



Trends and Prospects for Tax Policy in Emerging Markets

(With Particular Reference to Latin America)

by

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Overview of the presentation

- Main **tax policy objectives** of emerging market economies
- Main **constraints** facing tax policy-makers
- Major current **trends in taxation** in Latin America
- Major **remaining challenges**



Main desirable objectives of tax policy in emerging markets:

- ensuring **sustainable fiscal positions**, through low or declining public deficits and debt ratios;
- promoting **revenue mobilization**, to finance efficient spending programs, especially in the social area and in infrastructures; and
- **removing**, to the extent feasible, **distortive features** of the tax system, to promote economic efficiency and increase growth potential.




Main **constraints** facing policy makers in the pursuit of these objectives:

- .structure of the economy;
- .trade liberalization;
- .increased financial openness;
- .large income disparities;
- .fiscal decentralization;
- .administrative weaknesses



1.

- economies characterized by
 - relatively high degree of **informality** in labor markets
 - large shares of hard-to-tax **services** and **agricultural** sectors
 - fragmentation of the **retail** sector



Value Added (% of GDP, 2000)

	Agric.	Services	Total
Argentina	5	68	73
Bolivia	22	63	85
Brasil	7	64	71
Colombia	14	56	70
Mexico	4	67	71
Peru	8	65	73
Venezuela	5	59	64
Latin America	7	64	71
Europe EMU	2	68	70

Source: World Bank, World Development Indicators



2.

- **increasing openness in foreign trade**, leading to loss of revenues from import duties and export taxes

Taxes on International Trade, 1998-2000

(In percent of GDP)

	1985-89	1990-94	1995-98	1996-00
Argentina	1.8	0.9	0.8	0.9
Bolivia	1.9	1.4	1.4	1.1
Brazil	0.5	0.4	0.6	0.7
Chile	3.2	2.2	2.1	1.6
Colombia	2.2	1.4	1.0	1.0
Costa Rica	2.9	2.8	2.6	1.5
Mexico	1.1	1	0.6	0.6
Peru	2.2	1.3	1.5	1.6
Venezuela	1.9	1.8	1.6	1.6
Simple average	2.0	1.5	1.4	1.2

Source: Country documents and FAD staff estimates.



3.

- growing **financial integration** (as evidenced by rising FDI and financial capital flows) makes it more difficult to tax income from capital.



4.

- competition for FDI leads to excessive use of **tax incentives**
 - prospective investors shop for tax incentives, often obtaining privileges that undermine the tax system;
 - countries are better off if they agree with their neighbors on rules to limit tax incentives;
 - examples of efforts aiming at a harmonized treatment of FDI: the Organization of Eastern Caribbean Countries, the ECOWAS/WAEMU, and the East African Community.



Inflows of Foreign Direct Investment

(USD billion, annual averages)

Countries	1986-90	1991-95	1996-99
Developed	133.0	149.8	459.7
Developing	27.9	79.3	182.2
World	160.9	229.1	641.9

Source: World Economic Outlook, October 2001

Net Private Capital Flows to Emerging Markets

(USD billions)

	1994	1995	1996	1997	1998	1999	2000	2001
FDI, net	81	100	117	143	155	164	153	176
Portfolio, net	113	41	87	46	-5	34	-4	-30
Other, net	-43	71	30	-77	-85	-128	-141	-114
Total	151	212	234	112	65	70	8	31

Source: World Economic Outlook, April 2002



5.

- The relatively **high concentration of incomes** in emerging market countries would require taxing relatively more politically powerful groups. But such groups resist increased tax burdens, and frequently manage to obtain tax exemptions or privileges, as well as direct or indirect budgetary subsidies.



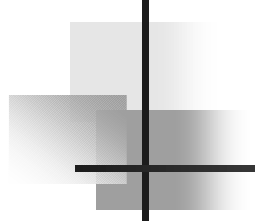
6.

