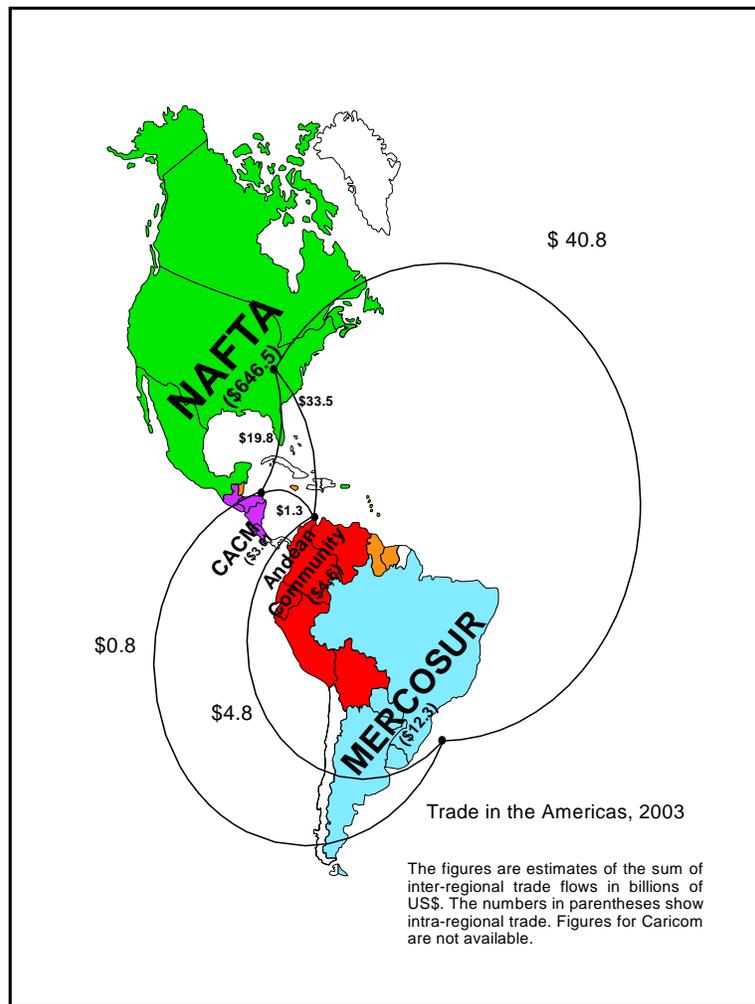




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INTEGRATION AND TRADE IN THE AMERICAS

Fiscal Impact of Trade Liberalization in the Americas



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PERIODIC NOTE ON INTEGRATION AND TRADE IN THE AMERICAS

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The purpose of this document is to inform Bank staff and other interested parties about recent developments in integration and trade among the countries of the Western Hemisphere and between these and other countries and world regions.

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The opinions expressed herein do not necessarily reflect the official position of the Bank or its member countries.

Note: The map displayed on the cover is included for illustrative purposes only. It does not constitute an official representation of the area covered.

ABBREVIATIONS

CET	Common external tariff
CIF	Cost, Insurance and Freight
FDI	Foreign direct investment
FTAA	Free Trade Area of the Americas
ECLAC	Economic Commission of Latin America and the Caribbean
EPZ	Export processing zones
EU	European Union
GDP	Gross domestic product
GNP	Gross national product
IDB	Inter-American Development Bank
IMF	International Monetary Fund
INTAL	Institute for the Integration of Latin America and the Caribbean
ITD	Integration, Trade and Hemispheric Issues Division
LAC	Latin America and the Caribbean
LTR	Loss of tariff revenue
MERCOSUR	Southern Common Market
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Cooperation and Development
TBI	Tax on business earnings
UNCTAD	United Nations Conference on Trade and Development
VAT	Value added tax
WTO	World Trade Organization

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I. INTRODUCTION

Three factors basically condition a tax system:¹ (1) the model of international insertion; (2) the level, quality and sustainability of public spending; and (3) the performance of the tax administration. International insertion determines a country's trade in goods and services, its investment flows, its level of technology and its production structure. It also conditions the tax structure – that is, the tax system and administration. The level of spending determines how much must be levied and, since taxes are simply transfers among the residents of a country (jurisdiction) and since their main function is to finance public spending, taxpayers' perceptions of the efficiency and transparency with which public expenditure is managed legitimates and facilitates the levying of taxes. Finally, irrespective of how well designed the tax instruments are, the system is unsustainable if tax administration is not ethical and efficient.

The tax systems of Latin America and the Caribbean (LAC) were set up in the 1970s and 1980s, when most countries were applying import-substitution policies and had only recently embarked on incipient processes of commercial and financial opening. Since economic conditions changed substantially in the last decade of the twentieth century, these systems do not efficiently promote trade and investment. The prospect of a far-reaching, hemisphere-wide trade agreement will permanently change economic structures in LAC. That change will be accompanied by significant adjustments to most countries' tax structures, including both the tax system and its administration. In 2000, for example, about 35% of LAC's trade was with the United States. The latter was also the leading source of foreign direct investment (FDI) in the region, accounting for 27% of inflows.

II. TAX EFFECTS OF TRADE AND FINANCIAL LIBERALIZATION

The intensification of trade and financial liberalization, and the subsequent deepening of economic integration processes, have significant implications for tax policy:

- i) impetus to those sectors with comparative advantages, but also to those that are hard to tax;
- ii) confining sectoral policies to tax incentives policies;
- iii) difficulties in taxing financial capital, the most mobile production factor;
- iv) the heightened importance of tax on international activities; and

¹ It is accepted in the literature on public finances that a tax system should have a series of desirable characteristics, which are essentially: i) sufficiency to meet public spending in a framework of fiscal sustainability; ii) efficiency, obviating distortions in the markets for goods, services and factors that bring about welfare losses (excessive burden) in the economy; and iii) horizontal equity – that is, equal treatment for taxpayers in each income bracket; and vertical equity – seeking to ensure that those with higher earnings pay more in terms of their income; the underlying principles are the benefit and ability to pay; and iv) simplicity, which facilitates implementation. In our view, as trade liberalization and economic integration advance, another characteristic should be added: the system's "coordinability" with main trade partners.

- v) the primacy of an active fiscal policy in light of the constraints on trade, monetary and exchange rate policy-making.

2.1 Impetus to those sectors with comparative advantages, but also to those that are hard to tax

In general, economic theory is very straightforward. It says, for example, that good and large-scale investment prompts growth; or that, without growth, systematic indebtedness is not viable. The idea of comparative advantages in international trade, however, is subtle. In short, the theory says that each country should export those goods that it can produce with a relatively greater cost advantage (or relatively lesser disadvantage), and import those goods in which it has a relatively lesser cost advantage (or relatively greater disadvantage). In other words, if two countries produce two goods and one country is more efficient in the production of both, the welfare of both countries will increase if each specializes in the production of the good at which it is relatively most efficient.

Emphasis on production in sectors with comparative advantages in LAC tends to lead to an increase in primary products (agricultural goods and non-renewable natural resources), and a partial decline in the industrial sector². Other trends, moreover, such as the outsourcing of services and the attendant proliferation of small and microenterprises, give rise to a new distribution of value added among the three main economic sectors. In two decades the region has lost almost 7% of industrial output and gained almost 10% in services. This has significant effects on tax policy and administration, since the majority group of taxpayers comprise those who are “hard to tax”³, especially farmers and urban microenterprises. It is likely that this circumstance might be partially offset by greater concentration of economic output, since in most countries of the region less than 1% of taxpayers provide almost 75% of the tax take.

2.2 Confining sectoral policies to tax incentives policies

Reduced and uniform tariffs have substantially lowered the effective protection of national production. This has triggered strong pressure for new incentives and fiscal benefits to protect sectors or regions, leading to significant tax waivers. Hence the proliferation in LAC of free zones, duty free shops and benefits for the tourist hotel industry, mining and forestation. Nonetheless, most assessments of sectoral or regional policies based on tax incentives (which are usually clientalist, since they benefit few) conclude that they have virtually no investment-promotion effect; they are simply conducive to tax evasion and, above all, avoidance, thereby damaging the economy as a whole. This has led to a “porous” income tax with fiscal loopholes through which taxable earnings leak. Hence income tax, especially on business, has high nominal rates (close to those of the developed countries) but real takings (effective tax rates) are very low, at about a third of the nominal value.

². Barreix, A. and D. Alvarez. “Cambios en el contexto internacional y sus efectos en la tributación en América Latina y el Caribe”, *XIII Seminario Regional de Política Fiscal*. ECLAC, Santiago, Chile. 2001

³. Shome, P. “Taxation in Latin America: Structural Trends and Impact of Administration”, *IMF Working Paper* N° 19. Washington, D.C.: International Monetary Fund. 1999.

In small countries, moreover, it is harder for the tax administration to specialize because of problems of scale. This complicates the management of the exemptions, be they special import regimes (classification and origin problems) or sectoral and regional incentives. Thus it would be much more transparent to manage them with direct and temporary subsidies.

Finally, there is a tendency to engage in harmful tax practices. When tariff barriers are eliminated it is no longer necessary to be installed in a market in order to supply it, and fiscal benefits become a means of retaining and attracting FDI. This is evidenced by the efforts of Brazilian states to induce automakers to set up local factories by offering fiscal incentives, a practice emulated by some provinces in Argentina.⁴ Given the increase in tax expenditure, however (revenue lost because of the exemptions), the federal government is trying to amend the law so as to impose greater discipline on the states.

2.3 Difficulties in taxing financial capital, the most mobile production factor

The liberalization of exchange controls and capital flows, in conjunction with the development of new financial instruments and communications technologies (which lowered marginal transaction costs), have given capital substantial relative mobility. In 2000, for example, trade in goods and services amounted to US\$ 7 trillion, while international capital flows were five times higher.⁵

First, more sophisticated mechanisms for fiscal planning of the financial structure (such as replacing dividends with interest when the latter is untaxed), in tandem with new financial products (derivatives and similar instruments), enhance the prospect of arbitrage and heighten the tendency towards erosion of the income tax base.

Second, capital volatility and fiscal planning, using instruments such as “financial centers”, offshore banking, hedge funds and inter-company loans, have spurred competition between jurisdictions, the latter reduce the tax burden in order to retain and attract savings.

As a result, the liberalization of trade and capital flows has eroded the bases of taxes on external trade and income, which have been offset in Latin America by an increase in tax on consumption and wages.⁶ These trends are similar to those in the OECD countries, and they have adverse effects on the equity of the tax systems.

