

Perspectives for Tax Policy Reform in Latin America in the 1990's

Glenn P. Jenkins

ABSTRACT

This paper presents an overview of the present state of tax policy in Latin America and identifies areas which are in need of improvement. During the 1980's many of the countries in Latin America implemented major reforms in both tax policies as well as fiscal administration. There is now an opportunity to build on these reforms by implementing policies to extend the value added tax to the public sector, implement major reforms in the customs administration, and link the administration of trade taxation with the income tax and VAT system. The design of effective environmental taxes is an important area of research and experimentation which should be encouraged.

In the area of direct taxation, the most important area of reform is social security taxes. Unfortunately, due to the history in Latin America of pay-as-you-go social security systems, the financial implications of a reform of social security financing imposes major fiscal and political burdens. Some Latin American countries (Chile and Argentina) have been world leaders in social security reform, but much is left to be done in most countries. In summary, the countries of Latin America have the momentum in the area of tax policy to become, by the year 2000, world leaders in the design and implementation of truly modern and efficient tax systems. To achieve this position, more innovation will be needed in the area of tax administrations policies than in policies which affect the structure of the tax systems.

Glenn P. Jenkins is an Institute Fellow at the Harvard Institute for International Development (HIID), and the Director of Harvard's International Tax Program.

PERSPECTIVES FOR TAX POLICY REFORM IN LATIN AMERICA IN THE 1990'S

Glenn P. Jenkins

I. INTRODUCTION

The tax reforms that took place in Latin America in the 1980's were designed primarily to enhance revenue collections and provide more stability in the revenue systems. This generally involved placing a greater reliance on value added type taxes, a rationalization and reduction in the number of excise taxes, a reduction in the top statutory income tax rates for individual and corporation income taxes, and improvements in the degree of integration of business and personal taxes on income from business activities.¹ The question that this paper attempts to address is, what should be on the agenda for tax policy changes in Latin America during the remainder of the decade?

The answer to that question obviously depends on which country one is referring to. For example, the tax policy "needs" of Chile, Mexico, Peru, or the Dominican Republic in the 1990's are all going to be very different in detail, even if they are fairly similar in direction. The countries of Latin America to various degrees are all turning to economic policies that focus on achieving growth by opening up to international trade and becoming internationally competitive. In this international context, being competitive means raising the level of efficiency of their governments and enterprises to match the fastest growing countries of Asia (i.e. Malaysia, Korea, and Taiwan) rather than being equal to the best of Latin America. In this era of unprecedented technical change and falling costs in communication and transportation, the "closeness" of the markets of North America, Western Europe and Japan to a country's exporters are not determined by physical distance but by the magnitude of transactions costs. The compliance costs associated with the tax system and government regulation are major determinants of such transactions costs. Tax policies in the 1990's must be focused on how to obtain the revenues to pay for the necessary public expenditures while inflicting the lowest possible compliance costs on business and individuals. For trade, value added

¹Parthasarathi Shome, "Trends and Future Directions in Tax Policy in Tax Policy Reform: A Latin American Perspective", IMF Working Paper, Wp/92/43, June 1992.

and income taxes, it is not unusual to find the compliance costs imposed on some of the more dynamic sectors to be more than 25 percent of the revenues obtained.² Major efforts are being made by tax authorities around the world to reduce these compliance costs. If business in Latin America is to be internationally competitive the governments of the area must be world leaders in this effort to reduce the compliance costs of government.

In order for business to be internationally competitive, macroeconomic stability, including the stability of the real exchange rate and the major rules and directions of tax policy, is very important. For a business to attempt to build its future on export markets when it is facing wide swings in the real exchange rate is to be engaged in some form of economic gambling. At the same time export programs that are built on generous tax incentives or direct export subsidies are never stable. Pressures from interest groups and fraud always cause frequent changes to be made over time. Such instability of tax policies usually induces "rent seeking" behavior rather than long term business strategies to gain international competitiveness.³

A necessary, but not sufficient condition, to achieve macro-economic stability is to build a tax system that can be administered and which yields an adequate level of revenue to the public sector. This has been the focus of many of the countries of Latin America such as Chile, Mexico, Bolivia and, recently, Argentina. Of course, unless sound expenditure policies are put in place it is highly unlikely that an effective tax system can be sustained. During 1980's many good tax policies have been put in place and the administrative capacity has been growing. Perhaps the greatest danger in the 1990's is that the success to date will tempt governments to introduce changes, aimed at social or political objectives, that will erode the gains and induce tax policy instability.

