REGIONAL REPORT

# The challenges of taxation in Latin America

Madrid, October 2014

d+i LLORENTE & CUENCA

BARCELONA | BOGOTA | BUENOS AIRES | LIMA | LISBOA | MADRID | MEXICO | PANAMA | QUITO | RIO J | SÃO PAULO | SANTIAGO | STO DOMINGO

## 1. INTRODUCTION

Since colonial times, fiscal policy has historically been one of the key areas that need to be addressed by Latin America and, in general, this issue was not well resolved, not even after independence or in the 20th century. As we're reminded by the Economic Commission for Latin America and the Caribbean (ECLAC), fiscal and tax reform was already considered to be one of the great transformations yet to be implemented by the Latin American economies in the 1960s: "The Charter of Punta del Este, through which the Alliance for Progress was created half a century ago, included on its agenda for the region the promotion of tax reforms with the aim of increasing the levels of taxation and making the systems more progressive, broadening revenue from direct taxes. As is well-known, these aims have not been perfectly achieved and therefore the challenge still remains".

More recently, since the 1990s, Latin American countries have attempted to reduce their traditional fiscal deficits by mobilising resources. These democracies since the 1980s have not found a definitive solution and, in the current decade, fiscal reforms have actually been the main focus of several governments, both centre-right and centre-left: in El Salvador in 2012, the President of the Republic, Mauricio Funes, sanctioned the decree passed by the Legislative Assembly containing a series of reforms to the country's law on Income Tax (ISR) to allow the treasury to collect around 150 million dollars more each year by raising the tax on income and profits for some companies from 25% to 30%. This route taken by El Salvador was also followed by Costa Rica and Guatemala, albeit without much success in these cases and by Mexico in 2013, whose government, led by Enrique Peña Nieto, managed to pass fiscal reforms in 2013. In Brazil, fiscal reform has been a problem for the last twenty years and a risk that no President is willing to take on. Twelve years ago, Constitution Amendment Proposal (PEC) number 474/01 went through National Congress, whose aim was to create a single tax on financial movements. Its collection method would be more efficient than other proposals and the most effective in combating tax evasion. It also simplifies the structure, reduces public and private costs, relieves the individual tax burden on current taxpayers and causes fewer geographical distortions than those claimed by its critics. But this was put to one side by the government of Luiz Inácio Lula da Silva in 2003. In Chile, in

**"When we talk of taxation in Latin America we're actually talking about a long history of frustrated tax reforms that have not managed to achieve their goals"**

2014, part of Michelle Bachelet's proposed fiscal reform contains the fundamental pillar supporting the great goal of her presidency: educational reform. As pointed out by Ascanio Cavallo, political analyst of the Chilean newspaper La Tercera, "none of the other presidential promises is more important than this [the educational reform]. Tax reform has been justified by the need to increase fiscal resources for education and the reform of the Constitution aims to provide institutional recognition for the proposed changes it contains; above all, the transformation of education".

All this merely demonstrates that the issue of taxation in the region has yet to be resolved, although it still occupies and preoccupies the various regional administrations. All these tax reform initiatives attempt to follow the same path, albeit with more or less success, namely the one recommended by ECLAC, in the words of its Executive Secretary, Alicia Bárcena: "Tax reforms with a vision of sustainable development are needed in Latin America and the Caribbean. Tax collection and public expenditure structures must be revised so that they are fairer and have the necessary resources to face the challenges of development and climate change".

Latin America's relationship with fiscal policy is actually a constant quest to achieve the objectives highlighted by Alicia Bárcena: governments present each fiscal reform as the definitive one, although ultimately this is very far from being the case as they are usually, in most cases, patches aimed at sorting out specific problems (such as the current fiscal imbalances) rather than comprehensive solutions for the medium and long term. When we talk of taxation in Latin America we're actually talking about a long history of frustrated tax reforms that have not managed to achieve their goals.

In fact, already in 2007, in the San José Consensus organised by the Inter-American Development Bank (IADB), the conclusion reached was that improving fiscal institutions and policies was not only one of the greatest challenges facing the region but also one of its greatest opportunities to boost its chances of economic and social development in the future. And Luis Alberto Moreno, President of the IADB, has stressed on several occasions that no reform is more important for the sustainable, inclusive growth of Latin America and the Caribbean than that related to the region's fiscal and tax systems.

What seems clear is that tax revenue in Latin America is still relatively low, hindered by the countries' own degree of development (lower than that of the OECD nations), by fiscal authorities with few resources, by large informal economies that dramatically reduce the tax base and lead to extensive sectors of society having no tax burden at all. This lack of tax revenue has social and economic consequences for those countries

"There's a markedly imbalanced tax structure biased towards indirect taxes and very high levels of tax evasion"

with greater macroeconomic volatility and whose states do not have the necessary financial capacity to promote investment in physical and human capital which, in turn, exposes lower-income sectors to increased instability as they cannot access effective mechanisms of social protection against abrupt economic changes.

The next few pages analyse the characteristics of the fiscal systems in Latin America (which are highly heterogeneous), the key transformations occurring over the last few years (increased revenue thanks to the greater weight of certain types of tax, particularly VAT) and the main challenges still facing the region in the fiscal area over the coming years.

## 2. FEATURES AND CHANGES IN TAXATION IN LATIN AMERICA (1990-2014)

There are several stereotypes and common points regarding taxation in Latin America that are worth examining as some are clearly outdated, although still alive and kicking in the collective subconscious. In general, Latin American taxation is usually considered to be low, there's a markedly imbalanced tax structure biased towards indirect taxes and very high levels of tax evasion. This view, only partly true, ignores some of the most important changes that have taken place in the region since the 1980s, extensively changing the fiscal panorama:

### Taxation has increased although it's still low (with few exceptions) and volatile

The first thing we should note is that, as stated by ECLAC, **there have been very substantial structural changes to the fiscal system in Latin America** since the start of the new millennium: "Over the past decade (in particular since 2002), most countries in the region witnessed a substantial increase in their tax burden as a percentage of GDP, together with far-reaching structural changes, including consolidation of the value added tax (VAT), a significant improvement in the share of direct taxes in total tax receipts and a decline in tariffs on international trade".

In the last two decades, the countries of Latin America have gradually reduced their traditional and historical gap between fiscal revenue and expenditure via an increase in the tax burden and structural changes in tax collection: a reduction in the share of taxes on international trade, a sharp rise in revenue from VAT and an albeit lower increase in the share of tax on income and assets, particularly personal income tax.

As ECLAC points out, a new phase in Latin American taxation has been unfolding since the mid-1990s and especially in the last decade. As can be seen in Table 1, the level of tax revenue as a percentage of GDP has trended upwards both as a regional average and also in the vast majority of Latin American

and Caribbean countries. Between 2000 and 2011, the average tax burden in Latin American countries rose from 15.4% to 19.1% of GDP while in the Caribbean it rose from 19.3% to 23% of GDP. In fact, the tax burden has increased more in Latin American and Caribbean countries than in any other region in the world: 2.7 points of GDP from the beginning of the 1990s to the second half of the first decade of the new millennium. More tax is currently paid in Latin America and the Caribbean (as a proportion of income) than in Asian or African countries because Latin American countries have carried out substantial tax reforms over the last two decades: VAT reforms in the 1990s and promoting income tax in the last decade.

As can be seen in Table 1 produced by ECLAC, and as noted by the IADB, "the tax burden has grown in almost all Latin American and Caribbean countries, whether relatively rich economies, such as Argentina, Chile and Uruguay; or lower-income countries such as Guatemala and Bolivia; in countries rich in oil and minerals, such as Colombia, Ecuador and Peru, in economies with fewer natural resources, such as the Dominican Republic and El Salvador; or in tourism-dependent countries, such as Barbados; as well as in those dependent on external transfers, such as Nicaragua. The tax burden fell in only three countries (Mexico, Trinidad and Tobago, and Venezuela), all oil exporters, in the three-year periods from 1991 to 93 and 2008 to 2010".

This increased revenue has been boosted by various factors and it's impossible to provide a single cause. The consensus of analysts points to the following as factors contributing to this rise in revenue: (1) the favourable, high prices of key exports, (2) improvements in the respective national tax administrations and (3) the good economic situation after a six-year boom (2003-2008) and growth (of around 5% annually) over the last four years (2010-2013) leading to high levels of financial and fiscal solvency.

## TABLE 1: LATIN AMERICA AND THE CARIBBEAN (33 COUNTRIES): TAX REVENUE 2000 AND 2011 (as a percentage of GDP)

| COUNTRY | Tax revenue wiht Social Security | | Tax revenue without Social Security | | Total revenue | |
|---|---|---|---|---|---|---|
| | 2000 | 2011 | 2000 | 2011 | 2000 | 2011 |
| GROUP 1 | | | | | | |
| Argentina | 18.1 | 27.4 | 21.5 | 34.9 | 25.0 | 38.0 |
| Brazil | 23.0 | 26.0 | 30.1 | 34.8 | 32.5 | 38.3 |
| Uruguay | 14.6 | 18.6 | 22.5 | 26.5 | 27.4 | 29.0 |
| GROUP 2 | | | | | | |
| Bolivia | 16.3 | 20.4 | 17.9 | 22.1 | 26.7 | 34.5 |
| Costa Rica | 12.6 | 14.4 | 18.9 | 22.0 | 21.3 | 24.1 |
| Chile | 16.9 | 18.9 | 18.2 | 20.2 | 21.3 | 24.1 |
| Ecuador | 16.9 | 18.9 | 18.2 | 20.2 | 21.9 | 24.6 |
| Nicaragua | 11.2 | 15.2 | 13.5 | 19.0 | 16.8 | 21.8 |
| Colombia | 11.6 | 16.2 | 14.0 | 18.1 | 17.7 | 22.4 |
| Panama | 9.6 | 11.3 | 16.0 | 17.8 | 24.6 | 24.3 |
| Peru | 12.4 | 15.3 | 14.1 | 17.0 | 17.0 | 19.4 |
| Paraguay | 9.3 | 12.1 | 12.5 | 16.1 | 18.1 | 21.7 |
| Honduras | 13.8 | 15.0 | 14.3 | 15.8 | 16.2 | 18.3 |
| El Salvador | 10.2 | 13.9 | 12.4 | 15.5 | 14.2 | 17.1 |
| GROUP 3 | | | | | | |
| Haiti | 7.9 | 13.1 | 7.9 | 13.1 | 8.2 | 14.3 |
| Guatemala | 10.5 | 10.9 | 12.4 | 12.8 | 14.1 | 13.6 |
| Dominican Republic | 11.2 | 12.7 | 11.3 | 12.8 | 14.1 | 13.6 |
| Venezuela | 12.9 | 11.9 | 13.6 | 12.5 | 20.9 | 23.0 |
| Mexico | 10.1 | 9.7 | 11.9 | 11.4 | 17.4 | 19.5 |
| Lat. America (19 countries) | 12.7 | 15.7 | 15.4 | 19.1 | 19.6 | 23.6 |
| The Caribbean (13 countries) | 19.3 | 23.0 | ... | ... | 24.5 | 28.3 |
| Cuba | 33.3 | 34.5 | 37.2 | 38.8 | 48.8 | 65.7 |
| OECD (34 countries) | 26.3 | 24.7 | 35.2 | 33.8 | 41.4 | 40.5 |

