

PRELIMINARY DRAFT

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TAX REFORMS IN LATIN AMERICA 1978-1992:

A COMPARATIVE ANALYSIS

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INTRODUCTION

The last fifteen years have seen a revolution in the way Latin-American countries consider the role of Government in the economy. In almost all countries in the region, fairly wide fiscal reforms have been made in some way or other and a high number of public-sector enterprises have been, or are being, privatized. One of the few exceptions to this trend is Venezuela, where its reform project is still under study by the Congress.

This paper analyzes the efforts made in the tax field and give an overview of some of the fiscal reforms that have been implemented in the region to either highlight their common features or to point out the differences among them. It also looks into the impact they have had on the public finance of the nations involved.

Six countries are sampled for this: México and Colombia, ~~Latin American pioneers on tax reforms,~~ the latter started its tax changes in late 60s and México in the 70s; three countries that began in the mid 80s -- Ecuador, Bolivia and the Dominican Republic-- although the last mentioned country carried out most of its tax reforms in July of this year. The sixth country is Paraguay, the one that began reform most recently, in late 1991.

The paper is divided into four parts. The first sets out the background to the tax reforms introduced in the six sample countries. The second examines the reforms carried out to find

their common features and their differences. The third analyzes their contribution to the public finances of the countries considered. Finally, the fourth part is for observations and conclusions.

An appendix is included that describes the sequence and particular features of the reforms implemented in the sample countries.

I -BACKGROUND.

The macroeconomic environment of the tax reforms in Latin America has been very different in almost all the sampled countries. Hence, the results from taxation changes have been influenced by the circumstances prevailing when they were introduced, and they explain the different objectives the countries had at the time when the modifications were enacted.

If the macroeconomic environment surrounding the countries at the moment they started their tax reforms is taken into account, they can be classified in three groups:

a) Mexico and Colombia began their most important changes in their tax system in a context of macroeconomic stability.

b) Bolivia implemented its reform in the middle of a stabilization program, after a hyperinflation.

c) Ecuador, the Dominican Republic and Paraguay made their tax modifications as an integrated part of their structural adjustment ~~programs~~.

Mexico and Colombia's original aims were to upgrade taxation efficiency, improve fairness and ease management.

On the other hand, in Bolivia which introduced its reform in the middle of a great macroeconomic crisis, the aim was much more immediate: to recuperate previous tax revenue levels. In this nation the main concern was to put a new system of taxation into practice that would finance public-sector spending, since the earlier system was practically destroyed by hyperinflation.

In the cases of Ecuador, the Dominican Republic and Paraguay, their tax systems had been lagging behind and the tax revenues had fallen considerably for the following reasons: the Olivera-Tanzi effect, by which delayed payment of taxes in periods of inflation reduces the real value of the revenue, as well as the existence of a large number of specific taxes that inflation had made negligible sources of tax revenue.

Therefore, the objectives of these three countries were to make their tax systems less vulnerable to the effects of inflation and to recover or raise the previous levels of revenue.

One characteristic common to the six countries is that they have launched trade liberalization programmes. These involve lowering tariff barriers and eliminating quantitative restrictions on imports, as well as removing tax from exports.

The cut on import tariffs and the reduction on the spread among them, as well as the elimination of export taxes, has led to lower revenues to the Governments from these sources. For some countries, like the Dominican Republic, that derive a major part of their income from foreign trade, this has meant they have to look for alternative tax sources to offset the reduced revenue. For others, such as Mexico and Ecuador, this source has never been very important and therefore trade liberalization does not affect their public finances much.

Graph 1 shows the importance of foreign trade taxes on total current revenues of sample countries over the last few years.

It is important to mention that quite apart from the macroeconomic conditions prevailing at the time when the countries decided to carry out their reforms, there were features common to the earlier taxation systems of all of them. These very conditions called for important changes in this area. The main common features were:

1) Indirect Taxation

-Presence of numerous specific indirect taxes that brought in very little revenue.

-Multiple ad-rem taxes extremely vulnerable to inflation.

-A long list of import tariffs, with rates ranging from 0 to over 300%.

~~==~~ -The exchange policy they followed ~~allowed~~ a lag between the exchange rate and inflation, meaning that foreign trade taxes were collected at rates of exchange that were far below their real value, thereby ~~reducing income from this source.~~

2) Income Tax

-Personal income tax included more than ten brackets, with numerous rates and maximum marginal rates above 50%. This made administration very difficult and encouraged tax evasion.

- Corporation tax also had several levels, with maximum rates far above the international average and double taxation of dividends common.

-Existence of many deductions and exemptions, that made systems highly inequitable both horizontally and vertically.

3) Tax Laws

-The tax laws were numerous, loosely connected and very discrete, since they had usually been introduced in answer to needs as they arose through decrees and partial laws. This made legislation very complex and difficult to apply.

4) Tax Administration

The tax administrations were characterized by the following features:

They were very short of funds, bound up in red tape, with slow and ~~very complicated~~ procedures, ~~practically un-~~automated and in the hands of undertrained personnel. Also, controls were mainly inoperative and there were no systems of cross-references.

In addition to the above problems, before efforts at reform there was a lack of clarity as to the nature of both the problems that existed and the policies to be followed in the matter of taxation in most of the countries under study. Decisions were made trying to solve immediate problems on a short-term basis, for example increasing tax revenue for the

current year or by thinking what tax incentives to offer so as to increase investment in some specific area. This was what really produced the tax system complexity mentioned above, especially in the matter of the innumerable specific taxes and the many deductions, exemptions and special incentives.

Obviously, because of the above problems, the financial crisis of the 80s led to necessary reforms to tax systems since these were in no condition to respond to the new demands imposed by the crisis: to increase revenue to financing the government when external sources had practically dried up and at the same time maintain the level of social and development spending.

II - TAX REFORMS

On reviewing the reforms implemented in the sample countries, several common guidelines that were followed by their designers become apparent:

1) To simplify the taxation system by reducing the number of taxes considerably.

2) To revise existing tax laws, which were generally replaced by a smaller number of laws covering the whole tax spectrum.¹

3) To modernize and improve tax administration by providing computing equipment and qualified technical staff.

A description follows of the main features of the reforms carried out, relating them to the above guidelines:

1) Simplification of the tax system

a) Indirect taxes

All the countries sampled² introduced as part of their reform two wide groups of indirect taxes and they usually replaced a large number of specific taxes, that were difficult...

¹The exception is Mexico, where legislation has not yet been simplified.

²With the exception of Venezuela and Cuba all the countries of Latin America have introduced VAT.

and costly to administer and produced very little revenue.³ These two groups are: the wide based value added tax and excise taxes on special consumption. This last category includes alcohol and cigarettes.

Value added tax is applied differently in the various countries. For example, Mexico and Colombia opted for a multi-tiered VAT, differentiating between essential, general and luxury products. In Colombia the initial rates ranged between 3 and 10%, while in Mexico they fell between 6 and 10%. On the other hand, Bolivia, Ecuador and the Dominican Republic introduced a general tax with a single rate, which was 10% in the first two countries and 6% in the Dominican Republic.

The VAT rates today range from 8% in the Dominican Republic to 14% in Colombia, under the latest amendments that the two countries made in June and July this year respectively.

