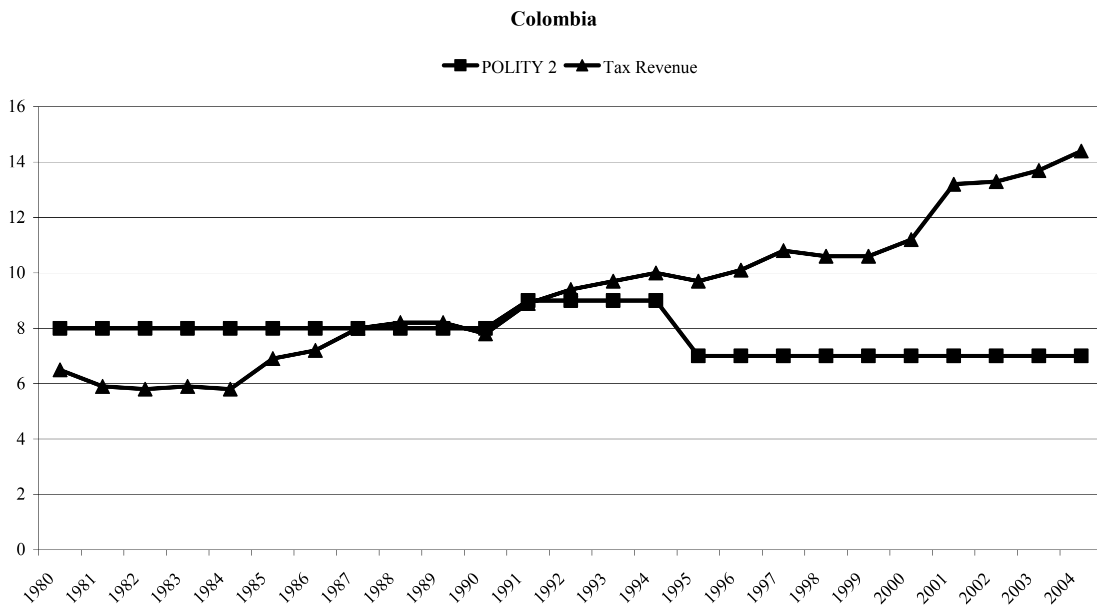
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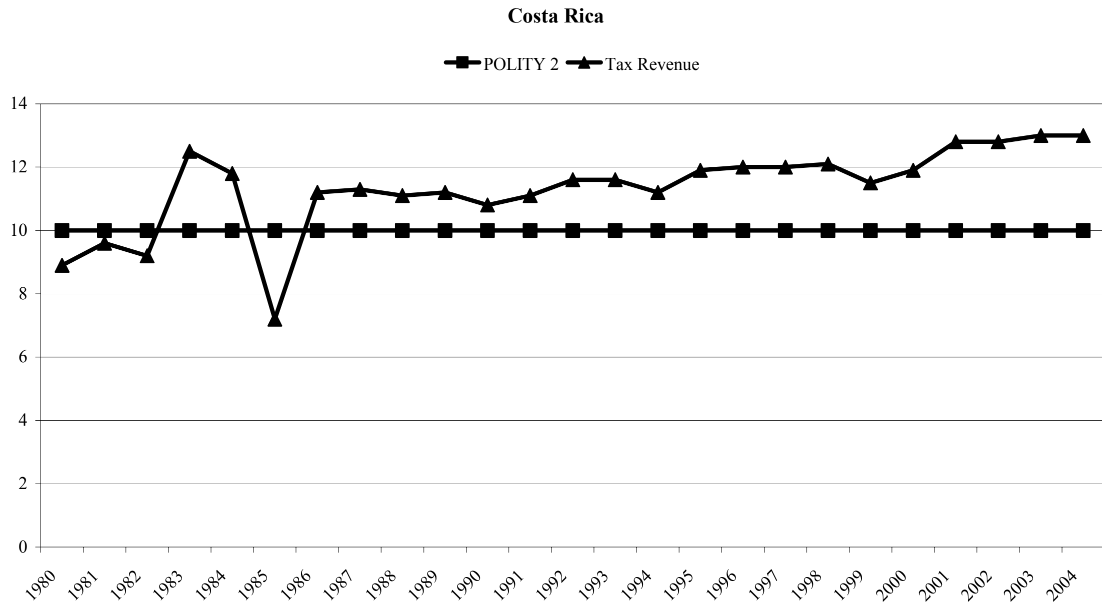
Costa Rica
POLITY 2
Tax Revenue
14
12
10
8
6
4
2
0
1980
1981
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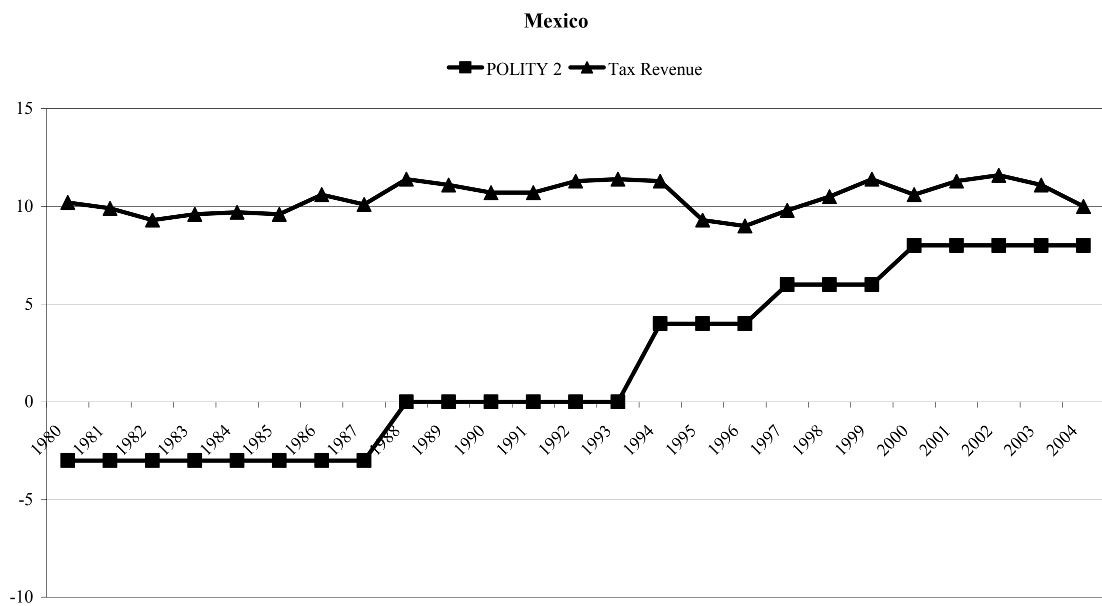
Mexico
POLITY 2
Tax Revenue
15
10
5
0
-5
-10
1980
1981
1982
1983
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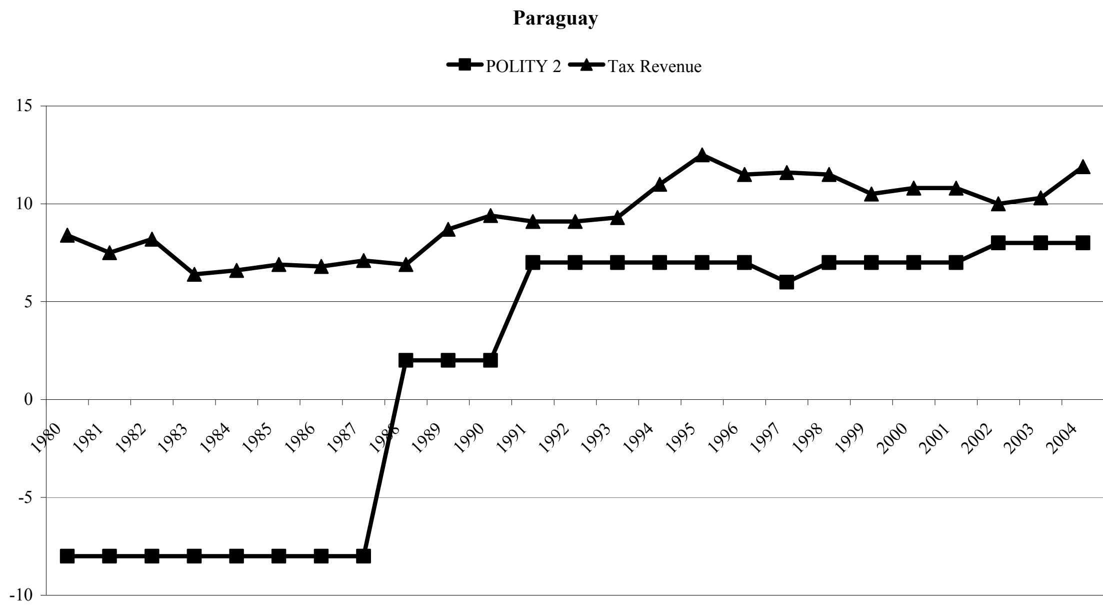

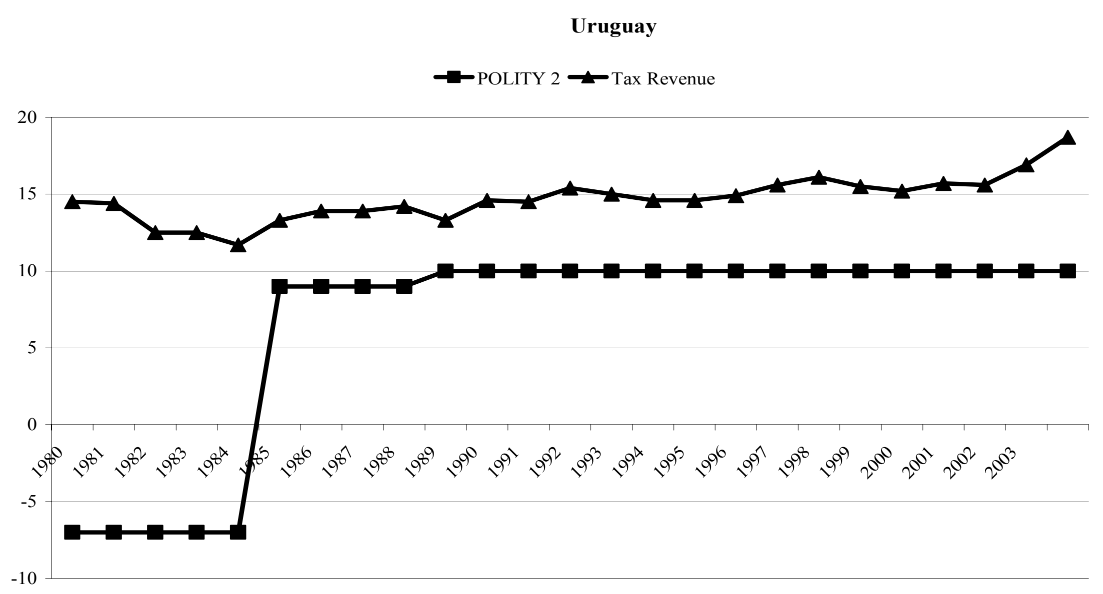

Note: Tax Revenue for Argentina and Brazil refers to general government
Source: POLITY2 from Polity IV dataset and Tax Revenue from ILPES CEPAL.

4. CORPORATE TAX SYSTEMS AND POLICIES FOR ATTRACTING FDI IN LATIN AMERICA

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. Reporting the experience of Latin American countries, the paper focuses on the effects of the corporation income tax (CIT) and fiscal incentives on foreign direct investment (FDI). The CIT affects both the marginal and inframarginal return to investment. Hence, it is an important factor in determining the cross-country distribution of FDI, together with tax incentives and other factors such as the stability of the institutional framework, the labor force abilities and good infrastructure. After the restrictive policies of the 1970s and the debt crisis of the 1980s, foreign direct investment in Latin America became a key element for fostering growth and development. Globalization in the form of increased trade and foreign investment has also encouraged countries to review their fiscal systems. In a world where an increasing number of countries compete to attract limited capital, tax authorities have to promote capital inflows by offering investment tax incentives while rationalizing the fiscal system. In this respect, countries in the region made extensive use of generous and broad-based tax incentives, mainly granted to firms located in tax-free zones. In the latter, investment is wholly or partly exempted from income and capital taxes. In a highly competitive environment where many developing countries can offer a generous treatment to low value-added FDIs, it is important for the development of Latin America to attract the "right" type of FDI. In other words, governments should stimulate foreign direct investment likely to generate spillover benefits in the host economy. The paper is organized as follows. After a general introduction, the first section depicts the evolution and the type of foreign direct investment in the region since the 1980s. Section two describes the policies used to promote capital inflows. Section three illustrates the corporation income tax systems and session four adds a description of the main rules adopted to tackle issues in international taxation.

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JEL Codes: **H20, H25, F21, F23**

1. Introduction, contents and main conclusions

Reporting the experience of Latin American countries, the paper focuses on the effects of the corporation income tax (CIT) and fiscal incentives on foreign direct investment (FDI). The CIT affects both the marginal and inframarginal return to investment through the effective marginal and the effective average tax rate (Devereux and Griffith 1998 and 2003). Hence, together with tax incentives, it is an important factor in determining the cross-country distribution of FDI (Hines 1999 and De Mooij and Ederveen 2003). After the restrictive policies of the 1970s and the debt crisis of the 1980s, FDI in Latin America became a key factor for fostering growth and development. The liberalization of the economy and the deregulation and privatization of services have largely contributed to the FDI inflows in the region since the 1990s (Rios-Morales and O'Donovan 2006). Also before that, Latin American governments have widely used tax incentives to attract foreign capital. The use of many different fiscal incentives created a complex and opaque system imposing high compliance costs on taxpayers and a serious burden on the administration (see, among others, Zee *et al.* 2002).