Source: ECLAC http://www.eclac.cl/publicaciones/xml/6/49276/PanoramaFiscaldeALC.pdf

"In addition to VAT, in the last decade there has already been a significant increase in revenue from corporate income tax and, at the same time, new taxes have emerged"

Over these years, **value added tax (VAT) has become the main source of tax revenue in Latin America and the Caribbean**, now totalling 6.3% of GDP. This strength in VAT revenue (due to it being extended to intermediate and end services and a progressive rise in the general tax rate) has also been helped, according to ECLAC, by stronger world economic growth, a rise in international commodity prices exported by Latin American countries and a favourable macroeconomic context, all helping to reduce fiscal and trade deficits. General taxes on consumption (mainly VAT and sales taxes) accounted for 33.8% of the tax revenue of the countries of Latin America and the Caribbean in 2011 compared with 20.3% of the countries of the OECD. From a historical point of view, **at the end of the 1980s and early 1990s (after neo-liberal reforms opened up economies to international trade), VAT replaced the taxes on international trade.**

In addition to VAT, in the last decade there has already been a significant increase in revenue from corporate income tax and, at the same time, new taxes have emerged (on bank debits, credits and financial operations). As can be seen in Table 2, in Latin American countries taxes on income and utilities accounted on average for 25.4% of tax revenues in 2011, while Social Security contributions totalled 16.9% (in the OECD these percentages are 33.5% and 26.2%, respectively). With regard to tax on consumption (such as selective taxes and taxes on international trade), this has fallen to 17.7% (in the OECD it is 10.7%).

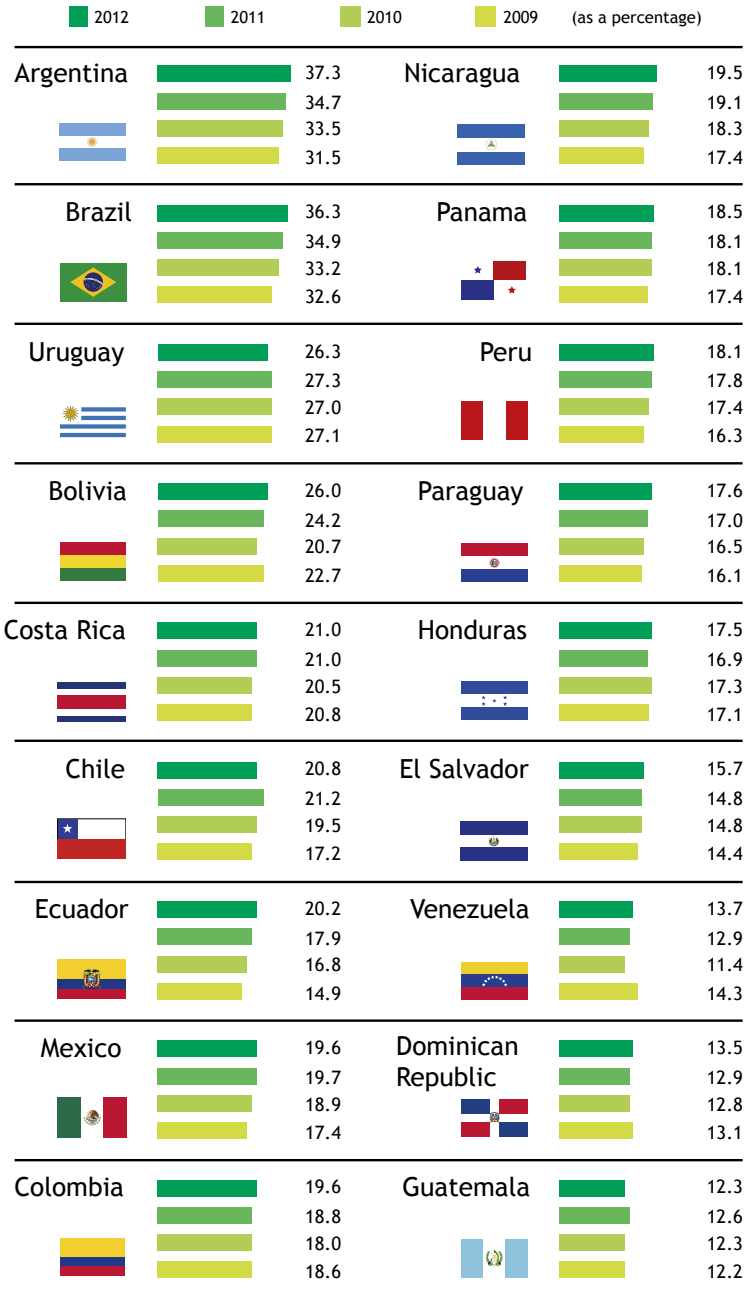
This higher tax revenue has also come from growth in formal employment and the consequent increase in private consumption and taxes levied on the goods and services consumed. Lastly, the reduction and abolition of numerous tax exemptions, deductions and benefits has also had a significant effect, as well as improvements in the administration of VAT and income tax.

However, in spite of these undeniable increases in the tax burden, tax revenues in Latin America are still low (20.7%), lower than in the other 32 non-Latin American countries of the Organization for Economic Cooperation and Development (OECD) (34.6%). Osvaldo Kacef, Head of the Economic Development Division at ECLAC in Buenos Aires, states that "only four Latin American countries (Argentina, the Plurinational State of Bolivia, Brazil and Nicaragua), out of the 19 contained in the sample are above the regression line, indicating that their tax pressure is high compared with their level of GDP per capita. Uruguay and Costa Rica are very close to the regression line; i.e. their tax burden seems to be in line with their degree of development, while the remaining 13 countries have a clearly lower tax burden than they should have according to their levels of development".

**This low revenue is due to many different factors that can be grouped into two broad areas: economic-social factors and institutional limitations.**

**One of the key economic-social factors** is the low level of development, which ends up limiting the capacity of tax administrations to collect taxes and enforce the rules and compliance on a national scale. These are also countries with a substantial informal economy, directly affecting the tax structure as these informal sectors evade any kind of tax burden, especially personal income tax. The tax base is therefore ultimately reduced by social issues (great inequalities in income) and economic issues (extensive informal economy). Revenue is also hampered by high levels of informality and tax evasion (according to ECLAC, tax evasion rates in Latin American countries are between 40% and 65%, approximately).

## TABLE 2: TAX REVENUE AS A PERCENTAGE OF GDP




Graphics: FMG/Source: Tax statistics in Latin America (OECD-ECLAC-CIAT)

**However, there is another group of limitations that go beyond the strictly economic, namely factors of an institutional and also political nature.** As pointed out by ECLAC and IADB, in the processes of public policymaking and implementation, institutional quality is as important as the policy content. One important institutional deficiency is the state's limited capacity to collect taxes due to lacks of an administrative nature and also in resources, making it impossible to control tax fraud, as well as the inability to control and reduce high levels of tax evasion in the informal economy, the low level of fiscal awareness and education among the population and high fiscal expenditure due to the existence of a large number of different exemptions or preferential tax treatment in economic sectors with a high tax capacity.

"The region's countries have increased their tax revenue but this is still collected little and poorly, weakening the redistributive capacity of fiscal policy"

**As has already been shown, revenue has increased but this is still low and highly volatile.** The region's tax revenue tends to be very volatile, especially in those countries specialising in exporting non-renewable natural resources and those whose income is related to international commodity prices. This low and volatile tax revenue can have serious consequences, not only at times of crisis but also during slowdowns with a risk of stagnation, as at present; especially because, in the last five years, states have taken on a greater role in social policies and have increased public expenditure on social spending in general and particularly on programmes to reduce poverty (conditioned transfers). This government spending depends on exports and not on the country's own internal resources, hence the model's volatility. At the same time, automatic stabilisers (insurance for unemployment, retirement, etc.) are not only limited but also highly ineffective, accentuating the vulnerability of lower-income sectors which suffer more directly from any substantial reduction in their income at times of crisis or recession.

In short, beyond the improvements observed recently in the fiscal conditions and tax revenue of most of the countries of Latin America, it can be concluded, as does ECLAC, that "the region's countries have increased their tax revenue but this is still collected little and poorly, weakening the redistributive capacity of fiscal policy".

## Regional heterogeneity

The increase in tax revenues occurring in Latin America since the 1990s has been highly heterogeneous in the region's countries, depending on the different tax policies implemented from country to country. As can be seen in Table 3, intra-regional differences with regard to tax burden levels can be observed in examples such as Argentina and Brazil, which exceed the average tax burden of members of the Organization for Economic Cooperation and Development (OECD), while others (Guatemala) do not even reach one third of such levels. In the area of tax, as in other economic and political areas, the region is diverse and contains countries with relatively high levels of tax revenue in relation to their gross domestic product (GDP), countries with very low rates and others with intermediate rates.

On the one hand there's a group of countries whose tax burden falls below 15% of GDP. Guatemala, Mexico, Panama and Trinidad and Tobago have the lowest tax burdens, around 10% of GDP: Guatemala, 12.2%; the Dominican Republic, 13.1% and El Salvador and Venezuela, both with 14.4%, while in Haiti it's barely 11.7% of its GDP. Mexico is around 11.8%, if we exclude its oil revenue.

