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TAX INCENTIVES FOR FDI IN SEVEN LATIN AMERICAN COUNTRIES

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I. Introduction

This paper compares the history of tax incentives in seven Latin American countries. It is an attempt to understand why countries enact tax incentive legislation; how countries measure the costs and benefits of such legislation; how such costs and benefits are viewed by the public; and what considerations have led to the repeal of such incentives. The information set forth below is the result of extensive interviews and correspondence with noted private and public sector tax experts in the countries reviewed. The information was collected over a two and one-half year period ending in September 2001.

This paper is not intended to be an authoritative summary of tax incentives. While considerable time and effort was invested in preparing a description of the incentives, it must be remembered that such legislation is subject to constant modification (indeed, some of the countries have made substantial changes to their incentive legislation over the last few months). Furthermore, the most knowledgeable tax experts often are not familiar with details of the incentives. The details are not important in such cases, because this analysis focuses on the public's perception.

Nor is this paper an attempt to measure actual revenue sacrificed because of the incentives. Again, actual revenue impact is less our concern than the perception (of course, the perception is affected where serious revenue estimates have been performed). Political decisions regarding incentives ordinarily are taken after measuring perceived costs against perceived benefits.

It is our hope that the information set forth below will be useful to countries who are considering new tax incentives or considering the repeal of tax incentives currently in force.

The seven countries were selected on the basis of their importance to investors and the availability of information. Each country description follows the same order: a. Tax Incentives (a general description of important tax incentives, both current and past); b. Analysis of Incentive Prior to Enactment (a review of the motivations behind the incentives set forth in part "a", including who lobbied for such incentives); c. Effectiveness of Incentives (the perception of the public as to the costs and benefits of the incentives, including abuses); d. Epilogue (the current state of play in each country, with the experts' perception as to future of tax incentives).

We welcome the comments of interested parties. Obviously, it was impossible to interview all the tax experts who could have made useful contributions. We are particularly interested in the adoption of new incentives, the repeal of incentives, abuses of incentives, or viewpoints regarding the effectiveness on incentives. To facilitate such comments, we have numbered the paragraphs, so comments can be easily directed to a specific point.

II. Argentina

1- Argentina has offered sweeping tax incentives to investors, both national and foreign, over the course of the last thirty years. The incentives have been directed both at certain less developed regions and industries considered important for national development. Argentina's experience has been complicated by the power of the provinces under Argentina's constitution: they have been successful in extracting tax benefits from the government, and even been empowered to administer the incentives. When the federal government has tried to curb abuses, the affected provinces often have been able to blunt the impact of the reforms.

2- Argentina's incentives generally have had sunset provisions, authorization procedures, or both. As will be seen, these characteristics have been both good and bad. In addition, the incentives are never included in the Income Tax Law, but rather in separate laws. The following discussion must be regarded only as a general description; the laws have been amended over the course of time, and hundreds of pages of related Executive Decrees and other guidance have been issued over the course of the years.

- a. Tax Incentives
- b. Analysis of Incentive Prior to Enactment
- c. Effectiveness of Incentives
- d. Epilogue

a. Tax Incentives

3- Tierra del Fuego- This incentive was initiated in 1972, during a military government, with the goal of populating the extreme south of Argentina. The incentives initially were comprehensive, though not all remain in force. Companies and individuals were exempt from all income taxes. Currently, individuals remain exempt from all national taxes, as are local businesses, though companies "exporting" to the rest of Argentina are exempt only if they initiated business several years ago (the provision was not repealed; rather, new permits are no longer granted.) Local sales are not subject to VAT. Sales by covered enterprises throughout the rest of Argentina are subject to Value Added Tax, with the difference that such tax need not be turned over to the government. Purchasers are allowed to take the VAT paid as an input credit even though the seller keeps the VAT. In some cases, input credits paid by the beneficiary were refunded.

5- While no duty is imposed on import of merchandise, an item is subject to duties on "export" to the rest of Argentina/ Mercosur. The difference between the duty imposed on items originating in Tierra del Fuego and other parts of the world has varied over the years. Visitors returning to the "mainland" of Argentina are given a \$300 duty free allowance (same as returning from abroad), which is administered by both local and federal officials.

6- Less Developed Provinces Incentives- In 1979 the government passed Law 22-021 (extended by subsequent laws), which created similar exemptions to those offered in Tierra del Fuego (though no exemption from personal income tax) for several Argentine provinces: San Luis, San Juan, Catamarca, and La Rioja, and parts of Mendoza (added as recently as 1994). The impact of this incentive has been considerably broader than the Tierra del Fuego incentive because of the harsh weather conditions and distance of Tierra del Fuego. To qualify, companies must employ a certain number of employees, and meet production goals. A hallmark of these incentives is local control. The local provinces were given a fixed number of exemptions (“cupos”) to award, and the power to regulate compliance with the conditions.

7- In recent years, the number of “cupos” allowed by the incentive law has dwindled. This has been achieved in Argentina’s annual budget. Furthermore, the incentives are awarded by the federal tax administration, and the activities that are deemed worthy of the incentive are generally limited to tourism, industrial, agriculture and related activities, i.e. activities that make some economic sense in the target regions.

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10- Mining & Forestry- During the 1970s and 1980s, while Chile prospered in part because of a strong mining sector (including mines very close to the Argentine border), mining activity in Argentina was nil. In addition to the political turmoil of the time, laws related to mining were either unfavorable or non-existent. In 1993, Argentina passed a Mining Law with the hope of improving this situation.

Incentives include:

- -Accelerated depreciation for investments by mining companies in infrastructure projects- 60% in year 1, then 20% in years 2 and 3.
- -Depletion- reasonable depletion allowed- research expense, feasibility studies, exploration costs should be capitalized for depletion purposes
- -Start-up expenses, research and development- may be deducted currently or amortized over 5 years
- -Assets Tax- under the general regime, imposed at 1% of gross assets as an alternative minimum tax - not applicable to mining
- -Imports of mining equipment and machinery exempt from customs duties and statistical tax, and other import tax is creditable against income tax
- -Value Added Tax- anticipated refunds of export-related VAT are available to mining companies after feasibility study approved by Ministry of Economy
- -Fiscal Stability -Mining companies can negotiate a 30-year guarantee of applicable Income Tax rules.

11- Perhaps it is not accurate to describe the Mining Investment Law as an incentive. Most of the benefits relate to timing issues (i.e. accelerated depreciation, advanced refund of export-related VAT) that ironically could prejudice miners because of Argentina’s

five-year loss carry-forward limitation. The exemption from Assets Tax reflects the fact that, unlike other industries, the basis of a mining concession bears little relation to the income it should produce.

12- Forestry benefits are nearly identical to the mining incentives. Even longer (50 year) stability is offered for “cultivated” projects, and relief is granted from local and provincial taxes. This latter benefit can be attributed to the fact that the Forestry Law was passed in 1998, five years after the Mining Law. During this interval, Argentina became aware of the obstacle presented by these local taxes (generally low rate, but gross basis).

b. Analysis of Incentive Prior to Enactment

13- As a rule, those interviewed agreed that all incentives were granted for domestic political reasons, and in no case could anyone recall Argentina’s competitive position with respect to other countries being an issue. The incentives generally were granted in response to domestic lobbies (often personal friends of the government) with a particular agenda. Nor were other countries’ actions used as a model, with the exception of the Mining Law, where other laws were used as guidance.