⁴ For the details of the “fiscal war” in Brazil, see Barreix, A. y L. Villela. *Tributación en el MERCOSUR: Evolución, comparación y posibilidades de coordinación*. ITD, INTAL - Departamento de Integración y Programas Regionales, Banco Interamericano de Desarrollo. Buenos Aires: BID-INTAL. 2003a. [Http://www.iadb.org/intal/publicaciones/Tributación_Barreix-Villela.pdf](http://www.iadb.org/intal/publicaciones/Tributación_Barreix-Villela.pdf)

⁵ Avi-Yonah, R. “Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State”, *Harvard Law Review* 1.573. Mayo, 2000.

⁶ According to Barreix, A. and D. Álvarez, *ibid*, footnote 1, between 1980 and 1997, for a representative set of Latin America countries, there was a 10% and 4% decline, respectively, in the share of external trade taxes and income tax in the total collected. At the same time, consumption and payroll taxes increased by 11% and 5%, respectively.

2.4 The heightened importance of tax on international transactions

The increase in transactions between affiliates in different countries has allowed inter-company prices to be set in a way that evades the tax authorities and the payment of tax.⁷ According to the Economic Commission for Latin America and the Caribbean (ECLAC)⁸, the sale of transnational companies' affiliates increased in the 1990s at a much higher rate than global exports, and their production levels rose from 5% of gross domestic product (GDP) in 1982 to 10% in 2000. The stock of FDI, meanwhile, increased from 6% of GDP in 1980 to 45% in 2002, according to the United Nations Conference on Trade and Development (UNCTAD)⁹. Moreover, regional economic integration is creating a new kind of transnational: the regional company. There are still no appropriate region-wide regulatory frameworks in the tax field either to benefit such firms (avoidance of double taxation, for example) or to control them so as to obviate their exploitation of trade facilities to evade tax.

In addition to inter-company operations and new international financial instruments, significant progress in the area of information and communications technology is promoting international transactions in new and intangible goods and services, especially through the Internet, by means of e-commerce. Cross-border transactions have increased in volume and changed in nature.

Electronic commerce in intangible goods and services has a series of features that distinguish it radically from traditional operations: the division of activities in the international network increases the chances that producers will not be physically located; thus the principle of territoriality (which is fundamental to determining tax borders) becomes hazy, while the internationalization of transactions makes it hard to determine the tax base.

As a corollary, it becomes very difficult for tax policy and the tax administration to set and levy taxes on activities that originate outside their jurisdiction if the tax authorities in other countries do not cooperate.¹⁰

Tax policy and administration face a series of additional problems attendant on the internationalization of economies:

- a) assigning the tax base of multinational companies' income;
- b) tax on earnings and capital gains;
- c) information exchange;
- d) double taxation agreements; and
- e) offshore centers and harmful incentives regimes.

⁷ Highly skilled professionals supplying value in a knowledge-based economy are becoming more aware of the differential tax rates applied to their earnings and regard this as a significant factor in their decisions to emigrate.

⁸ ECLAC. *Foreign Investment in Latin America and the Caribbean*. Santiago, Chile. 2000.

⁹ UNCTAD. *World Investment Report*. 2001.

¹⁰ Byrne, P. "US Tax Rules for Latin America", (mimeo). Inter-American Development Bank. 2001.

Most LAC countries have not faced these issues and, even worse, their tax administrations lack response capacity. In addition to the fall in the tax take, constraints on the control of these activities confer a relative advantage on international companies receiving a high level of professional advice, because they can exploit the situation.

2.5 The primacy of an active fiscal policy in light of the constraints on trade, monetary and exchange rate policy-making

Plainly, as tariff barriers fall, so too does the prospect of formulating trade policy. At the same time, the line between trade policy and tax policy is disappearing. Trade and integration negotiators are realizing that trade promotion will demand special attention to the economic effects of taxes. Tax specialists agree that tax systems can contain hidden subsidies and barriers to the international trade in goods, services and capital, as has been acknowledged by the World Trade Organization (WTO).

When countries coordinate their monetary policies, as with exchange rate alignments in the “European snake” system, or when they renounce their own currencies, as when the euro was adopted, it is obvious that there are substantial constraints on their monetary and exchange rate policies. This is also evident in Latin America and the Caribbean: there are three “dollarized” countries (Panama, El Salvador and Ecuador); others with fixed parity (the Bahamas, Belize); and others whose regulations preserve the real effective exchange rate with the US dollar.

As a corollary, these limits on trade, monetary and exchange rate policy make fiscal policy the most important active policy option. As economic integration deepens, however, and as countries make mutual concessions by coordinating international tax policies (agreements to avoid double taxation, transfer prices, information exchange) and by establishing supranational institutions on tax law such as the European Court, it is plain that they will cede some degree of fiscal sovereignty.

2.6 The tax system under pressure

In the last quarter of the twentieth century, as a result of structural adjustments triggered by the external debt crisis in developing countries, the abandonment of the state-led economic model, and the increase in trade and capital flows between countries, there was an unprecedented convergence of tax systems. In general, countries have adopted very similar systems. The six kinds of tax that have comprised the pillars of the export-promotion model applied in LAC since the 1970s are as follows: (i) VAT, which replaced myriad minor taxes on sales; (ii) income tax on the earnings of both individuals and companies; (iii) a small number of excise taxes exploiting the low price elasticity of some goods and services; (iv) social security contributions (mainly calculated on the basis of nominal wages); (v) property tax, especially on real estate; and (vi) tariffs, whose share of the total fell with greater unilateral opening, and then because of subregional integration.

Despite such similarities, the countries adopted significantly different regulations (tax base, exemptions, rates, procedures and so on), because there was no equivalent development in the consolidation of institutions that ensure a market economy, their depth, and the management capacity of the tax administrations. This has led to very different collection structures and levels of fiscal pressure.

In some countries of the region, moreover, the need to finance the permanent growth in public spending and exchange rate/financial crises has demanded a substantial fiscal effort that in some cases might exceed taxpaying capacity. This excess burden has distorted the tax system as an instrument of the development strategy (trade openness with export-promotion) for which it was created.

The “tax spiral” of continuous tax packages as a response to the demands of growing public spending has:

- (i) “sullied” the tax systems, for example: falling back on saturated tax bases with little chance of evasion like the payroll, applying inefficient taxes such as those on bank debits and exports set by arbitrary rulings, and using sales taxes that have cumulative effects. This “tax activism” has given rise to technically poor taxes, or has increased the burden of distortionary taxes that undermine competitiveness; and
- ii) increased the system’s unfairness. There being a limit on the extent to which the mobile factor (capital) can be taxed, and limited administrative capacity, the burden has fallen on consumption and wages. Excessive pressure on wages, through payroll or personal income taxes, undercuts the propensity to work (in the formal sector) and national savings.

III. RECENT TRENDS IN TARIFFS

Since the start of the 1980s, and especially since the Uruguay Round, unilateral trade liberalization has reduced average tariffs and their dispersion in LAC¹¹, and tariff revenue has therefore declined. Moreover, the prospect of significant progress on economic integration in the Western Hemisphere, particularly the Free Trade Area of the Americas (FTAA), could lead to a substantial loss of fiscal revenue because, with few exceptions, levels of nominal protection are now very low.

Table 1 shows the striking reduction in average nominal rates in LAC during the last 15 years.

TABLE 1
SIMPLE AVERAGE TARIFF AND ITS DEVIATION

¹¹ IDB. “Beyond Borders: The New Regionalism in Latin America”. IPES Report. Inter-American Development Bank. 2002.

Countries	1985	2000	
	Average	Average	Deviation
Argentina	28.0	13.3	6.7
Brazil	80.0	14.1	6.8
Chile	36.0	9.0	0.5
Colombia	83.0	11.6	6.3
Ecuador	50.0	11.3	6.4
El Salvador	53.2	7.3	8.6
Guatemala	50.0	7.1	8.0
Mexico	34.0	16.3	14.1
Nicaragua	54.0	4.2	5.8
Panama	41.3	9.2	10.1
Peru	64.0	13.5	3.7
Uruguay	32.0	12.5	6.8
Venezuela	30.0	12.0	6.0

Source: Database. Integration and Regional Programs Department. IDB.

Table 2 shows the clear trend towards the diminishing importance of external trade taxes throughout the world, and in Latin America in particular, in a context wherein the total tax burden has tended to increase slightly. It should be noted that, despite the significant decline, tariff income is still more important in LAC than in developed countries, which use quota systems or non-tariff barriers to protect crucial sectors.

TABLE 2
TAXES ON EXTERNAL TRADE: DEPENDENCE AND TREND, LAC, THE CARIBBEAN AND OTHER COUNTRIES

Countries	% of GDP		
	1985	1995	2000
Argentina	2.29	0.73	0.65
Bahamas	13.84	12.24	10.70
Bolivia	1.67	1.09	1.17
Brazil	0.62	0.80	0.77
Chile	3.06	2.07	1.29
Colombia	1.97	1.04	1.06
Costa Rica	4.38	3.06	1.03
Dominican Rep.	3.69	5.87	3.89
Mexico	0.65	0.61	0.55

Nicaragua	2.56	5.25	1.38
Peru	3.26	1.75	1.47
Uruguay	2.78	0.98	0.83
Venezuela	3.86	1.50	1.21
Australia	1.36	0.75	0.68
Austria	0.48	0.01	0.00
Canada	0.89	0.37	0.25
France	0.01	0.00	0.00
Italy	0.01	0.00	0.00
Spain	1.29	0.00	0.00
Sweden	0.23	0.27	0.02
United States	0.30	0.27	0.21

Source: Database. Integration and Regional Programs Department. IDB.

IV. A COMPARISON OF TAX STRUCTURES AND TRENDS

Table 3 offers a panoramic snapshot of tax in LAC. The total average tax burden (including social security contributions) accounts for 23% of total revenue, while without social security it reaches 19.2% for the 2000-2001 period.¹²

¹² Gross National Product (GNP), measured in terms of purchasing power parity, was used to weight the individual tax burdens. It should be recalled that the difference between the tax burden with and without social security contributions is smaller in countries with mixed or privately-run social security systems. The data also include local government income but not the net earnings of public companies.

Table 3 reveals the significant differences between country groups. The Southern Common Market (MERCOSUR) has the highest average (30%), followed by the Caribbean (19%), and then Central America and the Andean Community (about 15% in both cases).

In LAC, indirect taxes account for 70% of the tax take. Consumption taxes, generally value added tax (VAT), account for two thirds of that share. Income from excise taxes is double that from taxes on imports. These proportions, however, vary substantially between the regions. For example, the ratio of direct to indirect taxes is 1:3 in MERCOSUR but 1:1 in the non-Latin Caribbean. The burden of general consumption taxes is much lower in the Caribbean, where it accounts for 25% of tax revenue; it exceeds 40% in the rest of Latin America.