Since it is a broad based tax, the introduction of VAT has meant improved efficiency in the respective tax systems: greater tax neutrality has been achieved and, with this, distortions in resource allocation have been reduced that were caused by discriminatory tax treatment for the different types of product.

³ For example, in Mexico VAT replaced more than 300 small federal and local taxes, and in Paraguay more than 100. On the other hand, in the Dominican Republic it replaced a 10% surcharge on imports.

Excise taxes, as opposed to VAT, generally entail very high rates in the countries sampled, ranging from 10 to 220%. The exception is the Dominican Republic, which taxes these products at the very low rates of 10% on cigarettes and beer, and 15% on rum.

These taxes are currently among the most effective, with their share in total revenue increasing. This is because they not only contributed towards widening the base of taxpayers by bringing in fresh ones, but also because they are very flexible with regard to inflation: VAT because it is applied to the nominal value of transactions, and excise tax because the rates have been changed to ad-valorem. Additionally, payment periods for these taxes have been adjusted sufficiently to reduce the Olivera-Tanzi effect as much as possible.

b) Income tax

Two of the countries studied, Bolivia and Paraguay, do not apply this tax to individuals; in Bolivia because it was eliminated as part of the reform, and in Paraguay because it was not included in either earlier or current legislation.

However, the other four countries have made great efforts to simplify personal income tax, not only by cutting income brackets but also by lowering the rates applicable to each of them, as can be seen from Table 1. Another important aspect in which the four countries have advanced are in tax

collection at the source. Also, with the exception of the Dominican Republic, taxes have been indexed to maintain revenue at the same level in real terms.

TABLE 1
AMENDMENTS TO PERSONAL INCOME TAX

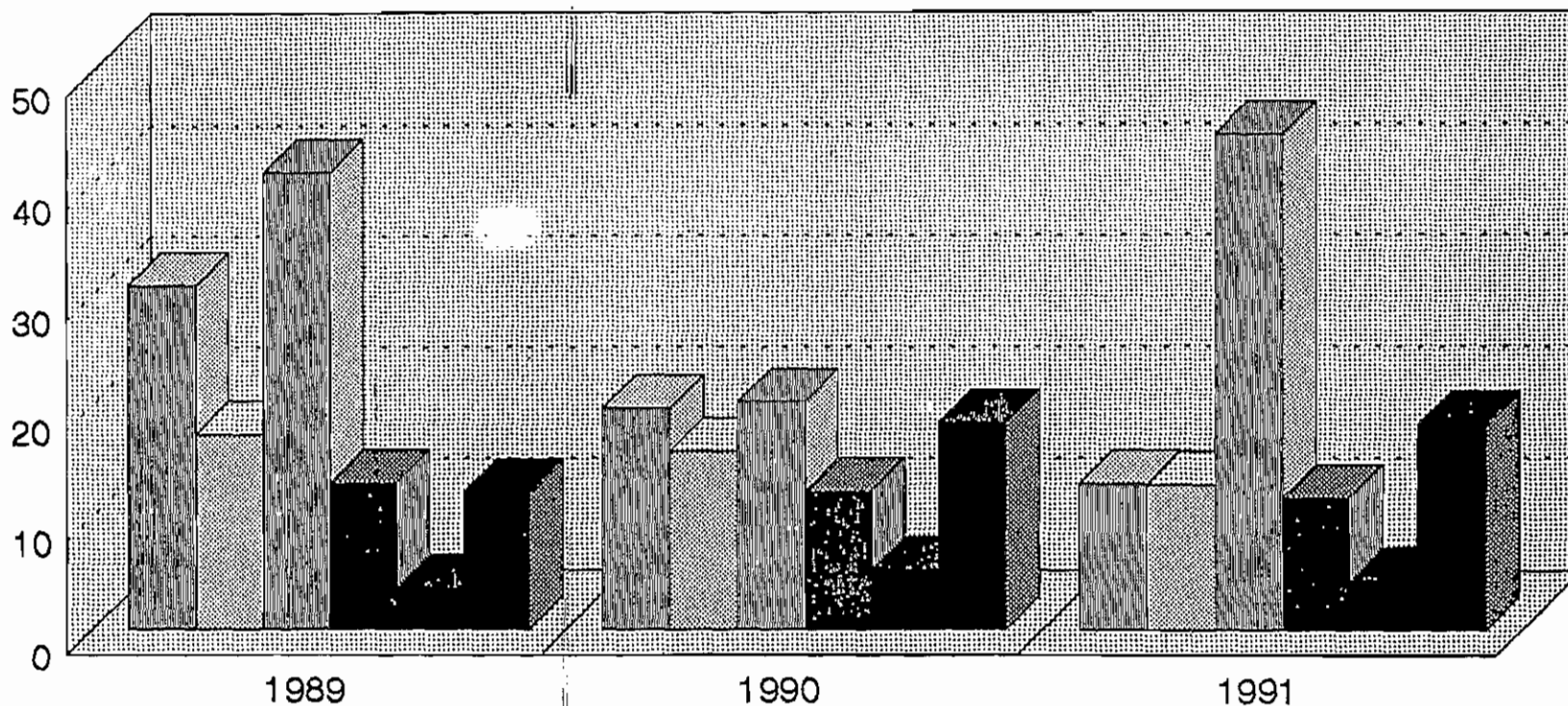
COLOMBIA	Maximum rate cut from 56% to 30%
ECUADOR	Reduced tax brackets to 4, and the maximum rate to 25%.
MEXICO	Reduced income brackets from 12 to 6, lowering the maximum rate from 55% to 40%.
DOMINICAN REPUBLIC	Tax brackets were reduced from 5 to 3, and the maximum rate was cut from 70% to 30%, to reach 25% in 3 years.

Simplification of company income tax has also eliminated double taxation on dividends, so that only companies pay. In addition, tax rate fragmentation has been lessened by the decision to apply a sole taxation rate, similar to the international one (i.e. Mexico and Ecuador) or far below it, as in the case of Bolivia, Paraguay and the Dominican Republic.

As concerns Colombia, this country had reduced corporation tax from 52 to 30%, but the latest tax amendment, made in July 1992 raised the rate to 37.5% again. Meanwhile, the tax applied to foreign companies rose from 38.4% to 43%,

FIGURE 1
TAXES ON INTERNATIONAL TRADE TRANSACTIONS
 (As a Percentage of Ordinary Income)

Per Cent



Bolivia	30.9	19.7	12.9
Colombia	17.4	15.8	12.8
Dom. Rep.	41	20.3	44.2
Ecuador	13	12.3	11.7
México	3.7	5.3	4.4
Paraguay	12.1	18.5	18.3

1 1

Sources: Central Bank Bulletins, respective countries

which is several percentage points over the international average rate.

Imposing a floor on the revenue from this source, Mexico introduced a 2% tax on company assets that can be offset against tax on profits when there are any. This is a fixed minimum tax, to be paid by companies whether they show profits or not. In Colombia there is also the bracket of presumptive income that functions in exactly the same way - to force companies to pay a minimum tax.