14- A landmark International Monetary Fund investigation carried out in the 1980s seems to have helped turn the tide against incentives. Never before had a serious attempt been made to quantify the cost of the incentives; nor had any serious chronicle of the abuses facilitated by the incentives ever been undertaken. In addition, tax incentive legislation has required an economic impact study for the last fifteen years. Such studies have improved as the incentives have dwindled.

15- Tierra del Fuego- the military government at the time gave little explanation for the incentives. There was an intention to “compensate” the region for the extra costs associated with being so far from population centers, as well as the obvious wish to develop and populate the region. Adjacent areas have been the subject of border disputes between Argentina and Chile. By creating job opportunities, people would be drawn to the region. Increased population was a strategic goal. No cost-benefit analysis was even contemplated, nor was there an attempt to limit the incentives to those sectors appropriate to the region. As the incentive has been cut back, little hard data seems to have been utilized. Rather, the defects and abuses are so obvious that limits and controls have gradually been imposed.

16- Less Developed Provinces Incentives- these incentives were implemented before the economic evaluation process became serious, and prior to the IMF study. Perhaps the gravity of the problems led to the change in attitude.

17- The original legislation was considered a “reparation” to the provinces covered, for the economic hardship they have endured as a result of government neglect. An economic analysis was carried out, but considered by those surveyed as superficial: revenue estimates reflected insignificant loss from industries relocating from areas where they

were paying tax, and a rosy analysis of economic development in the areas affected. The analysis only covered the first years of the program.

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20- Mining & Forestry- as noted above, the Mining Investment Law and Forestry Law generally provide timing benefits, rather than an actual reduction of tax liability. Furthermore, mining and forestry in Argentina were inactive notwithstanding clear potential. Tax stability was included to provide assurances to companies making a large, long-term investment in a country lacking a history of stability. No revenue estimates were prepared. Other countries' laws were consulted as a reference, but this apparently was an effort to draft sensible legislation, not match other countries' incentives.

c. Effectiveness of Incentives

21- Tierra del Fuego- the population of this region has multiplied from 10,000 just 20 years ago to nearly 50,000 now. Clearly, the incentives played a part in job creation. However, the revenue loss appears disproportionate to the increased job activity.

As a result of the incentives, Tierra del Fuego became a center of questionable activities. Almost no value was added to much of the merchandise moved through the area. In some cases, the activity consisted of taking the items out of one box and putting them in another. During an often-quoted court proceeding, an employee of one such company was asked what his job was, to which he replied "changing the tags." On further questioning, it was revealed that the only "processing" taking place was removal of the "Made in Korea" tag and, in its place, the attachment of a "Made in Argentina" tag.

22- Even after abuses were uncovered, enforcement continued to be weak. In one situation, a timber company reported timber exports (and corresponding tax benefits in the neighborhood of \$400 million) that were in excess of the timber in all of Tierra del Fuego. The former government official reporting this story noted that an investigation was ordered, but no punishment ever was imposed.

The industries that have moved to the region are a combination of foreign and Argentine investors. Many ceased operations in other parts of Argentina to relocate.

23- No new permits to "manufacture" in Tierra del Fuego have been issued for years. However, certain activities do not require a permit and continue to benefit. There also appears to be a lively commerce in permits that were issued many years ago: such permits may be used for businesses other than the original one upon fulfillment of certain conditions and authorization. The process is considered tainted by corruption. The petroleum sector, for example, does not require a permit. Therefore, oil exports to the rest of Argentina can generate a VAT windfall- VAT is charged (giving the purchaser an input credit), and the seller keeps the amount collected as VAT. This costly bonanza may

have increased oil exploration, and the companies now must pay income tax, so part of the benefit is recovered. The VAT regime is currently the subject of litigation.

24- Less Developed Provinces Incentives- This incentive is the best known for revenue loss and fraud. The stories of abuse are legion. Local authorities in the regions no doubt would point to the few factories that have located in the region, and cite them as a vindication of the incentives. However, the IMF study calculated the revenue loss to be on the order of 2% of GDP per year over the course of 7 to 8 years (nearly \$4 billion per year) before the federal authorities exerted some control over the situation.

25- Although the incentives were not as broad as those for Tierra del Fuego, the revenue impact was much greater because of the proximity to Buenos Aires. The impact can be measured both in terms of relocation and outright fraud. The fraud is noteworthy in that it involved cooperation between companies and local governments to cheat the federal government. The principal fraud consisted of fictitious investments and production, when the manufacturer continued to operate in a regular non-exempt area. To create the illusion of activity taking place in the tax exempt area, electricity was consumed, and fleets of trucks made trips-- but little or no economic activity was taking place, and the trucks were usually empty.

26- The local authorities were given control over the granting of licenses (a limited number per year) and confirming that the conditions required by law (i.e. production and employment quotas) were met. The local authorities were pleased to grant the licenses, but largely negligent in the control department. Though no important figures have been punished, it is widely believed that local authorities were bribed in exchange for granting the licenses and neglecting to control the investments. Ex-President Carlos Menem was Governor of one of the favored provinces (La Rioja) in the 1980s, and fairly or not, is widely believed to have benefited from such payments.

27- These schemes continued well into the 1990s, after the abuses had been exposed. One forceful measure authorizing the federal tax authorities to pursue and severely punish fraudulent schemes was passed under IMF pressure in 1992. One month later, the law was revoked.

28- Again in 1996, tax policymakers thought that the incentives had been eliminated, by the exclusion of "cupos" from the budget. During the traditional holiday season, with most tax policymakers out of town, the item reappeared.

29- Today, the abuses stem from the attempts to retain the benefit for an activity different from that originally licensed. This would occur when the original business is no longer profitable. As long as the new activity is not completely unrelated to the former activity, the authorities have had difficulty denying the tax exemption.

30- Part of the successful curtailment of this incentive has been a strict allocation of tax forgiven. To comply with the amount authorized in the national budget, certified

investors must project their income for the “exempt” period. Any amount in excess of the projected profit is taxed.

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33- Mining & Forestry-- Mining in Argentina has become a viable industry. Significant exploration is taking place, and significant projects have been undertaken, notwithstanding a relative lack of infrastructure. Indeed, compared to neighboring countries, Argentina’s mining tax laws are not particularly favorable, especially when provincial taxes are taken into consideration. No further incentives are proposed.

34- Tax revenue from mining activity is still insignificant, but several large projects are slated. Such projects often last decades and involve an investment of hundreds of millions of dollars. Of course, the taxable income generated depends on mineral prices, which have been depressed for several years. Experts believe the special regime has promoted exploration and made several projects feasible. However, the consensus is that investment is occurring not because of the benefits; rather, the special tax rules are viewed as necessary to make Argentina’s legal environment competitive.

35- Forestry has not been as high-profile as mining, but those working in the area believe that the benefits have made a difference for certain significant projects. As with mining, forestry is not considered to be an area where abuses currently are taking place.

d. Epilogue

36- Over the course of the last decade, Argentina’s incentive program has been scaled back, albeit in a haphazard manner. Those interviewed indicated that the outrageous abuses of the last two decades have been scaled back to a small number. Argentina still suffers from fraud and evasion on a massive scale, but the law generally no longer encourages irrational business arrangements to avoid taxation.