The second group is made up of countries with an average tax burden (above 15% and below 25%): Chile (18.4%), Colombia (17.4%) and Peru (15.9%).

"The tax burden in Brazil reached a record 36.27% of GDP after increasing by 3.63 percentage points over the last ten years"

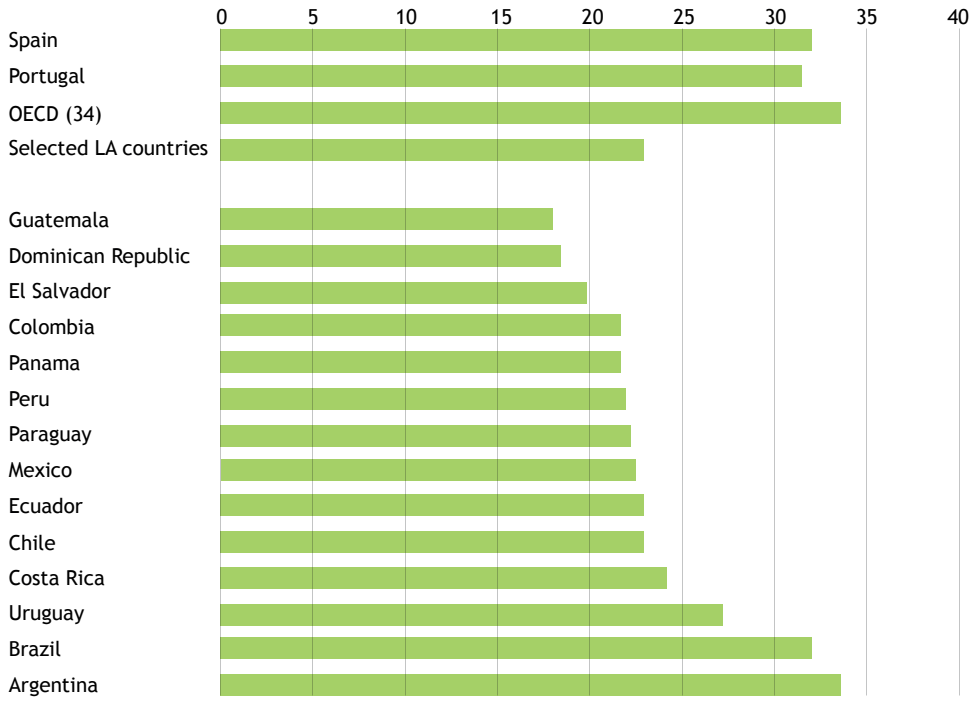
Lastly, there's a group of countries with very high tax burdens. Brazil and Argentina head this list. In fact, **Argentina has reached the top of the international ranking because, in 2013, it had the highest tax burden in Latin America, even larger than most developed countries.** This has been revealed by a study by the Organization for Economic Cooperation and Development (OECD), the Economic Commission for Latin America and the Caribbean (ECLAC) and the Inter American Center of Tax Administrations (CIAT), which states that, at the end of 2012, Argentina had a tax burden of 37.3%, compared with the average of 20.7% for Latin America and 34.1% for OECD countries, indicating considerable historical development: in 1990 the tax burden in the country was 16.1% of GDP and 20.1% after the crisis of 2001.

**Second in the ranking was Brazil, with 36.3%, a country which has traditionally occupied the highest position in this classification.** The tax burden in Brazil reached a record 36.27% of GDP after increasing by 3.63 percentage points over the last ten years. According to the OECD, Brazil has the highest tax burden among the emerging countries (China 17%, India 18%, Indonesia 12% and South Africa 27%). According to the study carried out in 2013 by the Brazilian Institute of Planning and Taxes (IBPT), Brazil posted the highest tax burden of all the BRICS countries (Brazil, Russia, India, China and South Africa), ending the year with a tax burden of 36.42 while the BRICS average is 22%.

With regard to how tax revenue has grown over the last decade or two, it can be established that, in the fiscal area, there is also marked heterogeneity and three groups of countries:

- A first group has seen a larger increase in the tax burden over this time, around 10%. Argentina and Ecuador are the ones recording the highest increase since 2001. In Argentina this new revenue has come through export duties since 2002 and through increased revenue from Social Security

TABLE 3: TOTAL TAX REVENUE AS PERCENTAGE OF GDP




Source OCDE

contributions after the pension system was nationalised in 2008. In Ecuador the largest increase has occurred thanks to successive tax reforms which have increased revenue from income tax, as well as in the negotiation of new contracts with oil exporters.

- A second group of countries has experienced an average increase in tax burden, around 5%. Brazil, Colombia, Bolivia, Haiti, Nicaragua, Cuba and Uruguay managed to increase their tax burden by between 4 and 5.5 percentage points of GDP in the period 2000-2011.

## TABLE 4: TABLE OF TAX REVENUE AS A PERCENTAGE OF GDP

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Argentina | 23.4 | 26.4 | 26.9 | 27.4 | 29.1 | 30.8 | 31.5 | 33.5 | 34.7 | 37.3 | Argentina |
| Bolivia | 13.3 | 15.5 | 19.1 | 21.8 | 22.6 | 20.5 | 22.7 | 20.7 | 24.2 | 26.0 | Bolivia[2] |
| Brazil | 31.2 | 32.1 | 33.1 | 33.1 | 33.8 | 34.0 | 32.6 | 33.2 | 34.9 | 36.3 | Brazil |
| Chile | 18.7 | 19.1 | 20.7 | 22.0 | 22.8 | 21.4 | 17.2 | 19.5 | 21.2 | 20.8 | Chile |
| Colombia | 16.7 | 17.5 | 18.1 | 19.1 | 19.1 | 18.8 | 18.6 | 18.0 | 18.8 | 19.6 | Colombia |
| Costa Rica | 19.4 | 19.3 | 19.8 | 20.3 | 21.7 | 22.4 | 20.8 | 20.5 | 21.0 | 21.0 | Costa Rica |
| Dominican Rep. | 12.0 | 12.9 | 14.7 | 15.0 | 16.0 | 15.0 | 13.1 | 12.8 | 12.9 | 13.5 | Dominican Rep. |
| Ecuador | 11.4 | 11.4 | 11.7 | 12.4 | 12.8 | 14.0 | 14.9 | 16.8 | 17.9 | 20.2 | Ecuador |
| El Salvador | 13.3 | 13.2 | 14.1 | 15.1 | 15.2 | 15.1 | 14.4 | 14.8 | 14.8 | 15.7 | El Salvador |
| Guatemala | 13.5 | 13.4 | 13.1 | 13.8 | 13.9 | 12.9 | 12.2 | 12.3 | 12.6 | 12.3 | Guatemala |
| Honduras | 16.2 | 17.0 | 16.9 | 17.6 | 19.0 | 18.9 | 17.1 | 17.3 | 16.9 | 17.5 | Honduras |
| Mexico | 17.4 | 17.1 | 18.1 | 18.2 | 17.7 | 20.9 | 17.4 | 18.9 | 19.7 | 19.6 | Mexico |
| Nicaragua | 19.1 | 19.8 | 20.9 | 17.1 | 17.4 | 17.3 | 17.4 | 18.3 | 19.1 | 19.5 | Nicaragua |
| Panama | 15.0 | 14.7 | 14.6 | 16.0 | 16.7 | 16.9 | 17.4 | 18.1 | 18.1 | 18.5 | Panama |
| Paraguay | 11.6 | 13.1 | 13.8 | 14.2 | 13.9 | 14.6 | 16.1 | 16.5 | 17.0 | 17.6 | Paraguay |
| Peru | 14.5 | 14.7 | 15.8 | 17.2 | 17.8 | 18.2 | 16.3 | 17.4 | 17.8 | 18.1 | Peru |
| Uruguay | 21.5 | 22.7 | 23.8 | 25.4 | 25.0 | 26.1 | 27.1 | 27.0 | 27.3 | 26.3 | Uruguay |
| Venezuela | 11.9 | 13.3 | 15.9 | 16.3 | 16.8 | 14.1 | 14.3 | 11.4 | 12.9 | 13.7 | Venezuela |
| | | | | | | | | | | | |
| Non-weighted average | | | | | | | | | | | Non-weighted average |
| LAC (18)[5] | 16.7 | 17.4 | 18.4 | 19.0 | 19.5 | 19.5 | 18.9 | 19.3 | 20.1 | 20.7 | LAC (18)[5] |
| OECD (34)[6] | 34.3 | 34.3 | 34.8 | 35.0 | 35.0 | 34.5 | 33.6 | 33.8 | 34.1 | na | OECD (34)[6] |
| n.a: Indicators not available | | | | | | | | | | | |

1. The figures exclude local government revenues for Argentina (but include provincial revenues), Bolivia, Costa Rica (up to 1997), Dominican Republic, Ecuador, El Salvador, Honduras, Nicaragua, Panama (up to 2004, 2011 and 2012), Peru (up to 2004), Uruguay (2012), and Venezuela as the data are not available.

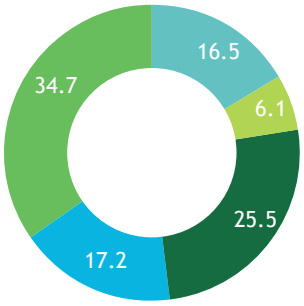
2. Estimated figures for 2011 and 2012.

Data from ECLAC published in Revista Summa: http://www.revistasumma.com/economia/45510-ingresos-tributarios-aumentan-en-america-latina-pero-aun-son-bajos.html

**TABLE 5:**
**TAX STRUCTURES IN MEXICO, LATIN AMERICA AND THE OECD (2010)**

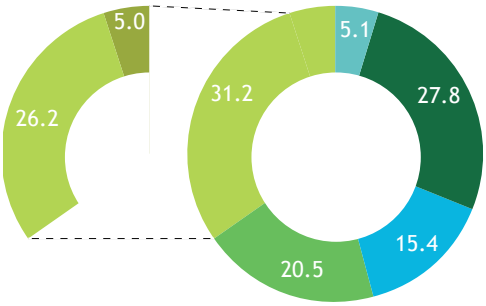
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes
- Specific taxes on hydrocarbon production

SELECTED LA COUNTRIES (15)




OECD (34)


MEXICO




Source OCDE, http://www.oecd.org/ctp/tax-global/Mexico%20country%20note_final.pdf

- And, lastly, there's a third group of countries with a lower rise in their tax burden. Mexico and Venezuela particularly stand out, the only countries with a reduction in tax burden as a percentage of GDP.