Among the common amendments made in income tax are the elimination or substantial reduction of all types of incentives, which included tax exemptions or remissions for both companies and individuals. With these measures, a widened tax base and the greater efforts that are being made to combat tax evasion, countries have offset the fall in revenue resulting from tax rate cuts.

Save the Dominican Republic, all countries have indexed this tax to avoid erosion through inflation.

2) New Tax Laws

The wide range and complexity of Tax regulations and laws make it difficult for taxpayers to meet their fiscal obligations voluntarily; at the same time they obstruct the proper functioning of control and collection within tax administration.

Therefore, among the efforts to make it easier to become familiar with and understand tax laws they have been revised and new ones issued that condense and organize the rules governing the different substantive and procedural aspects into a code.

In connection with the above, Bolivia enacted Law 843 in 1986 that transformed its whole taxation system by making it depend on only six permanent taxes and one transitory and thus eliminating all the various legal tax regulations in force until then.

In 1989, Colombia adopted a Tax Statute that includes all the different provisions regulating the taxes administered by the Direccion General de Impuestos Nacionales. In the same year, Ecuador enacted the Law on the Internal Tax System that modified most of the existing internal systems and reduced taxes to three large groups.

In December 1991 ~~Paraguay~~ Paraguay adopted a tax reform, which practically annulled the tax structure existing until then, with the innumerable, complex rules that governed it, and put a new system into operation that is mainly based on five taxes.

In June 1992, the Dominican Republic adopted A Tax Code that replaces and condenses the main taxes - income tax, excise tax and VAT - by organizing and simplifying them.

3) Tax Administration

All the reforms examined have put particular emphasis on modernizing and strengthening the administrative process by improving the quality of the human resources available through intensive training programmes in technical aspects and also by recruiting better human capital. For example, Mexico, Colombia and the Dominican Republic have created institutes for the advanced training of staff in the different bodies related to the field of taxes.

In connection with the above, there is a new concept of how honest and skilled personnel involved in taxes must be. As a mechanism to ensure staff are properly selected and promoted on a sound basis, systems of adequate remuneration are becoming more and more common which take the level of professional development and specialization as a point of reference. For example, Colombia has a system of basic salaries and wages and also a ~~system~~ of efficiency, technical and executive bonuses so that employees are ultimately paid on the basis of productivity and efficiency.

Furthermore, great efforts have been made to simplify administration. Some countries, such as Ecuador, Colombia and Bolivia are using the services of the bank network to collect taxes. In this way they not only reduce the direct contact of fiscal agents with the public, thereby narrowing the possibilities of corruption, but they have also liberated a

major part of their administrative capacity to redirect it to other types of work, such as the control of evasion.

Tax evasion has been a common evil that seriously affected the revenue that could be obtained from taxes, and therefore countries have allocated large amounts of resources to controlling it. Among the measures adopted are the strengthening of inspection and the creation of control mechanisms.

All the countries being studied have automated and updated their information systems and have also begun to systematize information on taxpayers, mainly in identifying their economic activity. Most of them have introduced computerized control mechanisms, such as accounting by means of current accounts that fully record the taxpayer's status. Efforts have been made to keep an accurate tax list so that by cross-referencing the information with that contained in the current account taxpayers can be classified according to their tax-paying capacity. For example, Mexico, Colombia, Ecuador and Bolivia have introduced special follow-up procedures for major taxpayers, ~~responsible for most tax revenue.~~

Related to the above, one important step that has been taken in practically all the countries has been to implement a system of sole registration for taxpayers that means they can be identified, located and classified. In addition, there is the tendency to concentrate all tax administrations under

a single organization, as has been done in Paraguay, Colombia, Ecuador and Bolivia. -

Also, the frequency of audits and inspections has been increased. Another measure that has been adopted is a scale of penalties for tax evasion that in some countries, such as Mexico, includes imprisonment when fraud is proved.

III- RESULTS OF THE REFORMS

1) Impact on Public Finances

One question that everybody interested in the subject of fiscal policy raise is how much the reforms made in taxation systems have really contributed towards improving the public finances of the countries of the sample.

A breakdown of the revenues collected under the two types of tax that have really been the focus of the changes - VAT and income tax - approximately since when the most important changes were made in them shows the following:

a) Value Added Tax

In the case of VAT, Table 2 shows the movements of its share in both GDP and in total current revenues since 1983, when the financial crisis began in Latin America and the Dominican Republic introduced this tax. Ecuador and Paraguay are not included in the table since they introduced this tax much later (1989 and 1992 respectively).

The importance of this tax in current revenues can be seen from this table, as its average share in them ranges from about 19% for Colombia to 50% in the case of Bolivia.

One fact that should be stressed is that this tax helped Mexico considerably in maintaining revenue during its financial crisis: as it had been in effect since 1978, when the financial crisis suddenly arose the country already could

already count on a tax that produced elastic revenue that was not eroded by inflation. The table shows that in this case VAT contribution to GDP remained steady at around 3%; on the other hand, its share in non-oil revenue rose by more than seven percentage points between 1984 and 1986, to settle from then at around 25% of this revenue.

TABLE NO. 2
REVENUE FROM VALUE ADDED TAX
1983 - 1990
(In per cent)

	1983	1984	1985	1986	1987	1988	1989	1990
Bolivia								
% of GDP					1.9	3.4	3.4	3.4
% Current Rev.					30.2	57.6	53.1	47.2
Colombia								
% of GDP	1.4	1.6	1.9	1.86	1.96	1.97	2.0	2.1
% Current Rev.	17.5	20.6	21.2	19.2	18.5	18.9	19.0	19.6
Dom. Rep.								
% of GDP	3.4	3.9	4.2	4.0	3.8	3.4	2.8	3.8
% Current Rev*	32.7	36.0	36.0	36.0	25.9	21.8	20.8	24.6
México								
% of GDP	2.8	2.7	2.7	2.7	2.8	3.0	2.8	3.1
% Current Rev*	21.3	30.0	29.0	27.3	24.7	26.3	23.5	26.0

* Ordinary revenue was taken for the Dominican Republic, and ordinary, non-oil revenue for Mexico.

SOURCES: Data for Bolivia and the Dominican Republic, Bulletins of the Central Bank (various numbers).

Mexico: Rodriguez, Alejandro, "La Política Fiscal en México, 1980-1992".

Colombia: Dirección de Impuestos Nacionales, "Bases para la Construcción de una Moderna y Eficiente Administración Tributaria".

Similarly, Bolivia based its new system on this tax and, as is clear from the table, since it was introduced in 1987 VAT has produced high receipts. This is particularly remarkable considering that the country had practically no experience at all in administering this tax and was just emerging from a period of hyperinflation.

Two countries, Colombia and the Dominican Republic, did not suffer such a macroeconomic crisis as the previous two (i.e. Mexico and Bolivia) and so their position is more representative of those countries with problems of falling tax revenues related rather to tax evasion.

Colombia introduced this tax in the mid 60s and so has wide experience in administering it. Table 2 shows that this country was able to increase the ratio of this tax in both GDP (42%) and in current revenues (about 8.6%), after the administrative and tax rate modifications made in 1983 and ~~1986~~.