37- Tax incentives still exist. They can be divided into three groups. First are those that the Argentine government has scaled back over the course of time, through a combination of Executive Decrees and successive budget cuts. Certain incentives still available in the “reparation” provinces fall into this category. Second are those surviving from the 1980s where the law is clear and the Argentine government either cannot or chooses not to repeal the law. The VAT scheme available to petroleum companies in Tierra del Fuego is an example. Third are laws that are beneficial, but perhaps are not properly labeled “incentives,” like the Mining and Forestry Laws. Such laws alter the economics of an investment, but not radically. The idea is to make marginal projects more attractive, which perhaps is reasonable in light of the massive economic commitment and the potential benefit to the country.

38- The first group is the most interesting. The “reparation” provinces have not had their tax incentives stripped, but now new beneficiaries are limited to certain activities and are carefully scrutinized. The current regime basically applies only to tourism and agriculture. In essence, the current regime allows an equity investment in an approved project to be taken as an interest free deferral of tax for ten years. Bond must be posted for the amount deferred. The benefit is limited to the investor; the project itself is subject to the Income Tax. The federal authorities retain control over compliance with the terms, although the provinces still approve the projects. The amount of tax credits they can award, however, is relatively limited (compared to before), so the local authorities seem to be selective. One success story is a large scale agricultural project (olives and peanuts) using imported technology for water preservation in this arid zone. Other stories provoke suspicion. An otherwise unobjectionable tourism project in a scenic area was granted to a Menem associate in the final part of his presidency.

39- Income tax exemptions that remain will expire gradually, but it seems that all (with the exception of petroleum related incentives) will disappear by 2013. This is a condition of the Mercosur free trade area. Interestingly, the exemptions were set to expire in 2003, but during the Mercosur negotiations, the tax free zones (such as Manaus in Brazil) flexed their political power and received a waiver until 2013. Since the international treaty supersedes domestic law, the exemptions will remain.

40- The tax stability provided for mining and forestry projects presents an interesting issue. Tax policy is hampered, and it is definitely burdensome for the tax administration to administer laws that in some cases are decades old. But Argentina, like many Latin American countries, provides the argument in favor of such agreements on a nearly annual basis- the frequency with which significant tax reforms are passed.

Overall, those interviewed saw the current incentive system as not overly costly, and perhaps even worthwhile.

41- A bright spot is the continuing enhancement of the tax incentive analysis included in Argentina’s annual budget. The figures used are now considered realistic. It will be difficult for future incentives to be implemented if this type of tax expenditure analysis is followed.

42- In response to Argentina’s continuing economic crisis, Argentina has recently granted extraordinary powers to the Minister of Economy. Law 25.414, enacted on March 30, 2001, established a delegation of functions to the Executive Power. Under the Federal Constitution such powers are granted to the Federal Congress. From the tax stand point, among the most important measures were the possibility:

- to create special contributions with specific purposes.
- to create or eliminate tax exemptions.
- to provide for tax measures, such as, tax deferrals, reimbursements, deductions, special amortization systems and tax benefits in the provinces with labor crisis derived from the public companies privatization process.

The underlying idea of these delegations was to grant the specific activities or areas competitiveness within the market. In order to achieve these goals one of the most important tool was the execution of different Agreements to be signed between the Federal Government and the provinces, with respect to specific activities that the government wishes to help. Such Agreements may grant the following main benefits:

- Exemption of the Tax on Indebtedness.
- Exemption of the Minimum Assumed Income Tax.
- Possibility to take as VAT tax credit, the certain social security contributions paid by the employers.
- Possibility to take as VAT tax credit certain special contributions paid companies that render complementary services of radio, TV cable, TV (open), TV and Film producers, among others.
- 50% of reduction of the VAT general rate for import, sales and leases of new vehicles to be used as taxis or remises.

To date, several Agreements have been signed. Each agreement settles the extension of benefits, conditions and requirements. They include the following activities:

- Capital Assets producers of shoes, fabrics and clothes.
- Motor Industry
- Cotton Industry
- TV and Actors activity
- Open TV
- Editors of News papers and magazines
- TV, Films and Musical producers
- Fruit activity located in the Patagonia Region.
- Rice producers
- Tourism
- Wood and Furniture industry
- Wine Producer
- Citric Producers
- Construction Activity.

III. Brazil

1- Brazil has a federal system with significant taxation at both the national level and the state and local level, over which the federal government has limited control. For purposes of the following discussion, it should be noted that Brazil has value added tax at both the federal and state level, but Income Tax only at the federal level. Of the seven Latin American countries included in this survey, Brazil is the only one where incentives on the state and local level present issues of any significance. Such incentives could affect investors' decisions whether to invest in Brazil as opposed to other countries, but also where to invest within Brazil.

2- On the federal level, tax incentive opportunities have diminished as analysis of them has become increasingly thorough and public. Income tax incentives for specific sectors are very limited now. Though recently reduced, and scheduled to expire in 2013, important incentives remain that are directed toward regional development. A large portion of the Northern part of the country is covered. On the state level, a mechanism exists to control competition among the states, but it has not been sufficient to stop such competition.

- a. Tax Incentives
- b. Analysis of Incentives Prior to Enactment
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a. Tax Incentives¹

National Level Incentives

3- Amazon/ Manaus Free Zone & ADA (*Agencia de Desenvolvimento da Amazonia*, which replaced the SUDAM -*Superintendencia do Desenvolvimento da Amazonia*- in 2001)-- The Amazon area/ Manaus has been accorded privileged tax treatment for nearly four decades. Before 2000, most industries fell into one of two categories, giving such investor either a complete exemption from Income Tax, or a 50% discount. As of 2000, the relief has been reduced by 25%: to 75% relief in the case of those formerly exempt, and to 37.5% relief in the case of those formerly given 50% relief (and 2001 legislation curtails this benefit even more for most projects). All incentives are scheduled to be phased out by 2013.

4- Reinvestment Incentive and Other Benefits-- A reinvestment incentive permits an investor to reinvest up to 30% of tax liability (effectively a credit) in the Amazon/ Manaus Free Zone (related to income earned in the area) as long as 50% of the reinvestment is fresh money from the investor. There are also are broad exemptions from

¹ A memorandum summarizing recent legislative changes is attached at the end of this paper.

import duties and federal Value Added Tax. Goods manufactured in the region “enter” the rest of Brazil at a reduced customs rate, and visitors returning from the zone are allowed to “enter” the rest of Brazil with a duty-free quota that is greater than that for persons arriving from other countries (\$2000 v. \$500). Other less significant taxes, such as excise taxes, are reduced or eliminated. The items subject to tax are less significant than those that are not-- the Amazon region is very close to being a true Tax Free Zone. According to Ministry of Finance calculations, the annual cost of these benefits in recent years exceeds US\$1 billion.

5- North-East Development Agency Incentives (ADENE, or *Agencia de Desenvolvimento do Nordeste*, which replaced the North-East Development Superintendancy / *Superintendencia do Desenvolvimento de Nordeste*, or SUDENE), covering the economically depressed areas of Northeast Brazil-- With respect to Income Tax, the areas covered by this incentive receive the same benefits as the Manaus/ Amazon area: before 2000, most industries fell into one of two categories, giving such investor either a complete exemption from Income Tax, or a 50% discount. As of 2000, the relief has been reduced, to 75% relief in the case of those formerly exempt, and to 37.5% relief in the case of those formerly given 50% relief.