- **fiscal decentralization**, leading to upward pressure on spending and overall tax burden, while local tax bases (especially property taxes) are underutilized
 - For political expediency, local governments tend to favor tax sharing instead of levying local taxes.
 - Difficulties in valuing properties hinder the development of property taxation

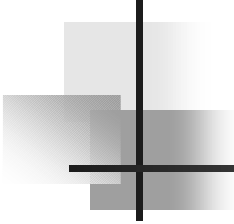


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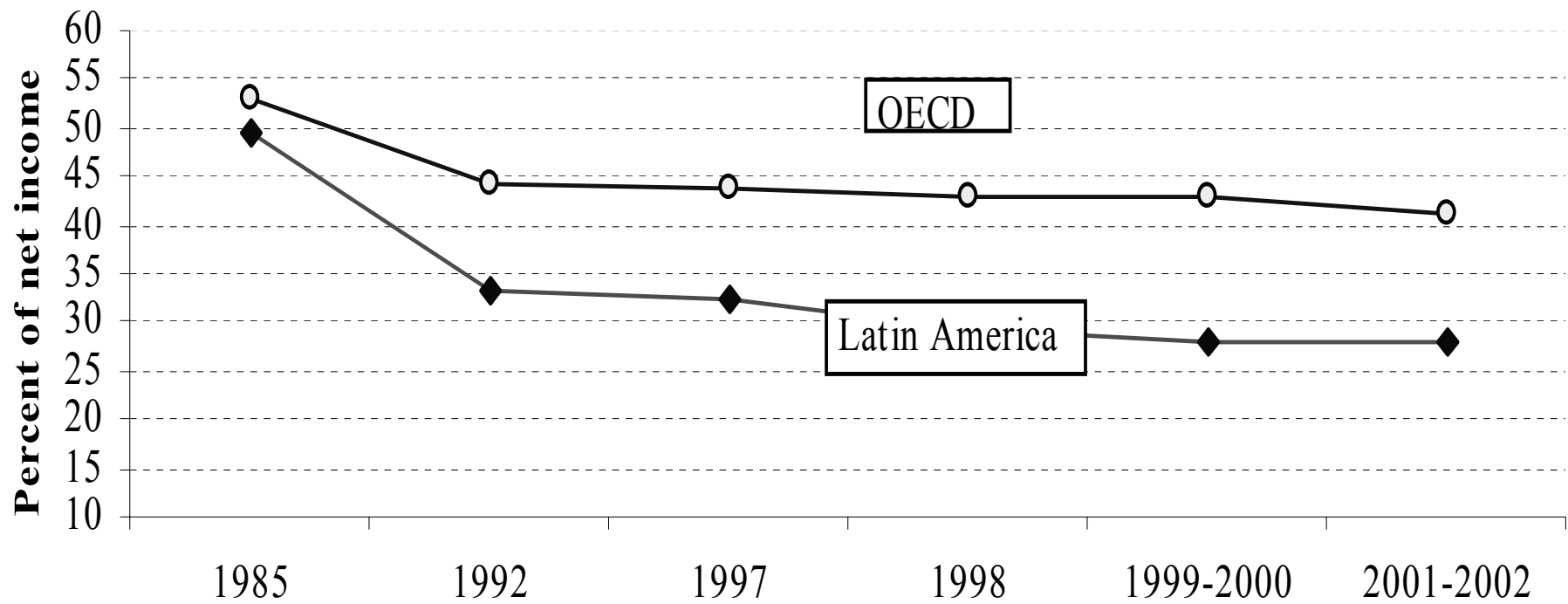
- **serious deficiencies in tax administration**, especially at the regional and local levels, are common in emerging market economies:
 - reforms of tax administrations/ customs take time, and are complex and costly financially and politically, while a few years of neglect are enough to ruin them;
 - complex and non transparent tax legislations make administration and enforcement more difficult
 - frequent changes in technology and markets require continuous catching up efforts by the tax administration.