Today, globalization in the form of increased trade and foreign investment has put fiscal systems even more under pressure. Developing countries all around the world have to attract investment in a more competitive environment and therefore, they still have to make use of fiscal incentives. At the same time, it is important to maintain an adequate stream of revenues for financing projects (e.g. education of the labor force, infrastructure) aimed at making the environment more attractive for FDIs. Since the mid-1990s, many countries in the region tried to re-organize their fiscal system more efficiently, mainly following the "low-rate broad-based" (LRBB) approach (Martner and Tromben 2004 and Tanzi 2000). As a result, nowadays Latin America has relatively low statutory corporate tax rates although there are still differentials in the tax rates and in the maturity of the CIT system. Nonetheless, the benefits from tax competition are not equally distributed among the countries of our selected sample (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay and Uruguay). For example, Chile has a modern corporate tax system which has assimilated most of the international standard rules, such as the taxation of worldwide income and the adoption of safeguards against tax arbitrage (e.g. transfer pricing rules, thin capitalization). On the contrary, Colombia and Paraguay still have a pre-global corporate tax system.

An efficient fiscal system should not support unproductive rent-seeking behaviors while trying to promote investment. Hence, it is important for fiscal incentives to be part of a coherent broad fiscal policy generating a transparent, efficient fiscal system. Generally, this doesn't happen

in the countries of our sample as they still offer generous and broad-based tax incentives mainly to foreign and domestic firms located in free-tax free-trade zones. Companies located in those areas are granted full or partial exemption from income and capital taxes. (Agosin *et al.* 2005). These forms of generalized incentives did not guarantee inflows of high value-added investment in the region. Latin America countries have attracted mainly natural resources, market-seeking and efficiency-seeking FDIs. There is no substantial *technological assets-seeking* investment. The latter is more likely to induce positive spillovers into the domestic economy through technology and knowledge transfers.

It is nowadays increasingly important for Latin America to attract high value-added FDI. The latter are more likely to create positive externalities for the local economy and they are therefore crucial for growth and development. This type of investment is attracted not only by fiscal incentives but also by specific characteristics of the host country such as the education of the labor force and the availability of proper infrastructure. For building up a stock of non-fiscal capabilities able to attract foreign capital, countries in the region need to generate tax revenues as well. Latin American fiscal administrations started adopting measures to protect their tax base internationally. They endorsed transfer-pricing and thin capitalization rules and they developed a network of tax treaties against double taxation. This is a further step in the direction of a more efficient and more modern fiscal system. The reforms were not implemented by all countries of the region, though. Furthermore, complex rules such as those regulating transfer-pricing are sometimes not enforced as the administrations still lack the expertise to apply them.

The paper is organized as follows. The first section depicts the evolution and the type of foreign direct investment in the region since the 1980s. Section two describes the policies used to promote capital inflows. Section three illustrates the corporation income tax systems and section four adds a description of the main rules adopted in the selected countries to tackle issues in international taxation.

2. Foreign direct investments in Latina America: evolution and patterns

The increasing integration of the global economy has lead to the amplified importance of FDI around the world. Since the 1980s, global net flows of FDI increased by about 100 percent from about fifty-seven US$ billions in 1980 to six hundred sixty-five US$ billions in 2004 (see Figure 1). The sizeable growth in FDIs has been quite volatile: phases of stagnation (such as the first half of the 1980s and 1990s) were followed by periods of significant growth (second half of the 1980s and

1990s). FDI flows to Latin America followed a similar trend even though the region did not take advantage of the first FDI boom of the late 1980s: in the 1970s and 1980s, the countries of the region applied import-substitution industrialization policies hence building an environment of trade protection. Inflows of FDI into the region remained fairly stable from 1980 until 1993, increasing at an annual rate of less than 2 percent and lingering around one percent of GDP. The FDI boom in Latin America began in 1993.

FIGURE 1 HERE

The view of Latin American governments changed radically in the 1990s: after the restrictive policies of the 1970s and the debt crisis of the 1980s FDI became a key element for fostering growth and development. FDI inflows prospered uninterruptedly until 1999. In terms of levels of net total FDI attracted, the leading countries are Brazil, Mexico, Argentina and Chile (see Figure 2). In terms of net total FDI as a percentage of GDP, the leading countries are Chile, Brazil, Costa Rica and Mexico (see Table 1). In this period, FDIs were attracted by deregulation and privatization of services and by policies opening up and liberalizing the economy (among others, Rios-Morales and O'Donovan 2006). Between 1990 and 1998, the countries in the region privatized assets for about US$ 154.2 billion and their high tariffs on imports and exports were reduced very quickly at about 10 percent -14 percent (Hosono and Nishijima 2001).

New regional integration schemes were also launched and/or revitalized through trade agreements signed by Latin American countries with both their neighbors and outside players (e.g. the Southern Common Market (MERCOSUR), the Group of Three, the North America free Trade Agreement (NAFTA) and the Free Trade Agreement of the Americas (FTAA)).

FIGURE 2 HERE

FIGURE 3 HERE

TABLE 1 HERE

More recently, after four years of deteriorating FDI inflows (from 2000 to 2003) as a consequence of the financial crisis, Latin America and the Caribbean underwent first a rebound and then an increase in FDI in 2004. In 2005, FDI inflows to the whole region increased by 12 percent and amounted to $67 billion ($104 billion including offshore financial centres) of which 40 percent

came form the United States[1] (UNCTAD 2006). The reasons are to be found in the global and local strong economic growth and in the high commodity prices. However, Argentina was the worse hit by the debt crisis in 2001 and it has not yet got back to its previous levels of FDI (UNCTAD 2004). FDI flows to the region have increased substantially but other types of capital flows have remained sluggish. FDI is certainly still the central source of private external finance to Latin America in recent years. Using Dunning's well-known scheme (Dunning 1993), foreign direct investment can be classified according to the economic rational driving them: natural resource-seeking investments, market access-seeking, efficiency seeking and strategic/technological asset-seeking (see Table 2).

TABLE 2 HERE

In the last century, FDI in the region has been of the *natural-resource seeking* kind as it was primarily aimed at securing oil, gas and minerals. This type of investment rarely induces positive spillovers in the host economy, in particular when resources are exported as raw materials. The liberalization and privatization waves encouraged this type of investment also in the 1990s: transnational corporations (TNCs) could acquire state assets in the form of either privatized companies or gas, petroleum (Venezuela, Colombia and Argentina) and mineral rights (Chile, Peru and Argentina). But the reforms occurred in the last decade of the twentieth century also fostered *market-seeking* FDI,[2] especially in the services sector where newly privatized telecommunication and energy companies became good investment opportunity together with the sale of private sectors activities such as banks and other financial institutions (Mortimore 2000). A major example is Brazil: it is the biggest recipient of FDI in Latin America and in particular, between 1991 and 1998, 28 percent of FDI entered the country through the privatization program (Mortimore 2000) mainly in the telecommunication (e.g. Telebras and cellular phone concessions) and electricity sector. In general, between 1996 and 2002, 59 percent of the FDI inflows in Latin America targeted the services while 28 percent manufacturing and only 13 percent the primary sector (Rios-Morales and O'Donovan 2006). More specifically, the south cone received more *market-seeking* investments in services (financial services, telecommunications, electricity and gas distribution) and manufactures (agro-industry, chemicals and automotive) while Mexico and the Caribbean Basin traditionally collected mainly *efficiency-seeking* flows aimed at securing lower production costs and establishing

[1] The second biggest investor was the Netherlands (but caution should be used as many multinational groups locate their holding companies in the Netherlands because of fiscal privileges). Spain followed with 6 percent of total investment. Additional key players were other countries in the region as a result of the activity of some "Trans-Latin" corporations such as the Argentinean Technit, the Mexican America Movil and the Brazilian Camargo Correa.
[2] This type of investment was typically targeted at gaining access to local markets.

export platforms (ECLAC 2006). FDI from the automobile industry exemplifies this pattern[3] but it is important to remember that *efficiency-seeking* investments in the Caribbean also entered the electronics, apparel, and services sectors (e.g. electronics and the administrative services in Costa Rica). In Brazil and Argentina investments from foreign (mainly European) automobile companies aimed at either consolidating their position or at gaining access to local automotive markets. On the contrary, investment in Mexico, largely from US companies, was in search of lower production costs to better compete in the home country market.[4] The difference between the two sub-regions lies in institutional and geographical factors. First, the MERCOSUR countries lacked the geographic closeness with a major market and, at the same time, their large market attracted *market-seeking* investments almost by definition.[5] But their institutional environment was also very different from the Mexican one. The Mexican authorities implemented the *maquila*[6] program which allowed foreign export-oriented firms to operate tax-free. They also allowed the assembling of vehicles with a high percentage of imported parts, vehicles which were exported once assembled. The NAFTA was also a key element in boosting automotive FDI from the US: the agreement grants special provisions for the automobile sector. Its regional norms of origin establish that a good is considered to be produced within the NAFTA countries if 62.5 percent of its production costs are incurred in that area. This has favored investment of the US corporations in Mexico as goods (and their value-added) produced in the NAFTA region attract lower indirect taxes when exported back to the US. MERCOSUR countries have free-trade zones as well. Nonetheless, Mortimore (2000) highlights they are not as advantageous as the Mexican export-processing zone for assemblers. Countries in the South cone also kept barriers to import of motor vehicles and high levels of mandatory regional content.

Table 2 shows there are no substantial *technological assets-seeking* investments aimed at securing technology-intensive production assets. This type of FDI is more likely to induce positive spillovers into the domestic economy through technology and knowledge transfers. The literature argues that this is the main weakness of the Latin American FDI attraction model (Rios-Morales

[3] Foreign direct investment in the automotive industry was a very important component of FDI in Latina America and the Caribbean during the 1990s. According to Mortimore (2000), in 1998 seven of the ten biggest companies in the region by consolidated sales belonged to that industry. They were General Motors, Volkswagen, Ford, and Chrysler in Mexico and Volkswagen, General Motors and Fiat in Brazil.

[4] Mortimore (2000) highlights that during the 1980s, European and particularly American corporations faced stiff competition from their Asian (in particular Japanese) counterparts in the automotive, apparel and electronics industries. By relocating part of the production (mainly the assembly process) in the Caribbean, American companies were able to fight back. They could assembly their final products at lower costs in the region and thus, export them back in their home market at lower prices.

[5] It is worth noting that as a consequence of the MERCOSUR, the market in the South cone is even bigger.

[6] A *maquiladora* is a Mexican corporation, wholly or predominantly owned by foreigners, that assembles products to export in other countries.

and O'Donovan 2006). Not only this is likely to be the reason why the literature does not find evidence of positive spillovers from foreign investment to the regional domestic economy (among others, Aitken *et al*. 1996) but it also makes the region vulnerable to the competition of Asian countries. Actually, Latin America continues to lose headway to destinations, such as China and other Asian nations even though FDI remains the biggest source of external private funding for the region. In the 1980s, the area received about 12 percent of global FDI. The percentage shrank to 10 percent in the following decade and to 8 percent since 2000 (ECLAC, 2006).[7] According to ECLAC (2006), while countries such as Singapore, Korea, China, Malaysia and Thailand implement more active and focused policies for attracting FDI, in Latin America strategies are still passive and not targeted at specific high-quality investments. Furthermore, whilst the more competitive European and Asian countries target their incentives to efficiency-seeking and strategic or technological-asset seeking FDIs, incentives in South America and the Caribbean are principally fiscal in nature and very general. Moreover, many countries of the region score quite low in various indexes measuring the quality of the business environment. Except for Costa Rica and Chile, the other countries appear in the bottom two quintile of the Index for Economic Freedom (Heritage Foundation),[8] Doing Business (International Finance Corporation),[9] the Corruption Perception Index (Transparency International)[10] and the A.T. Kearney Globalization Index.[11] This places the area far behind the developed nations and the Asia-Pacific region.

3. Investment promotion policies in Latin America

Before the FDI boom, most of the countries of our selected sample (e.g. Argentina, Mexico and Brazil) implemented batteries of diverse tax incentives aimed mainly at their less developed regions and at specific industries (Bird and Chen 2000). The incentives were not part of a broadly consistent industrialization and/or development policy. Therefore, they did not have much effect in terms of

[7] In 2005 South, East and South-East Asia attracted about $165 billion, with China alone accounting for about $72 billion. China was the third largest recipient of FDIs in 2005 totalling about 22 percent of total investment going to developing countries and about 7 percent of global investment (UNCTAD 2006).
[8] The index measures 10 broad economic factors: trade policy, tax burden, government intervention, monetary policy, foreign investment, banking, wages and prices, regulation, rights of ownership and degree of market informality.
[9] This index measures how easy it is to do business for a start-up company. It records he simplicity of company registration procedures, licensing agreement, and so on.
[10] This index measures the perceived and not the objective corruption in a country.
[11] This index measures four different aspects of globalization: economic integration (through trade and FDI inflows and outflows), technological connectivity (through number of internet users), and political engagement (number of country's memberships in international organizations and UN peacekeeping missions) and personal contact (through monitoring tourism and international travel).

promoting growth and development even if they might have had some positive effects on specific sectors (e.g. manufacturing and tourism in Mexico and Costa Rica). Being fragmented across sectors and regions and being implemented through particular laws, incentives were very likely to be abused, especially in federal systems such as Brazil and Argentina where local authorities are more exposed to lobbies' pressure (UNCTAD 2000).

The political economy literature attempts to pin down the mechanisms leading to some specific investment promotion policies (Jensen 2003) such as those mentioned above. Among others, Li and Resnick (2003) explain the level and type of investment incentives with the nature of the host country political institutions. The hypothesis is then tested in Li (2006). Using a cross-section of 52 developing countries, including the countries of our sample, the author finds evidence that the institutional characteristics of the host political system (*i.e.* democracy *versus* autocracy) affect the level of tax incentives granted to foreign investors. Generally, more democratic regimes offer effective property rights protection. Hence, strong tax incentives are not needed to compensate FDIs for the high risk of expropriation, seizure of assets, contract repudiation, and government corruption. Nonetheless, not all autocracies adopt the same incentives policy. Since tax incentives imply a transfer of benefits from domestic to foreign capital, the choice of which type of investment to promote is strictly bond to the economic *elites*' interests and their lobbying power. In Argentina, during the last military government, the incentives were implemented mainly for domestic political reasons either in response to domestic lobbies or to "compensate" some regions (e.g. Tierra del Fuego) for being far from the economic centre of the country (Byrne 2002). Borders security reasons also encouraged governments to promote a program of fiscal incentives for industries in some poor and under populated provinces such as the Manaus Free Zone in the Brazilian Amazon.