As regards import taxes, the level of dependence is very low for the LAC weighted average, standing at just 4.7% of the total. Again, however, this varies substantially between the regions. In MERCOSUR the average is 3.1% (high only in Paraguay, at 17.9%); in Central America and the Andean Community it accounts for more than 10%; and in the Caribbean for 21.6%. The Bahamas is an extreme case (60%). In the Caribbean countries, in fact, import tax revenue is very close to that from general consumption tax. Finally, note that revenue from import taxes in Central America is half that from excise taxes, and only a quarter of that from VAT.

It should be remembered that table 3 is an overview of the tax structure in LAC. There are substantial differences between countries. Three important characteristics should be added. First, as regards the different jurisdictions with the power to tax, unitary systems (which include only the central and municipal levels of government) should be distinguished from federal systems, which includes a third level (state or provincial). Latin America and the Caribbean (LAC) has four federal countries: Argentina, Brazil, Mexico and Venezuela. In the latter two, sub-national state revenue is below 5% of total tax income. In Argentina, by contrast, provincial tax revenue is equivalent to almost 4% of GDP, and accounts for a sixth of total income. In Brazil, state taxes are equivalent to 10% of GDP and a third of tax revenue. Colombia is unusual in this regard. Although the country is a unitary republic, almost 20% of tax is collected at the sub-national level. While their share is growing, the provinces secure the equivalent of only 1.3% of GDP, and the bulk is in the municipalities' account.

A second characteristic is the importance of income from non-renewable natural resources. Venezuela's oil sector accounted for 80% of exports, 25% of GDP and almost 45% of fiscal revenue (8.3% of GDP) in the period 2000-2001. Mexico is a similar case; revenue from hydrocarbons fluctuates between 15% and 25% of total income. Likewise, Ecuador's oil earnings accounts for 6% of GDP or 25% of total fiscal revenue. Trinidad and Tobago's income from natural gas and oil, meanwhile, collects for about 5% of GDP (20% of the tax take), while income from copper in Chile has varied between 1.5% and 2% of GDP in the last ten years.

Finally, note that contributions to social security are particularly significant in Uruguay, Brazil and Argentina, accounting for 8.3%, 7.7% and 3.4% of GDP, respectively, in 2000. Costa Rica is similar: social security contributions account for 5.7% of GDP. It should be recalled, however, that in countries like Chile, El Salvador, Bolivia and Mexico, social security is privately managed – with a minimal public contribution – on actuarial bases. Thus the contributions do not feature in the fiscal accounts. The situation is similar in Argentina, Colombia, Peru and Uruguay, where a system of public provision based on inter-generational solidarity is privately-run.

TABLE 3
LATIN AMERICA AND THE CARIBBEAN
Average, 2000-2001

Regions & Countries	GNI/PPP US\$ 10 ⁶	Tax Burden (% de GDP)							Share of Total Tax Revenue				
		Total Revenue	Total Taxes	Direct Taxes	Indirect Taxes	General G & S	Excise	Import Taxes	Direct Taxes	Indirect Taxes	General G & S	Excise	Import Taxes
MERCOSUR	1.743.5	30.28	24.36	6.47	17.89	11.44	1.88	0.75	0.27	0.73	0.47	0.08	0.03
Argentina	446.2	21.44	18.10	5.62	12.48	8.31	2.43	0.65	0.31	0.69	0.46	0.13	0.04
Brazil	1.243.3	34.00	27.10	6.93	20.17	12.80	1.65	0.77	0.26	0.74	0.47	0.06	0.03
Paraguay	24.4	11.15	10.00	1.99	8.02	4.24	1.83	1.79	0.20	0.80	0.42	0.18	0.18
Uruguay	29.6	23.43	15.43	3.73	11.70	7.35	3.38	0.83	0.24	0.76	0.48	0.22	0.05
Chile	138.4	19.02	17.57	5.68	11.89	8.02	2.31	1.29	0.32	0.68	0.46	0.13	0.07
Mexico	861.3	16.82	15.25	5.69	9.56	7.19	1.71	0.55	0.37	0.63	0.47	0.11	0.04
Andean Community	571.2	14.52	11.73	3.93	7.80	5.17	1.35	1.23	0.33	0.67	0.44	0.11	0.11
Bolivia	19.6	14.95	13.26	3.21	10.05	5.88	3.01	1.17	0.24	0.76	0.44	0.23	0.09
Colombia	256.4	17.87	13.25	5.78	7.48	5.04	1.13	1.06	0.44	0.56	0.38	0.09	0.08
Ecuador	36.9	13.76	11.66	2.46	9.20	6.60	0.66	1.82	0.21	0.79	0.57	0.06	0.16
Peru	119.6	13.63	11.96	2.80	9.16	6.20	1.81	1.47	0.23	0.77	0.52	0.15	0.12
Venezuela	138.7	17.57	8.54	1.98	6.56	4.05	1.30	1.21	0.23	0.77	0.47	0.15	0.14
Central America	143.2	15.18	13.07	3.73	9.35	4.99	2.53	1.55	0.27	0.73	0.41	0.19	0.13
Costa Rica	30.4	18.85	12.64	3.21	9.43	5.10	3.31	1.03	0.25	0.75	0.40	0.26	0.08
El Salvador	27.7	12.64	10.65	3.18	7.47	6.00	0.37	1.07	0.30	0.70	0.56	0.03	0.10
Guatemala	42.9	10.22	9.97	2.31	7.66	4.56	1.39	1.23	0.23	0.77	0.46	0.14	0.12
Honduras	15.4	17.17	16.66	3.73	12.93	5.63	4.94	2.37	0.22	0.78	0.34	0.30	0.14
Nicaragua	10.6	17.20	14.52	3.51	11.01	5.88	3.75	1.38	0.24	0.76	0.40	0.26	0.10
Panama	16.2	14.27	9.79	4.83	4.97	1.45	1.45	1.70	0.49	0.51	0.15	0.15	0.17
Caribbean	93.7	19.25	17.04	5.69	11.35	4.27	1.42	3.69	0.33	0.67	0.25	0.08	0.22
Jamaica	9.1	30.80	26.60	10.80	15.80	6.90	2.61	2.81	0.41	0.59	0.26	0.10	0.11
Trinidad and Tobago	10.7	25.90	16.40	7.80	8.60	4.00	2.61	1.60	0.48	0.52	0.24	0.16	0.10
Dominican Rep.	47.8	15.24	14.60	4.16	10.45	3.48	2.88	3.89	0.28	0.72	0.24	0.20	0.27
Haiti	11.7	8.67	8.67	1.49	7.18	1.99	0.59	1.97	0.17	0.83	0.23	0.07	0.23
Belize	1.3	24.10	19.40	5.00	14.40	5.34	0.22	6.66	0.26	0.74	0.28	0.01	0.34
Guyana	2.8	32.30	29.90	14.00	15.90	9.85	1.92	3.07	0.47	0.53	0.33	0.06	0.10
Suriname	1.4	31.70	26.95	13.40	13.50	4.10	2.70	6.60	0.50	0.50	0.15	0.10	0.24
Bahamas	4.9	19.10	17.60	2.20	15.40	0.00	4.70	10.70	0.13	0.88	0.00	0.27	0.61
Barbados	4.0	32.60	30.90	13.10	17.80	9.41	2.92	2.59	0.42	0.58	0.30	0.09	0.08
Latin America and the Caribbean	3.551.3	23.13	19.16	5.68	13.47	8.81	1.80	0.90	0.30	0.70	0.46	0.09	0.05

Source: Martner, R. y V. Tromben. "Tax Reform and Fiscal Stabilization in Latin America", presented at the *Jornadas de Política Fiscal* of the Bank of Italy. May, 2003. IMF Country Review Statistical Annex (various issues) and IDB.

V. THE TARIFF COST OF INTEGRATION

The proposition that trade liberalization improves economic efficiency and fosters development is accepted by many economists and exemplified by many successful experiences, but the fact that free trade can lead to a decline in public revenues is an issue that demands special attention. In countries with severe fiscal imbalances, a common circumstance in LAC, any loss of revenue requires careful assessment.

In addition to certain sectors' loss of protection, the countries must face a fiscal problem that arises when they decide to intensify their trade links with the rest of the world: the impact of the elimination of tariff barriers on public sector income. This is particularly important in developing countries with limited capacity to collect direct taxes, and whose public finances therefore depend to a significant extent on revenue from taxes on external trade.

5.1 The tax effects of trade integration

The income effects of regional integration, and of trade liberalization more generally, can be uncertain¹ and in the final analysis the net outcome will depend on empirical assessment. The effects depend on initial conditions in each country and the kind of tariff reform it undertakes.²

For the purposes of this analysis, changes in trade policy have five kinds of effects on tax earnings:

1. *Direct*: the loss of income associated with the reduction or elimination of nominal tariff rates on products subject to the trade agreement.
2. *Indirect*: the decline in revenue from other taxes based on Cost, Insurance and Freight (CIF) plus import tariff values (particularly VAT and excise taxes on consumption), associated with the fall in the tariff rate.
3. *Elasticity*: this is the net result of the probable increase in the volume of goods imported with lower or no tariffs, which are now cheaper, and the corresponding increase in internal taxes.³
4. *Substitution*: the decline in revenue attendant on trade diversion, since imports facing tariffs are displaced by purchases from the partners in the agreement (see Box 1).

¹ Tanzi, V. "Impact of Macroeconomic Policies on the Level of Taxation and the Fiscal Balance in Developing Countries", Staff Papers, IMF. September, 1989.

² For a traditional approach to estimating the impact of trade liberalization, see Ebrill, L.; J. Stotsky and R. Gropp. "Revenue Implications of Trade Liberalization", *IMF Occasional Paper* 180. 1999 and Abed, G. T. "Trade Liberalization and Tax Reform in the Southern Mediterranean Region", *IMF Working Paper* 98/49. April, 1998.

³ Although the goods are not completely tariff-exempt, the price-effect reduction leads to an increase in imported value and in the corresponding customs and internal taxes. As with any other tax, moreover, tariff reduction also has an income effect: more income is available because of the lower import cost.

5. *Induced*: the change in the collection of all taxes as a result of the new structure of production and consumption that springs from the new form of commercial insertion.

The first two effects, direct and indirect, are concomitant to the process of tariff reduction. The other three effects arise with greater or lesser intensity and at different stages after the reduction in tariff rates.

The direct (tariff reduction) and substitution (trade diversion) effects entail a loss of revenue. The substitution effect is negative for the public coffers because purchases from trade partners for which the tariff has been lowered displace taxed imports from third countries.

The overall fiscal impact of the indirect effect and the elasticity effect will depend on the market structure. While the indirect effect of tariff reduction diminishes the VAT base (and that of excise taxes, as the case may be), the decline can be offset at later stage in the marketing process, depending on the good's demand elasticity, and there is even a chance that the tax take will rise. The fiscal result of the elasticity effect, as well as being dependent on demand (like the indirect effect), will also be influenced by the structure of the market for the product in question. If the importer has a monopsony, for example, he can appropriate much of the tariff reduction. Thus the final prices falls little, other taxes will be marginally affected, and the benefit to the consumer is less.