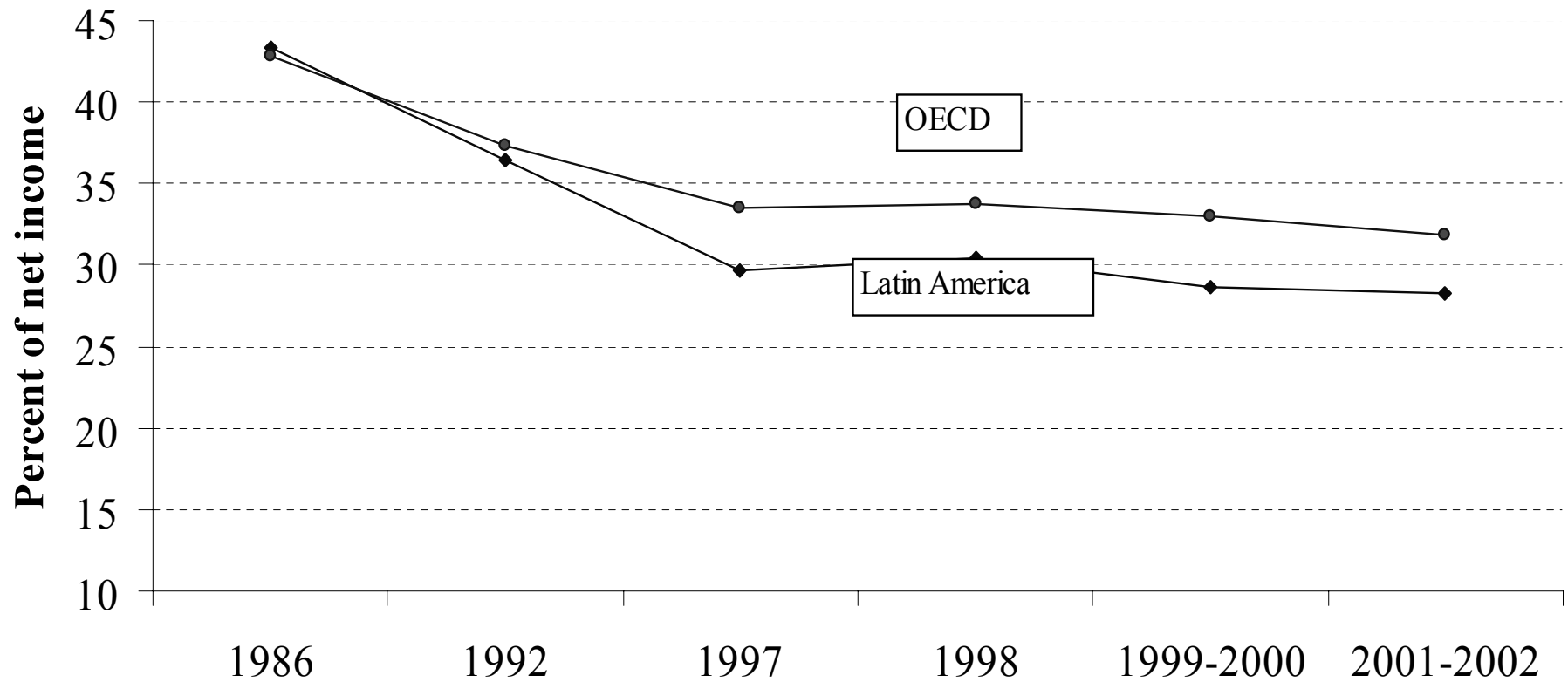
How are Latin American countries coping with the problems outlined above?

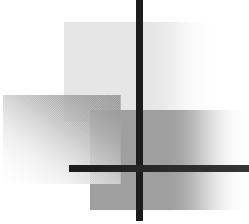
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- Top income tax rates for both individuals and enterprises have been reduced faster than in OECD countries.
 - At the same time, the lowest rates have generally been kept unchanged.
 - As a result, the overall profile of marginal tax rates has tended to flatten out.