Since the 1990s, countries in the region tried to rationalize the investment incentives systems (Figari and Gandullia 2007) as the different and fragmented rules in place displayed many shortcomings. First, they were highly distorsive with respect to agents' economic decisions as they also encouraged corruption and unproductive rent-seeking activities. They made the fiscal systems more complicated and less transparent imposing high compliance costs on taxpayers and a serious burden on the administration. Another major drawback consisted in great revenue losses. This could potentially prevent the authorities to develop infrastructure, education and health programs. The latter features can make the countries attractive for FDI. While rationalizing the fiscal system, in a world where an increasing number of countries compete to attract limited investment capital, tax authorities have to encourage capital inflows by offering investment tax incentives (see, among others, Morisset and Pirnia 2001; Holland and Vann 1998; Rios-Morales and O'Donovan 2006). This practice can lead to a race to the bottom where all countries end up with a comparable amount

of total investment and with serious revenue losses (Thomas 2000). In this respect, all the countries[12] in our sample relied upon free-trade zones which granted exemptions mainly from import duties and indirect taxes (e.g. VAT). Many of the free trade areas also exempt profits and their repatriation for a limited amount of years.[13] The aforementioned tax benefits were also extended to domestic firms (Agosin *et al.* 2005). Most of the fiscal advantages accruing in those areas have been phased out (e.g. Mexico) or will be eliminated as they are not compatible with many of the trade agreements signed by the countries in our sample (e.g. MERCOSUR and WTO).

As mentioned above, Latin America has attracted mainly natural resources, market-seeking and efficiency-seeking FDI with a "the-more-the-better" approach (Rios-Morales and O'Donovan 2006). In this environment, according to the UNCTAD FDI Indices,[14] between 2002 and 2004, Chile and Costa Rica have attracted a good amount of FDI with respect to their capability (see Table 3).

TABLE 3 HERE

Chile has performed well in attracting foreign capital as it is politically and economically stable. In addition, it has a low corporate tax rate (17 percent) coupled with the a full integration system in which the CIT paid is creditable against income taxes imposed on resident (Global Complementary Tax) and foreigners individuals (Additional Tax). Moreover, in order to boost financial markets, the government allowed full/partial exemption of capital gains on the disposal of certain assets. In 2002, a new and favorable tax regime for platform companies[15] was launched with the aim of encouraging multinational corporations to set up their regional headquarters in Chile. For tax purposes, platform companies are considered as non-resident or domiciled taxpayers so that only income generated in the country is taxed and dividends and profits that they may receive from subsidiaries abroad would be exempted. Chile has also signed a great number of tax treaties with other Latin American countries (e.g. Argentina, Brazil, Mexico, Paraguay), developed (e.g. Canada, France, Spain, Sweden and the UK) and developing countries (e.g. Malaysia) allowing a reduction in withholding taxes.

Costa Rica profits from a stable economic and political climate and from a well-educated labor force. The country has greatly used incentives to attract capital flows, in particular in the

[12] Argentina is the only exception.
[13] For an analysis of the costs and benefits of tax holidays, see OECD (2001).
[14] See www.unctad.org.
[15] Law 19,840 enacted in November 2002 enables foreign investors to set up a platform company in Chile for channelling and managing investments in third countries. Companies set up as a Business Platform must be incorporated in accordance with Chilean law and can either be open stock corporations or closed stock corporations, subject to the same regulations and governmental supervision as listed stock corporations.

manufacturing sector (e.g. electronics with the Intel semiconductor assembly and testing plant) which has prospered under the tax-free zone system.

Finally, both Chile and Costa Rica have specific institutions assisting and guiding foreign companies to set up their operations in the two countries.

In the actual highly competitive setting where many developing countries can offer generous treatment to attract low value-added FDI (D'Amuri and Marenzi 2006), it is important for the development of Latin America to attract the "right" type of FDI. In other words, governments should stimulate foreign direct investment likely to generate spillover benefits in the host economy (e.g. transfer of knowledge). Positive externalities of FDI are normally ignored by private investors and they are not incorporated in their decision making process so that the level of investment could be sub-optimal. In this direction, Brazil and Mexico granted incentives for qualified investments to encourage technological qualification of enterprises: a tax credit (15 and 30 percent, respectively) is available for R&D expenses incurred in the tax years and different forms of accelerated depreciation incentive are allowed for investment on new fixed assets and for new equipment used in R&D activities (Figari and Gandullia 2007).

4. Corporate taxation and investment in Latin American countries

The CIT affects both the marginal and inframarginal return to investment through the effective marginal and the effective average tax rate (Devereux and Griffith 1998 and 2003). Hence, together with tax incentives, it is an important factor in determining the cross-country distribution of FDI (Hines 1999 and De Mooij and Ederveen 2003). Specifically, tax burden on FDI depends on three elements: domestic corporate taxation of home country and host country, international taxation of cross border income flows (dividend, interest, etc.) and interaction of tax systems between home and host countries.

4.1 The systems of corporate taxation

The current corporate tax systems of the selected countries are the result of several fiscal reforms mainly started in the beginning of the 1990s and, for certain countries, still underway. Generally, most countries have realized a consistent reduction in the statutory tax rate in the last decades. At the same time, they have adopted base-broadening measures, such as, taxation of worldwide income, adoption of safeguards against tax arbitrage and reduction of tax exemptions and incentives

(see, among others, Tanzi 2000; Martner and Tromben 2004; Agosin *et al* 2005). Wibbels and Arce (2003) suggest that, as trade and financial liberalization consolidate, CIT revenues get less relevant for Latin American countries. In fact, the share of corporate income tax as a percentage of GDP declined from an average of 5 percent in 1975-78 to 3.9 percent in 1997-2002.

Each country has developed its own tax system in a different social, economic and political framework; this has conditioned the evolution of the national tax systems. As a result, the countries show different level of maturity in their corporate tax systems. In this respect, it is possible to identify three groups of countries[16]. Chile and Mexico display a corporate tax structure that assimilates most of the international standard rules, such as transfer pricing guidelines. A second group of countries (Argentina, Brazil and Colombia) exhibit a system where the current CIT reflects a protracted process of gradual changes, principally responding to macroeconomic fluctuations and shocks rather than to a well defined tax design project. Among these countries, Colombia has a pre-global system, primarily focusing on collecting revenues from internal transactions and local trade rather than favoring capital flows and foreign investments. The transition towards a modern tax system is the main aim of the new wave of tax reforms undertaken by the countries of the third group at the middle of the 2000 (Costa Rica, Uruguay and Paraguay). For different reasons, their full implementation has been delayed but these reforms could potentially modernize the tax systems. In particular, the proposed tax reforms in Costa Rica and Uruguay include several elements of international taxation: a transition towards the worldwide income taxation model and the introduction of a set of traditional instruments, such as transfer pricing rule, definition of permanent establishment and tax haven regulations. Finally, the reform underway in Paraguay broadens the CIT tax base and reduces the tax rate. It should reposition Paraguay system from a primitive to a one that is more appealing for capital and trade.

The main features of the corporate tax system in our sample of Latin America countries are summarized in Table 4.

TABLE 4 HERE

A domestic company is liable to be taxed on its worldwide income in Argentina, Brazil, Chile, Colombia, Mexico and it is granted tax credits for taxes paid abroad. A foreign company is normally taxed only on its host-source income. Costa Rica, Uruguay and Paraguay adopt the

[16] In considering the proposed classification, it should be noted that, the income tax systems of Brazil, Colombia, Costa Rica and Uruguay have a general income tax levied on both individual and business enterprises. The lack of a separate corporate tax law is a relevant element in evaluating the degree of maturity of a tax system.

territorial system,[17] although the proposal of moving to a worldwide system is actually under discussion for the first two countries[18]. Hence, in Costa Rica, Uruguay and Paraguay income arising from foreign sources and received by resident companies is not taxed at all, and foreign taxes are not deductible or creditable. Both Costa Rican and Uruguayan tax systems provide relief to non-residents with respect to source income. Under certain circumstances, Costa Rica may exempt or reduce income tax when there is evidence that the residence country does not grant any credit or deduction for the Costa Rican income tax. In Uruguay dividends and technical assistance are exempted from corporate taxation. Generally, subsidiaries of multinationals are taxed using the same basis of local entities. A different tax rate is applied in certain countries (Chile, Colombia, Costa Rica and Paraguay) to branches of foreign enterprises.

As noted by Martner and Tromben (2004) and Tanzi (2000), in the 1990s most countries began to reduce and unify their national corporate tax rate in order to be more in line with international standards. As a result, today Latin American countries have relatively low statutory corporate tax rates although the tax rate differentials across countries can still be significant. The Latin America average CIT rate was 28.3 percent in 2006: the highest values are those of Argentina and Colombia (35 percent), the lowest one is that of Paraguay (10 percent). All countries apply a standard flat corporate tax rate (see Table 4). However, most of the countries in the region display multiple regimes where together with the standard corporate tax rate, there also exist presumptive, preferential and simplified treatments (see also, Figari and Gandullia 2007).

4.2 Preferential and special regimes

The use of a presumptive taxation system is a common feature of several Latin American countries (Tanzi 2000 and Gonzalez 2006), such as Argentina, Brazil and Colombia. Generally, these systems estimate taxpayer's income using some specific base such as assets, gross receipts/turnover, or external indicators of income or wealth. For example, the Argentinean presumptive minimum income tax works as an assets tax. In Brazil annual turnover is the tax base for the regime of presumed profit. In Colombia, the minimum presumptive income is equal to 6 percent of the corporation's net worth, minus a fixed abatement.

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[17] In the past, Latin American countries, as most of the developing countries, used to rely on territorial taxation system for two reasons. Firstly, having a net external liability position, countries in the region had to gain more from taxing income of foreign investors than exempt residents' foreign income. Second, it was difficult for the tax administration to find out how much foreign income accrued to residents (see, Zee *et al*, 2002).

[18] In particular, according to the Base Report presented in August 2005 by the Tax Reform Commission, the Uruguayan tax system should move from residential approach to the territorial one, after a transitory period (see Barreix and Roca 2007).

Moreover, in most countries the current CIT regimes allow preferential treatments for enterprises operating in specific sectors. Mining companies in Chile are taxed under a progressive scheme with tax rates ranging from 0 to 5 percent. Small enterprises in Uruguay are exempt from CIT and pay a monthly lump-sum tax. In Brazil micro-companies and small enterprises have the option to be taxed under a simplified regime[19] with a progressive rates ranging from 3 to 5 percent for micro-companies and from 5.4 to 8.8 percent for the small enterprises.[20] Medium and large-sized Mexican companies engaged in transport and agriculture activities pay little or no CIT under the simplified regime. In Costa Rica the simplified regime replaces either the CIT or the VAT for qualified taxpayers[21] that adopt it. Simplifying regimes are normally introduced for reducing compliance costs for certain "weaker" entities. Nonetheless, it is widely recognized that, some so-called simplified regime may be actually very complicated (Chen and Martinez-Vazquez 2003).

4.3 Dividends, capital gains taxation and other taxes

In all countries of the sample, excluding Paraguay, inter-company dividends are partially or fully exempt from corporate income tax for resident companies. In Argentina an equalization tax applies where distributions are in excess of taxable profits. Capital gains accruing to corporations are usually treated as ordinary income for tax purposes. Latin American countries tend to impose high rates of withholding taxes (see Table 4). Net worth taxes are levied in Argentina, Colombia, Mexico and Uruguay with different characteristics across countries (Tanzi 2000; Sadka and Tanzi 1993). As already mentioned, a presumptive minimum income tax is levied on firms incorporated in Argentina: the tax is levied at a rate of 1 percent on the value of all assets held at the end of each fiscal year. In Mexico the net worth tax operates as a minimum tax (1.8 percent) for enterprises reporting no income tax liability in their annual tax return. Finally, in Colombia and Uruguay the tax is imposed on the net worth (which depends on the relevant taxpayer and on the type of assets involved) of resident and non-resident companies. The tax rate is fixed at 1.2 percent in Colombia and at 1.5 percent in Uruguay.

Finally, depending on the interaction across the different features of the corporate tax system, effective tax rates may differ substantially from statutory rates. Generous deductions and exemptions or large multifaceted incentives contribute to lowering effective tax rates. At the same

[19] Among other legal entities, subsidiaries, branches and permanent establishments of foreign companies do not qualify for the simplified tax regime.
[20] The tax rate covers mainly, corporate taxation, social contributions on profit, and federal social security tax and excise tax.
[21] The simplified regime is targeted to corporate and individual taxpayers with an annual purchases not greater than a certain amount and with no more than three employees, provided their business activity is one of the eleven included in this regime (china and porcelain production, furniture production, handmade shoes manufacturing, etc.).

time, taxes other than the corporation income tax, such as turnover taxes, gross or net taxes, and property taxes, may increase significantly the effective tax burden on capital investment. A recent comparative measure of total real tax burden affecting foreign capital in some countries of our sample has been produced by Chen and Martinez-Vazquez (2003). The authors calculate the marginal effective tax rates (METRs) on FDI of US multinationals in manufacturing and services sectors for Argentina, Brazil, Chile, Mexico and Peru. The all inclusive effective corporate tax rates are reported in Table 5.

TABLE 5 HERE

The results indicate that Mexico and Chile provide the most tax advantageous environment to US investors. Mexico has a relatively generous CIT regime in term of depreciation allowance (5 per cent for buildings, 25 per cent for vehicles, 30 per cent for computer, and 5-2 per cent for machinery[22]) and the lowest property tax among the four countries. Chile has the lowest legal tax rate.

4.4 Aspects of international taxation in Latin America

The competition for attracting FDI imposes two main constraints on tax administrations. First, they should avoid any double taxation on non-residents' income. Second, they should preserve the tax base so to finance projects (e.g. infrastructure building, education programs) to appeal more to high value-added FDI. Countries have established a series of treaties to avoid double taxation (DTTs) and the erosion of the tax base, specifying when the source country is allowed to levy a tax, whereas the country of residence is required to concede the right to credit. Tax treaties contribute to create a stable and transparent environment for trade development and FDI promotion through clear and steady rules. Furthermore, tax treaties contain specific limitations on the withholding tax rates on dividends, interest, and royalties imposed by the source country, as prescribed in the OECD Model Convention. Alternatively, the withholding tax rate levels are left to bilateral negotiations, as in the UN Model Convention for developing countries. DTTs should also include rules for the exchange of information between countries to facilitate the protection of the tax base. Unfortunately, this is rarely the case for developing countries and hence, withholding taxes are levied at higher rates.