The induced effect is macroeconomic and thus should be analyzed using general equilibrium models. Moreover, the induced effect is more uncertain because it affects production and consumption throughout the economy, as well as trade patterns, and hence the total of all the taxes levied.

Assessments of the fiscal impact of the final four require fieldwork; specific analyses of each market are needed to assess the indirect, elasticity and substitution effects; and an examination of the whole economy is required to gauge the induced effect. This Periodic Note therefore confines itself to estimating only the direct effect of tariff reduction, which is the most significant in the short term.

From the fiscal perspective, the challenges of trade liberalization and tariff reduction are:

1. Quantitative assessment of the measures' fiscal effects.
2. Deciding what to do about fiscal policy in general – that is, offset revenue losses with other taxes, cut spending, or accept a wider deficit.

BOX 1
The Substitution Effect

Broadly speaking, it can be said that the reduction of tariffs on imports from a particular country (the result, for example, of a trade agreement) has two effects: trade creation and trade diversion.

Trade is created in the sense that, because of the tariff preference, goods of a lower relative cost from the trade partner with which an agreement is concluded displace goods of a higher relative cost produced within the country itself. Trade is diverted in the sense that goods of a higher relative cost from the trade partner with which an agreement is concluded displace goods of a lower relative cost from third countries that do not enjoy tariff preferences.

The impact of trade diversion on tax revenue is negative because purchases from trade partners for which the tariff has been lowered displace taxed imports from third countries.

The scale of the diversion will depend on: i) the extent of the fall in relative prices prompted by the tariff reduction; and ii) the elasticity of substitution of the goods imported from partner countries, relative to the rest of the world. The elasticity of substitution measures the relative reaction of the relationship between imports from two countries, A and B, in a context of percentage changes in the relative prices of the imports.

If M_A and M_B are the imports from A and B, respectively, and P_A and P_B are the prices of those imports, then the elasticity of substitution is^a:

$$\epsilon_S = \left[\lambda(M_A / M_B) / (M_A / M_B) \right] / \left[\lambda(P_A / P_B) / (P_A / P_B) \right].$$

The elasticity of substitution is an empirical matter and thus quantification of the effect demands a more specific analysis of each market. As a general criterion, however, and given most countries' low share of extra-FTAA imports, it is not tendentious to aver that the revenue losses arising from this effect will be minor.

^a Hicks introduced the concept of elasticity of substitution in 1932 in order to measure the relative reaction of the capital-labor ratio in the context of percentage changes in the marginal rate of technical substitution of capital for labor

5.2 Trade liberalization or marginal tariff reduction

From the perspective of fiscal effects, it is helpful to distinguish between two kinds of tariff adjustment that have been experienced and are being experienced in the region. They depend on the scale of the change in the trade openness of the country in question.

One case, trade liberalization, is that of a quite closed economy with a high level of tariff and non-tariff protection, which decides to remove many of its trade barriers. This is a discrete substantive change, and thus estimates of elasticities using historical data are of little use in calculating income, among other things because of the significant change in the level and composition of imports. In this context, a simplistic calculation might be highly distorted because many tariff rates are redundant at the outset ("water" – redundant protection – in the tariffs). The other case is the marginal reduction in rates or the conclusion of trade agreements with partners that are not important to the country's trade. In this case, the reduction effect is less through rate level or import coverage; its fiscal impact therefore tends to be negative and generally easier to estimate.

Chile reduced tariffs in the mid-1970s, as table 4 shows, and there were practically no fiscal effects. Only when the rates were harmonized at around 15%-20% (lowering nominal protection) did successive reductions begin to cause significant revenue losses.

TABLE 4
CHILE: TARIFF RATES AND TAXES ON EXTERNAL TRADE

Years	Nominal Tariff Rate % (a)	Taxes on External Trade	
		% of imports	% of GDP
1975	49.0	13.9	2.9
1980	10.0	7.5	1.4
1985	26.0	17.1	3.2
1990	15.0	9.0	2.2
1995	11.0	7.6	1.9
2000	9.0	5.5	1.4
2001	8.0	4.5	1.2

(a) Note that non-tariff barriers as well as tariffs were lowered.

Source: Vial, Joaquín⁴.

Currently, and almost without exception, the countries of the region do **not** have tariff structures of such a scale that they could be classified as redundant protection. In general the economies are fairly open to foreign trade and feature very few non-tariff barriers, and the tariffs have almost no “water”.

In recent decades, almost the entire region has moved towards lower protection levels, reducing tariffs, lowering non-tariff barriers and eliminating “water” from the tariffs. This suggests that the fiscal effects of trade agreements will be a net loss in revenue. In most of the Caribbean countries, where some tariffs remain high, their main purpose is to generate revenue, not to protect domestic production.

Nonetheless, and as mentioned earlier with regard to the five effects, the impact is hard to estimate accurately because it will depend on different and complex economic reactions. While it is difficult to generalize, the demand for final consumer goods is more elastic than that for intermediate goods and raw materials. In developing countries, imports of final goods are less important than raw materials and capital goods, but they habitually face higher tariffs. The elimination of such higher tariffs on consumer goods can lead to significant revenue losses, but these can be partially offset by the increase in imported volumes, which entails higher revenue from domestic taxes because of the high elasticity.

5.3 Tariff exemptions and tax evasion

It should also be recalled that when the tariff structure changes, its design has a constraining determinant, as with any other tax: the capacity to administer it. This has been shown empirically in studies, such as that by Pritchett and Sethi⁵, which reveal the non-linear link between legal tariffs and those actually levied. The argument is that the

⁴ Vial, J. “Efectos Fiscales de la Política Exterior”, in Valencia, A., A. Barreix and L. Villela (eds.), *Fiscal Impact in the Economic Integration*. General Secretariat of the Andean Community-Inter-American Development Bank. 2003.

[Http://www.iadb.org/intal/publicaciones/ImpactoFiscalCAN-BID.pdf](http://www.iadb.org/intal/publicaciones/ImpactoFiscalCAN-BID.pdf)

⁵ Pritchett, L. and G. Sethi. “Tariff Rates, Tariff Revenue, and Tariff Reform: Some New Facts”, *World Bank Economic Review*, Vol. 8. 1994.

higher the tariff, the greater the incentive to seek an exemption. Thus income does not rise in line with tariff increases, just as reducing high tariffs does not lead to a proportional decline in income. When the tariff is high, moreover, there is an incentive to classify imported goods as lower-tariff or exempt products, or to engage in smuggling, which also entails a decline in internal taxes.

5.4 Estimate of the direct loss of tariff revenue caused by trade agreements

Table 5 presents an estimate of the loss of import tariff revenue, for the countries of LAC and as an average of the period 1999 and 2000, under three integration scenarios: (a) establishment of the FTAA; (b) full trade integration with the United States; and (c) Andean Community-MERCOSUR integration. All three scenarios assume a zero tariff in transactions between the parties to the agreement, so as to discern the scale of the final impact of the tariff-reduction process.

The tariff rates and imports considered in the estimates of revenue losses were taken from the Inter-American Development Bank's Free Trade Area of the Americas Hemispheric Database. It should be noted that the imports and their corresponding tariffs were considered item-by-item – that is, at the highest level of disaggregation of the tariff nomenclature.

In all cases, account was taken of the trade agreements in force. These apply tariffs that differ from those prevailing for other countries with which there is no agreement.

The tariff revenue losses estimated in the table stem solely from the first, direct effect of eliminating tariffs that were previously positive, assuming that the level of imports prior to the elimination remains constant. Hence this is a static comparison.

The lost revenue is expressed as a percentage of each country's tax income and GDP. To assess the scale of the loss, the table also shows the total tax burden relative to GDP. For the same percentage loss in tax income, the implications differ according to whether a country has a high or low level of taxation.

Under the FTAA scenario, the Caribbean and Central America experience the most significant fall in tariff revenue, and the decline in the Andean Community is also substantial. As a percentage of GDP, the decline is 2.7% for the Caribbean, 1.2% for Central America, and 0.8% for the Andean Community.

The results are quite widely dispersed among the Caribbean countries. The 2.7% average masks much higher losses in some countries: the Bahamas, 6.7%; Belize, 4.8%; and Suriname, 3.9%. There is less dispersion in Central America, and less still in the Andean Community.⁶ Apart from the three Caribbean countries indicated, which lose more than

⁶ The variation coefficients are: Caribbean, 0.77; Central America, 0.41; and Andean Community 0.23. The variation coefficient relates the mean with the standard deviation. The appeal of interpreting it is that it can be shown, for example, that the dispersion of losses for the Andean Community countries is only 23% of the bloc's mean loss.

an eighth of total income, the Dominican Republic loses 2.8%, and Jamaica, Guyana and Barbados lose income equivalent to about 1.5% of GDP. The Central American countries are next, especially Honduras⁷, Nicaragua, Panama and Guatemala, whose public revenue falls by almost 10%, or about 1% of GDP. To conclude, *a priori* the problem of tariff revenue losses occasioned by hemispheric trade integration is concentrated in the Caribbean and Central America.⁸

It is striking that MERCOSUR's loss of income is very low. There could be two reasons for this. First, in these economies external trade accounts for a relatively small share of national output, but they have undertaken a profound economic and financial opening. Second, their external trade structure is that of a mature subregional integration process that, in a decade, has seen intra-bloc trade increase three-fold. They also trade relatively more with extra-hemispheric partners, especially the European Union (EU). The level of MERCOSUR's trade with the EU is similar to that with the countries of North America.

In a very few cases there is a significant difference between the fiscal impact of the FTAA and full trade integration with the United States, since for most countries the United States is the leading source of imports (as evidenced by the relatively low level of trade among the subregions). The chief exceptions are Nicaragua and Guatemala in Central America, and Peru, Ecuador and Bolivia in the Andean Community.

From the fiscal perspective, full trade liberalization between the countries of MERCOSUR and the Andean Community would have little significant impact for either bloc, since in no case does the direct loss of public revenue exceed 1.5% of the total.

The last three columns of the table show:

- i) the simple average tariff: the sum of the tariffs of each tariff item divided by the number of items;
- ii) the weighted average tariff: the sum of the tariffs of each tariff item that is actually imported multiplied by the item's share in total imports;
- iii) the implicit tariff: import tariff revenue divided by total imports.

⁷ Honduras will lose 1.9% of the GDP assuming that its GDP is not undervalued.