²"Trade on better terms", *The Economist* (21 March 1992), and F. Vaillancourt, "The Compliance Costs of Sales Taxes in Canada: Evidence from the Eighties, Prospects for the Nineties." Paper prepared for the Symposium on the Simplification of Federal/Provincial Sales System, November 1992.

³Robin Burgess and Nicholas Stern, "Taxation and Development", *Journal of Economic Literature*, Vol XXXI, No 2, June 1993, pg 794.

II. POTENTIAL INDIRECT TAX POLICIES FOR THE 1990'S

By far the most important set of tax policies facing Latin America is to move from using tariffs and export taxes on traded goods as sources of revenue to using the value added and excise taxes. At the same time it must be recognized that the revenues and the information collected by customs on imported goods are essential elements for the successful operation of a value added tax system. In a developing country that is open to trade it is normal that 40 to 50 percent of total VAT revenues will be collected on imported goods. As the trade flows of Latin American countries increase, the importance of customs for the administration of the VAT will increase, exponentially.

Knowledge of the quantity and value of imports provides an important starting point for capturing information about potential domestic taxpayers and the level of their activities. Domestic producers and sellers are likely to have either imported goods directly or bought some their inputs from importers. A VAT system can only operate effectively if the tax authorities have some concept of the relative magnitudes of the inputs used by various production processes and the quantities of imported inputs used. If the tax administration has this information, it will be able to make reasonable estimates of the tax liabilities that should be accruing to that sector.

The VAT system also imposes important information requirements on exports. Without good information on the type, quantity and value of goods being exported by all VAT payers, the VAT system would be open to great abuse. Value-added tax fraud often comes about due to the zero rating of exports, an economically desirable policy because it eliminates the taxes that the producer has paid on intermediate inputs. This is done by providing a zero rate of tax on export sales and refunding any excess credits that might arise as a result of taxes already paid on inputs. The classic form of tax fraud in these circumstances is for a firm to overstate the value of its exports, as well as the amount of inputs used and taxes paid on the inputs through creating false invoices. In such cases, the ratio of inputs to outputs may appear to be legitimate when firms claim to have a large amount of excess credits. Often, such enterprises are able to successfully demand cash refunds for the excess credits. Unless the authorities have reliable information on the value of exports, the dishonest exporters will have an easy time defrauding the Treasury.

The information on imports subject to VAT and quantities of goods exported can only be used in an effective manner if the Customs and the VAT administrations are linked so that information is transferred in a timely fashion. The recent integration of the Customs, VAT and Income Tax administrations in Canada is a model that should be considered carefully by the countries of Latin America.

While tariffs may still be used to provide a degree of protection for domestic production, there is little or no economic justification to provide differential rates of effective protection, (differential rates of subsidy) for different domestic industries. Such differential rates of tariff not only create inefficiency in the allocation of domestic resources, but are one of the core causes of the huge transactions costs that are inflicted by many of the Customs administrations of Latin America on enterprises engaged in international trade. The success of several Latin American countries, such as Chile and Mexico, in introducing a simple (sometimes uniform) tariff system should encourage other countries in the region to follow this path.

Broadening the base of the VAT to cover more of the service sector, while maintaining a single positive tax rate with only selected exemptions and the zero rating of exports should continue to be the focus of tax policy under the VAT. Coverage of the financial sector with the VAT is an area that should be approached with great caution. On revenue grounds there is little incentive to include financial services as the reduction in credits for the inputs to the financial sector is offset against the untaxed value added in the services purchased by final consumers. However, as financial institutions expand their activities into other consumer related services other than financial intermediation, these activities (and their inputs) need to be segregated and taxed accordingly.

The tax inclusive budget for governments, where import duties, excises and VAT are paid by all government organizations is an important policy measure that deserves serious consideration. When the public sector does not pay import duties, there is a strong budgetary incentive for the governmental organizations to purchase imported goods rather than those domestically produced.

Furthermore, there is always significant losses of revenue through the diversion of public sector imports to private use.

Administration and compliance with the VAT is greatly facilitated when the VAT is extended to all public sector activities. The absence of exempt sales to the public sector reduces, in particular, the compliance costs of firms selling to the public sector. The experience of New Zealand with its comprehensive application of the VAT to all public sector functions has been very positive and should be a model for governments in Latin America.