[22] Among the four countries, the less generous regime of depreciation allowance is that in Argentina with the following percentages: 2 percent for buildings, 20 percent for vehicles, 33 percent for computer, and 10 percent for machinery.

In general, when compared with the tax treaty network of more developed countries, Latin America's one is rather limited (see Table 4). Nonetheless, it is rapidly expanding, especially for countries such as Argentina, Brazil, Chile and Mexico. Chile is very active in terms of DTTs negotiation: it signed twenty-one[23] treaties since the end of the 1990s. In general, Chilean treaties are based on the OECD model,[24] which contains reduced withholding tax rates for different kinds of income and grants tax credits for taxes paid in the host countries.[25] Argentina signed eighteen tax treaties with, among others, Austria, Belgium, Denmark, Finland, France, Germany, Italy, Norway, Spain, Sweden, Switzerland, the Netherlands and the UK. Most of the treaties are based on the OECD model. Brazil also has an extensive network including treaties with Belgium, Canada, France, Italy, Japan, Luxembourg, the Netherlands, Portugal, Spain, Argentina, Chile and Ecuador. It has recently concluded negotiations with Mexico, Israel, Belgium and South Africa starting a trend of reducing withholding taxes on royalty payments (from 10 per cent to 15 per cent) within the framework of the OECD model convention. By contrast, Colombia tax treaty network is underdeveloped. Until now, Colombia has one bilateral tax treaty signed with a traditional capital exporting country (*i.e*. Spain recently ratified on 1 July 2006). Another major treaty signed with the Andean Community created significant tax restrictions for the movement of services.[26] Since Costa Rica, Uruguay and Paraguay enforce the territorial model, there is no need to grant double taxation relief for their residents with respect to foreign-source income. All countries, in different ways, provide relief to non-residents with respect to source income. The transition towards a worldwide taxation system recently proposed in Costa Rica and Uruguay will require a revision of the current rules, though.

A number of anti-avoidance and anti-deferral measures such as transfer pricing regulations, thin capitalization rules and controlled foreign company (CFC) legislation have been adopted in the last ten years for protecting the national tax base (Table 4). With the exception of Paraguay and Costa Rica, all countries of our sample have implemented transfer pricing rules incorporating at least generally the arm's length principle contained in the 1995 OECD Transfer Pricing Guidelines. The process started in 1995[27] in Mexico, the only OECD member of region.[28] Other countries

[23] Countries which have in force a Double Tax Treaties with Chile are Argentina, Poland, Spain, Peru, Ecuador, Korea, Brazil, Mexico, Canada, Norway, UK, Denmark, Croatia, Sweden and New Zealand, Malaysia, France, Ireland, Paraguay, Russia, Portugal. The following countries are negotiating a treaty with Chile: Finland, Cuba, Hungary, the Netherlands, Colombia, Switzerland, US, Venezuela, Italy, Czech Republic, China, Thailand, South Africa, Australia, Belgium, Kuwait, India.

[24] Chile is not a member of the OECD but only an observer.

[25] Following the United Nations model, the treaty signed with Argentina in 1986 represents an exception as it grants the right to taxation almost entirely to the country of source.

[26] In order to avoid double taxation with regard to air and maritime transportation Colombia has signed some international tax agreements with Chile, Germany, US, Venezuela, France and Brazil.

[27] In 1995 the transfer-pricing legislation was enacted for *maquiladoras* and in 1997 for all taxpayers.

[28] Mexico joined the OECD in 1994.

followed suit: Argentina[29] (1998 and 1999), Chile (1997), Colombia (2004), Peru (2001), Venezuela (1999 and 2001) and Uruguay (2007) enacted transfer-pricing rules based on the OECD principles even if the individual legislation has differentiated aspects in each country. Brazil does not follow the international arm's length principle established by the OECD. Actually, the Brazilian legislation ratified in 1997 departs from international norms. It settled on a maximum amount for both deductible expenses on inter-company import transactions and for taxable revenues on inter-company export transactions. It also imposes some specific methods and fixed margins for determining the correct transfer pricing for Brazilian tax purposes. The introduction of transfer-pricing rules is an important step towards a modern fiscal system able to protect the national tax base. Enforcement activities are becoming more and more frequent in Argentina, Brazil, Chile, and Mexico. Nonetheless, the tax administration's lack of experience in dealing with complex rules has created a situation of arbitrariness chiefly in Brazil and Argentina (Villela and Barreix 2002). OECD arm's length principles have been nominally adopted in many countries of the region. The administrations which have applied transfer pricing rules in practice (e.g. Mexico and Argentina) departed from the OECD model, though. In fact, many Latin American tax administrations have employed more protective principles for calculating the tax base (Velayos *et al.* 2007).

Transfer-pricing rules become ineffective if companies in tax havens receive great part of the profits generated in another developing country. Legislation defensive against low-tax jurisdictions is already in place in Argentina, Brazil, and Mexico and will be effective in Uruguay as from 1st July 2007. CFC legislation prescribes that income from a controlled foreign entity situated in an offshore location will be attributed to the domestic taxpayer and subject to tax in her/his country of residence. There can be very different ways to apply this rule. In Latin America, the existing and more widely used model is to adopt a blacklist of low tax jurisdictions. Mexico adopted this approach in 1996,[30] Brazil (1996) and Argentina (1999) followed suit.[31]

The international aspects of taxation and tax incentives are crucial elements for Latin American countries willing to compete in today's world. The aforementioned implementation of anti-avoidance and anti-deferral measures is not enough: regional integration has to be encouraged even further through the free flow of information between governments and between governments and investors (Bird 2007).

[29] Argentina is an observer at the OECD.
[30] In 2006, Mexico has changed its system form the "black-list approach" to a more complex system in which the tax administration assesses whether a specific structure is in fact a low-tax structure.
[31] Colombia has also adopted CFC rules but it has not defined its "blacklist" yet.

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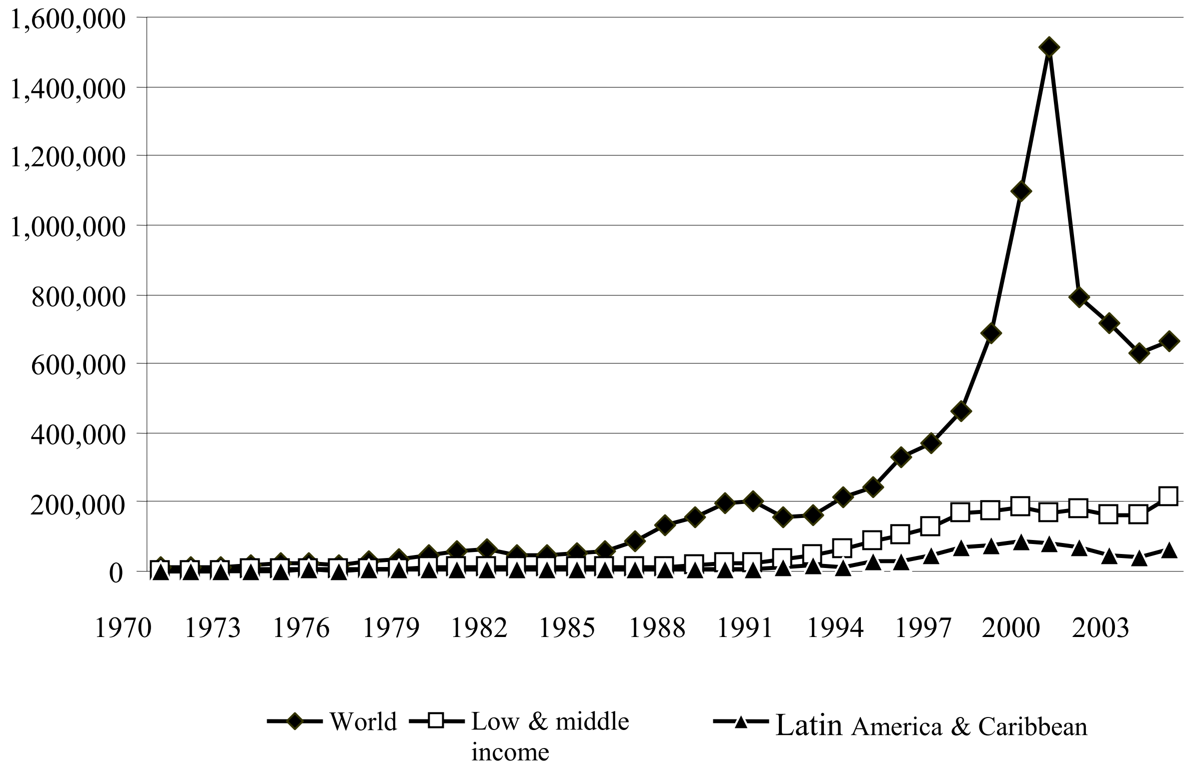
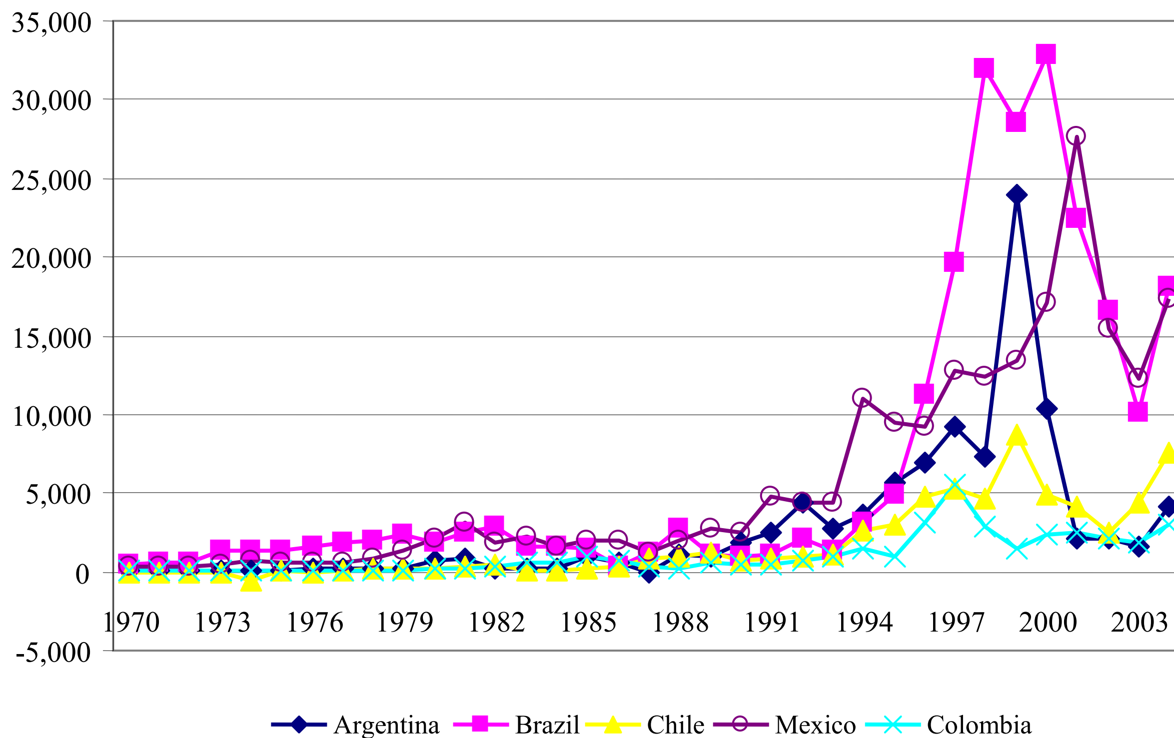
Figure 1 World FDI net inflows (current US$, millions)



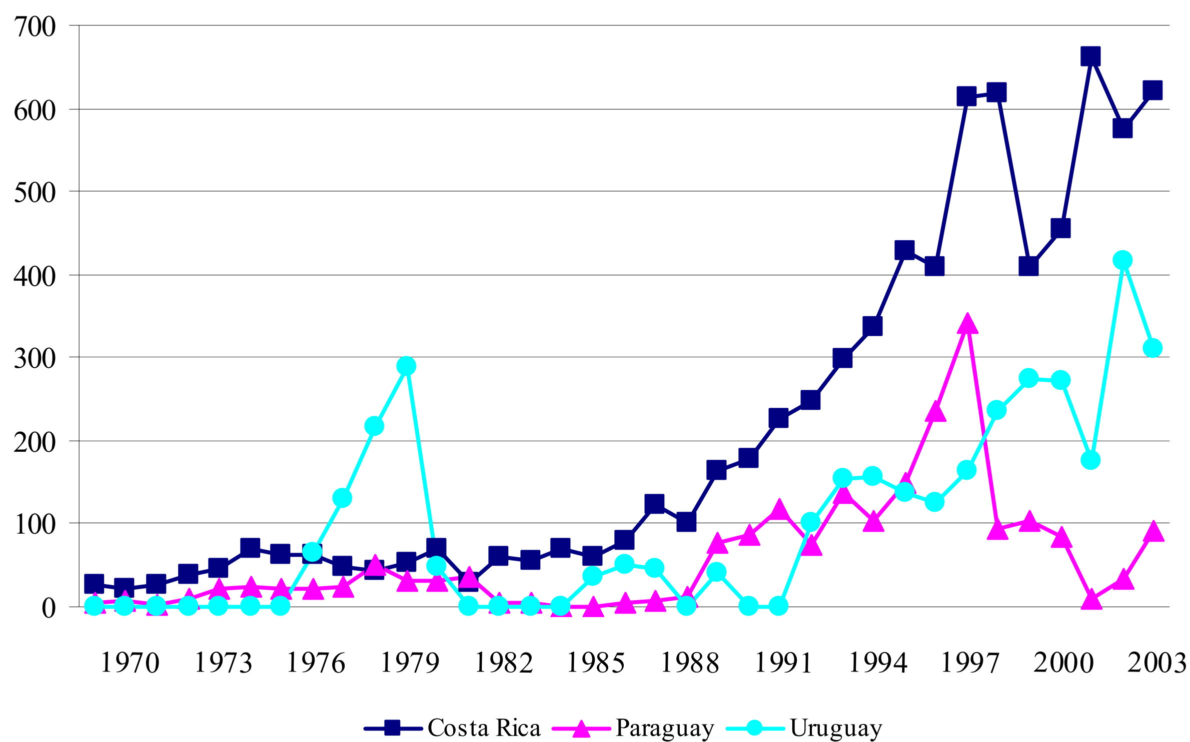
Source: World Development Indicators, World Bank. September 2006