Analysing the fiscal situation country by country, it can be concluded that revenue has grown in all of them (except for Venezuela and Mexico), that indirect taxes and especially VAT predominates within the tax structure, that the tax collected from income has grown although it's still relatively insignificant within the overall tax structure, and that, since the 1990s, the relative weight of taxes on international trade has diminished substantially.

**EIn Mexico**, according to the OECD, the tax burden has increased slightly over the last two decades due to a substantial rise in special taxes on the production of hydrocarbons (mainly oil). In fact, Mexico's tax burden was higher than the average for Latin America from 1990 to 2008, this last year reaching its highest level, namely 19.6%. But if we deduct the duties levied on hydrocarbon production, this country's tax burden only reaches 13.9% in 2010, below the region's average.

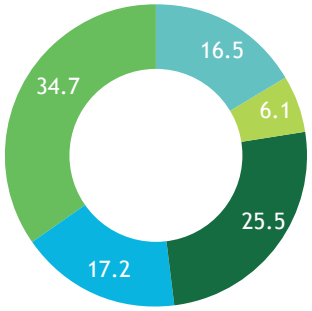
Mexico typically has narrow tax bases, a large informal economy and weak tax administration. Mexico's tax revenue depends on indirect taxes which account for more than 50% compared with 33% in the OECD. At the same time taxes on international trade have diminished in importance as a consequence of liberalising trade, carried out by Carlos Salinas de Gortari's government in the 1990s. VAT revenue accounted for just 3.9% of GDP in 2010, the second lowest in Latin America (6% of GDP) and the OECD (6.6% of GDP) while in 2010 revenue from corporate income tax accounted for little more than 2% of GDP in Mexico, in comparison with 3% in the OECD. The contribution of personal income tax in Mexico is low, less than 15% of all tax revenues compared with 24% in the OECD.

**The tax systems of Central American countries** tend to be highly sensitive to changes in the international situation and have weak, relatively outdated tax administrations. The main tax-related change occurring in the last 25 years has been the gradual reduction in revenue from customs tariffs, making it necessary to maintain macroeconomic stability by increasing taxes on consumption, sales or added value (VAT), as is the case in Honduras and Costa Rica. VAT has been an improvement in tax terms although the informal economy is still significant. Between 1990 and 2004 the tax burden (proportion of each country's GDP allocated to paying taxes) increased in Central American countries, especially Nicaragua. In spite of the fluctuations and diversity of the tax burden, countries can generally be divided into two groups: those with a tax burden close to 15% (Honduras, Nicaragua and Costa Rica) and those whose tax burden tends towards 10% (Gua-

**TABLE 6:**
**TAX STRUCTURE IN THE DOMINICAN REPUBLIC, LATIN AMERICA AND THE OECD (2010)**

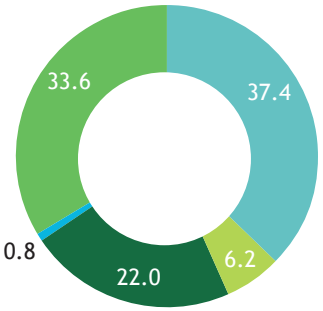
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

**SELECTED LA COUNTRIES (15)**




**OECD (34)**


**DOMINICAN REPUBLIC**




Source OCDE, http://www.oecd.org/ctp/tax-global/RepublicaDominicana%20country%20note_final.pdf

temala, El Salvador and Panama). Guatemala has Latin America's lowest average tax burden for the period 1990-2010, starting from below 9% in 1990 and reaching 12.3% in 2012.

There is one very special case among the Central American tax systems, namely Panama and the "territorial principle" on which its tax revenue system is based. Panama's tax Code establishes a territorial income tax regime according to which each natural or legal person, national or foreign, does not pay tax on income produced from any source outside the Republic of Panama. Article 694 of the Fiscal Code establishes the following with regard to income tax: “The object of this tax is taxable income produced, from any source, within the territory of the Republic of Panama, whatever the location where it is received”. Consequently, any individual or company, national or foreign, receiving any taxable income within or outside Panama does not have to pay tax "whatever the location where it is received”. Taxable income is that from any source within or outside the national borders.

So Panama's tax system (imposed on a "territorial basis", so that taxes only apply to income or earnings derived from business undertaken within Panama's borders) differs from the worldwide income tax regime where resident individuals and companies domiciled in a country pay tax on all their income or earnings obtained both within and outside the country in which they are domiciled for tax purposes. A taxpayer's taxable income consists of income from foreign sources and any taxpayers obtaining income from a foreign source, either individuals or companies, would have to pay income tax.

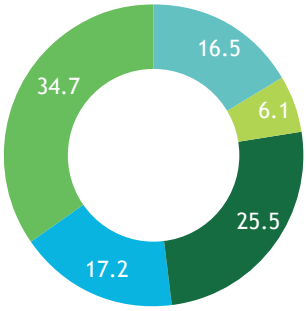
In Panama, however, this fiscal principle establishes that a taxpayer only has to pay tax on income or earnings received within Panama. Consequently, income will not be considered as produced within the Republic of Panama from activities “such as invoicing, from an office established in Panama, the sale of goods or products when these goods only move abroad; or directing, from an office established in Panama, transactions that are concluded, carried out or with effect abroad. This fiscal principle extends to limited companies (sociedades anónimas) which are not liable for income tax when they receive payments from abroad or carry out business outside Panama; international trade ships sailing under a Panamanian flag, when all their earnings come from global maritime operations to which Panamanian income tax does not apply, come under this principle”.

This tax collection system has been in force in Panama for more than 100 years and has made it an attractive financial haven in the world. It is calculated that the services arising as a result of this regime account for more than 15% of the country's GDP. The territorial principle enshrined in article 694 of Panama's Fiscal Code has

**TABLE 7:**
**TAX STRUCTURES IN VENEZUELA, LATIN AMERICA AND THE OECD (2010)**

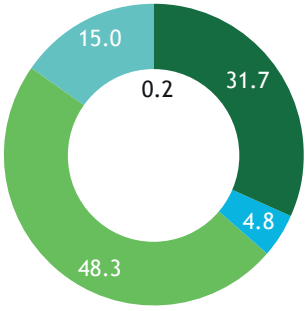
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

**SELECTED LA COUNTRIES (15)**




**OECD (34)**


**VENEZUELA**




Source OCDE, http://www.oecd.org/ctp/tax-global/Venezuela%20country%20note_final.pdf

allowed businesses to be developed such as the registration of shipping, international banking and limited companies domiciled in Panama to take advantage of the fact that offshore business is not subject to income tax.

**In the Dominican Republic**, the tax burden as a percentage of GDP (13.5%) is the third lowest of the region's countries, after Venezuela (13.7%) and Guatemala (12.3%). There have been changes in the tax structure over the last few years: an increased importance of VAT and decreased importance of taxes on international trade. The World Bank has concluded that the fiscal system is limited by the low revenue collected and stresses that the average tax burden in Latin America and the Caribbean is 20% of GDP while, on average, in the last decade tax revenue in the Dominican Republic has represented just 13.7% of GDP.

**Regarding the case of Venezuela**, this tends to have a low tax burden (13.7% of GDP in 2012), weak direct taxation that represents 2.29% of the total tax revenues and a preponderance of indirect taxes, around 4.94%. VAT has become the most important tax, accounting on average for 28% of all tax revenues. In contrast to the slight importance of VAT and income tax, a substantial amount of tax is collected from the exploitation of commodities (39% of the total). The two main features of Venezuela's tax structure are therefore the importance of indirect taxes, accounting for 63.3% of the total in 2010, and the reduction in relative weight of income tax, which fell from 83.7% of all tax revenues in 1990 to just 31.7% in 2010.

**In Colombia** the tax burden has increased markedly over the last two decades, by more than 10.6 percentage points since 1990 and now reaching 19.5%. In fact it is the country with the fifth largest growth in tax revenue after Argentina (21.4%), Bolivia (18.8%), Ecuador (13.1%) and Paraguay (12.2%). This increase is linked to the growing weight of general consumption taxes (VAT) that have offset the reduced use of taxes on international trade.

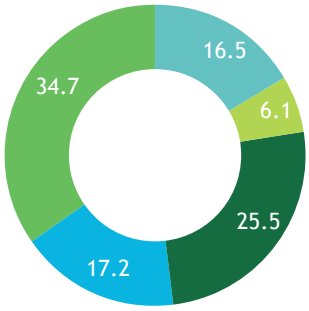
**In Ecuador** tax revenue has seen a huge expansion, especially since Rafael Correa came to power and with the implementation of a series of tax reforms (VAT and income tax) as from 2008, going from levels of 9.7% in 1990 to 20.2% in 2010. It has therefore reached the levels of Latin America, although it's still below the OECD average. Total tax revenues still depend largely on indirect taxes (54.2% of the total) and the relatively large proportion of general consumption taxes. Principally, VAT rose by about 6 percentage points between 1990 and 2010. On the other hand, the relative weight of direct taxation increased substantially, with taxes on income and utilities rising from 12.8% in 1990 to 20.7%, although their relative weight in 2010 is still below the average both for the region and for the OECD.

**Peru**, as pointed out by the OECD, is one of the countries that has seen the highest increase in tax revenue as a percentage of GDP,

**TABLE 8:**
**TAX STRUCTURES IN COLOMBIA, LATIN AMERICA AND THE OECD (2010)**

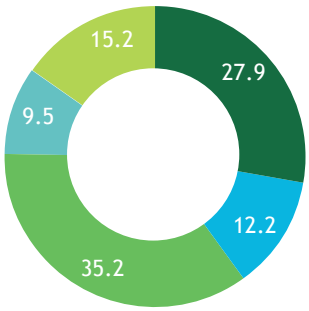
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

**SELECTED LA COUNTRIES (15)**




**OECD (34)**


**COLOMBIA**




Source OCDE, http://www.oecd.org/ctp/tax-global/Colombia%20country%20note_final.pdf

growing by more than 4 percentage points (from 14.5% in 2003 to 18.1% in 2012). However, its tax structure has also changed: in 1990 most of the revenue came from taxes on goods and services (53.5%) while VAT has now taken over (38% of total tax revenue) with just 8% for specific taxes. Taxes on income and utilities have also become more important (around 32 percentage points).