With the introduction of the VAT throughout Latin America, the number of excise taxes or special luxury taxes have been greatly reduced. When the number of items are small and they are final consumption items, the tax policies in this area tends to remain stable, if not controversial. When the number of goods subject to excise increases some cascading of these taxes will likely result. When this occurs there is a tension between maintaining a good subject to the excise tax, eliminating the excise tax, or adding an additional rate to the VAT system to eliminate the cascading. The desire to levy a higher rate on a few items, will almost never justify the additional compliance and administration costs imposed by having an additional rate of VAT in the system.

III. ENVIRONMENTAL TAXES

An area that is likely to see increased tax policy activity is the use of taxes to control pollution. First, tax policy attention should be given to eliminating the present subsidies on many of the activities that create pollution. It is seldom that one finds a major source of pollution,(e.g. pesticides, industrial effluent, air pollution from motor vehicles) that is not enjoying some form of public subsidy. Second, tax instruments need to be carefully designed to address specific environmental concerns. The difficulties faced with the design, administration, and enforcement of such environmental taxes can not be exaggerated. This will be a major area of innovation in tax policies in the next decade. If not designed properly, such taxes can become a major source of compliance costs and economic waste. To be designed properly they will need to be pollutant and perhaps

process specific. Given these difficulties, environmental taxes are likely to be far from a cheap source of tax revenue.

IV. PROPERTY TAXATION

The property tax in Latin America has been frequently discussed but seldom implemented. It has often been proposed as a way to force people to farm idle land, to redistribute wealth, or to capture the capital gains on land, but with the exception of Chile and the city of La Paz, it has not been an effective source of revenue. In other parts of the world, the property tax has only been successful when the revenues are earmarked for the use of local governments in providing local services. In an urbanized area a stable source of revenue can be very valuable. In the past the infrequent valuation of property in an inflationary environment has largely destroyed its revenue potential.

In recent years a number of innovations have been introduced in the implementation and administration of the property tax.⁴ The use of computer based valuations and information systems, with a collection oriented strategy, has lowered the administration and compliance costs significantly, while enhancing its stability and potential as a revenue source for local governments. Now there is no technical or cost constraint to prevent property valuations from being kept up to date,(at least with inflation), and collections enforced. This is a source of revenues that Latin American countries should consider carefully as a way to finance the maintenance costs of their urban infrastructure.

V. DIRECT TAXATION

A. Social Security Taxes

By far the greatest need for reform in the Latin American country's direct tax system is the financing of Social Security. The present pay-as-you-go social security systems in Latin America are basically bankrupt. The high payroll taxes used to finance these schemes are a major distortion in the

⁴Roy Kelly, "Implementing Tax Reform in Developing Countries: Lessons from Property Taxation in Indonesia", *Review of Urban and Development Studies*, Vol 4, 1992, pp 193-208.

labor market and are subject to a high degree of evasion. Chile has taken the lead of transferring its public, pay-as-you go social security system into a privately managed, but publicly regulated and guaranteed, pension and health insurance system.⁵ Chile provides a clear model for implementing a badly needed set of reforms, but it is not the only available model.

The heavy public cost of financing the conversion from a pay-as-you-go to a funded pension system should cause some thought to be given to converting the existing systems to a somewhat less rich, but funded, system. Given the history of inflation in Latin America, the values of the current pension systems are likely to have been put at great risk, in the recent memory of everyone. Hence, it might be acceptable to the majority of the public to convert the existing uncertain system to a fully funded and privately managed pension that would give a smaller pension, than the one now promised by the current system. Contributors to a fully funded pension system will have a much greater degree of compliance because what they get out of the system is based on their history of contributions.

Before implementing such social security reforms there is a need to put in place a pension law and administrative regulations that will serve as a foundation for a private pension system. Such a law and regulations will help to prevent a number of abuses that have risen in developed countries which have been partially responsible for the creation of the demand for public pensions.⁶

B. Income Taxes

With a few notable exceptions, the income tax has performed very badly in Latin America. Although the income tax administrations have received large amounts of technical assistance and training relative to those of indirect taxes and Customs, in most countries they tend to account for rather modest amounts of revenue. By its nature, the income tax is unstable with respect to tax policies and skill intensive in its administration. In order to reduce the level of evasion and avoidance

⁵Leon A. Larrain, "Social Security Reform in Chile: Privatization of the Pension Saving System", *Tax Notes International*, June 7, 1993.

⁶Yves Guerard and Glenn P. Jenkins, Building Private Pension Systems: A Handbook, ICEG Press, San Francisco, 1993.

the highest statutory tax rates must be kept as low as possible, while providing the fewest number of opportunities for avoidance of the tax.