Figure 2 FDI net inflows in Argentina, Brazil, Chile, Mexico, Colombia (current US$, millions)



Source: World Development Indicators, World Bank. September 2006

Figure 3 FDI net inflows in Costa Rica, Paraguay, Uruguay (current US$, millions)



Source: World Development Indicators, World Bank. September 2006

Table 1 FDI net inflows (% of GDP – average values per period)

	1970-1979	1980-1989	1990-1999	2000-2004
Chile	-0.19	2.03	4.99	6.06
Brazil	1.13	0.66	1.58	3.70
Costa Rica	2.26	1.78	3.13	3.18
Mexico	0.80	1.16	2.24	2.85
Colombia	0.36	1.30	2.14	2.79
Argentina	0.26	0.65	2.59	2.10
Uruguay	0.73	0.52	0.61	2.06
Paraguay	1.09	0.28	1.79	0.91
Latin America & Caribbean	0.73	0.80	2.21	3.20
Low & middle income countries	0.48	0.54	1.98	2.63
World	0.47	0.63	1.42	2.62

Source: World Development Indicators, World Bank, September 2006

Table 2 Type of FDI in Latina America

Sector	***Natural resource seeking***	***Market-seeking***	***Efficiency-seeking***
Goods	*Petroleum & gas* Bolivia, Colombia, Ecuador, Peru, Venezuela, Argentina, Trinidad and Tobago. *Mining* Chile, Argentina, Bolivia, Colombia, Ecuador, Peru, Venezuela.	*Automotive* Argentina, Brazil, Paraguay, Uruguay *Chemicals* Brazil *Food* Argentina, Brazil, Mexico *Beverages* Argentina, Brazil, Mexico. *Tobacco* Argentina, Brazil, Mexico.	*Automotive* Mexico *Electronics* Mexico Caribbean Basin. *Apparel* Mexico Caribbean Basin.
Services	*Turism* Mexico Caribbean Basin.	*Finance* Mexico, Chile, Argentina, Venezuela, Colombia, Peru, Brazil *Telecommunications* Brazil, Argentina, Chile, Peru, Venezuela *Retail trade* Brazil, Argentina, Mexico *Electricity* Colombia, Brazil, Chile, Argentina, Central America. *Gas distribution* Argentina, Chile, Colombia, Bolivia	*Administrative services* Costa Rica

Source: ECLAC (2005, Table 1.6)

Table 3 Matrix of inward FDI performance and potential, 1988-1990 and 2002-2004

1988-1990	*High FDI performance*	*Low FDI performance*
High FDI potential	Chile, Colombia, Costa Rica, Mexico	Brazil, Uruguay
Low FDI potential	Argentina, Paraguay	
2002-2004	*High FDI performance*	*Low FDI performance*
High FDI potential	Chile	Argentina, Brazil, Mexico
Low FDI potential	Costa Rica	Colombia, Paraguay, Uruguay

Source: UNCTAD, FDI Indices

Table 4 The main features of the corporate income tax systems

	Argentina	**Brazil**	**Chile**	**Colombia**	**Costa Rica**	**Mexico**
Territorial scope	worldwide	worldwide	worldwide	worldwide	source	worldwide
Standard CIT rate (%)	35[a]	15 + 9 (SC)	17	35	30	28
- Surtax rate		10		10 (2002-6)		
- Branch profit tax			35	7	15	
Inter-company dividends	fully/partially excluded	fully excluded	fully excluded	fully excluded	fully excluded	fully excluded
Capital gains	CIT rate	CIT rate	CIT rate	CIT rate	generally not taxed	CIT rate
Rule against thin capitalization	yes	yes	yes	none	yes	yes
Net worth or Assets tax (%)	1 on assets	none	none	0.4 on net worth	none	1.25 on assets
Tax treaties	18	+25	13	4		+30
Revenue protection	TP/TC/CFC	TP/CFC	TP	TP	none	TP/CFC
Withholding taxes (%):						
- dividends	0[b]	0	0-40[c]	7	15	0
- interest	15.05-35	15	35	39.55	15	4.9-10.0-28
- royalties	17.05-28-31.5	15	30	39.55	25	28

	Paraguay	**Uruguay**[e]
Territorial Scope	source	source
Standard CIT rate(%)	10	25
- Surtax rate		
- Branch profit tax	15	
Inter-company dividends	fully/partially excluded	fully excluded
Capital gains	CIT rate	CIT rate
Rule against thin capitalization	none	none[f]
Net worth or Assets tax (%)	1 on assets	1.5-3.5 on net worth
Tax treaties	5	2
Revenue protection	none	TP/CFC
Withholding taxes (%):		
- dividends	15	7
- interest	15 (i.e. 50% of 30%)	12
- royalties	15 (i.e. 50% of 30%)	12

Source: UNCTAD (2000), Byrne (2002) , KPMG (2003) and others.
Notes:
[a] A regional turnover taxes averaging 1-3.5% is in force.
[b] Distributions that exceed taxable profits are subject to the 35% equalization tax.
[c] Dividends distributed to individuals resident or domiciled are subject to Global Complementary Tax (GCT) of 0-40%. CIT is creditable against GCT.
[e] The information reported in the table refer to the tax reform approved by the Uruguayan Parliament in 2006.
[f] The new measures will be effective 1 July 2007.
Legend: SC= rate of social contribution on net profits; TP=transfer-pricing; TC=thin-capitalization; CFC= controlled foreign company legislation.

Table 5 Effective Corporate Tax rate on Foreign Capital Investment

	Argentina	Brazil	Chile	Mexico[a]
Services	44.2	41.6	31.0	24.0
Manufactoring	31.6	34.5	22.3	19.3

Source: Chen and Martinez-Vezquez (2003)
Notes: the simulation of METRs is based on 2001 tax legislation. Statutory CIT rate were: 35% in Argentina and Mexico, 34% in Brazil and 15% in Chile.
[a]The METRs incorporate the 2002 post-reform tax system.

5. FISCAL HAVENS IN LATIN AMERICA AND THE CARIBBEAN

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. Tax havens have played an increasingly important role in world financial markets, particularly in the Caribbean and Latin American regions. This paper examines the role of tax havens, particularly in the Caribbean, the response of the international community in the context of the OECD *Harmful Tax Practices* initiative and sets out what are the longer term prospects for these economies. After discussing the growing concerns about tax havens, particularly those of national tax administration, and reviewing the theoretical and empirical literature on tax havens and information exchange, the paper illustrates the origins and evolution of the Caribbean tax havens and their present weight in the international financial and economic landscape. Finally, the current position of these jurisdiction is examined in the light of the international initiative launched by the OECD Member countries to curb harmful tax practices.

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Keywords: Fiscal Havens, Caribbean, Latin America

JEL Codes: H20, H26, H87

1. Introduction[*]

Tax havens play an increasingly important role in world financial markets, particularly in the Caribbean and Latin American regions. Tax havens thrive in a climate characterized by excessively strict bank secrecy, a lack of transparency and where countries are not prepared to cooperate to counter abuse. Over the last 30 years, we have seen many Caribbean islands move into offshore financial activities. This has had profound implications for the structure of their economies. It has also had profound implications for both developed and developing countries. This paper examines the role of Caribbean tax havens, the response of the international community and sets out what is the current position of these jurisdictions in the light of the international initiatives aimed at curbing harmful tax practices.

The paper is organized as follows. Section 2 identifies the growing concerns about tax havens, particularly those of national tax administrations, and reviews the theoretical and empirical literature on tax havens and information exchange. Section 3 tracks the origins of the Caribbean tax havens, while Section 4 examines their present weight in the international financial and economic landscape. Section 5 reviews the international initiative undertaken at the OECD level to counter fiscal abuse through tax havens and the response of Caribbean jurisdictions. Finally, Section 6 examines the possible future prospects for these economies.

2. Tax havens: a growing concern for the international community

In recent years, improved communications and liberalization of financial markets have fostered an impressive growth of both cross-border financial transactions and foreign direct investment (FDI). The rising volume of international transactions has brought new risks, among which the wider potential adverse effects of financial crises and financial instability and the larger possibilities to hide abroad the proceeds of illicit activities.

A fundamental concern of national governments, both in developed and developing and transitional economies, relates to the possible erosion of national tax bases arising from

[*] The views expressed in this article are those of the authors and do not in any way commit the OECD and its Member countries nor the Banca d'Italia.

the transfer of their residents' capital to offshore financial centers. In fact, while there may be legitimate reasons to use offshore financial centers, including tax reasons, they are often used for tax evasion and avoidance purposes. This is due to the fact that offshore financial centers are often referred to as "*tax havens*", because these are often countries or territories which attract foreign capital by promoting themselves through a combination of low or no taxation, advanced communication facilities, reliable legal systems and a high degree of confidentiality for financial data, such as those on beneficial ownership, companies, trusts and bank accounts.[1] Tax havens are used both by individuals and companies. In the new era of "banking without borders" wealthy individuals can easily evade capital income taxes in their country of residence by transferring capital abroad and channeling passive investments through tax havens. This type of tax evasion is facilitated by the existence of jurisdictions with strict bank secrecy rules which prevent information exchange with the residence country, and by the increased recourse to foreign institutional investors and shell companies with opaque structures based in offshore financial centers, which can make it very difficult for domestic tax authorities to track the capital income. With the growth of cross-border capital flows, the potential for abuse created by the lack of access to bank information for tax purposes and the resulting adverse consequences have increased exponentially. At the same time, tax authorities find it more and more difficult to monitor foreign portfolio investments of their residents because of the removal of traditional sources of information on these transactions (e.g. exchange controls). The decision by one country to prevent or restrict access to bank information for tax purposes now is therefore much more likely than ever before to adversely affect tax administrations of other countries.

Furthermore, the progressive elimination of withholding taxes at source on non-residents' portfolio investment income allows more and more taxpayers to escape all form of capital income taxes. Quite often, even when investing in their own countries, resident investors use foreign financial intermediaries and corporate or trust vehicles based in bank secrecy jurisdictions or offshore financial centers to disguise themselves as non-residents and evade domestic taxes. Thus, for example, a significant part of the investment into China via Hong Kong is made by Chinese residents; Cyprus plays a similar role for Russia. An increasing proportion of investment into Asia is channeled through structures established in

[1] These different factors may have a different weight for each tax haven. This also means that there may be different groupings of tax havens, depending on the combination of relevant factors chosen to identify them.

the British Virgin Island. Even more significant is the possible use of bank secrecy jurisdictions to escape domestic taxes on income and wealth of a different origin (business income, inherited wealth, etc.) that represent the "*principal*" of the foreign investment.

Companies make use of tax havens mostly for tax minimization purposes. They shift income to tax havens through their foreign affiliates in order to reduce or defer residence-country taxes. In this respect, the most attractive features of tax havens are the low level of taxation and the availability of flexible and tax-advantaged vehicles to channel international business, such as shell or holding companies. Investments in high-tax countries, for example, may be financed with loans from affiliates in tax havens; the resulting interest payments reduce taxable incomes in high-tax locations while producing taxable income in the havens. Another method is the use of transfer pricing. Even if most high-tax countries require firms to use transfer prices that would be paid by unrelated parties, following the OECD's 1995 Transfer Pricing Guidelines, difficulties in enforcement makes it possible for firms to reduce the overall tax burden. Tax havens can be also used to avoid repatriating foreign income in the firm's home country and thereby producing a home country tax obligation. The resulting tax savings can be substantial, contributing to the value of tax haven operations (Dharmapala and Hines, 2006). Bank and financial confidentiality may nonetheless play a role, both for closely held or passive investment companies and, more generally, because it makes it more difficult for home-country tax administration to track tax haven activity aimed at tax avoidance and evasion.

The effects of tax havens have recently been the object of a theoretical and empirical literature (see box 1).

Box 1 - *Tax havens: theoretical analysis and empirical findings*

The nature of tax havens and the effects of tax haven activity on the economies of high-tax countries have been examined in the context of the tax competition literature.

A first question addressed by the theoretical studies concerns the factors that influence the desirability of becoming a tax haven (see Dharmapala and Hines, 2006, and Slemrod and Wilson, 2006, for a review). A common result is that small open economies have an incentive to undercut large countries in order to attract mobile capital: whilst they are not able to influence the interest rates prevailing on international markets through their mainstream economic policies, they can quite easily attract international capital flows by reducing their tax rates, either directly and/or by offering a "favorable" tax climate for non-resident investors. The budgetary cost of these tax reductions need not be very high, since the tax reduction is accompanied by a larger tax base due both to greater

investment by non residents and to greater taxable income of residents.[2]

This result seems confirmed by the patterns observed in tax havens economies. Tax havens tend to be small countries with extremely open economies and substantially smaller natural resource endowments that non-havens. Also the experience of tax haven economies over the last two decades is consistent with the predictions of the theory. The period of globalization has been very favorable for tax havens, which grew at an average annual real per capita rate of 3.3 percent between 1982 and 1999, compared to the 1.4 percent growth rate of the world as a whole (Hines, 2004). This result is consistent with the growth of FDI in the same period[3] *and with the empirical evidence showing that both the volume and location of FDI are sensitive to tax differentials.*[4]

The effects of tax haven activity on the economies of non-haven countries is a highly controversial point. A common fear of non-haven countries is that tax havens may help diverting economic activity away from them, eroding tax bases that might otherwise be used to raise government revenue. This fear is more acute in the case of nearby tax havens, which might divert activity from other countries within the same region or economic federation. In this respect, the empirical evidence seem to suggest a complementary rather than substitute relationship between investment in tax havens and investment in nearby countries: the availability of tax havens seem to stimulate, rather than divert, economic activity in nearby non-haven countries (Hines, 2004; Desai, Fritz Foley and Hines, 2004). However, as suggested by Sullivan (2006), it is possible that the complementary relationship holds for certain types of foreign investments in low-tax countries (for

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[2] The explanation lies in the classic argument of Diamond and Mirrlees (1971) that governments unnecessarily distort production when they tax intermediate production, from which it follows that in small open economies governments with a sufficient number of available tax instruments can make all domestic residents better off by not taxing internationally mobile capital. In fact, since small open economies are price-takers in world markets, they are unable to shift any of their tax burdens on foreign investors: any attempt to do so would simply distort their economies by putting additional costs on domestic factors in the form of lower wages and land prices. It follows that domestic residents would be made better off by removing any taxes on foreign investors and instead directly taxing the returns to local factors of production. In addition to the price-taker position of small economies and to the availability of a sufficient set of tax instruments for the governments of the same economies, another basic assumption on which the Diamond and Mirrlees argument relies is that foreign investors do not earn economic rents from their investments in the small economies.