Top Personal Income Tax Rates

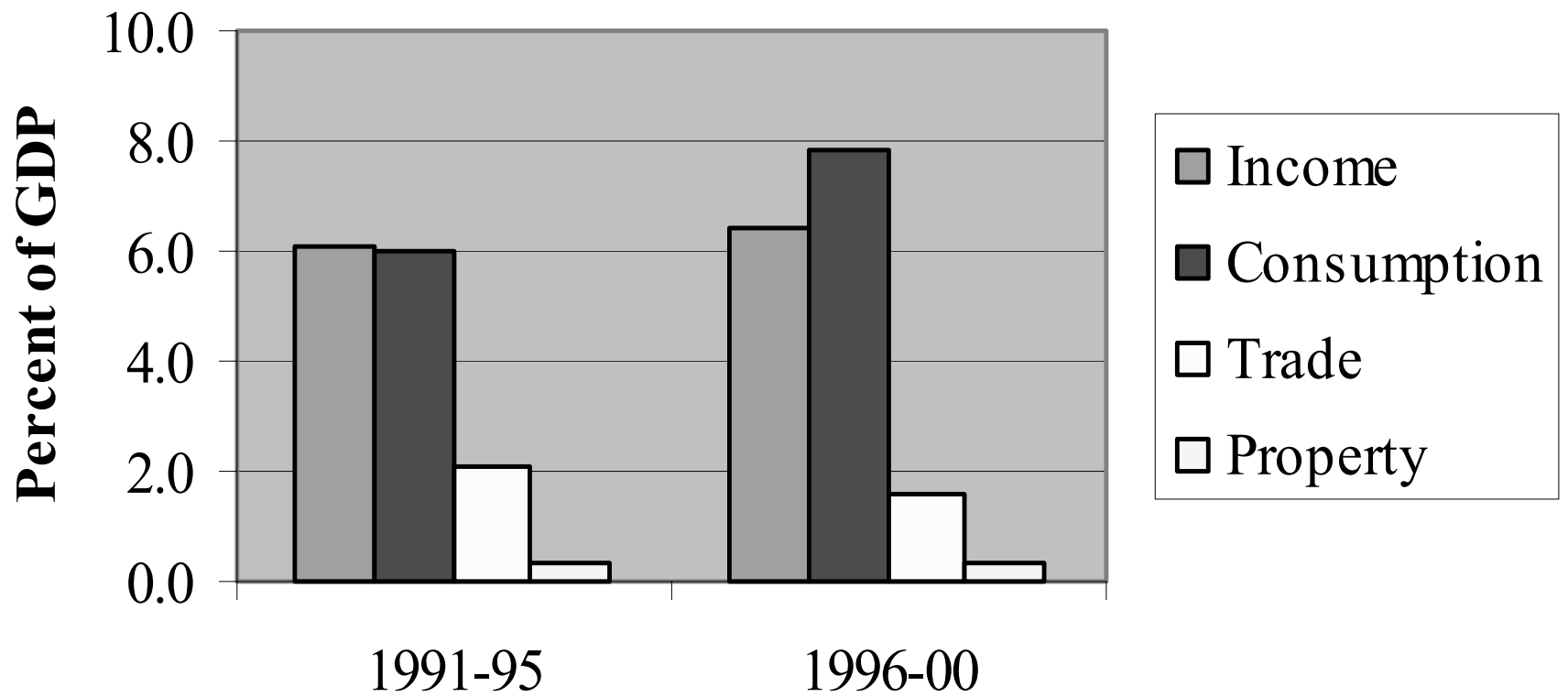


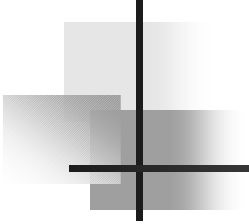
Top Corporate Income Tax Rates



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- Latin American countries have also tended to **reduce their reliance on taxes on foreign trade**, substituting the lost revenue with increased taxes on domestic consumption (**VAT** and selected **excises**).