**Bolivia is one of the countries with the largest increase in tax revenue over the last few years.** Out of 18 countries in Latin America, Bolivia ranks third in tax revenue in relation to its Gross Domestic Product (GDP), according to the report "Revenue statistics in Latin America 1990-2012". This document, produced by the Economic Commission for Latin America and the Caribbean (ECLAC), the Organization for Economic Cooperation and Development (OECD) and the Inter American Center of Tax Administrations (CIAT), states that, in 2012, the largest increases in the rate of tax revenue related to GDP occurred in Argentina (2.6%), Ecuador (2.3%) and Bolivia (1.8%).

From 2005 to 20013, Bolivia's tax revenue grew by 200% (from 13.3% to 26% of GDP from 2003 to 2012) as, according to its National Tax Service (SIN), eight years ago revenue barely reached 2.2 billion dollars while in 2013 State revenue totalled almost 6.7 billion dollars. During the eight years of Evo Morales's presidency, tax revenue reached record figures, supported by Value Added Tax (VAT) and new tax legislation such as the Gambling Act and Specific Consumption Tax (ICE). According to data from the Ministry of Finance, in 2006 VAT accounted for 38% of all tax collected while in 2013 it totalled 43% of the revenue.

**In Paraguay**, tax revenue grew substantially in the period 1993-2010, reaching the average level for Latin America although still far from the average for OECD countries, going from 10.2% in 1993 to 17.6% in 2012. The mainstay and principle source of tax revenue during this period changed with the introduction of VAT in 1995, with the increase in the tax burden as from 2004 and the reduction in the relative weight of specific taxes. Paraguay's tax system has been limited by the lack of tax on the income of individuals and greater dependency of revenue on indirect taxes and Social security contributions.

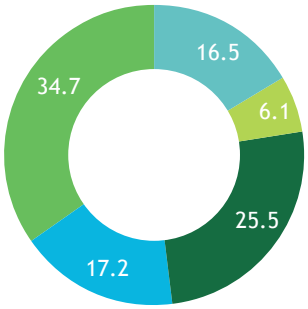
**In Chile**, the tax burden grew from 17% in 1990 to 20.8% in 2012. During the period 2003-2007 the tax burden increased mainly due to the rise in international copper prices. Tax revenue as a percentage of GDP went from 18.7% in 2003 to 22.8% in 2007. Historically, most of Chile's tax revenue has relied on indirect taxes, whose relative weight decreased during the period 1990-2010 although it is still high (more than half Chile's tax revenue in 2010, compared with levels of 33% in the OECD).

**Uruguay's tax revenue** has grown steadily since 2002, becoming the third highest in Latin America. In comparison with the other Latin America countries, **Uruguay has a relatively high tax burden (from 21.5% in 2003 to 26.3% in 2012),**

**TABLE 9:**
**TAX STRUCTURES IN ECUADOR, LATIN AMERICA AND THE OECD (2010)**

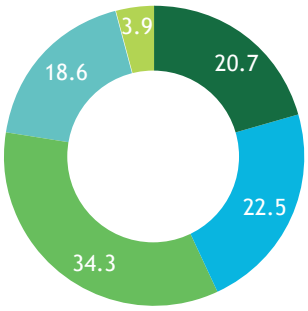
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

**SELECTED LA COUNTRIES (15)**




**OECD (34)**


**ECUADOR**




Source OCDE, http://www.oecd.org/ctp/tax-global/Ecuador%20country%20note_final.pdf

only below that of Argentina (37.3%) and Brazil (36.3%). Moreover, Uruguay's tax structure has substantially changed since 1990. Unlike in the rest of the region, Uruguay has seen a reduction in the contribution made by indirect taxes. In 1990, more than 57% of all tax revenue in Uruguay came from indirect taxes, compared with 53% in Latin America and 33% in the OECD countries.

In 2010, the importance of indirect taxes (in particular special taxes and those on imports) decreased by 10 percentage points. At the same time, income tax went from 5% in 1990 to 22% of the total tax revenue in 2010. This trend can largely be explained by the introduction of personal income tax.

**As can be seen, Argentina and Brazil are the obvious leaders in the region's tax revenues. Argentina has seen huge growth over the last two decades** in tax revenue terms (from 23% to 37.3, almost 14 percentage points). This is Latin America's largest growth in tax revenue as a percentage GDP, as highlighted by the OECD. In 2010 Argentina had the highest level of tax revenue related to GDP in Latin America, far above the region's average, standing at 20.7%. This extraordinary increase in Argentina's tax burden occurred as from 2002 after the crisis in 2001-2003. This trend is due to the reintroduction of tax on export income as from 2002 and the renewed importance of VAT, increasing by around 10 points between 1990 and 2010.

Until 2013 Brazil was the country with the largest tax revenue in Latin America. Up to 2012, Brazil ranked first in Latin America with 34.3%, followed by Argentina (31.6%) and Uruguay (25.1%); however, it currently ranks second in terms of VAT with 20.5%, only being surpassed by Argentina (21%) and above Chile (19%), Peru (18%) and Uruguay (22%). And it's the third-ranking country with regard to income tax, exceeded by Chile with 8.3% of GDP. Following behind are Peru (7.7%) and Brazil (7.6%).

## The Fiscal Reform required in Brazil

Since 1994, Brazil's National Congress has been working on the Constitution Amendment Proposal (PEC) with the aim of reforming the fiscal chapter of the Constitution, changing its form to adapt it to the current tax system (as it's unanimously considered to be obsolete), as well as to the structural changes verified both in Brazil's and the world's economy.

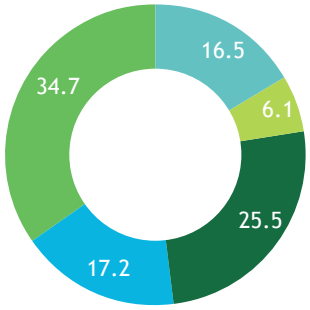
Brazil's current tax system still has the same format provided in the 1966 reform, which innovated and introduced the Tax on the Movement of Goods and IPI (Tax on Industrialised Products) and, in spite of the changes introduced by the 1988 Constitution, the tax system has not essentially changed; i.e. the format of this tax has basically remained the same for the last 36 years.

Among the 54 different taxes in Brazil, the most important for regional governments is the ICMS

**TABLE 10:**
**TAX STRUCTURES IN PERU, LATIN AMERICA AND THE OECD (2010)**

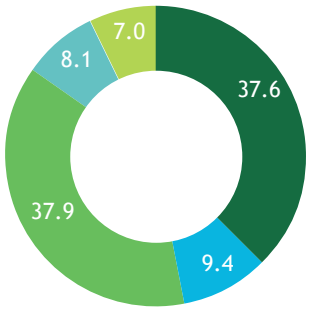
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

**SELECTED LA COUNTRIES (15)**




**OECD (34)**


**PERU**




Source OCDE, http://www.oecd.org/ctp/tax-global/Peru%20country%20note_final.pdf

(tax on operations related to the movement of goods and on services provided for interstate and intermunicipal transport and communication), as it is the most significant from the point of view of tax revenue, being a financial support for state (regional) governments. The friction regarding Fiscal Reform is mainly related to the interest of federal governments in this tax and, given that it's almost impossible to change the tax system without altering the distribution of income collected through the ICMS, some regions gain and others lose out.

## The creation of VAT

The discussion regarding Brazil's tax reform includes the proposal to create a value added tax (VAT) that would replace the ICMS (regional), IPI (national) and part of the ISS (municipal) and would be exclusively collected in the region where the goods or services are consumed; i.e. a kind of tax.

VAT, adopted in most of the world, is applied in the European Union and affects the expenditure or consumption of a product or service, charged on and therefore increasing the value of transactions carried out by taxpayers. In Brazil, this tax is divided into three IPI taxes (tax on industrialised products) for which the Union is responsible, the ICMS for which the member states and the DF (federal district) are responsible and the ISSQN, a municipal tax.

The loss of tax revenue is evident since, due to this division of VAT into three parts, conflict arises among the entities levying taxes which, in many cases, resort to special taxes to attract new investment to their regions. This interaction, which affects revenue, is being tackled by CONFAZ (the Tax Council), which has produced a tough bill to establish exemptions and rebates for the ICMS.

Given this situation, one positive and encouraging proposal is the one whereby a single tax would be used for goods and services without harming the constitutional precept of autonomy of the regional entities.

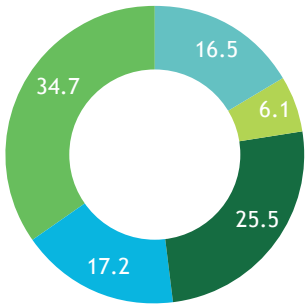
In addition to helping taxpayers, a single tax on goods and services in Brazil could also establish clearer rules for the collection of taxes on goods and services. It could be argued that, with a single tax, although the regions and municipalities would lose a lot of political power, clear rules resulting in higher tax quality and improved distribution could boost the country's growth, mainly in those areas lacking development.

Brazil's current tax model has created huge obstacles to economic growth as high taxation hinders new investment, as well as overloading taxpayers. Consequently, many regions and municipalities resort to lowering taxes to attract more companies to their regions. This strategy sounds extremely advantageous for investors because it relieves them of some of their tax burden but it also entails a loss of income for the administration.

**TABLE 11:**
**TAX STRUCTURES IN PARAGUAY, LATIN AMERICA AND THE OECD (2010)**

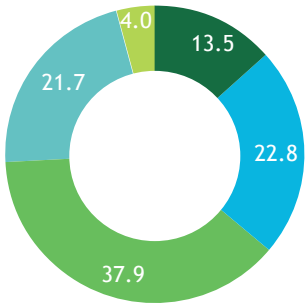
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

SELECTED LA COUNTRIES (15)




OECD (34)


PARAGUAY




Source OCDE, http://www.oecd.org/ctp/tax-global/Paraguay%20country%20note_final.pdf

The so-called "fiscal war" is causing significant conflict not only from a fiscal point of view but also legal, resulting in the Higher Courts of Justice being overloaded.