The Dominican Republic and Ecuador substituted VAT for another tax; the Dominican Republic for a 10% surcharge on imports, and Ecuador (not shown in Table 2) for turnover tax. In both cases tax receipts rose considerably. Ecuador managed to maintain the share of this tax in GDP at about 2.9% over the last three years, while in the Dominican Republic it has stayed at around 3.5%, although the share of this tax in the ordinary revenue has dropped considerably, due mainly to a rise in the share of taxes on foreign trade.

To summarize, value added tax has been very important in helping to maintain and increment tax collection in the sampled countries over the period examined - and this has been one of the most difficult periods ever experienced by Latin America. This is especially a result of its elasticity against inflation since as an ad-valorem tax, its payment dates can be shortened very easily so as to reduce the Olivera-Tanzi effect. There are still many evasion problems, but administration and inspection are constantly being improved with the help of EDP systems.

b) Income tax

As mentioned earlier, this tax applies in only four of the sampled countries: Colombia, Ecuador, Mexico and the Dominican Republic⁴. It should be noted that in none of the cases examined the tax has been introduced recently; on the ~~contrary~~, as a long-standing tax ~~it has~~ just been simplified, as emphasized in the above paragraph. As the Dominican Republic has only just implemented substantive changes to this tax ~~it is not included in the analysis that follows.~~

Table 3 shows the share of income tax, both of companies and individuals, in GDP and current revenues.

⁴ Only three Latin-American countries do not have this tax: Bolivia, Paraguay and Uruguay.

This tax is very important for both Colombia and Mexico, where it is the main source of ordinary revenue.⁵ In the case of Ecuador, the contribution of this tax is well below that of VAT and taxes on foreign trade.

TABLE NO. 3
INCOME TAX REVENUE 1985-1990
(In per cent)

	1985	1986	1987	1988	1989	1990
Colombia						
% of GDP	3.26	3.3	3.65	3.7	3.9	4.2
% Current Revenues	36.1	34.0	34.4	35.6	36.4	39.6
Ecuador						
% of GDP	1.2	1.4	1.4	1.2	1.7	1.2
% Current revenues*	17.8	16.8	17.3	14.6	20.2	15.3
México						
% of GDP	4.1	4.2	4.0	4.9	5.0	4.9
% Current Revenues*	44.1	42.4	41.2	43.0	42.0	41.2

* Ordinary non-oil revenues.

SOURCES: Colombia: Dirección de Impuestos Nacionales, "Bases para la Construcción de una Moderna y Eficiente Administración Tributaria", 1991.

Ecuador: Banco Central del Ecuador, "Información Estadística Quincenal", July 31, 1992.

Mexico: Rodríguez, Alejandro, "La Política Fiscal en México, 1980-1992", January, 1992.

The most serious problems confronting this tax in the three countries examined were mentioned in the previous chapter, i.e. evasion, the presence of a large number of

⁵ In the case of Mexico this refers to non-oil revenue.

exemptions and the erosion that inflation caused to the real value of the revenue it produced. Thus, in Mexico the revenue it brought in dropped from 5.5% of GDP in 1980 to only 4.0% in 1986, while in Colombia its share in GDP fell from 4.46% in 1975 to 2.72% in 1982. Ecuador, on the other hand, has maintained the ratio fluctuating between 1.2 and 1.4% of GDP since 1985.

The above table clearly shows that what the modifications introduced in income tax in the countries studied have achieved is to bring receipts close to previous levels, but in no case have these been surpassed - if we exclude the case of Ecuador in 1989 where, thanks to the tax amnesty record receipts were obtained, only to fall back to old levels afterwards.

However, it should be noted that the recovery of earlier levels is no mean feat, since this has been accomplished through a more flexible arrangement where the tax has been indexed to inflation and payment periods shortened. In addition, administration has been simplified enormously by reducing the income levels where differential rates were charged. As a result, the levels reached can be expected to continue.

2) Impact on Public-Sector Deficit

The changes in taxation have contributed very little towards reducing the fiscal deficit in the sample countries. The real success of the reforms is to have maintained tax revenue practically stable during the long period of macroeconomic uncertainty and stagnation that the 80s were for most Latin-American countries.

Graphs 2 and 3 show the movement of public-sector deficit, tax receipts and VAT (which was the fastest-growing tax in the period 1980-1990) against GDP in Colombia and Mexico.

As can be seen, public-sector deficit in these countries rose to a level well above even total tax receipts⁶. Also, it can be seen that VAT revenue grew very slowly in relation to the increasing deficit.

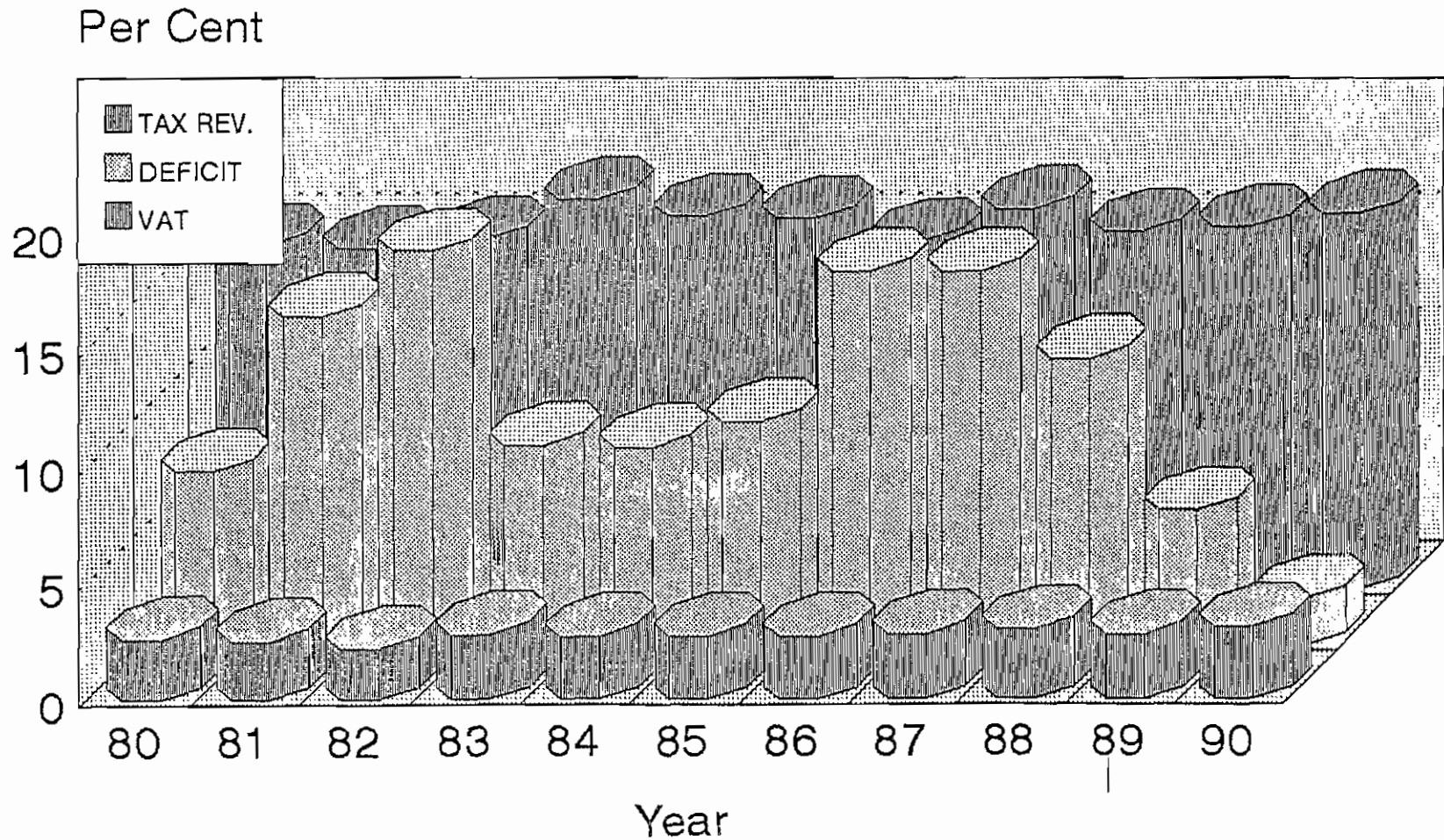
The above means that even these two countries, the ones with the longest tradition of concern to keep up a solid, stable taxation system, and also reform pioneers, would have needed to at least double their revenue during the years of most acute fiscal disequilibrium to balance the public-sector budget.