[3] Between 1982 and 1999 total world foreign direct investment grew from around 0,5 per cent to around 3,5 per cent of world GDP. See Hines (2004), that reports data from the World Bank database *World Development Indicators.*

[4] Empirical studies have shown other relevant features of tax havens. For instance, better-governed countries seem more likely to become tax havens (Dharmapala and Hines, 2006). A possible interpretation of this is that only better-governed countries can credibly commit not to expropriate foreign investors. It is not clear, however, whether it is the decision to become a tax haven that affects the quality of local governance or the quality of governance itself is influenced by economic and political conditions that also determine whether or not a country becomes a tax haven. Another relevant finding (from studies referring to American multinational firms) is that the highest share of tax haven operations seem to come from large firms with high volumes of international activity, high R&D intensity and significant volumes of intrafirm trade (Desai, Fritz Foley and Hines, 2006b). For these firms tax haven affiliates appear to facilitate the relocation of taxable income from high to low tax locations and to reduce the cost of deferring home country taxation of income earned in low tax foreign locations. Of course, the issue at stake here is not the tax haven characteristics of the jurisdiction, but the existence of a low rate of tax.

instance, those aimed at establishing "export platforms" that provide market access for goods and services from the home country), while a substitute link holds for other types of FDI (those aimed at establishing production facilities for goods and services). Thus, the overall impact of tax havens on the welfare of high-tax countries is still ambiguous. Tax haven operations may stimulate activity in nearby countries by facilitating the avoidance of taxes in that country, the avoidance of taxes elsewhere, or by reducing the cost of goods and services that are inputs to production or sales in high-tax countries. At the same time, tax haven activity could provide governments of high-tax countries with a device to move toward a less-distorting tax regime, that could not otherwise be implemented, mainly for political constraints. The use of tax havens could in fact allow high-tax countries to apply a lower effective tax rate on mobile firms compared to the one applied on immobile firms. On the other hand, tax avoidance and evasion will erode the tax base and therefore tax revenues of high-tax countries. In a recent study, Slemrod and Wilson (2006) demonstrate that the full or partial elimination of tax havens would improve welfare in non-haven countries, reduce compliance costs and lead to a more balanced tax structure.

Even if the conclusions of the theoretical and empirical analysis are somewhat still controversial, policy makers in non-haven countries are increasingly concerned about the potential adverse effects of tax haven activity on their national tax systems and, more generally, on their economies. These concerns have prompted many governments to consider international cooperative efforts designed to preserve their economies from the negative externalities due to tax havens. Following an endorsement by the G-7 at the Lyon Summit in June 1996, the OECD launched in 1998 the *Harmful Tax Practices* initiative[5] to discourage OECD Member countries and certain tax havens outside the OECD from pursuing policies that were thought to harm other countries by unfairly eroding tax bases.

The OECD initiative has evolved considerably since its launch in 1998, offering a forum for constructive dialogue between on and offshore financial centres. Overtime, an increasing emphasis has been put on access to bank and financial information and on exchange of taxpayer-specific information between national tax authorities, which are increasingly viewed as necessary pre-conditions for the effective functioning of national tax systems in a context where the ever-increasing levels of foreign direct investment and of portfolio cross-border capital flows implies the risk of a growing demand for tax haven operations. In the OECD's view, an effective information exchange should allow all countries to protect the integrity of their tax system from the effects of international tax

[5] OECD (1998), hereafter "the 1998 Report". Luxembourg and Switzerland abstained on the approval of the Report.

evasion, while preserving the right to tailor their tax systems to their own needs.[6] Put it another way, effective cooperation to counter abuse is an essential requirement to get the full benefits of a more competitive environment.

Conversely, the existence of obstacles hampering the access to financial information by domestic and foreign tax authorities leads to adverse consequences. First, it distorts international capital flows, since funds can be attracted by or routed through countries whose strict secrecy provisions offer a favorable environment to tax evaders. Second, it has adverse consequences on the structure of national tax systems, since the tax burden is shifted from capital to less mobile factors (such as labor) or consumption, in an attempt to limit the erosion of the tax base. Preventing the full taxation of income arising from portfolio investments, the lack of access to bank information jeopardizes the overall equity of the tax system, both between compliant and non-compliant taxpayers and among different income sources. Strict bank secrecy rules may represent a significant constraint for governments wishing to raise a given amount of tax revenues in order to be able to deliver the desired amount of public goods. This latter effect is particularly serious for developing countries where capital flight towards bank secrecy jurisdictions may give rise to an erosion of their already potentially weak tax base, which can seriously undermine the ability of governments to make the vital investments in social services and economic infrastructure upon which sustainable economic development depends. Finally, strict bank secrecy regimes may have adverse effects in domains other than taxation, attracting money laundering and other types of criminal activities, ranging from terrorism to financial fraud.

The issues of bank secrecy and information exchange and, in more general terms, the need for an increased level of transparency - have become a priority also on the political agenda of other international organizations, particularly those dealing with the different forms of financial abuse or taking care of the stability of the international financial system: both the *Financial Stability Forum* (FSF) and the *Financial Action Task Force on Money Laundering* (FATF) have undertaken efforts to convince offshore financial centers to comply with international standards by requiring, among other things, enhanced transparency.[7]

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[6] OECD (2004a).

[7] In April 2000 the *Financial Stability Forum* (FSF) launched an assessment of the compliance of supervisory and regulatory systems of the OFCs' financial sector with international standards with the prospect of enhancing financial stability and fighting financial fraud and the financing of terrorism. The assessment led to the identification of several OFCs, especially in the smaller and poorer jurisdictions, having critical deficiencies. In the

The lifting of bank secrecy and the need for information exchange have received considerable attention in the economic literature (see Box 2), which has also tried to answer the question of whether information exchange agreements can arise spontaneously.

Box 2 - *The theoretical and empirical analysis on information exchange: a survey*

In the theoretical literature, the lifting of bank secrecy and the need for information exchange between national tax authorities have received consideration within the analysis of the impact of tax policy on mobile financial capital in a context of open economies (Giovannini 1990; Bacchetta and Espinoza 1995; Huizinga and Nielsen 2000; Makris 2003; Sørensen 2001; Keen and Ligthart 2003). Information exchange between tax authorities and the prerequisite of access to relevant information have been recognized as essential for the taxation of capital income according to the residence principle. The residence principle is recommended by several authors as a second-best measure to the full coordination of tax policies (interpreted as a system of uniform tax rates and uniform tax bases: see, for instance, Giovannini, 1990, and Sørensen, 2001), since it allows national governments to choose their own preferred tax rates without violating international production efficiency, i.e. without distorting the location of international investment (the Diamond and Mirrlees theorem, 1971).[8] Other reasons in favor of the residence principle are interpersonal equity, as it allows for the progressive taxation of worldwide capital income, and a fair distribution of tax revenues among countries (since each country is able to tax its own residents).

An effective implementation of the residence principle is only possible when national tax authorities have full information on foreign source income earned by domestic taxpayers. This condition is met when information exchange covers all types of foreign source income and when foreign tax authorities have access to all relevant information. In practice, however, information exchange is far from perfect, mainly for two reasons: transaction costs and differences in country incentives. The last factor is probably the most important: the level of information sharing with foreign

same year the *Financial Action Task Force on Money Laundering* (FATF) undertook an initiative to identify non-cooperative countries and territories in the fight against money laundering. Between 2000 and 2001 the FATF identified a list of 21 non-cooperative countries and territories, among which several Caribbean OFCs. Thanks to the significant and rapid progress in addressing deficiencies, all countries have been gradually removed from the list.

[8] The residence principle is consistent with the Capital Export Neutrality (CEN) condition, since it implies that the taxpayer faces the same tax burden on domestic and foreign source income. In the presence of different marginal tax rates across countries, the CEN condition implies that the international allocation of investments is neutral because the cost of capital (the required pre-tax rate of return) is equated across countries. For this reason the residence principle is considered superior to the source principle of taxation, which implies taxation of capital income at different rates depending on the country of the investment. The source principle allows for neutrality in the international allocation of savings and is thus consistent with the condition of Capital Import Neutrality (CIN), since it assures that capital income is taxed in the source country (usually through withholding taxes) at the same rate for residents and non residents and that foreign source capital income is exempted from tax in the investors' home countries. However, it distorts the investment decisions because it allows the pre-tax rates of return to differ among countries.

governments is considered a strategic variable and is taken into account by national governments when designing the optimal international tax system in the same way as the tax rate on domestic and foreign source income (Bacchetta and Espinoza, 1995). Since countries face a diverse set of incentives to exchange taxpayers' information, it is far from clear that information exchange agreements can be self-enforcing.[9] This question has been addressed by several studies. Assuming perfect capital market integration, Eggert and Kolmar (2002) show that there exist equilibriums where information exchange arises spontaneously. However, this happens in a paradoxical context, where the high elasticity of capital makes governments unable to apply any tax that could potentially benefit from the exchange of information (typically, taxes on capital income). In other words, if capital is perfectly mobile, information exchange arises spontaneously but is useless, since all the taxes that are potential candidates for information-induced tax-base effects simply disappear. In the authors' opinion, this model can help explain why in recent years the growing integration of capital markets is being accompanied by some progress in measures of tax information exchange.

Apart from the paradoxical case of perfect capital mobility described by Eggert and Kolmar, three sets of circumstances have been identified in which countries may find in their interest to provide information (Keen and Ligthart, 2003). The first can be modeled as a two-stage game where countries first decide the level of information exchange and then set the tax rates. Assuming that the institutional features of the tax system are given from the outset to tax authorities, Bacchetta and Espinosa (1995) find that a country may choose to provide at least some information to foreign tax authorities if this enables the information-receiving country to increase its own income tax rate. These conclusions are confirmed by Sørensen (2001). On the other hand, using the same two-stage game framework, but with the different assumption that all the institutional features of the tax system (i.e. the degree of information exchange and the level of tax rates) are chosen by the tax authorities instead of being given from the outset,[10] Makris (2003) finds not only that the non-cooperative equilibrium is characterized by zero information transmission, but also that there is no scope for cooperation in information sharing policies, irrespective of the transactions cost function and of the double taxation schemes. In fact, he shows that a coordinated increase in information exchange not only will make no difference, but in the case where information exchange is an equilibrium outcome, it will even leave countries worse off.

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[9] Some countries may choose to not release bank information to foreign jurisdictions in the attempt to enhance their attractiveness for foreign investors, thereby increasing the size of their financial industry, employment and national welfare. Other countries, particularly those which have substantial capital outflows, may be interested in obtaining information on portfolio investments made abroad by their residents, in order to limit the erosion of their tax base due to underreporting of foreign source income. In general, the discrepancy in the values placed by any two countries on each other's taxpayer information depends on a number of factors (Tanzi and Zee, 2001). The most relevant are: asymmetries in the economies' size (as GDP level, taxpayers' number, capital flows, etc.); differences in the capital account balances (taxpayer information provided by the tax authorities of a capital-importing country to a capital-exporting country is more valuable to the latter than similar information to the former provided to it by the latter); differences in the completeness and reliability of information gathered by national tax administrations.

The second possibility, explored in a later paper by Bacchetta and Espinoza (2000) and by Huizinga and Nielsen (2002), is one where countries view the choice of tax rates and information provision as an infinitely repeated game and continuously adapt their decisions to those of other countries. In this setting, information exchange arises spontaneously if the possible advantages that each country can have by defecting from (or not entering) the agreement are balanced by some form of punishment.[11] *The result of this balance – and hence the long-term sustainability of cooperative information exchange agreements – depends on several variables. The attractions of defection will be greater the higher are policy-makers' discount rates (information exchange is more likely to be chosen if governments have little discounting of the future, i.e. if they are long-term oriented), the more imbalanced are capital flows and the more sensitive are capital flows to their effective tax treatment. One clear implication of this approach is that small capital-importing countries are likely to have least to gain from information exchange: for these countries, the advantages arising from the choice of lower tax rates in order to attract inward investment - an increase in the size of the banking and financial industry, a resulting increase of the wage tax base and of welfare in general - largely compensate the losses of any revenue from the small domestic capital tax base.*

The third possibility consists in introducing some kind of compensation rather than punishment in order to induce countries to exchange information, as proposed by Keen and Ligthart (2003, 2004). Countries may redistribute to the information providing jurisdictions a certain proportion of the additional revenue they are able to collect thanks to the exchange of information, in order to compensate them for the adverse economic effects of voluntarily engaging to exchange information. Keen and Ligthart (2004) show that while large countries always prefer information exchange with any level of revenue sharing (since they always gain more from taxing their residents thanks to the information they receive compared to what they lose from the transfer of a certain amount of revenues to the information providing countries) small countries only have attractions to information exchange if the difference in size with the information receiving country is not very pronounced and if the share of revenue they receive from the residence country is sufficiently large.[12]

An issue connected with the implementation of information exchange is the "third country problem", i.e. whether a group of countries (i.e., the OECD or the EU) as a whole can gain from reaching an agreement on information exchange if the rest of the world does not join into the agreement. Unless all countries take part in the information exchange, the gains to any subset from

[10] Unlike Bacchetta and Espinoza, Makris assumes that all distortionary tax rates can be different and endogenously determined.

[11] Since in this context it is likely that uncooperative behaviour by any country would led to other countries behaving also non-cooperatively, each country must balance the long-term gains from continued cooperation with the temporary gain from failing to provide information and with the permanent cost of non-cooperative behaviour by the other countries.