6- A reinvestment incentive tracks the Amazon reinvestment, described above. However, this region does not receive the full range of benefits given to the Amazon region. No relief is given in the area of import duties (other than the limited exceptions allowed anywhere in the country). The annual cost of this benefit in recent years is well over \$100 million.

7- Investment Funds (FINAM [Amazon], FINOR [Northeast], and FUNRES [Espiritu Santo])-- This is a further measure to enhance development in the Amazon and Northeast, along with Espiritu Santo, another less developed region. An investor can contribute money to these funds and take a 30% deduction of income tax owed.² The investor receives a negotiable bond, which is particularly valuable for privatizations. The funds received are used to finance development projects in the favored regions. The annual cost of this benefit in recent years has approached \$500,000,000.

8- Computers/ Other Technology-- Various measures have been adopted to promote technology in Brazil, particularly computers (a very serious trade dispute erupted between the U.S. and Brazil in the mid-1980s because of Brazil’s protection of its computer industry and U.S. claims of piracy). Three noteworthy incentives are a credit equal to 30% of the amount of withholding tax imposed on qualifying royalties (essentially technology), an exemption or reduction in customs duties on imported components for computers or research and development, and an exemption from the

² Corporate taxpayers can opt to invest direct in projects (companies located in the area) or in bonds issued by the entities (FINAM, FINOR, FUNRES). The limits are a percentage on the income tax due. For FINOR and FINAM the percentages are: 30% from 98 to 2003, 20% from 2004 to 2008, 10% from 2009 to 2013, zero after 2014. For FUNRES the percentages are 25% from 98 to 2003, 17% from 2004 to 2008, 9% from 2009 to 2013, zero after 2013.

federal VAT (“IPI”) for computer products (to be phased out over 10 years). On the other hand, Brazil has not given this sector, or any other, preferential Income Tax treatment based on the type of business (though, of course, they could obtain a partial exemption on geographical grounds).

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10- Local level: Of the several taxes that are imposed and administered at the sub-national level, two are important in terms of revenue and, therefore, incentives. It should first be mentioned that sub-national incentives are permitted, in theory, only after they have been authorized by the unanimous consent of the CONFAZ (*Conselho Nacional Fazendario*, or the National Finance Committee, made up of each state’s Secretary of Finance), which meets several times a year. First is the state-level VAT. Brazil’s VAT is unique both in terms of complexity and approach. It combines a federal level destination-based VAT with a larger state level VAT that is origin-based with respect to cross-border economic activity within Brazil, but destination-based with respect to exports to the rest of the world. Another unusual aspect of Brazil’s VAT is the “amortization” over four years of the input credit for machinery. Recent attempts to standardize the VAT at the federal level failed, and it appears that the current structure will remain for the next few years. The obvious question is how a state can provide an incentive to an investor on what is theoretically a consumer-based tax.

11- The property tax is imposed at the municipal level. Consent of the CONFAZ is unnecessary, making exemption from this tax simple.

12- The state-level VAT, by contrast, has been the subject of great creativity. The preferred method of granting relief has evolved over the years, in part because the privatization of banks owned and operated at the state level has made it more difficult to manage an incentive through offsetting credits/ rebates. Furthermore, the consent of CONFAZ often has made it necessary to disguise the incentive. In summary, the delicate legal environment has led to a proliferation of arrangements.

13- Examples of negotiated incentives might be an indefinite deferral of the requirement to turn over the VAT that is due; exemption from VAT on import of equipment where the end product may or may not be exported; or full payment of the VAT combined with an immediate direct offsetting credit provided by the state (this last approach is particularly useful where the input credit must be amortized).

b. Analysis of Incentive Prior to Enactment

15- To appreciate the debate that has taken place over the last forty years, two facts must be understood. First is the economic reality that wealth in Brazil is distributed extremely unevenly between the North and the South. The South, particularly the Sao Paulo region, is an economic powerhouse, with corresponding wealth. The North is underdeveloped. The second reality is the political strength of the North. Not only is the North extensive,

with several population centers, but it also has disproportionate representation under Brazil's federal system.

16- The foregoing makes it difficult to repeal the regional tax incentives, even with the costs of the measures published by the Ministry of Finance. The politicians from the North have the clout to block repeal efforts, and the economic condition of the North makes politicians from the South somewhat sympathetic.

17- SUDAM / SUDENE -- In the 1960s, Brazil took serious action to close the gaping disparity in development between the North and South of Brazil. In accordance with the prevailing United Nations economic thinking, tax exemptions were a natural way to draw industry to the North. At the time, few Brazilians viewed tax incentives as a threat, and the sweeping incentives (including tax exemptions for many industries) were passed, apparently with considerable support from other regions. Other items were enacted during the military regime in the latter part of the 1960s, obviously with insignificant opposition.

18- An illustration of the bruising political implications of the incentives occurred ten years ago, when the Collor de Mello government succeeded in repealing the tax exemptions. Six months later, the Northern politicians and their allies managed to reinstate the exemptions. Last year's reductions in the level of exempt income generated a fierce debate that ended in compromise. Opponents of the incentives wanted greater deductions, but the defenders were able to hold the line at the 75% and 37.5% levels. No further reduction has been proposed prior to the expiration of the incentives in 2013. Nor have the Northern politicians started to propose substitute benefits for those that will be taken away. Such substitutes would seem inevitable, but it is interesting that no substitutions have been seriously considered. Perhaps the politicians fear that their opponents would take away the exemptions without adopting the substitute (as was feared by proponents of U.S. IRC Sec. 936 for Puerto Rico).

19- Amazon/ Manaus Free Zone-- This remote area in the middle of the Amazon region, which had languished for decades after a moment of immense wealth in the 19th century during the rubber boom, regained prominence in the late 1960s when Brazil's military government created the *Zona Franca*, or "Free Zone." The principal motivation was national security: to defend Brazil against any foreign claims regarding dominion over or use of the Amazon region, the military determined it essential to develop and populate the area, with Manaus as its hub. The *Zona Franca* was bolstered by the development promoted by SUDAM Income Tax exemptions. As with other instances of military imposed economic policy related to national security, there was no serious debate on the proposals.

20- Constitution of 1988-- Brazil's Constitution merits an important reference in the discussion of tax incentive analysis. This Constitution, still in force, established two transcendent mandates. First, the sweeping tax incentives that exempt or reduce the Income Tax in around half of Brazil's territory would end no later than the Year 2013 (25 years after the Constitution entered into force).

21- Second, the Constitution required the Ministry of Finance to assess the revenue impact of tax “benefits.” Such analyses, which cover a host of items most tax advisors would not consider incentives, have been issued regularly since 1989, each year in a more credible format. The analyses generated over the last few years are available on the internet at:

www.receita.fazenda.gov.br, under “estudios tributarios.”

As part of this second mandate, Congress is required to review revenue estimates of any tax benefit before such measure is adopted. In essence, Brazil has constitutionally mandated tax expenditure analysis.

22- This constitutional requirement has been supplemented by a law called the “Fiscal Responsibility Act,” which establishes annual budgeting requirements, including state and local governments. In accordance with a controversial amendment, effective June 2000, state and local jurisdictions are required to take an offsetting revenue measure for every tax incentive granted.