From this it can be deduced that tax reforms in themselves did not generate the resources needed to balance the budget, and so the countries that have made them, with or without access to foreign financing, have had to generate

⁶ The deficit referred to is financial, which includes payment of nominal interest on the public debt.

MEXICO: FISCAL DEFICIT, TAX REVENUE, AND VALUE ADDED TAX, 1980-1990

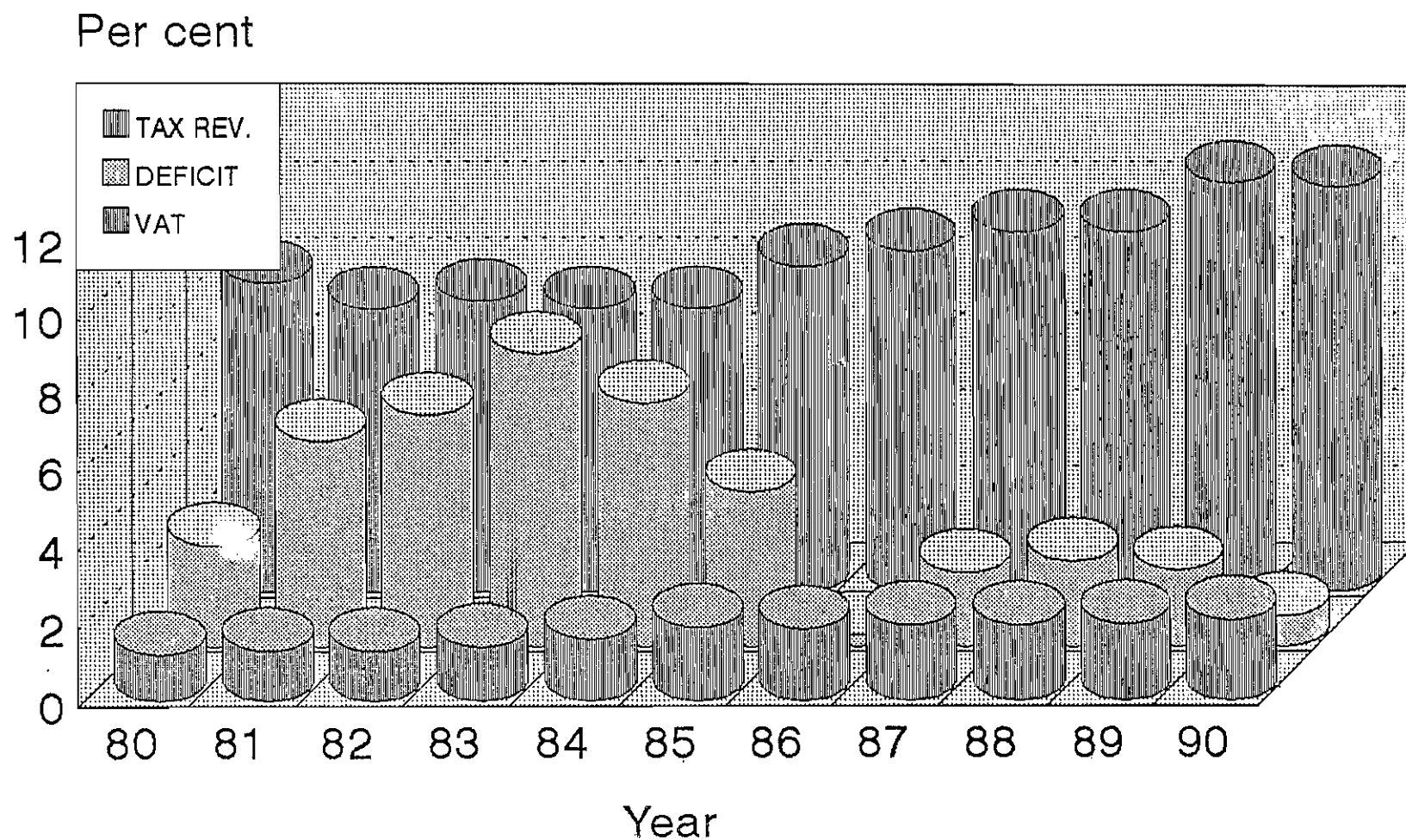
(In percentage of GDP)



Sources in footnote

COLOMBIA: FISCAL DEFICIT, TAX REVENUES AND VALUE ADDED TAX, 1980-1990

(In percentage of GDP)



supplementary resources to adjust their public finances. This ~~has~~ has been the role played by the privatization of government ~~companies,~~ companies, where previously the means used were increased prices and tariffs, inflation tax and reduced public spending, especially in investment and maintenance.

The graph also shows that Colombia's revenues fell between 1981 and 1984, but in this year they made a recovery and from then on had sustained growth. This can be attributed to the taxation modifications made in 1983 and 1986. Meanwhile, Mexico raised taxes slowly and silently over the same period.

The most worrying aspect of the subject under study is that if the reforms have not brought more than 3% changes in GDP in the course of 13 years in countries such as Colombia⁷ and Mexico, then what is going to happen to revenue in countries that are just beginning their tax reforms and at ~~the same time~~ implementing tariff ~~reforms~~ that will strongly affect their income from foreign trade. For this, Table 4 should be carefully examined as it shows the ~~revenue elasticity of the taxation system in four of~~ the countries studied - Bolivia, Colombia, the Dominican Republic and Mexico. Ecuador and Paraguay are not included

⁷ In Colombia tax revenue rose from 8% of GDP in 1978 to 10.6% in 1990, a 32.5% increase over 13 years of strenuous efforts to improve tax administration. Meanwhile, in the same period Mexico increased tax receipts by 29.6%, bringing total tax revenue up from 12.5% of GDP to 16.2%.

because their reforms are too recent for the data on them to be significant.