⁸ It should be noted that the various countries of Central America and the Caribbean will have to redesign their income tax. The Uruguay Round agreements, reaffirmed in the Doha meeting, call for the elimination of differentials in the tax on business earnings (TBI) in dynamic industrial export processing zones (EPZ) as of 2008, except in those countries whose per capita income is below US\$ 1,000. Thus several countries of the region will have to devise a strategy to reconcile two goals: one is to continue to attract investment in the EPZ, which calls for attractive TBI rates; and the other is to preserve TBI collection since companies outside the EPZs will face lower rates because of the unification of the TBI regime (Agosin, M. and R. Machado. "Opciones a la eliminación de las exoneraciones al impuesto a la renta corporativa en Zonas Francas", (mimeo). Presented at the Seminar IDB-Foreign Trade Ministry. San Jose, Costa Rica. November, 2001). This is crucial because many of these special tax regimes for investment, especially FDI, emerged from preferential trade regimes established by developing countries to which the exports were sent, such as quotas, special bilateral arrangements and so on.

TABLE 5
ESTIMATE OF THE LOSS OF IMPORT TARIFF REVENUE UNDER DIFFERENT
INTEGRATION SCENARIOS

As % of tax revenue and % of total revenue
Average, 1999-2000

	FTAA			USA		And. Com/Merc.		Tariffs		
	Tax Revenue/GDP	% Tax Revenue	% GDP	% Tax Revenue	% GDP	% Tax Revenue	% GDP	Simple Average	Weighted Average	Implicit
MERCOSUR										
Argentina	18.1	1.1	0.2	0.9	0.2	0.0	0.0	13.4	10.6	8.2
Brazil	27.1	1.0	0.3	0.8	0.2	0.0	0.0	13.9	9.4	7.9
Paraguay	10.0	4.0	0.4	3.9	0.4	0.2	0.0	11.0	5.0	4.7
Uruguay	15.4	1.4	0.2	1.0	0.2	0.1	0.0	12.3	5.9	5.3
Chile	17.6	3.1	0.5	2.1	0.4			8.0	5.7	5.8
Mexico	15.3	2.1	0.3	0.0	0.0			16.4	6.4	1.9
Andean Community										
Bolivia	13.3	5.5	0.7	3.0	0.4	0.8	0.1	9.8	5.3	6.2
Colombia	13.3	5.0	0.7	3.7	0.5	0.6	0.1	11.6	8.5	8.0
Ecuador	11.7	9.7	1.1	5.3	0.6	1.5	0.2	11.3	6.7	8.6
Peru	12.0	7.4	0.9	3.5	0.4	1.4	0.2	13.5	11.8	10.9
Venezuela	8.5	8.4	0.7	5.7	0.5	1.2	0.1	12.2	11.7	9.2
Central America										
Costa Rica	12.6	6.5	0.8	5.5	0.7			6.0	3.3	2.7
El Salvador	10.7	7.6	0.8	7.1	0.8			7.0	4.6	3.2
Guatemala	10.0	9.2	0.9	4.4	0.4			6.9	4.8	5.2
Honduras	16.7	11.5	1.9	7.5	1.3			6.5	5.0	5.3
Nicaragua	14.5	6.8	1.0	2.4	0.3			5.1	5.0	2.8
Panama	9.8	9.6	0.9	7.1	0.7			8.9	6.8	2.7
Caribbean										
Jamaica	26.6	6.4	1.7	5.2	1.4			8.4	8.9	7.4
Trinidad & Tobago	16.4	5.3	0.9	3.6	0.6			9.2	5.0	3.9
Dominican Rep.	14.6	19.3	2.8	13.9	2.0			17.8	15.5	8.6
Haiti	8.7	5.5	0.5	5.5	0.5			6.6	3.2	2.8
Belize	19.4	24.9	4.8	18.2	3.5			11.4	10.9	11.8
Guyana	29.9	4.9	1.5	3.7	1.1			12.0	5.1	3.8
Suriname	27.0	14.4	3.9	14.4	3.9			13.4	13.5	8.4
Bahamas	17.6	38.0	6.7	26.4	4.6			30.9	28.3	27.2
Barbados	30.9	4.4	1.4	3.5	1.1			14.6	14.5	5.9

Source: Database. Integration and Regional Programs Department. IDB.

The implicit tariff is generally lower than the weighted average tariff because some imports (although they appear as taxed on the tariff schedule) are in fact discretionally exempt as part of regional and/or sectoral incentives.

Since the loss of tariff revenue is calculated on the basis of the tariffs prevailing before these discretionary exemptions applied (the exempted tariff items are unidentified), if the exemptions are significant the revenue loss will have been overestimated here. This is the

case for Mexico, for Nicaragua and Panama in Central America, and for the Dominican Republic, Suriname and Barbados in the Caribbean.

VI. FISCAL CHALLENGES

Irrespective of the challenges posed by trade liberalization, treasuries in LAC are currently facing a critical situation. Hence integration adds to the demands made on the traditional functions of fiscal policy, and especially tax policy. Tax policy must meet the sufficiency criteria to: (i) finance traditional spending and investment, be they in social areas or infrastructure; (ii) finance temporary spending, such as stabilization of the economic cycle or crises in the external sector; (iii) finance contingencies, such as financial-exchange rate crises; and additionally (iv) tackle the fiscal impact of trade liberalization and integration. One function is permanent: replacing tariff revenue; the other is temporary: compensating “losers” among the sectors and regions that are currently protected. To address these challenges in the most effective way, the tax authorities must institute a new instrument: a minimum coordination of national tax policy and administration by means of international cooperation.

6.1 Fiscal sustainability and equity in replacing tariff income

Fiscal sustainability is a central pillar of economic stability and development, and LAC has not been noted for exercising it. During the last five years, in fact, no country in the region has had a fiscal surplus. Debt indicators, as well as the ratio of the decline in tariff revenue to public investment, suggest that the fiscal cost of integration is substantial even for countries in which the loss is low in terms of GDP and total revenue. This is the case for MERCOSUR, for example, where the fiscal situation – in terms of debt stock and the fiscal result – is highly compromised. Thus the cost of integration should be assessed in light of relative fiscal sustainability, and not solely in terms of the absolute loss of revenue.

The literature has suggested two ways of measuring sustainability in practice: tests and indicators related to economic growth, and trends in the fiscal result and public indebtedness. Tests seek to determine whether solvency prevailed in previous budgets, and on that basis to infer results. By definition, the main limitation in these tests is that while past performance serves as a guide it does not guarantee that such performance will persist in the future. Most of the indicators proposed seek to determine if fiscal policy helps stabilize the debt-GDP ratio. These indicators are estimated by forecasting government income and spending in line with current fiscal policy.⁹

⁹ In general terms, macroeconomic stability is ensured by means of another key factor, the sustainability of the current account. This is determined by the solvency of the current account, meaning a balance that is consistent with a stable debt-GDP ratio (see Edwards, S. “Debt relief and fiscal sustainability”. *NBER Working Paper* 8939. 2002).

The purpose of this study is to analyze the fiscal cost of integration, not fiscal sustainability in LAC, but two conclusions can be drawn: first, fiscal sustainability in LAC is a cause for concern; and second, consequently, the permanent loss of income must be replaced by real and lasting resources.

As regards the substitution of resources, Chile's two successful tariff reductions in the 1990s are enlightening, because in both cases the loss of revenue from import tariffs was offset by increases in other taxes. In the 1991 tariff reduction, which cut the tariff level from 15% to 11% (preserving the prior exemptions), an extension of the stamp duty base was combined with the introduction of external debt swaps (which had a quasi-fiscal effect on the balance of the Central Bank) and an increase in the fuels tax. In the staggered tariff reduction of one point a year to 6% in 2003 (which was approved in 1998), there was a wider range of compensation. This included a rise in the tobacco tax, a staggered increase in the gasoline tax, increases in the rate of the stamp duty on financial transactions, the elimination or reduction of the simplified drawback of tariffs paid by exporters, and the elimination of exemptions for deferred payments of import tariffs on capital goods. While the taxes involved are not normally efficient, in both cases the compensation of fiscal revenue was total.¹⁰

Finally, the substitution of tariffs by other kinds of tax will affect post-tax income distribution. This is important for the legitimacy of the adjustments and of integration itself, since LAC has the world's most unequal pattern of income distribution.¹¹ Moreover, recent studies confirm that income distribution is most inequitable after taxes.¹² Admittedly, the most effective means of bringing about greater equity in income distribution is a fiscal combination of taxes and public spending, rather than taxes alone. Nonetheless, tax should not increase regressivity, and making it at least neutral is a reasonable goal. Hence Section 7 of this study (Tariff Substitution Options) proposes a series of short- and long-term measures, including a balanced package of direct and indirect taxation.

¹⁰ An argument often used by the political opposition to the Chilean governments that made these tariff reductions was that the rise in other taxes was unnecessary because economic growth (about 6% on average in this period) was enough to generate additional compensating income. The authorities of the day rejected this argument on the grounds that growth, as well as increasing income, would also exert pressure for higher real public sector wages and a growing demand for public goods in terms of both coverage and quality. Consequently, the net effect of growth on public finances is very difficult to assess *ex-ante*. Hence permanent revenue losses must be offset by permanent increases in other sources or permanent reductions in certain expenditures.

¹¹ It should be noted that the concentration of income distribution varies significantly by region in LAC (it is more equitable in the Caribbean, for example) and by country.

¹² For instance, Gómez Sabaini, J.C., J. Santieri and D. Rossignolo. "La equidad distributiva y el sistema tributario: un análisis para el caso argentino", *Serie Gestión Pública* N° 20. ILPES/ECLAC, Santiago. 2002; Roca, J. and H. Vallarino. "Incidencia Distributiva del Sistema Tributario en Ecuador", (mimeo). USAID. June, 2003; Gomez Sabaini, J. C. "Política Tributaria para el Desarrollo Humano en Centroamérica: Capítulo Nicaragua", (mimeo) and "Política Tributaria para el Desarrollo Humano en Centroamérica: Capítulo Honduras", (mimeo). Inter-American Development Bank. October, 2002; and FUSADES. "Política Tributaria para el Desarrollo Humano en Centroamérica: Capítulo El Salvador" (mimeo). Inter-American Development Bank. July, 2003.

6.2 “Compensation” and the “losers” in a process of greater trade opening

While trade opening yields significant economic benefits over the long term, the timing and scale of the impact on the existing productive structure could cause losses and transitional costs that endanger the political viability of the reforms. To ensure that they are implemented correctly, therefore, and to attenuate the social costs, there is a need for (sectoral and regional) support and reconversion programs based on objective economic criteria. These represent an additional cost for public finances. These “compensations” to reconvert the losers, and the “facilitation” of assistance and infrastructure to support the new opportunities conferred by expanded trade, are eminently fiscal.

Finally, these temporary reconversion and assistance programs might be needed to guarantee that the transition to free trade is successful. Above all, they should be designed in such a way as to allow market forces to help the resources in the economy to be devoted to activities that are conducive to higher growth and long-term job-creation. Since national treasuries in LAC are compromised (see table 6), the international community can act as a catalyst.