23- Another point worth mentioning is the subjective use of statistics. Brazil’s annual report of “Tax Benefits” contains far more than tax incentives. Virtually all tax-exempt income (such as certain pensions) and deductions from the Income Tax (such as medical expenses) are listed as well. There is no suggestion that this methodology is meant to distort the situation, but when these items are included, the summary of tax benefits based on geographical distribution actually shows a disproportionate amount of the benefits going to the South (though this likely is a result of more high-income taxpayers residing in the South). This no doubt makes it easier to keep the incentives in force.

24- Investment Funds-- As with the income tax exemptions permitted in less developed regions, the investment fund incentive was enacted in the 1970s, before the full impact of such incentives was appreciated in Brazil. Accordingly, there was little analysis or opposition.

25- Computers/ Other Technology-- This is the only sector that has received special tax treatment on a regular basis, though the incentives have not been overly generous. It is fair to say that Brazil views the computer sector (and other technology to a lesser degree) to be a strategic issue. Therefore, the incentives have been passed without significant debate, including recent measures subject to the tax expenditure discipline.

26- State and Local Incentives-- Since the state and local incentives generally are granted on an *ad hoc* basis, there is no way to summarize them, other than to note that many cases involve investors shopping the states in order to negotiate more favorable incentives. As noted above, the states and municipalities only can modify the taxes they control, primarily VAT and property taxes.

c. Effectiveness of Incentives

27- SUDAM/ Amazon / Manaus Free Zone-- It is not difficult to identify success stories in the Amazon region. Notwithstanding its remote location and substandard infrastructure, Manaus now has an established industrial base, and there was significant internal immigration to the region, thus furthering the military's national security aspirations. The prosperity of Manaus was most noteworthy in the 1970s and early 1980s. Though the incentives did not change, other circumstances in Brazil did. During the period when Brazil was a less prosperous, closed economy, Manaus was a both a shoppers' and investors' paradise (though it should be noted that getting money out of Brazil at this time was subject to onerous taxation and exchange requirements). A shopper could fly to Manaus for far less than an international trip, and bring back far more duty free. An investor could manufacture in Manaus tax-free, and know that competing foreign products would be subject to punitive customs duties.

28- International travel is now much easier, and items produced in Brazil must compete with imports. It seems that Manaus has followed a boom and bust cycle, depending on the import duties in force and the perceived advantages of Manaus for the future.

29- SUDENE—The Northeast also has many investments that have benefited the region. No doubt, many would have located elsewhere if not for the benefits.

30- SUDAM / SUDENE Abuses-- Brazil has a long history of corruption. Though the current government is making progress in this area, it is not surprising that there are many stories of fraud and abuse relating to these longstanding incentives. A typical example (found in most countries with tax-exempt zones) is the transfer of profit from the real profit center to the branch where such income will be exempt. This has been done in Brazil through transfer pricing, fictitious output, invoice manipulation, and other techniques. The tax administration has gradually become able to control the abuses, but it is an ongoing struggle that consumes significant resources.

31- The Free Zone in the Amazon is also a constant headache. Internal contraband is generally more difficult to control than international contraband. As with any contraband operation, this can lead to violence and bribery of police and other government officials.

32- Investment Funds-- It cannot be disputed that FINAM, FINOR, and FUNRES have served as a conduit to pump hundreds of millions of dollars annually into the less developed regions of Brazil. As such, it is not difficult for champions of these funds to claim great success. At the same time, the cost to the Brazilian Treasury has been correspondingly high.

33- It is quite possible that most of the promising projects that received financing through the development funds would have received financing in any event. It is certain that abuses have taken place, though the level of corruption is unclear. Most tax experts interviewed had a general impression that favoritism had played a significant role in the award of funds, either because of personal connections or bribes. Controls have been

tightened, but skepticism remains. There are also reports of fraudulent documentation being submitted in the approval process, often with the collaboration of the officials involved in the funding process.

34- Computers/ Other Technology -- Brazil has a more vibrant computer sector than its neighbors. No doubt many factors have contributed to this, including the protectionism of earlier times, the size of Brazil's economy, and the strength of Brazil's manufacturing base. The minor tax benefits may have contributed as well.

35- State and Local Incentives-- This issue has to be broken into two parts. The first is whether Brazil has received investment that it would not otherwise have received because of the negotiated tax relief. The second part is whether investment has been shifted from one region to another because of the incentives. In this latter analysis, no net benefit has been achieved; rather, one region has benefited itself at the expense of its neighbor.

36- The second issue is easier to answer. Nearly everyone is familiar with the fact that Ford located a major automotive factory in Bahia rather than Rio Grande do Sul because Bahia offered more enticing incentives. No doubt other investments have been transferred as well³-- no net benefit for Brazil, but a clear loss of local revenue. There are numerous examples of this. For example, several food industries established plants in the State of Goiás, due to a program called FOMENTAR, which basically provides zero-interest financing for the ICMS (State VAT) for a period of 10 years.

36A- With respect to the first issue, it may be that state and local level incentives have played a role in attracting investment that may have gone to other countries. It is clear that Brazil has an overall tax environment that is less attractive than its neighbors. It has been able to overcome this fact because it is such an attractive market. But abatement of state and local taxes perhaps has attracted investment

d. Epilogue

37- Brazil's tax incentives, especially those available in the Amazon and Northeast regions, remain highly controversial. Advocates of the measures can point to numerous successes. At the same time, after decades of incentives, the North and South remain at completely different levels of development. And the cost of the incentives has been staggering. Defenders of the incentives respond that the cost has not been excessive when measured against other tax benefits that have a disproportionate effect in the South.

37A. The current government (Cardoso) decided in 2001 that the Amazon/ Northeast investments were so wrought with corruption that a new model was necessary (thus confirming the perception of several tax practitioners interviewed for this project prior to the reforms). Though the incentives survive, they will now be administered from Brasilia.

³ Additional examples of car manufacturing plants (all of them performed a "state and city shopping" before deciding for the proper place) : Renault, Citroen, Peugeot, Mercedes Benz, Honda, Toyota.

38- The Year 2013 figures to be a watershed for Brazil and its system of incentives. As noted, the Constitution of 1988 limited the life of the major tax benefits to 25 years. Tax favored zones were also a controversial issue in the Mercosur Free Trade Area negotiations. No doubt because of the benchmark established in Brazil's Constitution, the member countries used the Year 2013 as the expiration date for all such zones. As a practical matter, the weight of international obligations on top of the Constitution should make postponement of the date very difficult.

ADDENDUM—August, 2001 update

The items are numbered according to the text.

3. **MANAUS FREE ZONE**

The Manaus Free Zone, in terms of the Decree-law n. 288/67, amended by Law n. 9.387/91, still has tax incentives concerning Import Duty and Federal VAT. The Normative Rule n. 24 from the Inland Revenue Service, from March 2, 2001 rules the sale of goods from the Manaus Free Zone and the Export Processing Zones.

SUDAM

The SUDAM was extinguished by the Provisional Remedy n. 2145, of May 02nd 2001 (“MP 2145”), which was last amended by the Provisional Remedy n. 2157, of July 28th 2001 (“MP 2157”).

In substitution to SUDAM, the Amazon Development Agency (Agência de Desenvolvimento da Amazônia - ADA), a Governmental Agency linked to the Ministry of National Integration, was created.