However, the most unfortunate aspect is the attempt to introduce, in the Constitution, a special definition of "service" for the purposes of VAT-F: any operation that does not constitute the movement or transfer of goods is considered to be a "service". Such a definition is totally inconsistent with the legal sphere and conflicts directly with the concept of service adopted a long time ago by private and tax law. If approved, this aspect of the proposal will undoubtedly become a source of interminable legal wrangling, even affecting the interpretation of the effect of other taxes such as the ISS. It reveals a lack of legislative skill in the legislative bill, resulting from legal experts becoming ever further removed from the production of fiscal legislation.

One of the first introductory lessons in law is the fact that legislators do not have the function of formulating concepts or definitions (in this case clearly motivated by the area of revenue collection). In fact, these are constructed by doctrine and jurisprudence based on a systematic interpretation of the law, its institutions, rules and principles. The recently proposed fiscal reform will not change this situation.

## The weakness of subnational tax revenue

Tax revenue is low in Latin America not only because the central government does not collect enough taxes but also because the subnational levels (regional and municipal) aren't capable of collecting enough revenue either since they lack resources and autonomous management. The local authorities in Latin America are not only weak but also have few resources and those they do receive come mostly from central government transfers, significantly reducing their administrative, decisive and political independence.

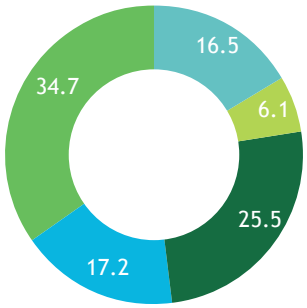
In most Latin American countries, fiscal decentralisation has been brief and limited. Except for two countries, both with a traditional and historic federal structure, namely Argentina and Brazil (whose subnational governments collect 5.9% and 9.8% of GDP, respectively), local tax revenue is very limited; for example, in Colombia, a highly decentralised country politically, the subnational tax revenues represent barely 2.9% of GDP. Excluding Argentina and Brazil, the tax burden of subnational governments is around 1% of GDP.

Consequently, the subnational governments of Latin American and the Caribbean need to take on more responsibility in generating their own revenue in order to promote local development and meet the growing demand for infrastructures and local services to respond to their grow-

**TABLE 12:**
**TAX STRUCTURES IN CHILE, LATIN AMERICA AND THE OECD (2010)**

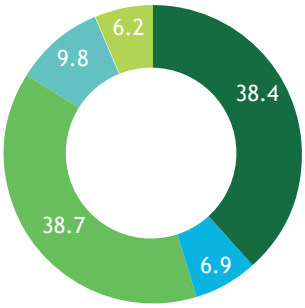
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

**SELECTED LA COUNTRIES (15)**




**OECD (34)**


**CHILE**




Source OCDE, http://www.oecd.org/ctp/tax-global/Chile%20country%20note_final.pdf

ing populations and the need to become part of globalised trade. This local revenue tends to be inefficient and regional governments currently have a very narrow tax base on which they can exert pressure.

As pointed out by ECLAC, greater fiscal responsibility of local governments is recommended for several reasons:

- Firstly, it would lead to local authorities having more autonomy to take and implement their own public policy decisions.
- Secondly, it would reduce dependence on central government transfers.
- And thirdly, it would improve efficiency and transparency in expenditure given that, on paying tax, citizens tend to demand more accountability from their governments.

An increase in subnational tax revenue is necessary not only to reduce local government deficits but also to stop them depending on highly volatile central government transfers (which are also sometimes politicised and not very institutionalised). In most countries with a medium or high degree of fiscal decentralisation, subnational governments are strongly dependent on the transfer system from each central government. Brazil is an exception as its subnational governments (states and municipalities) contribute close to 28% of total tax revenues (around 9.1 points of GDP). A second group of countries is made up of Argentina and Colombia, where the subnational levels account for about 15% of total revenues. The governments of the rest of the countries have not made significant progress in this respect and subnational taxes represent between 1.5% and 6.2% of total tax revenues.

In principle, according to ECLAC, subnational taxes should meet certain characteristics which the region's countries do not tend to have: a stable tax base, a reduction in subsidies and subventions and easy compliance and collection. The proposal made by various international bodies consists of focusing on regional personal income tax, regional or local taxes on retail sales, the implementation of subnational VAT (or a subnational surcharge on national VAT) and subnational tax reforms that should be complemented by reforms in the intergovernmental transfer systems (to make them less discretional and politicised) as well as greater controls on subnational debt.

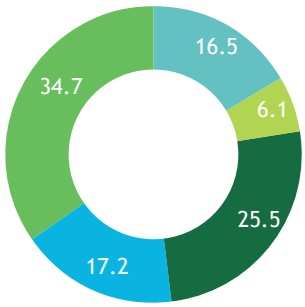
## Taxes are not very progressive

The predominant idea is that tax revenue in Latin America is not very progressive, especially compared with European countries. Latin America's tax revenue is closely related to regressive type taxes, such as VAT, or those applied fundamentally to employees (Social Security

**TABLE 13:**
**TAX STRUCTURES IN URUGUAY, LATIN AMERICA AND THE OECD (2010)**

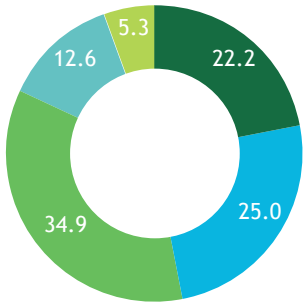
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

**SELECTED LA COUNTRIES (15)**




**OECD (34)**


**URUGUAY**




Source OCDE, http://www.oecd.org/ctp/tax-global/Uruguay%20country%20note_final.pdf

contributions). However, the IADB has revised this belief and points out that "more serious than the lack of progressiveness is the fact that individuals or firms (within the same country) with similar income levels or earnings effectively pay very different tax rates, leading to horizontal inequality. The exemptions to income tax for firms, which benefit numerous industries, are granted based on highly diverse arguments and lack proved effectiveness".

Not only is Latin America's tax system not progressive at a horizontal level but it's actually ultimately regressive. In OECD countries, the estimated Gini coefficient, before tax and transfers, is 0.45 but this falls to 0.31 after direct redistributive action carried out by the central government through levying taxes and the public policies implemented thanks to this revenue. However, in Latin America the variation in the Gini coefficient is, at most, between half and a third of that in developed countries.

The conclusion is that the region's countries are facing the challenge not only of increasing their revenues but also of improving revenue distribution. However, while the obstacles to fiscal policy remain (such as low tax revenues, a regressive tax structure and relatively inefficient social public spending), the distributive impact of both expenditure and revenue will not be very significant in the region.

## High tax evasion and very weak tax administrations

The countries of Latin America lack a fiscal culture that encourages the population to perceive the fulfilment of their fiscal duties as part of their identity as a citizen. Moreover, most states also lack the necessary tools for enforcement. All this leads to high levels of evasion, resulting from structural deficiencies in the economies, deficiencies in the legal framework and even these kinds of cultural issues. Tax evasion harms social cohesion as it helps to weaken society's confidence in the state and limits the resources available to the different administrations to implement public policies.

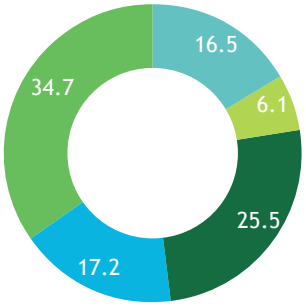
However, the tax administrations in Latin America and the Caribbean have become stronger and more effective since the 1990s. They've achieved significant gains in the last two decades and, in fact, tax revenue as a percentage of gross domestic product (GDP) has increased by about 30% on average. One notable part of this increase is due to improvements in the tax authorities, which have become more independent in terms of expertise and budget, have taken on better qualified and trained professionals and have been modernised thanks to the widespread use of technology. One example of this is Chile's Internal Tax Service, considered to be highly professional and efficient.

Over the last fifteen years, Latin American tax authorities have

**TABLE 14:**
**TAX STRUCTURES IN ARGENTINA, LATIN AMERICA AND THE OECD (2010)**

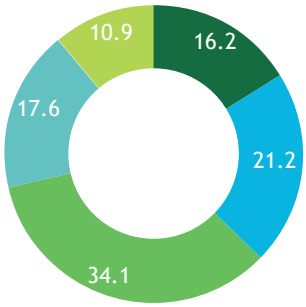
- Taxes on income and utilities
- General consumption taxes
- Other taxes
- Social security contributions
- Specific consumption taxes

SELECTED LA COUNTRIES (15)




OECD (34)


ARGENTINA




Source OCDE, http://www.oecd.org/ctp/tax-global/Argentina%20country%20note_final.pdf

become stronger although it has been calculated that only 3 out of every 100 tax returns made by taxpayers are inspected (in Mexico barely 1 out of every 200 and in Chile 1 in 7). Additionally, more than half the workers in Latin America are within the informal economy, thereby avoiding the tax burden.

## Highly volatile tax revenue

Tax revenue is volatile in Latin America as it is estimated that this can increase or decrease by around 8%, almost two points of GDP, every year. This volatility is much higher than in the OECD countries, where it fluctuates by around 1% from year to year.

The tax burden is more volatile in countries such as Bolivia, Dominican Republic, Trinidad and Tobago and Venezuela, where fiscal resources tend to be highly concentrated in a few sectors, particularly exports, and is usually less volatile in more diversified economies with more firmly established tax systems, such as Brazil and Uruguay.

## Features of the tax structure

**In terms of the tax structure, in Latin America and the Caribbean VAT and income tax constitute the two main cores of the fiscal and tax system although their relative weight differs.** Most of the burden falls on indirect consumption taxes while direct taxes account for just a third of total revenues. Moreover, some countries base their fiscal revenue on sources of financing other than taxes, so they don't need to improve their tax revenue.

- **Income tax**

Taxes on income, especially on individuals (together with value added tax and Social security contributions), constitute one of the three mainstays of the tax system in modern democracies. In developed countries the revenue from personal income tax represents 8.4% of GDP, around 35% of the tax burden.

Over the last decade, income tax has gained in relative weight and importance in Latin America and has established itself as the second mainstay of the region's tax system. Revenue from this tax grew by 60% between the end of the 20th century and 2008, going from 3 points of GDP in the 1990s to 4.9 points in the current decade. This is significant growth, although the revenue from this tax is still very low compared with OECD levels and is not effective in redistributing income. Latin America's income tax is also heterogeneous: Brazil, Chile and Uruguay have high figures as revenue from personal income tax has increased significantly since the 1990s. In some Latin American countries, such as Uruguay, it has grown by more than two points of GDP.