6.3 The need for minimum coordination among the members

The European Union (EU) is a successful example of cooperation. It is the only integration process that has made substantial progress on fiscal coordination, albeit only partially in the tax field.

In meeting deep integration objectives there are three basic lessons to be drawn from the EU experience of tax. The first, is to harmonize indirect taxes because they impact squarely on trade, in line with the principles of non-discrimination between domestic production and imports, and transparency that reduces discretionary power of national authorities strengthening investors’ property rights. This requires the prior harmonization of tax bases and procedures, as well as the equalization of rates, which can vary within a certain range.

The second is to establish an institutional apparatus for settling disputes and to set up cooperation mechanisms, mainly information exchange so as to combat evasion and ensure that the income derived from intra-bloc operations is fairly divided.¹

¹ The European Union (EU) has a unique institutional system. The member states agree to cede some sovereignty to supranational institutions that represent community interests. Legislative functions are shared by the Council of the EU, which is the main decision-making institution and consists of the ministers with the various portfolios, and the European Parliament, elected every five years by direct universal suffrage. These two institutions approve European laws in the form of directives, regulations, and decisions (Nicoll, W. and T. Salmon. *Understanding the European Union*. Londres: Longman. 2001). The European Court of Justice is the supranational judicial institution. Its mission is to guarantee compliance with the law, and enforcement of the founding treaties and decisions taken by the competent institutions. For more on this issue see Barreix, A. and L. Villela. “Tax Policy Changes related to Regional Integration”. Presented at the 2^a Reunión Plenaria de la Federación Interparlamentaria de las Américas, Panama. 2003b. [Http://www.dgroups.org/groups/fipa/public/docs/Working_document_1_Group_I_ENGLISH.pdf](http://www.dgroups.org/groups/fipa/public/docs/Working_document_1_Group_I_ENGLISH.pdf)

TABLE 6
FISCAL PROBLEM - SCENARIO: FTA
 Loss of Tariff Revenue (LTR) as a Percentage of GDP, Tax Revenue,
 Central Government Spending, Public Investment and Interest Payments

	LTR as % of GDP	LTR as % of Tax Revenue	LTR as % of Central Gov. Spending	LTR as % of Public Investment	LTR as % of Interest Payments	Interest Payments/ GDP	DEBT/GDP
MERCOSUR							
Argentina	0.2	1.1	1.2	10.3	4.6	4.36	125.5
Brazil	0.3	1.0	1.1	14.4	7.1	3.74	55.9
Paraguay	0.4	4.0	1.7	12.0	33.7	1.20	49.0
Uruguay	0.2	1.4	0.9	16.9	9.4	2.31	79.8
Chile	0.5	3.1	2.4	13.7	111.7	0.48	38.5
Mexico	0.3	2.1	1.7	13.3	14.2	2.27	39.3
Andean Community							
Bolivia	0.7	5.5	2.9	11.3	38.2	1.90	83.7
Colombia	0.7	5.0	3.5	17.6	21.4	3.12	58.4
Ecuador	1.1	9.7	4.8	20.6	18.9	6.00	79.0
Peru	0.9	7.4	5.0	33.1	40.9	2.16	45.8
Venezuela	0.7	8.4	3.6	15.8	26.9	2.65	29.0
Central America							
Costa Rica	0.8	6.5	5.5	37.9	21.8	3.78	56.9
El Salvador	0.8	7.6	5.8	76.0	124.3	0.65	45.1
Guatemala	0.9	9.2	7.2	41.7	76.5	1.20	23.6
Honduras	1.9	11.5	7.4	34.2	1978.7	0.10	78.8
Nicaragua	1.0	8.7	2.8	5.8	30.9	1.95	215.3
Panama	0.9	9.6	4.1	42.6	19.4	4.82	95.0
Caribbean							
Jamaica	1.7	6.4	4.5	35.8	12.4	13.81	132.7
Trinidad and Tobago	0.9	5.3	3.4	28.2	16.2	5.40	63.6
Dominican Rep.	2.8	19.3	18.2	70.3	400.1	0.71	47.0
Haiti	0.5	5.5	4.3	21.3	55.9	0.86	43.0
Belize	4.8	24.9	14.4	32.2	206.0	2.34	85.0
Guyana	1.5	4.9	3.1	11.9	16.8	8.80	171.0
Suriname	3.9	14.4	10.5	155.0	250.0	1.55	54.1
Bahamas	6.7	38.0	35.3	335.9	341.4	1.96	45.4
Barbados	1.4	4.4	4.0	27.4	32.6	4.20	60.6

Source: Database. Integration and Regional Programs Department, IDB and IMF Country Report and Statistical Annexes (various issues).

Finally, there is a need for a compensation system; this could cover sectors and regions in the various countries. There are two reasons for the fiscal compensation. The first is temporary compensation for the less developed regions that are affected by closer integration and trade liberalization. The second is based on the use of a system of fiscal transfers so as to compensate for asymmetries in the overall negotiations, such as excluded sectors or special treatment, as with the common agricultural policy. Income from the common external tariff (CET) and a percentage of national VAT is used to finance these activities.²

² Since the founding of the European Coal and Steel Community in 1951 there have been common sources of financing, which in this case were levies based on coal and steel production. The same was true for the

The EU sought to create a common market after having made substantial progress in the area of macroeconomic coordination, which gave rise to a single currency, as well as in areas such as regulation and social policies. It should also be acknowledged that in the field of external trade, the EU has protected strategic productive sectors, mostly primary products, by means of tariff quotas, production subsidies and, in some cases, export subsidies.

VII. TARIFF SUBSTITUTION OPTIONS

Once possible losses from fiscal income have been estimated, the authorities must decide on the direction of fiscal policy: to offset the revenue loss, reduce spending, or accept a deficit by increasing public indebtedness. The various options will be different for each country, according to the amount of compensation needed, the characteristics of each economy, the current (and politically feasible) structure of internal taxes, and the capacity of the tax administration. The higher deficit alternative is increasingly limited in LAC, where average indebtedness levels are already high (see table 6). Cutting spending is only viable in conjunction with a much greater effort to increase public sector productivity, given the immense social needs and the demand for public goods in the form of infrastructure. Offsetting the losses by raising other taxes demands a country-by-country analysis of the tax strategy to be followed.

The following are simply some general guidelines, with particular attention to those countries deemed to be the most vulnerable in the FTAA's trade liberalization process. The first two sections concern immediate effects; the following three assume a substantial medium-term effort; and the last one is temporary. In principle, and in view of the urgency, it seems reasonable that tariff substitution be based on a higher burden of indirect taxes (VAT and excise taxes), as discussed in the following two sections. For the purposes of the fiscal sustainability and legitimacy of the integration process, however, it is important that there be an effective increase in direct tax revenue. Moreover, the improved performance of income and real estate taxes over the medium and long term will improve the horizontal and vertical equity of the system (sections 7.3-7.5). Finally, and for all the reasons given plus the greater second-best efficiency, fiscal compensation born of exceptions in the trade agreement is also important.

European Economic Community and then the EU. Initially, national contributions were set as a percentage of the member states' budget spending. In 1970, this system was replaced by another, whereby contributions came from levies on agriculture, taxes on sugar production, customs duties received at the Community's external borders and 1% of the VAT base collected by each member. In 1985, the Community's budget needs gave rise to an increase in the VAT contribution from 1.0% to 1.4%. This led in 1988 to the creation of a complementary system based on the members' GNP. Thereafter the VAT contribution fell to 1% in 1999, and it was agreed that supplementary financing was needed to guarantee a balanced budget grounded in the GNP-based contribution, confined to 1.27% of each country's GNP. It is important to note that the VAT contribution and the complementary GNP contribution finance more than 80% of EU expenditures.

7.1 The semantic correction: tariffs disguised as excise taxes

It is true that high customs tariffs were a feature of the import-substitution policy implemented by many countries, including the United States in the nineteenth century and LAC between the 1930s and the 1980s. The aim was to protect infant industries and allow them to consolidate before they faced international competition.

Some LAC countries never pursued that goal, especially small countries with limited capacity to develop competitive industries, and for which tariffs were essentially a convenient and simple form of tax collection. In the region's small and open economies, such as several in the Caribbean, the greater share of internal taxes (like VAT and excise taxes) are collected in customs during the import process. For many of them, therefore, customs remains the natural place to collect tax, and the tariff is the most convenient and most used device. If there is no need to protect a domestic productive sector, however, the term "tariff" is purely semantic. Much of the revenue collected as an import tariff could continue to be collected in the same customs as, for example, an excise tax. This is clearly the case for the small economies that do not produce fuels, vehicles and cigarettes, but that impose high taxes on imports of those goods. A simple change of nomenclature would allow the same amounts to continue to be collected in the same customs, but as excise taxes.

To a large extent this is what has happened in Cyprus in the many years it has been preparing to accede to the EU. Cyprus took the opportunity to embark on a wide-ranging tax reform, introduce VAT and impose excise taxes on a range of products that previously bore high tariffs. Cyprus, a small island country and one heavily dependent on its trade with and tourism from Europe, serves as an example for the LAC economies.³

There follows a simple attempt to facilitate analysis of this option, whereby the loss of tariff income is (at least partly) offset by excise taxes.

The prospect of this will essentially depend on the initial (pre-liberalization) scale of tariffs and excise taxes. A country could be in one of the following quadrants of table 7:

- (1) high tariffs, high excise taxes;
- (2) high tariffs, low excise taxes;
- (3) low tariffs, low excise taxes; and
- (4) low tariffs, high excise taxes.

In quadrant 1, the viability of the strategy is minimal because the severe loss of tariff revenue expected could not be offset by already high excise taxes.

A country in quadrant 3, by contrast, could replace tariffs by augmenting excise taxes, and there is even a possibility of an increase in revenue that would more than compensate for the loss of tariffs.

³ On this matter see Jenkins, G. and G. Kuo for Belize. "Tax Reform for Human Development in Central America: Chapter Belize", (mimeo). Inter-American Development Bank. August, 2002.

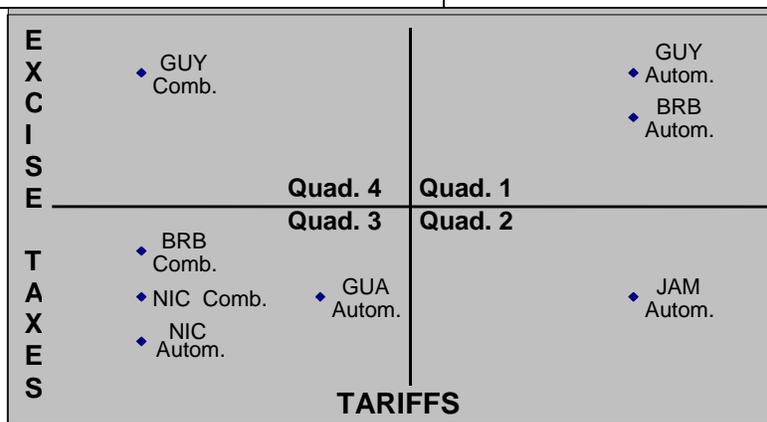
In quadrant 2, the limited significance of excise taxes would allow a country to increase them so as to offset at least the relevant tariff losses.