TABLE NO. 4
INCOME ELASTICITY OF THE TAX SYSTEM IN SAMPLED
COUNTRIES 1980-1990

	1980	1985	1988	1989	1990
Bolivia	-	-	1.39	1.09	1.18
Colombia	0.66	1.4	1.0	1.4	
Dominican Rep.	-	1.2	1.09	0.8	0.55
México	0.97	0.987	0.96	1.05	

SOURCES: Bolivia: Banco Central de Bolivia, Statistical Bulletins Nos. 264 and 271.

Colombia: Direccion de Impuestos Nacionales, "Bases para la Construccion de una Moderna y Eficiente Administracion Tributaria", Bogota, 1991.

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It is reassuring to see from the above table that in Bolivia and Colombia there is a revenue elasticity above one percentage point, which means that their systems of taxation have become more flexible after the recent reforms, and tax receipts can be expected to rise a little more rapidly than GDP. On the other hand, Mexico has a more or less unitary elasticity that suggests that GDP and tax receipts move at the same rate.

As for the Dominican Republic, the low ratio of elasticity to receipts that its taxation system has shown in recent years points up that the country still has serious tax collection problems. This is due mainly to the many incentives and exemptions included in income tax and to the fact that the system was not indexed to inflation. It is to be hoped that with the recent modifications made in this country (including the elimination of almost all tax incentives) the situation will improve. If not, tax receipts will grow at a lower rate in proportion to GDP, and this will mean difficulties in financing public-sector spending if external funding is not available.

IV - CONCLUSIONS

The study of tax reforms made in the sample countries reveals that a common feature of all of them is the aim to simplify taxes. This has led to eliminating a host of unproductive taxes, to be replaced in most cases by value added tax.

At the same time, the number of steps involved in income tax have been reduced, and most of the tax breaks and exemptions it included have been eliminated.

These simplifications have led to increased efficiency and neutrality in resource allocation in the countries examined and have also helped in tax administration.

In addition, the above has also been enhanced by the improvements made in tax administration, which have involved upgrading the quality of human resources in the field of ~~taxation~~ and streamlining and automating information systems.

One of the most serious doubts about these reforms is that though they may have increased equity horizontally, they have drastically reduced the overall equity of the systems. This is because with the large cuts to the maximum rates of profits tax and personal tax, direct taxation on groups with the highest earnings has actually been reduced. At the same time, the emphasis placed on withholding income tax at source, and on indirect taxes through VAT and import taxes (accounting for a major part of revenue) mean that the tax burden falls

largely on low and middle income groups, thus making it regressive.

It has been argued that this is not important because fiscal policy must be looked at from its two angles, income and expenditure, and the problem of redistributing income will be handled through the latter^a. But, as examined in the preceding paragraph, tax reforms have not brought about any great increases in public-sector revenue. Therefore, expenditure will have to be adjusted, as has been happening, to maintain fiscal balance.

Therefore, margins in expenditure are in fact not so wide as the above reasoning would have them since as it can only grow within very narrow margins it can only be restructured as well as possible to channel more funds into social and capital expenditure, cutting current expenditure, where there is in fact little to cut. Where much could be done in this respect is in ~~reducing~~ the financial costs of servicing public debt.

For example, Mexico has used a major part of the funds coming from the privatization of government enterprises to reduce public-sector debt, thereby liberating the inflow of resources previously earmarked for this purpose.

^a On this subject, see Tanzi (1992)

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A P P E N D I X

SUMMARY OF MAIN MEASURES ON TAX REFORMS
IN SELECTED COUNTRIES

TAX REFORM IN ECUADOR 1988-1992

Tax reform in this country was designed with the purpose of reducing the high dependence of public sector income on the oil industry, simplifying the complicated tax structure, which was characterized by a large number of levies yielding low receipts, and reducing the numerous deductions and exemptions.

The first step in this direction was taken in December 1988, with the reform of the Civil and Tax Codes and also the General Bank Act, the Monetary System Act and laws on Municipalities, Income Tax, Trade Transactions and Services Tax, and Stamp and Postal and Telegraphic Tariffs.

At the same time, steps were taken to bring tax administration into line with the reform about to be made: the systems of deduction at source and objective overall assessment were introduced. Also, legal provisions were made for collecting taxes through banks.

The reform was actually made effective on December 22, 1989, when Law No. 56 of the Internal Tax System was enacted. This amended a large number of the existing internal regimes, reducing them to three broad categories: income tax, value-added tax (VAT) and special consumption tax (ICE).

Income tax:

The three types of tax - graduated, proportional and additional - that used to be levied on income according to origin, amount, type of taxpayer and geographical location were brought together in a single graduated tax.

Tax on individuals was pegged to the average national consumer price index, to which both the tax base and deductible value must be adjusted every year in direct relation to its percentage of increase. A graduated table of four tariffs is applied to this category, ranging from 10 to 25% after deducting a fixed sum of income equal to 6.25 x 12 the minimum living wage.

Domestic companies have to pay a flat 25% rate on their tax base, while firms that pay, send or credit income, profits and dividends abroad pay 36% on taxable income. This regime encompassed a 20% tax on the retained profits of Ecuadorian firms and 40% on the Ecuadorian profits of companies formed abroad and also on the dividends either credited or remitted to foreign shareholders resident abroad.

The new law on company tax establishes a comprehensive system of adjustment for currency devaluation in financial statements, as well as a system for assessment by coefficient and self-appraisal. At the same time, the exemptions and waivers included in the earlier law were drastically reduced.

Value-added tax (VAT):

This tax was instituted in place of the "Tax on Trade Transactions and Services" and incorporated activities that it had not included, such as the sale of airline tickets, insurance, leasing and other services.

The rate is 10%, with the exclusion of staple foods, medicine, agricultural machinery and parts and items not produced domestically for priority public works and facilities, as well as local purchases made by public agencies.

Excise tax (ET):

This bracket groups together taxes on cigarettes, beer, soft drinks, mineral and purified water, alcohol and alcoholic products. This replaced numerous low-yielding taxes.

Despite the grouping, the tariffs in this tax bracket are still very widely spaced. Tax on cigarettes ranges from 10 to 200%, 85% on beer, 20% on soft drinks, 5% on mineral water and 100% on alcoholic products.

CUSTOMS TARIFF REFORM:

Customs tariff reform began ~~on~~ May 21, 1990, when Law No.72 was enacted. This adopted the Andean Group's common nomenclature as its system of product classification and codification, and the 30% duty on luxury imports was lifted.

As from this date the tax range, which originally spread from 0 to 200% has been reduced to a 2% floor and a 30% ceiling, save a few 40% items. Tariffs for countries of Andean Sub-region were established at between 5 and 20%, depending on the grade of product improvement.

TAX REFORM IN PARAGUAY:

Tax reform in Paraguay has been in answer to low receipts and the growing need for new sources of income to finance the public sector.

Earlier efforts to increase tax collection had been based on creating new taxes or on imposing a surcharge on existing ones. This all led to very inefficient regime with a large number of taxes that each yielded very low receipts and also made administration tremendously difficult; this naturally led to considerable tax evasion; on the other hand, there was a wide range of exemptions and franchises.

At the same time, a proliferation of legal measures generated many tax laws, particularly specific ones (Special Laws). As a result of this, the tax ratio in Paraguay is one of the lowest in the region. In the 80's it fell by 2.5 percentage points from 10% of GDP to 7.5%.