Widespread withholding is essential for the effective collection of the income tax. It is in this area that the technological revolution in computerized information systems can have a major impact.

The use of a withholding tax⁷ is an effective way of implementing voluntary compliance because it is at once a preventive policy and a service. It is preventive in that it enables taxpayers to fulfill their tax obligations fractionally so as not to be burdened by a substantial tax bill at the end of the tax year. In this connection, both the state and the taxpayers spare themselves the trouble of having to endlessly negotiate late tax payments. The tax administration can curb noncompliance preemptively by broadening the scope of withholding taxes at source.

Withholding can also be a service. By facilitating the incremental pre-payment of taxes based on the estimated value of annual income streams, the tax administration serves taxpayers needs to a reasonable extent. It enables them to keep track of their liabilities or their possible tax credits. The information yielded by withholding thus makes it easier for some taxpayers to allocate their consumption or investment resources ahead of time.

An information system that combines withholding with the use of third party information is also instrumental in facilitating the enforcement of tax rules. Automation, which constitutes the bedrock of taxpayer service, facilitates in the pooling of information from assorted sources which can be useful in enforcing compliance at a lower administrative costs than the exclusive use of traditional auditing schemes. The fact that taxpayers are aware of the availability of information regarding their transactions or income sources deters them from attempting to avoid or evade their tax obligations. Of course, the information must be used and collection actions vigorously pursued.

⁷For a detailed analysis of various issues related to withholding, see P. Soos, "Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues", in *University of California at Davis Law Review*.

In order to maintain an income tax system, constant attention must be placed on eliminating special incentives that will be continuously introduced into the system to address some short term political or social objective. Of course, the pressure for such tax avoidance opportunities is greatly reduced when the top statutory tax rate is kept at a fairly low level.

Incentives that use financial institutions, such as tax free saving instruments or after tax financing schemes are particularly dangerous as they provide for a much greater degree of tax avoidance than the narrow purposes of the initial incentive. At the same time special tax measures to tax financial institutions can be extremely harmful to the development of a modern system for financial intermediation. Such a system is necessary for a modern, competitive economy and can not develop efficiently if the tax system imposes a variety of transaction based taxes and reporting requirements.

Many attempts have been made to tax financial institutions in special ways to offset the use of tax preferences given by other income tax legislation. To date all such schemes have either been ineffective or impose an unacceptable level of transactions costs on normal commerce. The best policy with respect to the taxation of financial institutions is to not get them involved in the delivery of special tax incentives in the first place, and then to impose the same tax rules on them as on other forms of business.

V. CONCLUSIONS

During the 1980's a great deal of progress has been made in Latin America in the development of sound tax policies that are consistent with modern, international competitive economies. Generally the tax systems have been simplified and the tax administrations have been simplified. In the 1990's this same trend should be pursued. There are still many areas where further simplification and deregulation are needed. The focus of such efforts should be to find ways to reduce the compliance costs imposed on business and individuals while collecting the necessary revenue.

The advances of information technology will enable tax liabilities to be met with lower compliance costs, provided that tax policies and administrative procedures are streamlined. Whether it be in the indirect, property or direct tax areas, policy makers must realize that the way they design and administer their tax systems will have a direct impact on the compliance and transactions costs imposed on their residents and business and will affect ability of their country to be internationally competitive. Public sector revenues are needed for economic development, but ill designed and administered tax systems impose compliance costs and distort economic decisions and work against the modernization of economies.

REFERENCES

Robin Burgess and Nicholas Stern, "Taxation and Development", *Journal of Economic Literature*, Vol XXXI, No 2, June 1993, pg 794.

Yves Guerard and Glenn P. Jenkins, Building Private Pension Systems: A Handbook, ICEG Press, San Francisco, 1993.

Roy Kelly, "Implementing Tax Reform in Developing Countries: Lessons from Property Taxation in Indonesia", *Review of Urban and Development Studies*, Vol 4, 1992.

Leon A. Larrain, "Social Security Reform in Chile: Privatization of the Pension Saving System", *Tax Notes International*, June 7, 1993.

Parthasarathi Shome, "Trends and Future Directions in Tax Policy Reform: A Latin American Perspective", IMF Working Paper, Wp/92/43, June 1992.

P. Soos, "Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues", in *University of California at Davis Law Review*, 1990.

"Trade on better terms", *The Economist* (21 March 1992).

F. Vaillancourt, "The Compliance Costs of Sales Taxes in Canada: Evidence from the Eighties, Prospects for the Nineties." Paper prepared for the Symposium on the Simplification of Sales System, November 1992.