The MP 2145 revoked some articles of the Law n. 5.174/66, which concerned the tax incentives for investments in the Amazon Region, as well as some articles of the Decree-law n. 756/69, referring to Income Tax deductions on investments, and also of the Decree-law n. 1.376/74, referring to the application of deductible instalments of Income Tax on FINOR, FINAM and FUNRES.

PROVISIONAL REMEDY N. 2.199-13/01

The Provisional Remedy n. 2.199-13, of July 27th 2001, regulates the tax incentives of Income Tax exemption or reduction offered to companies located in the areas comprehended by SUDAM and SUDENE. The first article of such Provisional Remedy states that:

“Art. 1. Without prejudice to the applicable rules of the subject, from the fiscal year 2000 to December 31st 2013, the companies which have approved projects for construction, enlargement, modernisation or diversification in the economic sectors under consideration, by act of the Executive, priorities for the regional development, in the areas comprehended by the extinguished SUDENE and SUDAM, have a right to a seventy five per cent reduction on their Income Tax, calculated on the profits of exploration basis” (underlined by ourselves).

The Art. 2 of the MP 2199 also states dispositions related to tax incentives, as follows:

“Art. 2. In relation to the tax period beginning after January 1st 2001, the tax incentive of Income Tax reduction regulated by the article 14 of the Law n. 4.239, of June 27th 1963,

and the article 22 of the Decree-law n. 756, of August 11th 1969, is extinguished, except for economical undertakings which may be considered, by the Executive, priorities for the regional development, and for those located in the jurisdiction of the Manaus Free Zone”.

Therefore, this article partially revokes the article 22 of the Decree-law n. 756/69, which conceded a 50% reduction of Income Tax (later reduced to 37,5%, as from the January 1st 1998, by the Law n. 9.532/97) for the companies located in the areas comprehended by SUDENE and SUDAM.

However, it must be noted that the MP 2199 did not revoke the article 23 of the Decree-law n. 756/69, which states that:

“Art. 23 The industrial or agricultural undertakings, constructed, enlarged, modernised or diversified, in the area comprehended by SUDAM or SUDENE, until the fiscal year of 1982, including 1982, will be free of Income Tax on their operational results, for 10 years, as of the financial year immediately after the year in which the undertakings were in effect, or the year the project of modernisation, enlargement or diversification began, in accordance to the report issued by SUDAM or SUDENE” (P.S.: The Law n. 7.450/85 postponed for another 10 years the terms of this Article).

Therefore, regarding the industrial and agricultural undertakings, the tax benefits are still ruled by the Decree-law n. 756/69, amended by the Law n. 9.532/97, which changed the total exemption of Income Tax into the following reductions:

- 75%, from 01/01/98 to 31/12/03;
- 50%, from 01/01/04 to 31/12/08;
- 25%, from 01/01/09 to 31/12/13.

5. SUDENE

SUDENE was extinguished by the Provisional Remedy n. 2145, of May 02nd 2001 (“MP 2145”), reedited several times with amendments – the last one was the Provisional Remedy n. 2156, of July 28th 2001 (“MP 2156”).

To substitute the SUDENE, the Northeast Development Agency (ADENE), a Governmental Agency linked to the Ministry of National Integration, was created.

P.S.: See also comments on the PROVISIONAL REMEDY N. 2.199-13/01

TABLE OF TAX INCENTIVES IN THE AREAS COMPREHENDED BY SUDAM AND SUDENE

Area	Undertakings	Benefits	Validity	Legislation
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SUDAM	Economic Sector	75%		until 31/12/2013	Provisional Remedy 2199-13/01, art. 1
SUDAM	Industrial and Agricultural Sector	75% (until 2003) 50% (until 2008) 25% (until 2013)		until 31/12/2013	Law n. 9.532/97, art. 3
SUDENE	Economic Sector	75%		until 31/12/2013	Provisional Remedy 2199-13/01, art. 1
SUDENE	Industrial and Agricultural Sector	75% (until 2003) 50% (until 2008) 25% (until 2013)		until 31/12/2013	Law n. 9.532/97, art. 3

7. FINAM

The Decree-law n. 756/69 (art. 1, b), defined as 50% of the total Income Tax the applicable value on FINAM. This percentage was further reduced to 30% with the art. 2 of the Law n. 9.532/97, thereafter maintained by the Provisional Remedy 2199.

On the other hand, the article 50, X, of the Provisional Remedy 2145, eliminated the possibility of investing part of the Income Tax on FINAM.

FINOR and FUNRES

The article 50, X, of the Provisional Remedy 2145, eliminated the possibility of investing part of the Income Tax on FINOR or FUNRES.

8. INFORMATICS SECTOR

Federal VAT (*Imposto sobre produtos industrializados - IPI*)

The Law n. 10.176, of January 11th 2001, changed the article 4 of the Law n. 8.248/91, postponing the benefit of IPI exemption until December 31st 2001, and, as from that date, converted the IPI exemption into reduction, with the following percentage (ruled by the Decree n. 3.800, of April 20th, 2001, art. 1, II):

- 95% - from 01/01/01 until 12/31/01;
- 90% - from 01/01/02 until 12/31/02;
- 85% - from 01/01/03 until 12/31/03;
- 80% - from 01/01/04 until 12/31/04;
- 75% - from 01/01/05 until 12/31/05;
- 70% - from 01/01/06 until 12/31/09, when it shall be extinguished.

In the areas comprehended by SUDAM and SUDENE and in the central western area, the companies with projects approved since January 12th 2001, that invest in research activities, will have a right to the following tax benefits, related to the IPI (art. 1, I of the Decree n. 3.800/01):

- exemption until 12/31/03
- 95% - from 01/01/04 until 12/31/04;
- 90% - from 01/01/05 until 12/31/05;
- 85% - from 01/01/06 until 12/31/09, when it shall be extinguished.

Withholding Tax

The article 500 of the Income Tax Regulation (Decree n. 3000, of March 26th 1999) states that the companies which own the Industrial and Technological Development Program (*Programa de desenvolvimento tecnológico e industrial – PDTI*), have a right to a credit of up to 50% on the Withholding tax calculated on amounts that have been paid, sent, or credited to beneficiary living in a foreign country, as *royalties*, technical, scientific, administrative or similar assistance, and specialised technical services.

The § 1 of the same article reduces to 25% the credit for companies which own the PDTI, whose programs have been approved since 12/29/89 (Law n 7.988/89, art. 3, I).

20. The article 40 of the Constitutional Transitory Provisions (*Ato das disposições constitucionais transitórias – ADCT*) refers solely to the Free Zone of Manaus.

There are four Bills proposing to amend the Constitution being analysed by the Brazilian congress regarding the postpone of the tax incentives in the Free Zone of Manaus until 2030 (“*Proposta de emenda à Constituição – PEC*” n. 550/1997).

IV. Colombia

1. Colombia enjoyed several decades of uninterrupted economic growth until recently. Some attribute this growth to the drug trade, but it is also true that Colombia historically has pursued more stable economic policies than its neighbors. The prevailing climate of violence has left Colombia unattractive to foreign investors, notwithstanding its many attractive investment opportunities. The level of violence also has caused a massive outflow of Colombian capital and talent.

2- Colombia has been slow to adopt international norms regarding taxation. There is no tax treaty program, a discriminatory tax on 'remittances' has been in effect for years, and only recently has Colombia enacted transfer pricing legislation. Among other reasons, Colombia's former prosperity with relatively little foreign investment has dispersed pressure to make its tax system more attractive to foreign investors. Even now, the level of violence makes it unlikely that tax incentives or reforms would have a major impact on foreign investment.