Tax reform was passed by means of Law No. 125, dated December 30, 1991, which has been partially in force since January 2, 1992.

The main purpose of the reform is to reduce all the system to a few clearly and rationally enforceable taxes, so as to improve administration and collection and also to widen the tax base.

The reform is based on four tax groups: company income; capital invested in real property; value added (VAT) and others. This last group includes only a tax on deeds and documents.

Income tax:

This eliminates personal duties and taxes only income from commercial, industrial, agricultural activities and non-personal services. It also specifies an additional 5% tax for those firms that pay or credit income to non-residents. It also establishes a flat rate for small taxpayers whose activities are of a non-personal nature.

The general system's coverage is widened by including bodies that formerly were exempt or else benefitted from special treatment, such as associations, corporations and other private-sector bodies of any type as well as public enterprises, self-sufficient bodies, decentralized agencies and dual economy companies.

It also includes income from agricultural and livestock activities, with a tax based on average values, by areas, for both sectors. Thus, the presumptive income per hectare is

established, from which percentages can be calculated for necessary expenses involved in obtaining and preserving the source of income.

The reform establishes bases for automatically re-evaluating capital goods and allows amortization on the basis of reassessed value. This is to be based on the domestic price index drawn up by the Banco Central del Paraguay.

Real Property Tax

This tax brings together all taxation on real property; all the taxes on additional capital included under the earlier system (capital of economic agencies; inheritance, legacy and gift; stamped paper) are repealed.

The rate will be 1% and the tax base is the official valuation of the property, given by the Servicio Nacional de Catastro.

The current value of property will be gradually adjusted to market value over a period of not less than five years.

Value added tax (VAT):

This is the fundamental component of the reform, since the major part of the revenue and tax structure will be based on this tax.

It replaces taxes on sales, services, and unstamped paper and stamps (which was levied on bills of sale, import-export sales, etc.)

Tax administration:

The Direccion General de Recaudaciones (Tax Office) was created, which centralizes existing revenue services so as to simplify and streamline the tax system.

Currently, tax collection and payment are being systematized and automated.

TAX REFORM IN MEXICO:

Mexico's experience in tax reform, together with Colombia's, is one of the most interesting, since this country began transforming the taxation system in the 70s. This was long before the financial crisis, and since then the country has continued its efforts to simplify taxes, widen the system's coverage and reduce the tax burden to a minimum.

Although these have been the formal objectives of the reform, even now the Mexican government has not managed to achieve its aims completely as far as simplifying the system. Taxes, particularly income tax, continue to be somewhat complicated in administrative procedure, particularly in the period of transition towards indexation to inflation. In addition, globalization of income tax has not been accomplished and efforts in this direction have created distortions and inequity.

Beginning of the reforms

In the early 70s efforts were begun to simplify Mexico's tax system and reduce it to just a few taxes. During this period, efforts were made to globalize income tax by including in the tax base income derived from leasing property and from interest on finance. At the same time, the maximum rate of individual income tax was raised from 35 to 50%.

Indirect taxes were simplified considerably by all the different federal and state sales taxes being consolidated in a tax on commercial revenue derived from sales (turnover sales tax). The rate was 4%.

The system of dividing the tax between the states and the federation that was introduced with this new tax paved the way for the later introduction of value added tax (VAT). The system of distribution was to leave the states with approximately 50% of the taxes that they collected.

Introduction of value added tax (VAT)

Very important reforms were carried out between 1978 and 1982, such as the introduction of value added tax (VAT), and efforts were continued to broaden the base for income tax (ISR). This last tax was partially indexed by allowing companies to update the value of their depreciation costs.

At the same time, the maximum rate for personal income tax was raised from 50 to 55% in 1979, and this tax was indexed as from 1978, although this was not done for company income, as mentioned earlier.

Among the measures adopted during this period to broaden the income tax base, a scheme was introduced to integrate profit tax with the one on personal income by allowing dividends to be cumulative to personal tax, with company profit tax being credited fully. In addition, capital gains were included in the base for personal tax, except for gains from shares quoted on the stock market.

Also, the construction sector was brought under the normal law, since before it had enjoyed a very favorable regime, paying a fixed tax of 3.2% on its gross receipts.

VAT was approved by Congress in 1979, to be introduced a year later, so as to give companies time to become more familiar with the new law and to make the necessary accounting, computer and administrative adjustments called for by the new tax.

VAT replaced the 4% tax on commercial revenue and a 30% tax on luxury goods (luxury rate) as well as 25 federal and 300 specific taxes.

Value added tax was introduced with a multi-rate system: a 10% general rate, 0% for some agricultural products and staple foods, and 6% for goods traded on the U.S. border.

The introduction of a value added tax with multiple rates made the administrative work involved in collecting the tax much more difficult. This was all the more so because state governments are the ones that collect this tax on their territory, and in some, less advanced states, personnel were not sufficiently trained to do this job. This meant that fraudulent claims for refunds ~~could~~ accumulate.

When value added tax first began to operate, the division of revenue from it with the states was made on the basis of fixed coefficients until 1987, when it was stipulated that states would be granted 30% of the VAT that they collected. This gave them an incentive to increase revenue derived from this tax.

Economic and financial crisis 1983-1988

As can be seen from the above reforms, when the economic and financial crisis exploded in Mexico in late 1982 the country had a system of taxation that could face up to the situation, since specific taxes had been eliminated in 1980 when VAT came into force, and this made it possible to avoid a great loss of tax revenue.

The same was not true of income tax because as it had not been indexed, revenues from this source dropped steeply.

Company tax fell as a proportion of GDP from 2.7% in 1980 to 1.5% in 1985, mainly due to the lack of a system fully indexing the tax, as well as the Olivera-Tanzi effect of the falling value of taxes through lags in payment during periods of inflation.

The transformation of the tax system was continued in response to the crisis; in 1983 the different VAT rates were increased and new ones were added. The general rate was raised from 10 to 15%, a new 20% rate was applied to luxury items and a lower rate of 6% introduced for medicines and some foods. The 0% rate for some products was retained, as was the 6% for articles sold in the northern border area. This increase in the number of rates made administering this tax much more difficult, with the further difficulty that the increase in the general rate encouraged evasion.

Excise taxes were raised and a temporary surtax of 10% was imposed on personal income tax.

The erosion of tax revenue made it necessary to index company income tax and also to shorten the periods for paying taxes. These changes were completed in 1987, when the payment period for income tax was reduced from quarterly to monthly. Also VAT and other special taxes had their date of payment moved forward from 20 working days after the month of the operation to eight days. This reduced the Olivera-Tanzi effect, but at the price of increasing administrative and accounting difficulties.

An effort was made to make the introduction of company tax indexing as simple as possible, but all the same, calculating the tax proved to be a nightmare for companies. This was because instead of being introduced once and for all, changes were brought in piecemeal in an attempt to avoid large gains and losses among the taxable parties. So, under the scheme introduced in the first year (1987), companies paid 20% of the tax according to the new provisions, and 80% according to the earlier one; in 1988 they paid 40 and 60% respectively. As a result of the complaints that this transitory mechanism gave rise to it was abandoned in 1989.