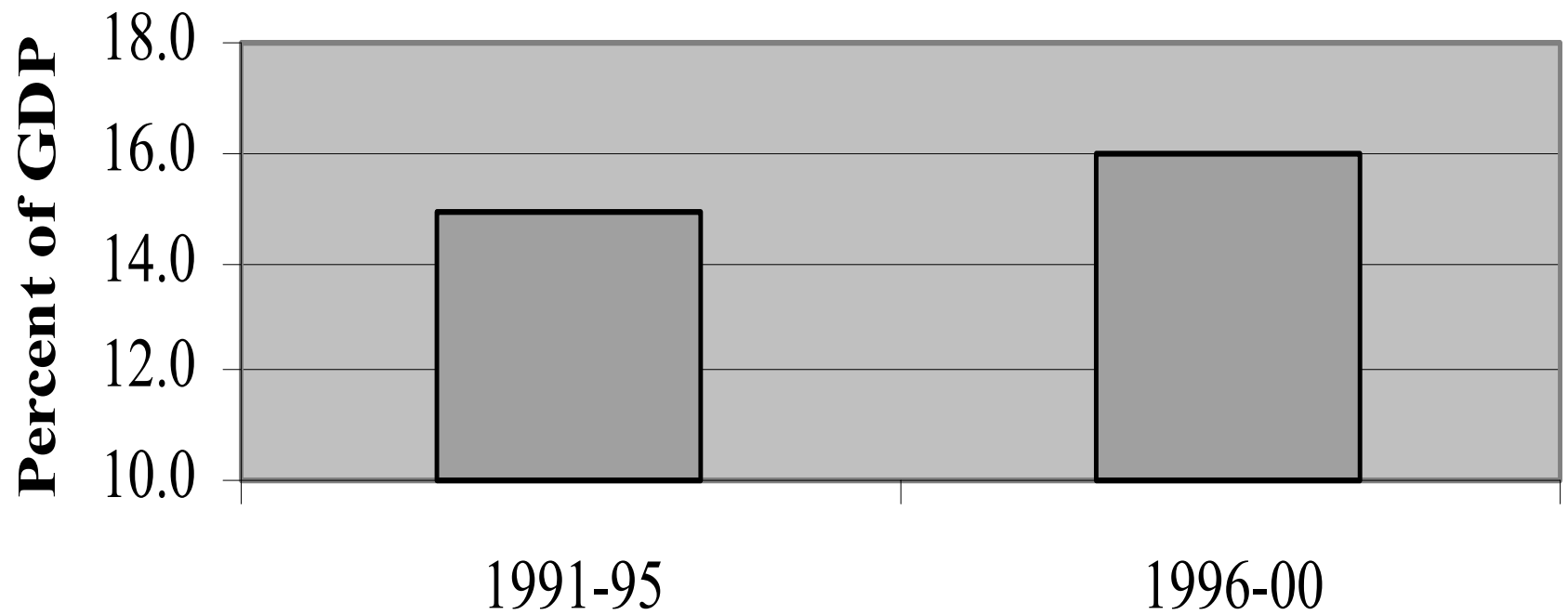
Latin America Tax Mix

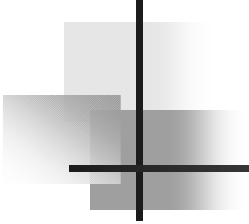




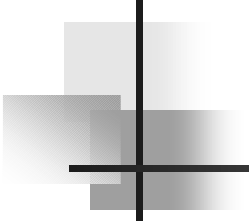
Despite cuts in some tax rates, most Latin American countries have been able to **increase their tax ratios** in recent years. This has reflected a number of factors.

LatAm Tax Revenue (Central Govt)





The increase in overall tax revenue has been made possible mainly by **increased taxation of goods and services**, especially the value-added tax (VAT) and a few excises. All Latin American countries have had VATs in place for at least ten years. Excises are typically levied ad valorem on tobacco, alcoholic and soft drinks, motor vehicles and petroleum products.



.Some countries have, however, kept up revenues by resorting to **distortive taxes**, for example:

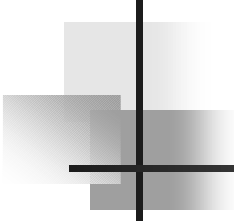
taxes on financial transactions: Brazil's CPMF 0.38%, Colombia's "tres por mil", Ecuador's 1% on bank lending, Venezuela's 0.75% on bank debits

cascading taxes on turnover: Argentina's provincial sales taxes, Brazil's PIS/PASEP and COFINS, Colombia's municipal sales taxes



Many Latin American countries have also adopted **base-broadening measures**, such as:

- .taxation of worldwide income;
- .adoption of safeguards against tax arbitrage; and
- .reduction of tax exemptions and incentives

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- Latin American countries used to rely on territorial taxation (i.e., exempting income earned abroad), which facilitated tax evasion.
 - The change to **taxation of worldwide income**—where a credit is granted for taxes paid abroad, up to the rate of the domestic tax—has helped to reduce evasion.
 - Of course, worldwide taxation usually does not apply to branches of foreign enterprises, which are taxed only on profits made locally; it is applied, however, to subsidiaries.
 - Worldwide income taxation has been adopted by, among others, Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and recently Venezuela.



2. A number of **safeguards against tax arbitrage** (*thin capitalization, transfer pricing rules, anti tax-haven legislation*) have been adopted:

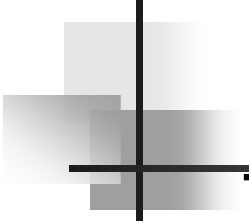
- Transfer pricing rules** are used in Argentina, Brazil, Chile, Mexico, and Venezuela;
- Argentina, Bolivia, and Colombia **limit the deduction of interest paid** abroad, whereas Brazil allows deduction an imputed interest on equity;
- Legislation defensive against **low-tax jurisdictions** are in place in Argentina, Brazil, Peru, and Venezuela.