3- In light of the foregoing, it is perhaps not surprising that natural disasters have been the major source of tax incentives in Colombia for the last two decades. Tax free zones do exist, as do miscellaneous export incentives, but these incentives are relatively unknown.

- a. Tax Incentives
- b. Analysis of Incentive Prior to Enactment
- c. Effectiveness of Incentives
- d. Epilogue

a. Tax Incentives

Natural disaster incentives

4- Nevado de Ruiz- Thirteen years ago, a volcano known as Nevado de Ruiz erupted, causing 20,000 deaths and immense economic damage. In the event of such disasters, Colombia's president is authorized to issue decrees with the force of law. Such decrees expire automatically after two years, but often are formalized as law by the legislature. In this case, the Colombian Congress passed a law granting the following incentives:

- a tax credit against Income Tax for amounts invested in the region, starting with a credit of 100% of the amount invested, and decreasing over the ten year period of the law;
- an income tax exemption, starting at 100%, and decreasing over time.

5- Rio Paez- this disaster arose from severe flooding in the southwestern part of Colombia in 1992. The same general incentives as Nevado de Ruiz were granted. An investment credit and income tax exemption are offered to enterprises that are formed in the disaster areas. When the Congress approved the incentives, no sunset provisions were included; accordingly, the Colombian Congress has had to repeal the benefits over the last few years.

6- Quimbaya- this 1999 incentive package relates to the zone affected by the earthquake in the coffee growing Armenia region. Damage was severe, including damage to one million homes. Though the severity of this tragedy was no less than the two mentioned above, the scope of the incentives offered is much narrower. No credit is given for amounts invested. Depending on the region and the damage incurred, the income tax exemption ranges from 50-90%, and is tied to a clear schedule for reduction and elimination of the incentive over a ten-year period. Relief from VAT and customs duties also is provided for assets to be used in the affected regions. Perhaps most important, specific rules are established for the type of investments qualifying for the benefit.

Incentives for Specific Industries

7- Publishing- this incentive applies to income derived by authors and publishers of all types, including book and newspaper publishers. The incentive consists of an income tax exemption for income related to publishing. This incentive has been in effect for approximately 20 years, and there is no sunset provision.

8- International transport- the proportion of income derived by an air carrier from its international operations is exempt from income tax. The exemption is aimed at income from international operations, though the proportion of revenue from domestic and international operations may not correspond to the net income attributable to each. Aircraft used in international transport are not subject to Value Added Tax. International transportation is subject to VAT, though domestic air transport is not.

9- Sports teams- such enterprises are considered non-profit 'clubs' and not subject to income tax. Though no support was offered, there is a perception that huge profits are generated and no tax is paid.

10- Public service companies- one of the most generous incentives affects several types of public services, such as water, sewage, and electricity generation of various natures. Qualifying investments are exempt from income tax under a series of regimes. For example, companies providing water, sewage or residential electricity services are not taxed on reinvested profits for a period of seven years, beginning in 1995; companies engaged in electricity generation, residential telephone service and residential gas service are subject to a decreasing exemption on reinvested amounts over a seven year period (1996-2002); and companies engaged in solar, "clean" coal or small-scale hydroelectric generation are exempt from income tax for a period of twenty years.

Export incentives

11- Tax Free Zones - there are three types of such zones. Two of these are considered important, those related to export-oriented industry and those where items can be purchased free of VAT and customs duties. The third, allowing an exemption for export services performed in Tax Free Zones, seems not to be of interest or importance.

12- The export industry zones follow the international model. First, there are exemptions from VAT and customs duties on imported machinery and inputs (as explained in government promotional material, the items are deemed not to have entered Colombia). Second, there is an exemption from income tax to the extent output is exported, and no withholding on 'distributions' (as noted above, Colombia does not tax dividends, but does tax remittances from Colombia to any other country). The zones are spread throughout the country, often near the coast, borders, or international airports. Industries targeted are "production, distribution, commercial operation and tourism." A \$2 million investment is generally required. The Income Tax exemption is valid through 2003, when the exemption will lapse as a result of Colombia's WTO obligations.

13- Customs and VAT free areas have long been a part of Colombia's political and economic development landscape. Two specific areas, San Andres Island (several hundred miles off the Caribbean coast) and La Guajira region (an area bordering Venezuela that has a long history of outlaw activity) have had the benefits so long that it is difficult for Colombians to contemplate these as ordinary taxable areas. Similar benefits have been granted to other areas that are near Colombia's borders.

14- Each area receives slightly different treatment. San Andres and La Guajira depend primarily on Colombian purchasers. San Andres is a popular vacation area for Colombians, and holidays are made more affordable by a \$1000 duty-free allowance for goods purchased and brought back to the mainland. La Guajira purchases were subject to virtually no regulation until recently, though the region is not considered an attractive one to visit. A compromise between the region and the central government makes items brought into the rest of Colombia subject to a 10% tariff, which the region receives. This benefits the government because, for the first time, there is now a mechanism to control merchandise originating in La Guajira.

15- Other free trade areas are directed toward tourists and other purchasers who will export the merchandise.

16- Plan Vallejo/ CERTS- CERTS are tax reimbursement certificates that have been granted for many years to exporters. These credits are based on a percentage of gross export value, with the rate depending on the item exported. These credits can be used against any tax liability and are transferable.

Plan Vallejo benefits have evolved over the last 30 years. Subject to agreement by the government, imported inputs and capital assets are relieved from VAT and Customs duties to the extent output is exported.

Capital Markets

17- Exemption from capital gains tax for sales of publicly traded stock- most Colombians consider this provision to be an incentive. Gains from sales of shares of Colombian shares listed on the Bogota stock exchange are exempt from tax. (In light of the fact that Colombia does not tax dividends, and the fact that many countries tax capital gains at residence, this exemption arguably is not properly described as an incentive.)

b. Analysis of Incentives Prior to Enactment

19- Natural disaster incentives- there is broad agreement that virtually no analysis of the Nevado de Ruiz incentives was undertaken prior to enactment. Rather, there seems to have been a great sense of urgency to do something for the region, and the broad range of tax incentives was perceived to be a way to help that would not involve significant government outlays.

20- Several years later, at the time of the time of the Rio Paez disaster, there was sufficient familiarity with the Nevado de Ruiz incentives to have an idea of the cost of such incentives. Nevertheless the same pattern as Nevado de Ruiz was followed; the president searched for ways to assist the region without dramatically increasing the (current) budget deficit, and decreed a package of tax incentives similar to those offered in the Nevado de Ruiz disaster. Legislators from the affected region pushed subsequent legislation through. The Ministry of Finance, ordinarily the source of technical tax expertise, was unable or unwilling to stop the legislation. This was the period of the Samper presidency. Though some of the tax officials at this time were of high quality, others were not. In addition, the Ministry of Finance's influence in the Congress was compromised by the embattled president's lack of leadership. No doubt some Congressman were well aware of the severe revenue consequences that the poorly drafted incentive law entailed. It is very possible that the incentives were partly a giveaway to political cronies.