[12] When the difference in size with the information receiving country is very pronounced, small countries may resist moving to exchange information, whatever the share of revenue sharing. If, however, the size of the two countries is sufficiently close, the small country will prefer information exchange even if all the additional revenue it generates is retained by the information receiving country (the residence country).

agreeing to exchange information are likely to be reduced to the extent that third countries continue to provide an opportunity to invest without declaring the proceeds. These latter countries could even become more aggressive in tax competition because of their enhanced monopoly power in the provision of strictly confidential saving schemes and in consideration of their potentially higher gains. Since small countries have probably more to gain from remaining outside information exchange agreements, and since the number of small jurisdictions is quite high, the difficulties of implementing a truly comprehensive information exchange agreement are obvious. However, it is also possible that the small dimension of these countries represents a factor of vulnerability on which bigger countries can rely to persuade the small ones to agree to exchange information.

To sum up, it turns out from the theoretical literature that it is unlikely that full information exchange will spontaneously emerge, particularly because offshore financial centers have little interest to agree to any international agreement that will curb their ability to attract capital, unless some form of positive incentives is given. This solution requires a coordinated effort on a multilateral basis and needs to be extended to as many tax havens and bank secrecy jurisdictions as possible in order to reduce the risk of defections.

The empirical literature on the implications of bank secrecy is more limited. A few studies (Grilli, 1989; Alworth and Andresen, 1992; Huizinga and Nicodème, 2004) have found a certain degree of sensitivity of international bank deposits to bank secrecy and other tax variables, from which it could be argued that cross-border financial flows are, at least to a certain extent, "tax-driven", i.e. affected by tax cheating purposes.

3. Origins and evolution of the Caribbean tax havens

Most tax havens are small, very open economies, and this is particularly true in the Caribbean region where the majority of islands have, over the last thirty years, moved into the offshore financial business. At least three reasons can explain this development.

a) The agricultural sector in the Caribbean area was increasingly unviable as preferential trading schemes were removed and more efficient producers entered their traditional markets;

b) Few of the islands have any natural resource endowments;

c) Tourism, which was highly successful in certain of the islands, was volatile and, in some cases, it could not be further exploited.

Financial services have been seen as an area in which, for a modest initial investment, Caribbean islands could upgrade the skills of the population, generate employment and revenues for their governments and, more generally, boost their GDP by taking advantage of the high growth rate of the industry.

For some of these dependencies the move towards the offshore financial center and tax haven status was quite successful and led to significant rates of economic growth. Their colonial heritage gave them important competitive advantages, among which a modern-style legal system (usually based on the Anglo-Saxon model), English language (for most of them), a currency tied to that of the mother country, and in many cases the benefit of tax treaties which had been extended to them. These advantages were strengthened through the introduction of attractive rules for the incorporation of international business companies (IBCs) and for the establishment of trusts, the adoption of zero or very low taxes on incomes, profits and wealth tax (particularly for foreign-source and non-resident income), the absence of exchange controls and the introduction of strict bank secrecy and confidentiality of information rules.[13] Further advantages were the political stability, a pleasant physical environment and, more importantly, the proximity to or links with major on-shore financial centers (such as the US and the UK).[14]

In the Caribbean region these factors allowed the Bahamas first and the Cayman Islands soon later to become leading offshore financial centres, moving from poor subsidized economies in the beginning of the 1960s to net providers of resources to the Commonwealth since the 1980s. The Bahamas is nowadays ranked among the top five locations in the world for offshore mutual funds and trust funds and has also developed a significant inter-bank market. The Cayman Islands are nowadays the world's fifth largest banking centre, and the first among offshore jurisdictions, with a prominent position both in the inter-bank business and in private banking. The Cayman also host half of the world's hedge funds, hundreds of major non-financial subsidiaries of US corporations and the World's second-largest captive insurance market. The British Virgin Island has developed into one of the most successful centres for IBCs and Trust arrangements.

The Netherlands Antilles developed as a typical "treaty tax haven", being used in the 1960s through the mid-1980s to allow non-resident investors to receive portfolio income from the United States tax free.[15] Once the US abolished its withholding tax, there was no longer

[13] For instance, the rules for the legal protection of bank secrecy were introduced in 1966 in the Cayman Islands and in 1980 in the Bahamas.

[14] Sullivan (2004) reports that, according to the Cayman Islands Monetary Authority 2002 Annual Report, about 70 percent of the international assets and liabilities booked through the Cayman Islands originate from the US.

[15] Until 1984, interest income received by non-residents from US sources was subject to withholding tax, either at 30 percent or at a lower rate as provided in a tax treaty. Since the treaty between the US and the Netherlands

any motive for taking this route. Nowadays, the country is not anymore among the most prominent offshore jurisdictions, and is trying to develop other sectors of the offshore industry, namely incentives aimed at international business companies.

In more recent years, the demand for tax haven facilities has considerably expanded, owing to the high growth rates of cross-border investment and to the increased number of potential customers arising from the new possibilities offered by the new technological and communication infrastructures and the growing use of multiple layers of transactions to structure offshore operations through vehicles located in different countries. The gradual relaxation of reserve requirements, interest rate controls and capital controls in the main "onshore" markets and the creation of offshore banking facilities in some of the main industrial countries (the US and Japan) have reduced the regulatory advantages of offshore financial centres, making them less attractive for conventional banking. On the other hand, the tax avoidance facilities of OFCs have become more and more important, particularly for FDI and asset management.[16] The limited initial investments needed to enter the offshore industry have induced new countries, especially the smaller ones, to implement the "offshore package" of financial services and asset protection products in order to join in the competition for attracting internationally mobile capital:[17] hence, the number of tax havens has grown remarkably. This process have involved also some new entrants in the Caribbean area: Antigua and Barbuda, St. Kitts and Nevis, Grenada, Dominica, St. Lucia.

In this more competitive environment, the choice of a tax haven is increasingly determined by their 'specialization' and by their proximity to target investment markets, although in some cases the geographical proximity to taxpayers still acts as a driver.[18] Some Caribbean tax havens have been able to succeed or to retain their market share thanks to

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Antilles reduced the withholding tax rate to zero, and the Netherlands Antilles did not charge any withholding tax, the country was used to route interest payments from the US to third-country recipients free of taxes at source.

[16] With reference to this latter market, it is especially the possibility to reduce inheritance and other capital taxes for individual investors that acts as a prime incentive and has led to a large expansion in offshore fund management activity, in particular by the use of investment vehicles such as trusts and private companies.

[17] For example, Malta launched its international financial centre facilities in 1994.

[18] Thus in the last few years, we have witnessed the growth of some new OFC and tax haven practices in the East-Asia region, where some jurisdictions (Labuan in Malaysia, and Samoa) are emerging thanks to their ability to intermediate in a "tax-efficient" way the growing capital flows which circulate in the area. Given the significant economic growth rates currently reached by some of the biggest countries in the region, such as China and India, the global weight of Asian OFCs - both of well established ones, such as Singapore and Hong Kong, and of those which seem to be emerging more recently - is likely to increase.

product diversification and specialization in specific market niches. For instance, Bermuda is nowadays one of the world's biggest insurance and reinsurance markets; the British Virgin Islands have become one of the world's favorite locations for international business corporations (which are used exclusively as offshore vehicles); the Bahamas have developed a significant inter-bank market. Furthermore, in order to enhance their reputation, some of the most significant Caribbean offshore centres have taken the political decision to commit to tax information exchange by entering into *Tax Information Exchange Agreeements* (TIEAs).[19]

Some of the late arrivals in the Caribbean region and elsewhere, however, have had little success, because they have not been able to offer any advantage over the more established centers.[20] Overall, it is fair to say that with the exception of the Bahamas, Bermuda, British Virgin Island, the Cayman Islands and Panama, the other Caribbean offshore financial centres are struggling to make their financial activities a sustainable part of their economies.

4. The position of the Caribbean tax havens in the global financial markets

The relative importance of Caribbean tax havens can be measured through several indexes. However, a difficulty often encountered when trying this kind of estimates is the limited availability of reliable and internationally comparable data for many sectors of the OFC industry.

Suss, Williams and Mendis (2002) collect some relevant indicators with reference to 2001 or previous years. Overall, these indicators show that the size of the Caribbean tax havens and offshore financial centers varies significantly from one country or territory to another, and that there is a wide range of specialization across the region. So, for instance, while the British Virgin Islands is the largest register of international business companies (estimated to account for 48 percent of global IBC incorporations), the Cayman Islands, estimated to be the fifth largest offshore financial center in the world, has fewer registered IBCs, but significantly more banks, insurance companies and trusts. Among recent entrants into the OFC sec-

[19] The Cayman Island, for example, has a TIEA with the United States and Bermuda; Antigua has one with Australia; the Netherlands Antilles have signed a TIEA with Australia and New Zealand.

[20] This was the case, for instance, of Dominica, Grenada, St. Lucia and, to a lesser extent, St. Kitts and Nevis.

tor, St. Kitts and Nevis has the largest number of registered IBCs, while Antigua and Barbuda has the most diversified OFC industry, including not only IBCs, but also banks and trusts.

The study also examines the contribution of the OFC sector to specific economic indicators. So, for example, it emerges that in many Caribbean jurisdictions employment opportunities arising from the OFC industry are significant. In 2000 the estimated employment in the OFC sector represented 15 percent of the labor force in the British Virgin Islands, 8 percent in Antigua and Barbuda, 1 percent in the Bahamas and 0.5 percent in Dominica. The wide range of variation depends both on the relative size of the economy and on the type of OFC business prevailing in each jurisdiction (for instance, offshore banks and shell companies do not require physical presence and as such, do not require a significant number of people).

Another significant indicator used in the study is the amount of the fees collected by the central government from OFCs service providers. As of end-2000, Antigua and Barbuda derived over 7 percent of central government revenues from offshore sector fees, followed by Grenada at 4.5 percent and Anguilla at 3.6 percent. Among the more established OFCs, the British Virgin Islands, which is the world market leader in incorporation of international business companies, collected fees representing 55 percent of government revenues, equal to 13 percent of GDP. The Cayman Islands also rely heavily on fees collected from offshore banks, which accounted for 14.5 percent of government revenues by end-2000. In contrast, the governments of Bahamas and Barbados were less dependent on offshore sector fees (respectively: about 1 percent of government revenues and between 0.2 percent and 0.4 percent of GDP).

Further information on the weight of the financial industry and offshore business for tax havens can be obtained looking at the contribution of these sectors to GDP. According to the limited information publicly available, it can be estimated that at end 2001 the contribution of all offshore services to GDP ranged from around 25 percent in the Cayman Islands to 30 percent in the Bahamas and 45 percent in the British Virgin Islands. For other tax havens, the only available information was the GDP share of the whole area of services; quite often, the financial sector and tourism represent the main components of this share. According to available information, at end 2001 the GDP share of all services was 89 percent for Bermuda, 84 percent for the Netherlands Antilles, 81 percent for Montserrat, 77 percent for Antigua and Barbuda.

With reference to the offshore banking sector, a more detailed set of comparable sta-

tistical data can be taken from the Bank for International Settlements *Locational Statistics* as complemented, in some cases, by national sources.

Table 1 reports (at the first column) the size of foreign bank liabilities as a multiple of GDP[21] for a set of offshore financial centers that have historically relied heavily on bank secrecy and for other representative offshore and mainstream financial centers; the second column of the table reports each country's share of global foreign bank liabilities. Countries in each group are ranked according to the amount of their foreign liabilities *vis-à-vis* all sectors, banks and non-banks.

The Caribbean tax havens amount to just under 8.5 percent of the world foreign bank liabilities. As can be expected, the foreign liability/GDP ratio is much higher in small havens compared to other financial centers, however, even within small countries, the ratio shows a wide diversity, ranging from the highest value of 617.87 in the Cayman Islands to less than 0.11 for Aruba. Apart from the Cayman Islands and, to a lesser extent, the Bahamas, the Netherlands Antilles and Bermuda, for the remaining tax havens the banking business with non-residents seems to be far less important, confirming the specialization of the different Caribbean jurisdictions.

Table 2 reports similar indicators with reference to the amount of bank deposits of non-bank non-residents for a subset of countries for which relevant data are available. These indicators can be useful to assess more specifically the value of private banking in each tax haven. Once again, the Cayman Islands show a very high ratio (bank deposits *vis-à-vis* non-bank non-residents being equal to 230.87 times the country GDP), followed at a distance by the Bahamas (21.52). Also the share of total bank deposits of non-resident non-banks which is held by the most prominent offshore financial centers appears to be significant: as can be seen from the last column in the table, the Cayman Islands hold more than 10 percent of the global stock of these deposits, a share comparable to that of Switzerland and higher than the United States.

TABLE 1 HERE

TABLE 2 HERE

[21] Data on GDP are from the *World Development Indicator* of the World Bank.

5. The OECD initiative on *Harmful Tax Practices* and the position of Caribbean jurisdictions

5.1 The OECD *Harmful Tax Practices* initiative

In 1998, the OECD Ministerial Council established a forum which identified the following four key criteria for identifying harmful tax practices:

a) No or nominal taxes, in the case of tax havens, and no or low taxation, in the case of Member country preferential tax regimes;

b) Lack of transparency.

c) Lack of effective exchange of information.

d) No substantial activities, in the case of tax havens, and ring-fencing, in the case of Member country preferential regimes.

The no/nominal/low taxes criterion was intended merely as a gateway to determine those situations in which an analysis of the other criteria is necessary. The adoption of low or zero tax rates is *never* by itself sufficient to identify a jurisdiction as a tax haven. The OECD does not prescribe appropriate levels of taxation or dictate the design of any country's tax system. This work has received considerable political support.[22]

In 2000, the OECD identified 35 jurisdictions that were found to meet the tax haven criteria.[23] A process was also established whereby the identified tax havens could commit to improve transparency and establish effective exchange of information for tax purposes. Those jurisdictions that were not willing to make such commitments would be included in a list of uncooperative tax havens. Thus, the key distinction for OECD countries became whether a tax haven was cooperative or uncooperative. *The 2001 Progress Report* made certain

[22] The G7/8 Finance Ministers have consistently provided political support for the project and the G-8 Heads of Government confirmed their support at the Gleneagles Summit in July 2005. Also, at the November 2004 meeting of the G-20 Finance Ministers a strong statement in support of this work was issued and further endorsement of this work was provided in the most recent G-20 Communiqué issued in November 2006 and in a Communiqué from the Caribbean-UK Forum on 28 April 2006.