By way of example, and keeping in mind the limitations of the available information, some countries were subject to the preceding analysis – Guyana, Barbados, Nicaragua and Guatemala – in the fuels and vehicles sectors (considered separately), which habitually feature excise taxes.

Table 7 presents the information used to locate each country in the corresponding quadrant of the diagram.

**TABLE 7
EXCISE TAXES IN SELECTED LAC COUNTRIES**

	Share of fuels in total imports	Share of fuels in total tariff revenue	Average tariff on fuels	Excise taxes on fuels	Share of motor vehicles in total imports	Share of motor vehicles in total tariff revenue	Average tariff on motor vehicles	Excise taxes on motor vehicles
Jamaica					5.5%	21.5%	34.6%	No
Guyana	1.2%	1.1%	4.7%	50% on CIF + tariff	2.7%	23.5%	44.5%	Purchase tax: 10%, 30%, 70% or 100% according to CC plus consumption tax: between 0% and 30%
Barbados	4.9%	3.0%	8.8%	For imported fuels: from 0% to 26% on CIF + duties. VAT levied.	5.1%	15.5%	44.5%	Between 46.95% and 93.73% according to CC
Nicaragua	13.1%	8.3%	0.0%	Nafta Súper: 30%, Nafta Regular: 31%, Diesel: 25.5%	3.9%	7.8%	9.9%	35.0%
Guatemala					7.3%	16.9%	11.2%	No



Consistent with what was said earlier, in the vehicles sector Guyana and Barbados would face severe obstacles to replacing tariffs with excise taxes. By contrast, with this strategy Nicaragua (in fuels and vehicles), Guatemala (in vehicles) and Barbados (in fuels) could more than compensate for the loss of import tariffs. Guyana (in fuels) and Jamaica (in vehicles) would have some maneuvering room.

7.2 VAT: the strongest candidate

Most theoretical studies and practical experience concur that introducing or increasing VAT, either by raising the rate or expanding the base, may be the most efficient way of offsetting tariff revenue losses. In his 1985 study, Avinash Dixit⁴ established that the optimal way for a small and open economy to collect revenue and maximize its welfare is to reduce tariffs to zero and depend wholly on destination-based consumption taxes (taxing imports and exempting exports). In a more recent study, Keen and Ligthart⁵ advance an elegant theory on coordination between the reduction in tariffs and domestic tax reform. They show that in small “normal” economies, any tariff reduction that boosts productive efficiency, in conjunction with a reform of consumption tax that keeps consumer prices unchanged, will trigger an increase in both welfare and public income. These conclusions offer support to strategies of upgrading (or introducing) VAT in combination with tariff reform. To a large extent this happened in Chile and Cyprus, the former raising proportional rates and the latter introducing VAT as part of processes of trade liberalization and economic integration.

Table 8 presents the countries most vulnerable to the elimination of customs tariffs in hemispheric trade as a result of the FTAA.

TABLE 8
ESTIMATE OF POTENTIAL LOSSES WITH TRADE LIBERALIZATION IN THE FTAA

Countries	% GDP	% of income	% of public investment
Bahamas	6.7	38.0	335.9
Belize	4.8	24.9	32.2
Suriname	3.9	14.4	155.0
Dominican Rep.	2.8	19.3	70.3
Honduras	1.9	11.5	34.2
Panama	0.9	9.6	42.6
Guatemala	0.9	9.2	41.7
Ecuador	1.1	9.7	20.6
Venezuela	0.7	8.4	15.8
Peru	0.9	7.4	33.1

Source: Database. Integration and Regional Programs Department. IDB.

⁴ Dixit, A. “Tax Policy in Open Economies”, in A. J. Auerbach and M. Feldstein (eds.), *Handbook of Public Economics*. North Holland. 1985.

⁵ Keen M. and J. Ligthart. “Coordinating Tariff Reduction and Domestic Tax Policy”, *IMF Working Paper* 99/93. July, 1999.

Three of the most vulnerable countries – the Bahamas, Belize and Suriname – do not have VAT but partial forms of domestic consumption tax. The introduction of VAT alone is not the solution for these three countries, but it is hard to imagine some way of offsetting the estimated potential losses that does not include VAT as part of a reform package. Other measures to increase income from excise taxes (Belize) and income tax (the Bahamas) will also be needed. Note that in Suriname and the Bahamas, the potential losses would eliminate any chance of public investment, and that even then the deficit would widen.

In the Dominican Republic, the need to raise domestic tax revenue should lead to a slight rise in the proportional rate of VAT and, mainly, an increase in its productivity (which is very low). Ecuador, with the same proportional rate of 12% as the Dominican Republic, has a productivity of 54% of GDP (see table 9), as against less than 30% in the latter country. To this end the VAT base should be expanded and the tax administration should be strengthened.

Table 9 also shows that the VAT rate is very low in Panama and that an increase in it, negotiated as part of a concomitant package of tariff reform, could yield good results.

Honduras is a different matter. It introduced VAT and the tax is very productive (50%) at a rate of 12%. Assuming that GDP is not underestimated, the maneuvering room to raise VAT is clearly limited to no more than one or two percentage points, and even then it will be difficult to secure approval. Revenue collection by means of excise taxes is already reasonable. Hence the way to cover the potential fiscal gap caused by the FTAA will be to increase direct tax (on income and property), which is still low, or substantially improving its administration.

In Guatemala, the same VAT rate of 12% yields a lower percentage of income relative to GDP than in Honduras, which suggests that measures to expand the tax base and strengthen the tax administration are needed. Direct tax is very low here too, and should be improved.

In the Andean countries, VAT performs very differently. Ecuador has the best VAT productivity, which suggests that its only option is a small rise in the rate, despite the fact that past experiences indicate this will be politically hard to do (table 9). It should be part of a package, so that the population is fully aware that there will be an attendant reduction in tariffs. Moreover, Ecuador should increase excise taxes, which now account for 0.66% of GDP (table 3). This is less than half the Andean Community average and a third of the LAC average. Peru and Venezuela should clearly improve (and very much so in Venezuela's case) the productivity of their VAT. Peru has a rate of 18% and collects almost the same as Ecuador, whose rate is 12%. Venezuela is in the worst situation. Its excise taxes are poorly collected and its collection of direct tax is even worse.

TABLE 9
TAX INDICATORS
(In percentages)

	Direct taxes/ Indirect taxes	VAT revenue/ Total income, Average, 00-01	VAT rates	VAT Productivity ^a	Income tax revenue /Total tax income Average, 00-01	Corp. income Tax/Total income Tax ^b	Business income tax rates	Personal income tax rates
MERCOSUR	36.2							
Argentina	45.0	30.8	21	31.9	22.2	61.1	35	9 to 35
Brazil	34.4	n/c	n/c	n/c	26.4	27.3	34	15 to 27.5
Paraguay	24.8	25.9	10	42.8	17.1	100.0	30	n/c
Uruguay	31.8	28.8	23	35.7	13.9	100.0	35	n/c
Chile	47.7	36.2	18	44.4	24.8	56.1	15	5 to 45
Mexico	59.5	22.2	15	22.7	34.1	s/d	35	3 to 40
Andean Community	50.3							
Bolivia	31.9	22.2	14.92	37.2	19.0	81.6	25	12.5 to 25
Colombia	77.3	37.0	16	31.9	36.0	95.0	35	0 to 35
Ecuador	26.7	56.0	12	54.5	19.0	72.6	25	5 to 25
Peru	30.6	42.7	18	35.0	23.4	49.8	20	0 to 30
Venezuela	30.2	20.5	14.50	24.5	20.9	n.a	15 to 67.7	6 to 34
Central America	35.4							
Costa Rica	34.1	35.8	13	34.2	22.9	n.a	10 to 30	10 to 25
El Salvador	42.5	47.6	13	41.6	29.8	61.5	25	10 to 30
Guatemala	30.2	38.8	12	34.6	23.1	n.a	31	15 to 31
Honduras	28.8	32.0	12	50.0	20.6	18.2	15 and 25	10 to 25
Nicaragua	31.5	34.2	15	39.2	1.90	n.a	25	10 to 25
Panama	97.2	8.0	5	32.0	43.2	42.2	30	2.5 to 30
Caribbean	50.2							
Jamaica	68.4	22.4	15	43.9	40.6	51.0	7.5 to 33.33	25
Trinidad and Tobago	90.7	15.6	15	26.7	47.0	n.a	15 to 50	25 and 35
Dominican Rep.	39.8	21.7	12	29.4	26.6	n.a	25	15 to 25
Haiti	20.8	29.2	10	22.5	17.2	48.7	10 to 35	10 to 30
Belize	34.7	n/c	n/c	n/c	25.3	s/d	25	25
Guyana	88.1	n/c	n/c	n/c	44.1	50.3	35 and 45	20 and 33
Suriname	99.3	n/c	n/c	n/c	42.3	68.0	38	10 to 40
Bahamas	14.3	n/c	n/c	n/c	n/c	n/c	n/c	n/c
Barbados	73.6	28.9	15	63.8	36.6	41.9	5 to 40	25 and 40

a. Productivity is the quotient between VAT revenue over GDP divided by the general rate of the tax; b. Total income tax is the addition of corporate income tax and personal income tax. Source: Database. Integration and Regional Programs Department. IDB.

7.3 In search of lost income

Economic integration can offer opportunities to the LAC economies, but it also poses a series of challenges. Countries' economic decision-making is increasingly constrained by actions and developments beyond their borders, a fact that is as true for small countries as for large ones.

The liberalization of capital flows, in conjunction with the development of telecommunications and new investment instruments, has increased capital inflows and outflows. Hence the Latin American markets integrated, at least partially, in the international financial architecture, accessed new and more efficient sources of credit, and raised the prospect of higher national savings. As with trade opening, problems arose in large part as a result of mistakes in the processes and the timing of implementation. The removal of exchange controls, capital flows and new instruments make financial capital highly mobile. The increase in transactions between affiliates in different countries has allowed transfer prices to be set in a way that evades the tax authorities and the payment of tax.

In conclusion, the liberalization of trade and capital flows undoubtedly has the potential to increase countries' welfare substantially, but it also poses challenges to governments since it erodes the bases of income taxes.