Latest measures adopted 1989 -1991

The measures adopted in this period have been mainly geared to reducing evasion and simplifying tax administration, at the same time increasing its efficiency.

The most important step during this time has been the introduction of a 2% tax on company assets. The purpose of this is to reduce tax evasion and avoidance, since the tax can be credited against income tax payments.

The marginal company income tax rate was reduced from 39.2% in 1988 to 35% in 1990. At the same time, deductible expenses were eliminated or severely curtailed, e.g. entertainment expenses of companies and car expenses, which are only accepted for vehicles belonging to the work fleet of the company.

In pursuit of simplification, personal income tax brackets were trimmed from 12 to only 6, while the lowest earners pay a marginal tax rate of 3%, and the highest earners 40%.

Another important measure connected with income tax is income indexation. The rate will be updated on a quarterly basis in accordance with inflation so that increments in personal nominal income will not mean higher taxation when in fact the actual purchasing power has not grown.

In order to broaden the tax base, the special one known as "small taxpayers" was limited to the sub-category of those earning up to 300 million pesos per year (some 100,000 U.S. dollars). Small businesses with an income ranging from 300 to 600 million pesos were include in a "Simplified" tax regime, according to which they have to carry ledgers on cash flow. In other words, they only record income and expenditure and have to issue and retain the respective proofs. Whilessoever resources remain within the company they do not incur income tax. On the other hand, all money extracted or used for non-deductible items will be subject to the normal 35% rate. This new regime also included income from agriculture and fishing as well as from land transportation.

~~====~~ A whole series of taxes has been eliminated, such as the one on telephone services, which was as much as 72%. Similarly, taxes on soft drinks, cacao and sugar were lifted, as well as the 7% tax on gross receipts from mining. At the same time a large number of taxes were reduced, such as the one on interest paid by the financial system from 2.52 to 2%, the one on property purchase from 10 to 2%, and on new vehicles to 10% (before ranging from 15 to 50% depending on the value of the vehicle).

Another important tax relief measure was adopted in 1991, when the general rate of the value added tax was brought down from 15 to 10%. Prior to this the VAT rate for the northern border area (6%) had been brought into line with the general one.

In order to upgrade the data banks for tax administration, designed to reduce evasion and fraud, legal provisions in force since 1991 encourage taxpayers to produce bills of sale that conform to tax requirements. So, to improve

compliance with VAT a campaign was inaugurated for installing tax recording cash registers. These ensure that amounts shown on bills of sale are permanently recorded on an indelible memory. Establishments that do not give their clients the duly filled out sales slip can be closed down for up to 15 days as a penalty. The sales slips must also bear the seller's Federal Registration for Taxation Purposes (RFC) to make the tracing of each taxpayer easier through the system of fiscal information.

The measures adopted over the last four years have considerably enlarged the tax list by increasing the number of taxpayers and ensuring that those already on the list meet their obligations more fully. Tax administration has been improved and its efficiency increased. This is evidenced by the fact that non-oil tax revenue grew by 20.5% at constant prices from 1989 to 1990, at a time when economic growth was renewed after a decade of stagnation, with substantial increases in private-sector investment and employment in general.

TAX REFORM IN BOLIVIA

Bolivia was the first country in Latin America to suffer hyperinflation in the mid 80s; from September 1984 to September 1985 inflation rose to 23,500%. This high inflation rate, coupled with the Olivera-Tanzi effect from the time lag in tax collection, explains why the Bolivian tax system collapsed during the first half of the 80s. Tax revenue fell from 10% of GDP in early 1980 to around 1% in mid 1985.

The collapse was due to the combination of high rates of inflation with a very fragile tax system, real estate tax fixed in nominal terms, specific taxes on foreign trade and an income tax that was being paid considerably in arrears.

In addition to the above features, the taxation system was also affected by a high rate of evasion and avoidance. This was due, among other things, to the fact that legal regulations were thinly spread and administrative mechanisms were insufficient to carry out assessment, payment, inspection and enforced collection. In addition, corruption was rife in administration.

Since the tax system almost completely disappeared, thanks to inflation, the Bolivian authorities had to begin tax reform practically from zero.

The 1986 Tax Reform

The reform came into effect on May 20, 1986 when the National Congress passed it under Law No. 843.

The new system is based on six taxes; the main one supporting the reform is value added tax (VAT). This tax accounts for 50% of total tax revenues. The rate is 10%, which must be included in the price and is applied to the sale and importation of goods and services.

The other five taxes that complete the new system of taxation and are practically complementary to VAT are as follows:

- 1) Supplementary Taxation to VAT (ST-VAT)
- 2) Tax on the Presumptive Income of Property Owners (TPIPO).
- 3) Tax on transactions (TT).
- 4) Excise Tax (ET).

The fifth was a temporary tax called the "Special Tax for the Regularization of Taxation" (STRT), which was actually a "laundering" or amnesty. It was introduced through the creation of the Compulsory Tax Amnesty, which included all the national and municipal taxes existing before December 31,

1985. To be able to do this "laundering" the STRT had to be paid.

The Supplementary Taxation to VAT practically replaced the personal income tax of the earlier system, since it applies to income from wages and salaries; income from professional or skilled operations; technical assistance; royalties, patents, earnings from capital investment, and rents of personal property and real estate.

The rate is 10%, but the Law specifies that should the VAT rate be changed, that of the ST-VAT must automatically be adjusted in equal proportion and with the same scope.

When the reform eliminated corporate income tax, the Tax on the Presumptive Income of the same was introduced, which is calculated by using estimations of net worth. This tax applies to all economic units, even single person ones, whether public or private. The tax rate is 3%.

The Tax on the Income of Property Owners is imposed on owners of both urban and rural real estate, as well as on the owners of vehicles, motorboats and aircraft. A rate of either 3 or 4% is applied, depending on the value of the assets.

The 2% tax on transactions applies to the gross income earned by individuals or companies engaged in trade, industry, a profession or skilled trade, or any other activity, whether for profit or not.

Finally, the Excise Tax is charged on cigarettes, cigars, alcohol and luxury items, with ad-valorem rates that range from 10 to 60%.

Tax Administration

Parallel to the implementation of the Tax Reform, a programme of activities was initiated that includes creating a system of tax collection and control, as well as establishing inspection and control procedures.

A Consolidated Taxpayers List was created with great success thanks to an intensive publicity campaign and to the establishment of operating controls and institution-based assistance.

Since the resources necessary for controlling and following up a large number of taxpayers are not available, a control has been set up within the scheme for "major taxpayers" in the three largest cities, i.e. La Paz, Cochabamba and Santa Cruz.. Meanwhile, progress is being made

in a programme to bring some 14,000 "mid-level taxpayers" into the system.

To make it easier for taxpayers to meet their obligations, systems have been developed and implemented that are based wholly on the bank network. Thus, the problem of corruption is circumvented, since the taxpayer has no direct contact with the Administration.

Another aspect worth examining is inspection. Several inspection programmes have been designed that focus on a small number of potentially major taxpayers. Most of these systems are based on controlling value added tax.

Results

With the reform tax revenue increased from 0.94% of GDP in 1985 to 6.06% in 1990. Although this tax ratio is still far below the one that prevailed in the late 70s, it has been possible to make non inflationary financing of the public sector viable once more.