[23] Andorra; Anguilla; Antigua and Barbuda; Aruba; The Bahamas; Bahrain; Barbados; Belize; British Virgin Islands; Cook Islands; Dominica; Gibraltar; Grenada; Guernsey; Isle of man; Jersey; Liberia; Liechtenstein; the Maldives; Marshall Islands; Monaco; Montserrat; Nauru; Netherlands Antilles; Niue; Panama; Samoa; Seychelles; St. Lucia; St. Kitts and Nevis; St. Vincent and the Grenadines; Tonga; Turks and Caicos; US Virgin Islands; Vanuatu. Six other jurisdictions - Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino - were not included in the 2000 report because they committed to eliminate their harmful tax practices prior to the release of that report.

modifications to the tax haven work. There were two principal modifications. First, a tax haven that committed to eliminating lack of transparency and lack of effective exchange of information would be considered cooperative and therefore would not be included on the OECD's list of uncooperative tax havens. A second modification was that a potential framework of coordinated defensive measures would not apply to uncooperative tax havens any earlier than it would apply to OECD countries with harmful preferential tax regimes. In April 2002, the OECD published the list of uncooperative tax havens, containing 7 jurisdictions that still were at that time unwilling to commit to transparency and exchange of information for tax purposes; two jurisdictions - Nauru and Vanuatu - made commitments in 2003 and the list now contains only 5 jurisdictions: Andorra, Liberia, Liechtenstein, the Marshall Islands and Monaco.

The 33 jurisdictions that made commitments to transparency and effective exchange of information are referred to as Participating Partners. The OECD and non-OECD Participating Partners have worked together in the *Global Forum on Taxation* to develop the international standards for transparency and effective exchange of information in tax matters. The Caribbean offshore financial centers have played a particularly active role in the Forum. They took part in the specially created working group which developed the 2002 *Model Agreement on Exchange of Information on Tax Matters.*[24]

In order to determine exactly where countries stand in relation to transparency and information exchange, the Global Forum decided at its June 2004 meeting in Berlin that it was important to carry out a review of countries' legal and administrative frameworks in these areas so as to assess progress towards a level playing field. In addition to Global Forum Participating Partners (Table 3a), other significant financial centers (Table 3b) where invited to participate in the review.[25] Overall, the factual assessment covered 82 countries.

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[24] Available on the OECD website at http://www.oecd.org/ctp). The Model Agreement, released in March 2002, was developed by the Global Forum Working Group on Effective Exchange of Information which consisted of representatives from OECD countries and delegates from Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino. The work of that group has been complemented by the work of the Global Forum's Joint Ad Hoc Group on Accounts which has developed guidance on accounting and recordkeeping requirements for corporations, partnerships, trusts and other entities or arrangements.

[25] All Global Forum Participating Partners except Antigua and Barbuda and Grenada responded to the questionnaire which forms the basis of the factual assessment. The information of the factual assessment about Antigua and Barbuda and Grenada is based on publicly available information or information previously provided by Antigua and Barbuda and Grenada. Among the invitees, all but two – Brunei and Liberia – responded to the ques-

TABLE 3 HERE

The Report *"Tax Co-operation: Towards a Level Playing Field - 2006 Assessment by the Global Forum on Taxation"* issued in May 2006 reflects the outcome of the factual review carried out by the Global Forum. All the OECD and non-OECD Participating Partners in the Global Forum on Taxation have endorsed the principles of transparency and exchange of information for tax purposes that are reflected in the Report. They have also agreed to their legal and administrative frameworks being reviewed in the light of these principles. For the first time, other significant non-OECD economies such as Hong Kong, China and Singapore have participated in the work of the Global Forum in these areas. Six of these non-OECD economies have also endorsed the principles of transparency and exchange of information and agreed to work with the Global Forum towards a level playing field: Argentina; China; Hong Kong, China; Macao, China; the Russian Federation and South Africa.

5.2 How do the Caribbean and other financial centers measure up to these criteria?

The results of the Global Forum assessment of legal and administrative practices concerning transparency and information exchange is a valuable mean to examine the current standpoint of the Caribbean tax havens towards the OECD *Harmful Tax Practices Initiative.* Their position regarding the different aspects of the assessment is as follows:

A. Exchanging Information

Many of the Caribbean jurisdictions have (or are in the process of negotiating) exchange of information arrangements that permit them to exchange information for both civil and criminal tax purposes in the form of double tax conventions or TIEAs (some exceptions are Anguilla, Panama and Turks and Caicos). In addition, as a practical matter, Panama is

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tionnaire used as the basis for the factual assessment. Liberia was unable to do so due to its current political situation.

rarely, if ever, able to exchange information in criminal tax matters. None of the Caribbean jurisdictions reported having a *domestic tax interest*, i.e. being unable to respond to a request for information where they have no interest in obtaining the information for their own tax purposes. Also, none of the Caribbean jurisdictions reported applying the principle of dual incrimination to all their information exchange relationships concerning the administration or enforcement of domestic tax law. However, Saint Lucia and Saint Vincent and the Grenadines apply this principle in connection with exchange of bank information (see Section B below).

B. Access to Bank Information

While in 77 countries covered by the factual assessment governmental authorities have access to bank information and/or information from other financial institutions for at least some tax information exchange purposes, among the Caribbean jurisdictions Panama have indicated an inability to access bank information for any exchange of information purposes. In 17 countries, access to bank information is granted only for the purpose of responding to a request for exchange of information in criminal tax matters. Of these the Caribbean jurisdictions of Saint Lucia, Saint Vincent and the Grenadines (in addition to Andorra, Austria, Cook Islands, Luxembourg, Samoa, San Marino, and Switzerland) apply the principle of dual criminality in connection with access to bank information for exchange of information purposes.

C. Access to Ownership, Identity and Accounting Information

Of the 82 countries reviewed, 78 - including all the OECD countries - generally have powers to obtain information that is kept by a person subject to record keeping obligations which may be invoked to respond to a request for exchange of information in tax matters. In addition, 71 countries reported that they also generally have powers to obtain information from persons not required to keep such information which may be invoked to respond to a request for information. Anguilla, Montserrat, Panama and Turks and Caicos Islands have very limited powers to obtain this kind of information for criminal tax matters.

D. *Availability of Ownership, Identity and Accounting Information*

Companies

Of the 82 countries reviewed, 77 require companies to report legal ownership information to governmental authorities or to hold such information at the company level. Three countries (Montserrat, Saint Kitts and Nevis and the U.S. Virgin Islands) each have one form of company where this is not the case[26]. More stringent ownership reporting requirements exist in the financial sector in certain countries. All but 5 countries (Aruba; Guatemala; Hong Kong, China; Macao, China and Singapore) indicated that applicable anti-money laundering legislation would normally require corporate service providers or other service providers to identify the beneficial owners of their client companies.

In 75 countries, all domestic companies are required to keep accounting records. No such requirements exist for international business companies in Belize, Brunei and Samoa or for limited liability companies in Anguilla, Montserrat and Saint Kitts and Nevis[27]. In the Bahamas, only public companies and regulated companies in the banking, securities and insurance sectors are required to keep accounting records. Mandatory accounting records retention periods of five years or more exist in 63 countries.

Bearer shares may be issued in 48 countries. Of these, 39 have adopted mechanisms to identify the legal owners of bearer shares in some or all cases. Furthermore, 10 of these 39 countries (Antigua and Barbuda, Belize, British Virgin Islands, Cayman Islands, the Cook Islands, Dominica, Grenada, Montserrat, Saint Kitts and Nevis and Saint Vincent and the Grenadines) also require bearer shares to be immobilized or held by an approved custodian. The remaining 29 rely mainly on anti-money laundering rules, investigative mechanisms or a requirement for the holders of shares to notify the company of their interest in the shares. Anguilla is one of the 9 countries that reported not having any mechanism to identify the owners of bearer shares, although it indicated to plan to adopt such mechanisms in the near future.

Bearer debt instruments may be issued in 52 countries and 40 of these have adopted mechanisms to identify the owners of such instruments. In general, these mechanisms rely on anti-money laundering rules, on investigative powers or, in the case of EU Member

[26] With respect to Grenada there was not sufficient information to reach a conclusion.

[27] In these cases only records that the directors of such consider necessary or desirable need to be kept

States and their associated or dependent territories, on procedures set out in the EU Savings Tax Directive and savings tax agreements.

Trusts

Of the 82 countries reviewed, 54 have trust law. Of these, Macao, China and the Seychelles have no trust law applicable to residents, but have trust law applicable to non-residents. Information on the settlers and beneficiaries of domestic trusts is required to be held under the laws of 47 countries. In 36 of the countries with trust law, a domestic trustee of a foreign trust would also be required to have information on the identity of settlers and beneficiaries, in some or all cases. Of the 28 countries that do not have trust law, 18 indicated that their residents may act as trustees of a foreign trust. In all of these, except for Luxembourg, there is a requirement on resident trustees to identify settlers and beneficiaries of foreign trusts. Of the 54 countries which have trust law, 45 countries reported requiring all trusts formed under their law to keep accounting records. Dominica, Saint Lucia and Turks and Caicos are among the 7 countries that have not reported a requirement to keep records under their trust law.

6. The way forward for Caribbean Offshore Financial Centres

The future for Caribbean offshore financial centres depends, to a large extent, on their willingness to meet the new international standards that have been developed by such bodies as the FATF, the FSF and the OECD. Meeting these standards will enhance their reputation and make them more attractive as financial centres in which to carry out legitimate transactions.

For the more established centers, such as the Bahamas, the Cayman Islands and the British Virgin Islands, which have already developed relatively strong and extensive legislative and regulatory frameworks, the cost of introducing the additional measures necessary to comply with international standards need not be substantial. At the same time, the international community is committed to helping these countries and territories to implement effectively these standards. The main mechanism for this implementation in the tax area is *Tax Information Exchange Agreements* (TIEAs). These agreements provide an effective mechanism that minimizes the risk that these centres are misused by residents of

other countries to evade their tax responsibilities. Over the last few years, all the major Caribbean offshore financial centres, other than Panama, have entered into one or more TIEAs. We can expect that this trend will accelerate and that these OFCs will extend their network of TIEAs, not just with OECD countries, but also with major non-OECD countries (China, India, Brazil and South Africa have already begun negotiations).

In the case of some of the smaller Caribbean OFCs, they may decide that the burden of meeting these new standards means that the cost of having an offshore sector outweighs the benefits. In these cases, the international community needs to stand ready to provide assistance so that other economic activities are open up for these islands.

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Table 1 Weight of foreign banking activity in selected OFCs (2001)

	Bank liabilities vis-à-vis non-residents as multiple of GDP	**Country share of total bank liabilities vis-à-vis nonresidents (%)**
CARIBBEAN OFCs IDENTIFIED AS TAX HAVENS BY THE OECD		
The Cayman Islands	617.87	6.97
The Bahamas	20.86	0.94
Netherlands Antilles	13.33	0.28
Bermuda	3.91	0.13
Panama	0.73	0.11
Aruba	0.11	0.0020
Antigua and Barbuda	0.20	0.0013
St. Kitts & Nevis	0.26	0.0012
The Commonwealth of Dominica	0.31	0.0011
St Lucia	0.13	0.0010
Grenada	0.24	0.0009
St. Vincent and the Grenadines	0.12	0.0006
Anguilla	0.65	0.0006
OTHER NON-OECD OFCs		
Singapore	4.36	3.63
Hong Kong SAR	1.58	2.35
OECD OFCs		
Switzerland	3.16	5.70
Luxembourg	16.93	3.57
Belgium	1.16	2.71
Austria	0.46	0.90
OTHER SELECTED FINANCIAL CENTRES		
United Kingdom	1.65	20.77
United States	0.13	11.42
Germany	0.47	8.77
France	0.49	6.76
Japan	0.15	4.64

Sources: data on foreign liabilities are taken from BIS Locational Statistics and from national sources; data on GDP are from World Bank (World Development Indicators database), from national sources or from other international organizations estimates.
Notes: data on foreign liabilities and GDP are for 2001 when available, otherwise latest available.

Table 2 Weight of foreign private banking in selected OFCs (2001)

	Bank deposits of non-resident non-banks as multiple of GDP	**Country share of total bank deposits of non-resident non-banks (%)***
OFCs		
The Cayman Islands	230.87	10.83
The Bahamas	21.52	4.04
Bahrain	2.02	0.89
Netherlands Antilles	3.21	0.28
Singapore	1.31	4.52
Hong Kong SAR	0.44	2.71
Switzerland	1.43	10.72
Luxembourg	5.37	4.70
Belgium	0.36	3.44
Austria	0.04	0.35
OTHER SELECTED FINANCIAL CENTRES		
United Kingdom	0.33	17.46
United States	0.02	7.01
Germany	0.15	11.33
France	0.04	2.34
Japan	0.01	1.13

Sources: data on non-residents bank deposits are from BIS Locational Statistics; data on GDP are from World Bank (World Development Indicators database), from national sources or from other international organizations estimates.

Notes: data at end 2001 when available, otherwise latest available; *total stock for BIS reporting countries.

Table 3 Countries covered by factual assessment

a) Global Forum Participating Partners

Anguilla	Dominica	Korea	San Marino
Antigua and Barbuda	Finland	Malta	Seychelles
Aruba	France	Mauritius	Slovak Republic
Australia	Germany	Mexico	Spain
The Bahamas	Gibraltar	Montserrat	Saint Kitts and Nevis
Bahrain, Kingdom of	Greece	Nauru	Saint Lucia
Belize	Grenada	Netherlands	Saint Vincent and the Grenadines
Bermuda	Guernsey	Netherlands Antilles	Sweden
British Virgin Islands	Hungary	New Zealand	Turkey
Canada	Iceland	Niue	Turks and Caicos Islands
Cayman Islands	Ireland	Norway	United Kingdom
Cook Islands	Isle of Man	Panama	United States
Cyprus	Italy	Poland	U. S. Virgin Islands
Czech Republic	Japan	Portugal	Vanuatu
Denmark	Jersey	Samoa	

b) Invitees

Andorra	Guatemala	Monaco
Argentina	Hong Kong, China	Philippines
Austria	Liberia	Russian Federation
Barbados	Liechtenstein	Singapore
Belgium	Luxembourg	South Africa
Brunei	Macao, China	Switzerland
China	Malaysia (Labuan)	United Arab Emirates
Costa Rica	Marshall Islands	Uruguay