The redistributive capacity of income tax is lost and not maximised In Latin American countries, largely due to the greater amount of revenue from payroll

"The increase in VAT revenue over the last few decades is due to this tax being more widely applied"

income tax with only a small number of individuals paying tax to the authorities (in OECD countries this represents around 50% of the population while in Nicaragua or Bolivia it's barely 1%, in Argentina 4%, in Chile 9%, in Brazil 10% and in Uruguay 14%). If we add the fact that there are many exemptions, deductions and special treatments for earnings from capital as well as very high levels of evasion, we can see why income tax is far from fulfilling the role it has in Europe.

Another distinctive trait of personal income tax in Latin America is that it's theoretically very progressive but, in practice, is not capable of redistributing income. As has been pointed out by the OECD over the last decade, "The potential of fiscal policy ... is still substantially unrealised in the region. While taxes and transfers reduce inequality by 19 Gini points in Europe, the reduction is only 2 Gini points in Latin America".

In summary, the fact that the redistributive capacity of income tax is lower in Latin America and that the level of revenue from income tax is half that of the OECD, would have great impact on the redistribution of income if it were not for the obstacles in place (low rates, narrow bases, high evasion). Its design is progressive but with little impact on inequality, mainly applying income tax on payrolls and with little effect on earnings from capital.

- **VAT**

**VAT is the most important source of tax revenue in Latin American countries.** Although the general tax rate is three points lower than in OECD countries (15.1% vs. 18.1%), as shown by ECLAC, tax revenues are similar (around 6.6% of GDP in Latin America and 6.9% in OECD countries). With regard to the relative share of VAT in all tax revenue, this is much higher in Latin America by almost a third compared with the average of 19% in OECD countries. The increase in VAT revenue over the last few decades is due to this tax being more widely applied. In the 1980s it was almost exclusively applied to physical goods while it's currently also levied on intermediate and end services. Moreover, there has also been a gradual rise in the general tax rate over this period.

The secret of VAT's success lies in that it is easier to collect and its tax administration has improved substantially as there is greater control over sales and transactions. All this has resulted in its contribution to total tax revenues increasing by more than 40% since the 1990s. In spite of this, VAT revenue has some deficiencies and problems that should be noted as, above all, it still has some regressive components and not all the revenue potential

**"Why did Latin American countries choose VAT as part of the core of their respective tax systems as from the 1980s and 1990s?"**

it might have. A significant part of the potential revenue is lost and not collected due to reduced rates and exemptions that aim to relieve the regressive nature of VAT. ECLAC points out that, on average, in Latin American societies, the poorest 20% of the population allocates 13.7% of their declared income in household surveys to paying VAT, while the wealthiest 20% only allocate 5.8% of their income to this tax. For ECLAC this means that, in spite of exemptions and low rates aimed at reducing the burden for lower-income groups, the poorest have a tax burden that is 2.4 times greater in relation to their income than that for the most advantaged segment of society.

- Alberto Barreix, Martín Bès from the Inter-American Development Bank and Jerónimo Roca from the Planning and Budget Office of Uruguay note that "In particular, VAT is often mentioned due to the regressive nature which characterises indirect taxes. Although we dismiss this as an over-simplification, we believe that tax design could be improved in order to deal with the challenge posed by inequality in the region, which leads the global ranking in this area. Moreover, we consider that this improvement can be carried out by asserting the core role which VAT performs in a modern tax system by adopting instruments used to target and deliver benefits which have already been successfully applied for 15 years in the new generation of Latin American social programs, such as the conditioned cash transfers".

Why did Latin American countries choose VAT as part of the core of their respective tax systems as from the 1980s and 1990s?

The reason can be found in the liberalisation of markets that started during this time and led to lower customs duties and taxes on imports. Such transformations made it necessary to replace revenue from taxes on international trade, with VAT becoming stronger and spreading quickly throughout the region. This became the main source of financing and the tax burden grew from 12% in 1990 to 17% in 2005.

## 3. CONCLUSIONS

Looking to the future, we must conclude that the tax systems in Latin America are facing a threefold challenge: (1) they must undergo even more extensive and far-reaching changes and transformations, (2) some kind of agreement must be implemented between the state and the citizens of these countries in order to increase the tax burden while ensuring this measure is legitimate in political and social terms, and (3) the tax systems themselves must play an important role in the next few years

"The fiscal reforms of the future must attempt to reduce the more regressive features of the region's tax systems"

given the likely slowdown in the region's economy.

## The fiscal reform still pending

From what has been seen in the preceding pages, Latin America's fiscal and tax systems have undergone a transformation in terms of quality (regarding their tax structure) and quantity (increased revenue: according to the OECD, the average rate of tax as a proportion of GDP rose from 18.9% in 2009 to 20.7% in 2012).

Although the region is markedly heterogeneous, its countries have managed to increase the tax burden as a percentage of GDP, have introduced far-reaching structural changes with VAT being established as the main tax and gaining relative weight in the share of indirect taxes, both on income and capital, at the same time as reducing duties on international trade. In spite of these undeniable improvements in revenue, the main fiscal challenge facing Latin American countries is still to achieve a tax burden that is comparable to that of OECD countries, is higher (except in some specific cases, such as Brazil and Argentina), less volatile and less regressive, as well as capable of encouraging the informal economy to become formal.

This fiscal reform required by Latin America must be comprehensive and not, as has happened to date, partial, mere patches to resolve specific problems due to liquidity shortages. This comprehensive nature would be assured by attacking the main problems and deficiencies of Latin American fiscal policy. Institutions such as ECLAC and the World Bank have indicated that these problems are, among others: the lack of equity between similar taxpayers (so-called horizontal equity); the widespread use of fiscal incentives (taking large sectors out of the fiscal system's population); and an over-dependence on payroll taxes to finance Social Security programmes. The fiscal reforms of the future must attempt to reduce the more regressive features of the region's tax systems: especially the large proportion of consumption taxes within total revenues, the relative insignificance of personal income tax, the widespread violation of tax rules and high evasion rates.

To achieve more revenue, Latin American countries also need to find other sources of financing, for example by using new taxes such as those on urban and rural property, or improving the fight against fraud. This greater revenue potential must be accompanied by stronger, modernised tax administrations with greater financial and technical autonomy and better human resources. The own-source resources of local governments must be strengthened as much of the great potential of local revenue is still wasted.

## The need for a fiscal covenant

**The great challenge of this renewed tax burden is that it is only viable if it has the political**

"Latin American citizens realise they must pay tax but the problem lies in the fact that they don't trust the state"

**and social legitimacy required to be implemented**. The different governments of the region must respond to growing expectations of improved standards of living and get ready to govern changing societies and an ageing population (by way of example, Brazil's model shares out and collects resources from employers but, as its demographic pyramid is inverting, the relationship between taxpayers and beneficiaries is altering and it will be increasingly difficult to narrow the deficit). Meeting such expectations means having enough new revenue via the tax burden, as well as knowing how to administer this revenue with transparency, efficiency and effectiveness. Not collecting enough revenue, resorting to preferential treatment, wasting resources or administering them inefficiently would break the virtuous circle that must sustain the fiscal system and political legitimacy. As Alicia Bárcena, Executive Secretary of ECLAC reminds us, "In countries such as Brazil, people are in the streets because the middle and lower classes have had more access to goods and services. But, when they go out, there are no public goods, or transport or citizen security, and that's worrying. This year the region stands at a crucial crossroads because the model or models followed must change in order to boost growth based on extra-regional exports".

For this reason, there must be mutual agreement between the state and citizens, a "fiscal covenant" ECLAC calls is, via which citizens accept and do not try to avoid the need to contribute to the public treasury so that they can feel that, after paying taxes, they receive direct or indirect benefits. The weak tax administration must also legitimise its actions by having the necessary technical and human resources to ensure its presence throughout the territory and have sufficient persuasive powers to ensure fiscal legislation is complied with. This fiscal covenant is vital to construct a modern state in Latin America where, on the other hand, there is consensus in considering taxation an essential component of public policy.

As noted by ECLAC, collecting taxes is one of the most complex and conflictive public actions facing states: "It's based on a tacit agreement between society and the state and constitutes the core of the relationship between them. The state's relationship with society obviously becomes less legitimate due to the inefficiency of political and economic institutions that weaken the implicit contract between citizens and state underpinning the fiscal system. They also state that this institutional weakness is rooted in the social and economic structure of the region's countries and has created a vicious circle that prevents the tax system from being reformed effectively".

In general, it can be said that the bare bones of this fiscal covenant already exist. Latin American citizens realise they must pay tax but the problem lies in the fact that they don't trust the state, in terms of neutrality or professionalism, to administer the revenue well (a sur-

**"The aim is merely that the tax burden be perceived by the population as fair, necessary and with direct, positive effects on the life of every citizen"**

vey carried out by Latinobarómetro showed that 79% of the population do not believe that money from taxes is going to be spent properly). The strategy of the fiscal covenant depends on breaking this vicious circle of not paying taxes because the services provided by the state are inefficient and the administration is incapable of controlling fraud. If citizens perceive that they benefit from the provision of public goods and services by the state "governments will become more legitimate and political and state institutions will gain in prestige as, ultimately, the way in which the government spends public resources will largely determine its degree of legitimacy and its right to demand more taxes from taxpayers".

The negative beliefs and perceptions of citizens do not only lead to high levels of evasion but also generate resistance in society to possible tax increases. This vicious circle must be broken by encouraging the willingness (which is statistically significant ) of most Latin American citizens to pay more taxes provided this leads to better quality public services in health, education and security, and to less corruption and better control of evasion. ECLAC notes that these "social contracts need to be renewed to bring them in line with today's reality. The fiscal covenant can particularly be interpreted as an agreement regarding the amount, origin and destination of resources required by the state, accompanied by transparency and accountability to ensure it is monitored and complied with".