The only ways to tackle the problem of "lost income", a typical feature of globalization and one that is intensified by trade agreements, are: (a) exchange of information between tax administrations, so as to obviate international evasion; (b) the proper treatment of transfer prices, in order to avert under- or over-billing; (c) international agreements that facilitate the distribution among jurisdictions of income received in both, thereby forestalling double taxation (bilateral agreements); and (d) as part of a trade agreement, conclusion of a multilateral accord to eliminate harmful tax practices (peace clauses), like the EU's Code of Conduct on Business Taxation (Commission of the European Communities)⁶.

It is important to stress that little progress has been made in recent years on the exchange of information between tax administrations, with a view to averting the possibility that a multinational taxpayer might exploit the asymmetry of information to evade tax. Clauses on information exchange are generally part of agreements to avoid double taxation, but such accords are less common in LAC and are always bilateral. It is time to conclude multilateral agreements on information exchange, especially when groups of countries are engaged in a process of economic integration to strengthen trade and investment.

It is no coincidence that, during the North American Free Trade Agreement (NAFTA) negotiations, the US and Mexican fiscal authorities concluded a taxation agreement in

⁶ Commission of the European Communities. *Code of Conduct for Business Taxation and Fiscal State Aid*. 1997.

parallel to the trade talks: they realized such an accord would be essential to support the growth in trade and, above all, investment between the two countries.⁷

7.4 Tax expenditures and foregoing taxes for incentives

The notion of tax expenditure was used for the first time in 1967 by Surrey⁸, then the Secretary for Fiscal Policy at the US Treasury Department. Surrey stressed that deductions, exemptions and other income tax benefits were not part of the tax structure. They were, in fact, government spending effected through the tax system rather than directly, through the budget. For this reason he called them “tax expenditures”.

This way of perceiving fiscal benefits, as comparable to budgetary spending but effected through the tax system, was novel. Analysis of tax expenditure rests on the premise that any form of tax has two components:

- (i) one that covers all the legal provisions that make up the tax regulations; and
- (ii) the special provisions that represent a departure from those regulations.

The former are crucial to the definition of the tax itself: taxable base, passive subject, rate structure, payment conditions, jurisdiction, and ancillary taxpayer obligations required by the tax administration (controlling evasion).

The special provisions are departures from the regulations thus defined, and are designed to meet the government’s goals in areas other than tax. They offer fiscal benefits in the broad sense of the term – that is, they include tax incentives and benefits that are not incentives.

For a long time, but particularly in the last two decades, it has been standard practice in developing and developed countries to grant incentives in order to attract FDI. These incentives lower the tax burden on businesses so as to alter their behavior and induce them to invest in particular sectors or regions. Exceptions to the general tax system, they include reductions in the income tax rate, tax holidays, accelerated depreciation regimes, specific deductions of certain earnings in income tax liquidation, deductions for reinvestment, and lower social security contributions.⁹

The main advantage of the concept of tax expenditure over the traditional notion of fiscal incentive is that it introduces the idea that the reduction or selective elimination of taxes has a fiscal cost. Only rarely, however, is that cost gauged, and when it is the estimates are rough.

⁷. Additionally, the effective collaboration between Mexico (SAT) and the United States (IRS, Customs Service) has led to the significant and mutual professional development of their auditors.

⁸. Surrey, S. *Pathways to Tax Reform*. Cambridge: Harvard University Press. 1973.

⁹. Villela, L. and A. Barreix. “Taxation and Investment Promotion”. Background note for the World Bank's *Global Economic Prospects 2003*. Inter-American Development Bank. Washington, D.C. 2002.
[Http://www.iadb.org/INT/Trade/1_english/2_WhatWeDo/1_PublicationsFrame.htm](http://www.iadb.org/INT/Trade/1_english/2_WhatWeDo/1_PublicationsFrame.htm)

Given the need to increase the level of public revenue to offset the possible loss of tariff income, one of the measures that must be adopted is a complete review of tax expenditures in current tax legislation. In other words, the special provisions that represent a departure from the tax regulations must be identified, and their fiscal cost must be measured. This exercise is known as a Tax Expenditure Budget. It allows policy-makers to set priorities and, by eliminating non-essential fiscal benefits, to foster a higher level of revenue and equity without necessarily creating new taxes or raising existing taxes.

This policy is advisable for all LAC countries, especially when they are seeking new ways of offsetting the potential income losses attendant on trade liberalization.

7.5 Inter-governmental fiscal relations and weak property tax

Most LAC countries will have to undertake fiscal adjustment in order to adapt to a globalized world and address the fiscal impact of trade liberalization. That adjustment will demand a change in their inter-governmental fiscal relations – that is, with their sub-national jurisdictions. To a greater or lesser extent, irrespective of whether they have a federal structure, in almost every country the central government transfers resources to other levels of government, of which there might be two or three. In most cases these transfers are automatic; they are established by law, or even by the constitution.

This means that additional government efforts to raise revenue through domestic taxes, as a means of offsetting tariff losses, must be matched by further increases to meet the legal need to transfer resources to provinces, states, municipalities, districts, boroughs, and so on.

Since import tariffs seek to regulate external trade and/or protect national production, in many cases they are not listed among the revenues shared with sub-national governments¹⁰. Thus when the loss of the import tariff is offset by domestic taxes, there might be substantially greater need for additional income from VAT, income tax or selective consumption taxes.

Moreover, sub-national taxation in many LAC countries is of very poor quality. Property tax is generally of little importance, and the municipalities use and abuse taxes on economic movement (sales) with cumulative effects of taxes over taxes. In many cases these taxes undermine the countries' competitiveness relative to their trade partners. The fiscal solution might therefore be complex, involving wide-ranging tax reform, an adjustment in the powers to tax, and changes to the systems for inter-governmental transfers or joint resource-sharing, on the grounds that the arrangements do not "fit".

¹⁰ Varsano, R., S. Ferreira and J. R. Afonso. "Fiscal Competition: A Bird's Eye View", *International Conference on Federalism 2002*, St. Gallen, Switzerland. August, 2002.

7.6 Direct fiscal compensation due to exceptions in the trade agreement

A paradox particularly evident in LAC is the reduction in taxes, especially direct taxes, on the agricultural sector. As trade opening reduces tariff, and makes them more uniform, effective protection becomes lower. The revenue raised from the higher levels of protection was distributed through political-economic mechanisms among the State, the workers and the entrepreneurs, the flipside being a higher cost to consumers. With trade openness and the consequent lowering of protection, it is reasonable to expect the agricultural sector (which has comparative advantages) to pay higher taxes in order to provide the revenue lost by the State on the protected sectors. As mentioned earlier, however, direct tax on the agricultural sector has paradoxically fallen.

The reason for this paradox lies in the sector's limited profitability, the result of protection that affects the countries' terms of trade and hampers or prevents access to their markets; they subsidize production and even exports. Unlike the "double dividend" involved in rectifying negative externalities in environmental taxes,¹¹ in this case what might be termed an "anti-double dividend" prevails: on the one hand, the cost to the treasuries of protectionist countries for the subsidies granted; and on the other, the decline in revenue in countries producing agricultural goods and by-products.

Excluding sectors from regional trade negotiations, therefore, has serious tax effects in terms of economic efficiency. Resource allocation is sub-optimal, and thus investment efficiency and welfare decline. More importantly, such exclusion affects the fiscal capacity of the country discriminated against. Hence fiscal compensation is a traditional, second-best concept that is widely accepted in the economic literature. Fair compensation attenuates the effect of excluding certain sectors from free trade: inefficiency and inequity in international trade and treasuries, circumstances that heighten the pressure to cease such exclusion. In the long term, these constraints on international trade will have to disappear if countries are to enjoy the economic benefits of the specialization (economies of scale and agglomeration) that stem from free trade.

In short, it is neither efficient nor fair to obviate the tax effects of excluding sectors from trade liberalization, but those effects can be attenuated by means of fiscal compensations that increase the economic efficiency and equity of the agreements.

VIII. CONCLUSIONS

Economic integration, like globalization and commercial and financial opening, creates opportunities for the more efficient transfer of goods, services, technology and capital, thereby fostering greater labor productivity – which is the prime source of long-term per capita income growth. At the same time, integration makes a country more dependent on its partners, and thus requires institutional development that promotes competitiveness.

¹¹ The double dividend related to an environmental tax consists of the improvement gained by correcting the negative externality (reducing the supply of a good or service to the social, not private, optimum), and the improvement in collection.

To adapt to this new form of international insertion, countries will have to change their tax policy and administration.

While taxes on external trade have fallen substantially in Latin America, those taxes are still a significant source of public revenue in countries whose public finances are in a critical state. Any tariff reduction in free trade agreements must therefore be assessed in detail, so as to measure its positive and negative effects in each case. Since income is lost permanently, countries will have to coordinate a set of measures that have a lasting fiscal impact and that are consistent with long-term fiscal sustainability. This is only possible if there are significant groups in favor of greater trade liberalization, which regrettably is not the case in many countries.

While in some cases the loss of tariff revenue is serious, it is a problem that can be solved with a reasonable effort. It should not therefore add a new obstacle to integration by adding an internal front (negotiation between each country's trade and treasury authorities) to international trade talks. Nonetheless, it is short sighted to believe that a country might have to miss the integration boat, which is sailing towards greater economic development, because it is unable to meet the fiscal cost of the ticket. On the contrary, for fiscal policy, and for tax policy in particular, wide-ranging trade integration should be seen as a significant opportunity to rectify tax structures, systems and administration. The old goals of efficiency and equity persist, but there is a new one: international cooperation is a key instrument to deal with the inevitable globalization that has already affected them significantly.

To conclude, taxation is crucial to the functioning of a country at all levels of government. It generates transfers that finance essential public goods, while seeking to have no adverse effects on economic efficiency and while improving income distribution to some extent. Apart from technical options, therefore, taxes are determined by a political dynamics over how to distribute an economy's income¹². The fiscal cost of economic integration, however, includes the additional factor of international coordination, and thus poses a greater challenge. As an instrument to foster economic growth in a context of supranational institutions, international coordination should be grounded in professional and academic developments, but the main responsibility for its proper use falls squarely on political decision-makers.

¹². There are two main approaches to the study of the political economy of taxation: (a) to regard taxes as an imperfect exchange between citizens and their government so as to secure financing for public goods and services, an approach that emphasizes the collective mechanisms for pricing those goods and the methods and institutions governing income distribution and public spending; and (b) to view taxation as the coercive appropriation of resources to finance unspecified government activities, an approach that stresses minimizing the efficiency costs of a social planner's policy choices, which may include distributional considerations. (Winer, S. and W. Hettich. "The Political Economy of Taxation: Positive and Normative Analysis when Collective Choice Matters", in *Encyclopedia of Public Choice*; Rowley, C. and F. Schneider (eds.). Kluwer Academic Publishers, forthcoming).

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