3. Reduction of tax incentives

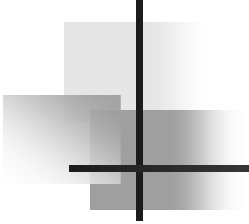
Owing to the difficulty in increasing further the rates of the main indirect taxes, almost every recent program of fiscal consolidation in Latin American countries has included some **streamlining of tax exemptions.**

A number of Latin American countries have introduced annual **tax expenditure budgets**, to monitor the cost of tax incentives in terms of foregone revenue.



These moves reflect growing consciousness by Latin American policy makers of the **limited economic benefits of tax incentives**, as well as of **their shortcomings**, including:

- the distortions in resource allocation they create, while often failing to meet their economic objectives;
- the fact that they add unnecessary complexity to the tax system, and reduce transparency;
- their tendency to foster corruption and socially unproductive rent-seeking activities; and of course
- the loss of revenue they entail.

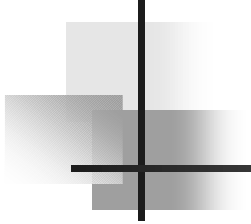
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- There are still (too) many tax incentives around, although they are now usually more selective (e.g., for industrial development in the poorer regions in Brazil, Chile, Bolivia, Ecuador, Peru, and Venezuela).
 - As part of its surveillance and program work, the IMF also encourages the elimination of remaining tax incentives.



Strengthening Tax Administration

Efforts to **strengthen and modernize tax administrations** in Latin America have been motivated not only by revenue-raising objectives, but also by a growing recognition that improved tax enforcement increases equity and, by levelling the playing field for business, promotes efficiency in resource allocation.

.These efforts have been only partially successful to date, and there have also been reversals, especially in some crisis countries, like Argentina.



Major challenges remaining



Further Reducing Tax Incentives

- Further **rationalization of tax incentives**: to the extent that they continue to be used, they need to be streamlined, and follow simple guidelines that minimize discretion, maintain transparency, render them less prone to abuse, and allow for constant monitoring of their cost-effectiveness.



Regional Tax Harmonization

Regional tax harmonization can:

- *facilitate moderate taxation of financial income; and*
- *reduce tax competition for FDI*

MERCOSUR, the Andean Group, and Central America could provide good examples in this area



Improving Local Taxation

The objective should be to **make municipalities more self-reliant** by collecting their own taxes. (This works better when there are no great disparities in potential tax bases.)

Mechanisms have been devised (e.g. by Canada and Australia) to **link tax-sharing formulas to fiscal effort by local governments**, but they are relatively demanding in terms of informational requirements, and have not been adopted so far in Latin America.



Increasing tax decentralization

Many Latin American countries already have complex national tax systems. Many larger countries have been facing demands for increasing the taxation power of subnational governments.

- Example: Since the beginning of this year, Mexican states can collect their own sales taxes.
- Questions: Will subnational governments be able to collect taxes efficiently? Will laws still be applied uniformly with greater decentralization? Is decentralization adding to the complexity of tax systems or making them less transparent?



Further Strengthening Tax Administrations

- The state of tax administrations varies significantly across Latin America.
- Nevertheless, some **common challenges** can be identified:
 - simplifying tax legislation and regulations;
 - improving audit programs;
 - strengthening collection enforcement, including through legal and judicial reforms; and
 - improving taxpayer services.



Achieving Further Tax Simplification

- Also because of greater communication and informal coordination, tax systems in Latin America are converging to a simpler model, with fewer taxes, thereby making tax systems leaner and more enforceable.
- Question: What is the desirable scope for further simplification and standardization, and how much time is this process likely to take?



Judicial & Institutional Reforms

- Further **judicial & institutional reforms** are also needed, to allow for quicker and more effective resolution of tax disputes, and to reduce legal uncertainty.
- For example, tax appeal systems still have plenty of scope for improvement; but also framework legislation often needs to be modernized (e.g., bankruptcy laws) or implemented.
- Questions: What should be the key reform priorities in this area? How can they be advanced?



Improving Taxpayer Services

Latin American countries have generally embraced innovations in tax administration; the IMF's Fiscal Affairs Department (FAD) has played an extensive role in advising countries in the region on modernizing their tax administrations.

- Many tax administrations already provide taxpayer services online (e.g., dissemination of information, tax filing). In general, the greater use of internet "democratizes" information and reduces the need for relying on insider knowledge.
- Question: What is the scope for further modernization and automatization?