Ultimately, the aim is merely that the tax burden be perceived by the population as fair, necessary and with direct, positive effects on the life of every citizen. As shown by Carlos Peña, Dean of Universidad Diego Portales in Chile, "Taxes are coercive extractions of income not only because, as economics states, they are destined for goods that no-one would be willing to finance voluntarily (because, once they exist, those who pay and those who don't can both take advantage of them) but because they are required by a sense of fairness. Saint Thomas Aquinas (whom the Catholic Church calls the Angelic Doctor, perhaps fully justified given the notable intelligence revealed by his work) teaches that only a fair tax generates the moral obligation to pay it, from which it follows that the only thing that needs to be discussed is whether it is fair or not. If not, then there's no obligation to pay it. If it is, then it's no longer voluntary; it's strictly due and does not require the willingness of the taxpayer to exist".

Moreover, this fiscal covenant must be aimed at cracking down on the ways a considerable part of the fiscal efforts made by Latin American countries is wasted: corruption. The high levels of evasion, as we have already seen, and of corruption neutralise fiscal and modernisation efforts and the extension of revenue in the region's countries. Corruption is still an important obstacle that limits not only the development of Latin

"Fiscal policy is going to move even more centre stage in the coming years as the region is facing a change in cycle"

America and erodes confidence in institutions but also reduces the amount of resources reaching the state via taxes. The population does not pay tax for two reasons related to corruption:

- Because there are corrupt networks made up of business people, civil servants and advisors who make it easier to evade taxes; networks sometimes connected to the world of drug dealing and organised crime. These networks also use tax havens to launder money, hide profits from illegal activities and also to evade the law and not pay taxes.

  A modern tax administration will be of no use if society is complacent and even collaborates with corruption. As pointed out by Jerónimo Roca in the ECLAC report "Evasion and equity in Latin America": "If the functioning of the economy is affected by irregular conduct (corruption and legal insecurity, such as weak property rights, violation of contracts) there will surely be a climate that encourages evasion and not social censure, even though the Tax Administration may work well".

- Because no there's no tax culture or education among citizens so that, traditionally and historically, it has been more convenient and easier to commit fraud, legitimising this position by the fact that an inefficient and also corrupt state should not be given any money.

## Tax policies during a slowdown

Fiscal policy is going to move even more centre stage in the coming years as the region is facing a change in cycle. After a decade (2003-2013) of high and constant growth (with the exception of 2009), a period is now starting of slow, volatile growth caused by lower growth in China, the change in economic policy in the USA (tapering) and the slow exit of the crisis by the EU.

If world economic growth slows up and demand for commodities does not grow or even falls, commodity prices will drop and continue to weaken over the coming years. That's why the countries of Latin America should, as advised by the IMF, avoid the depression associated with commodity cycles and attempt to reduce the link between commodity prices and economic activity. The aim is to avoid procyclical policies in Latin America (expansionary during booms and restrictive during crises). This was already achieved during the crisis of 2008-2009 when most of the region's countries launched reactivation plans in the midst of the global crisis but the economic policies of Latin American countries still depend on the economic situation and commodity prices for export.

As noted by the IADB, "for many of the region's economies, one of the most important outstanding tasks is to reduce depend-

**"With less revenue due to a less dynamic economy, Latin American countries must find new sources of financing through new taxes but also by cutting spending"**

ence on fiscal revenue from non-renewable, volatile natural resources. Among these outstanding tasks is the reform of personal income tax, which should improve its revenue, redistributive capacity and stabilising potential and also reduce its anti-labour bias; reducing the personal exemption threshold to a level that's below (or at least the same as) the country's average income per capita; setting a ceiling for deductions whose value tends to be greater for higher wealth individuals (such as the deduction on mortgage interest payments); extending the tax base to include income that is currently exempt (such as interest, dividends or pensions) and earnings from capital".

With less revenue due to a less dynamic economy, Latin American countries must find new sources of financing through new taxes but also by cutting spending. Especially, given that primary surpluses are lower but the growth in spending has not diminished, subsidies will have to be reduced, many of which are not well focused. There is a huge "proliferation of tax incentives" the IADB continues, "which erode the tax base of societies without generating a benefit in terms of additional investment and job creation. Such incentives complicate tax administration, encourage corruption and can give rise to a "race to zero", a situation where countries use increasingly more tax breaks in response to the actions of neighbouring countries, complicating the tax system even further and eroding the tax base".

# LLORENTE & CUENCA

CONSULTORES DE COMUNICACIÓN

## Leading Communications Consultancy in Spain, Portugal and Latin America

LLORENTE & CUENCA is the largest communications consultancy in Spain, Portugal and Latin America. It has **17 partners** and **330 professionals** who provide strategic consultancy services to companies in all business sectors with operations aimed at the **Spanish and Portuguese** speaking countries.

It currently has offices in **Argentina, Brazil, Colombia, Chile, China, Ecuador, Spain, Mexico, Panama, Peru, Portugal** and **the Dominican Republic.** It also offers its services through affiliates in **the United States, Bolivia, Uruguay** and **Venezuela.**

Its international development has meant that in 2014 LLORENTE & CUENCA is 55th in the Global ranking of the most important communication companies in the world, as reflected in the annual Ranking published by The Holmes Report.

## Organisation

### CORPORATE MANAGEMENT

José Antonio Llorente
Founding partner and Chairman
jallorente@llorenteycuenca.com

Enrique González
Partner and CFO
egonzalez@llorenteycuenca.com

Jorge Cachinero
Corporate Director for Innovation
jcachinero@llorenteycuenca.com

### SPAIN AND PORTUGAL

Arturo Pinedo
Partner and General Director
apinedo@llorenteycuenca.com

Adolfo Corujo
Partner and General Director
acorujo@llorenteycuenca.com

**Madrid**

Joan Navarro
Partner and Vice-President of Public Affairs
jnavarro@llorenteycuenca.com

Amalio Moratalla
Partner and Senior Director
amoratalla@llorenteycuenca.com

Juan Castillero
Financial Director
jcastillero@llorenteycuenca.com

Lagasca, 88 — planta 3
28001 Madrid
Tel: +34 91 563 77 22

**Barcelona**

María Cura
Partner and General Director
mcura@llorenteycuenca.com

Muntaner, 240-242, 1º-1ª
08021 Barcelona
Tel: +34 93 217 22 17

**Lisbon**

Madalena Martins
Founding Partner
mmartins@llorenteycuenca.com

Carlos Matos
Founding Partner
cmatos@llotenteycuenca.com

Rua do Fetal, 18
2714-504 S. Pedro de Sintra
Tel: + 351 21 923 97 00

### LATIN AMERICA

Alejandro Romero
Partner and Latin American CEO
aromero@llorenteycuenca.com

José Luis Di Girolamo
Partner and Latin American CFO
jldgirolamo@llorenteycuenca.com

Antonio Lois
Regional Director of Human Resources
alois@llorenteycuenca.com

**Bogota**

María Esteve
General Director
mesteve@llorenteycuenca.com

Carrera 14, # 94-44. Torre B — of. 501
Bogota (Colombia)
Tel: +57 1 7438000

**Buenos Aires**

Pablo Abiad
Partner and General Director
pabiad@llorenteycuenca.com

Enrique Morad
President Director for the Southern Cone
emorad@llorenteycuenca.com

Av. Corrientes 222, piso 8. C1043AAP
Ciudad de Buenos Aires (Argentina)
Tel: +54 11 5556 0700

**Lima**

Luisa García
Partner and CEO of the Andean Region
lgarcia@llorenteycuenca.com

Cayetana Aljovín
General Manager
caljovin@llorenteycuenca.com

Av. Andrés Reyes 420, piso 7
San Isidro. Lima (Peru)
Tel: +51 1 2229491

**Mexico**

Alejandro Romero
Partner and Latin American CEO
aromero@llorenteycuenca.com

Juan Rivera
Partner and General Director
jrivera@llorenteycuenca.com

Bosque de Radiatas # 22 — PH7
05120 Bosques las Lomas (México D.F.)
Tel: +52 55 52571084

**Panama**

Javier Rosado
Partner and General Director
jrosado@llorenteycuenca.com

Avda. Samuel Lewis. Edificio Omega, piso 6
Tel: +507 206 5200

**Quito**

Catherine Buelvas
General Director
cbuelvas@llorenteycuenca.com

Av. 12 de Octubre 1830 y Cordero.
Edificio World Trade Center, Torre B, piso 11
Distrito Metropolitano de Quito (Ecuador)
Tel: +593 2 2565820

**Rio de Janeiro**

Yeray Carretero
Director
ycarretero@llorenteycuenca.com

Rua da Assembleia, 10 — sala 1801
Rio de Janeiro — RJ (Brazil)
Tel: +55 21 3797 6400

**São Paulo**

José Antonio Llorente
Founding partner and President

Juan Carlos Gozzer
General Director
jcgozzer@llorenteycuenca.com

Alameda Santos, 200 — Sala 210
Cerqueira Cesar. SP 01418-000
São Paulo (Brazil)
Tel.: +55 11 3587 1230

**Santiago de Chile**

Claudio Ramírez
Partner and General Manager
cramirez@llorenteycuenca.com

Avenida Vitacura 2939 Piso 10. Las Condes
Santiago de Chile (Chile)
Telephone: +56 2 24315441

**Santo Domingo**

Alejandra Pellerano
General Director
apellerano@llorenteycuenca.com

Avda. Abraham Lincoln
Torre Ejecutiva Sonora, planta 7
Tel: +1 8096161975

**LinkedIn**
www.linkedin.com/company/llorente-&-cuenca

**Corporative webpage**
www.llorenteycuenca.com

**Corporative blog**
www.elblogdellorenteycuenca.com

**Twitter**
http://twitter.com/llorenteycuenca

**Facebook**
www.facebook.com/llorenteycuenca

**Centre of Ideas**
www.dmasillorenteycuenca.com

**UNO Magazine**
www.revista-uno.com

**YouTube**
www.youtube.com/LLORENTEYCUENCA

**Slideshare**
www.slideshare.net/LLORENTEYCUENCA

d+i is a hub by LLORENTE & CUENCA, for Ideas, Analysis and Trends.

We live in a new macroeconomic and social context, and communication has to evolve.

d+i is a global combination of partnership and knowledge exchange, identifying, focusing and communicating new information models, from an independent perspective.

d+i is a constant ideas flow, looking to the future information and management trends.

Because nothing is black or white, there is something like d+i LLORENTE & CUENCA.

www.dmasillorenteycuenca.com

d+i LLORENTE & CUENCA