21- Only in the last two years has Colombia even made a serious attempt to assess the revenue impact of the Rio Paez law, and by analogy predict the impact of the benefits proposed with respect to the Armenia earthquake (the Quimbaya incentives). Government officials agree that the precedent of tax incentives being handed out in prior disaster situations made it impossible to resist such incentives being granted in this latest crisis. Nevertheless, the government was armed with revenue estimates for the first time ever. The rough revenue impact of the Rio Paez law, along with stories of abuse, made it possible to convince legislators to limit the incentives (both in terms of qualifying investments and benefits available) and impose a definite phase-out.

22- Sector incentives- these incentives have been in place for many years. No one recalls any objective analysis of the benefits. Rather, they seem to have been the result of lobbying efforts by members of Colombia's economic elite (see the discussion of the stock market incentives, below). As with most incentives of this type, there no doubt was an argument made that these particular sectors are especially important to the country and

therefore deserve relief. It is understandable that Congress and even the Ministry of Finance might consider the costs of the publishers' exemption or the public service benefit to be small when measured against the importance of supporting these sectors. At the same time, it is clear that no one had any serious data regarding revenue costs at the time the legislation was passed.

23- These incentives were based on internal policy issues- competitiveness and policies of neighboring countries did not play a role. Nevertheless, even in the public services area, there are suggestions that lobbying efforts by special interests played a greater role in the legislative process than an objective analysis of Colombia's national interests.

24- Export incentives- The export incentives that have been in existence for many years, primarily the CERTs, appear to be the result of interventionist policies of the 1970s. At the time, many economists and international organizations (such as CEPAL, the United Nations Latin America Economic Policy Center) encouraged such incentives.

25- Tax Free Zones - Tax free zones are a far more recent phenomenon. Legislators from the affected regions appear to have been behind the legislation, and no cost/benefit or other significant analysis was carried out. Though no one specifically recalls other countries' tax free zones being mentioned in support of the tax-free zone legislation, it may have been part of the debate. The existence of such zones in other regions of Colombia was more important. As with the disaster incentives, it is difficult to deny benefits requested by one region when a different region with similar circumstances has been granted benefits.

26- Capital Markets- the debate related to the capital gains exemption for stock market transactions attracted more attention than most. It seems to have been a sincere attempt to diversify ownership of Colombia's largest companies. To illustrate, at the end of 1987, 81% of the shares of Colombia's largest companies were owned by .2% of the population.

27- Though an exemption for stock market sales is common in Latin America, the debate in Colombia appears to have focused on domestic considerations.

c. Effectiveness of Incentives

28- It is difficult to find anyone in Colombia, in either the private or public sector, who believes that the benefit of any incentive remotely approximates the cost (though there was no opportunity to interview any representatives from the companies benefiting from "sector" benefits). Indeed, it is difficult to identify any measurable benefit, whereas recent investigations put the revenue loss in the hundreds of millions of dollars. The cost is enormous in terms of administrative resources: one auditor claimed that **95%** of auditing resources went into controlling tax incentives. Even accounting for extreme hyperbole, this amount is too much for any tax administration.

29- Natural disaster incentives- the Nevado Ruiz incentives and the Rio Paez incentives are considered by tax professionals, both private and public, to be both extremely costly in terms of revenue, yet almost meaningless in terms of economic development. Some described the Rio Paez program as a “complete failure.” This is a consequence of both poor drafting and outright tax fraud. The 100% tax credit for investment in affected areas involved an immediate revenue cost, yet the related investment did not have to be carried out for several years. In some cases, the subject investment was not even made in an affected area, because the law specified only that the enterprise had to be “based” in the area.

30- Some consider even the legitimate investment to have caused more harm than good. Many of the investors using the incentives have been grocery store chains and other large investors that likely would have invested without the incentives. It is believed by some that the arrival of these investors hastened the failure of locally owned small businesses.

31- The level of fraud and avoidance is impressive, though not surprising. Responsible tax advisors report being consulted by clients who had been approached by more dubious tax advisors offering the opportunity to “clean up” their taxes through use of an entity registered in the disaster areas. No change in business operations was proposed; rather, profits simply had to be channeled through the exempt entity. The DIAN (Colombia’s tax administration) did not begin auditing the Rio Paez investors until last year because the promised investments did not have to be carried out for a period of four years. With 30% of the beneficiaries audited, nearly 90% were determined not to have fulfilled the requirements of the incentive program.

32- The Quimbaya incentives have not had time to develop. There is limited optimism that the incentives will contribute to economic development. The subject region has a level of economic development that is of interest to investors, which was not the case with Rio Paez. Nevertheless, tax professionals are fairly confident that the more limited benefits (based on the experience with the earlier incentives) will limit the revenue cost.

33- Sector incentives- most attention has been focused on the disaster incentives, probably because of the extraordinary opportunities for abuse. These benefits are limited to important but narrow sectors of the economy. There is no general sense that international transportation is better, the publishing industry more vigorous, or the sports industry healthier because of the tax benefits offered. At the same time, there is a feeling that the sectors are so powerful that eliminating the benefits would be almost impossible.

34- Export incentives- Neither the older incentives nor the newer Tax Free Zones have had a significant impact on either investment or revenue. The traditional incentives (Plan Vallejo benefits and CERTS) are used by many exporters, but no one believes that they have made a significant difference in output. Colombia’s Tax Free Zones are as good as any when the investor is a non-resident. Much of the attraction is lost for Colombian investors because of (an apparent) technical error that has never been corrected: Colombian enterprises exempt from taxes in the Tax Free Zones are subject to a compensatory tax upon distribution. It may be that being competitive is not enough in a

country with a history of violence, especially when the last president (in office 1994-1998) had little international credibility, and many of the incentives are set to expire within three years. Then again, it may be that these incentives pale by comparison to the disaster zones, and therefore do not receive much attention.

35- The border areas that function as duty free zones place great value on this status. However, the “development” in these areas has been limited to sales outlets; no production has been attracted. Some of those interviewed thought that the focus on commerce had detracted from other development, with the result that comparable areas that are not duty free zones had experienced superior economic growth.

36- Though the Tax Free Zones are relatively low-profile, there are reports of fraud. The activities are of the normal sort, such as the re-direction of assets supposed to be destined for a Zone (domestic contraband, or false exports).

37- Capital Markets- In one serious study presented at the 1998 annual conference of the Colombian Institute of Tax Law, the author concludes that the “incentive” has not significantly improved the situation that motivated the original incentive. Stock ownership continues to be extremely concentrated, and the performance of the Colombian stock market has been abysmal for several years.

d. Epilogue

38- Public and private sector tax professionals alike are cynical about tax incentives. The revenue cost has been enormous over the years, and no one seems to view any incentive as having helped the country. One bright spot is the establishment of an office to analyze the revenue impact of tax proposals, including incentives. Though this office is new and has modest resources, it is credited with reducing the scope of the original Quimbaya incentive proposal to a far more reasonable level. Few new incentives are expected in light of Colombia’s precarious fiscal situation, which has led Colombia to implement senseless taxes such as a .2% tax on financial transactions.

39- The evidence suggests that the disaster relief incentives will be very limited in the future, and that the export incentives/ Tax Free Zones will dry up in accordance with international trade obligations. The sectoral incentives are more problematic. Only the public service incentives have a built-in sunset provision (indeed, some will begin to expire in two years). It will require immense political will to take on the powerful interest groups that would be affected. Under Colombia’s current political structure, so many politicians are beholden to these same interest groups that these incentives likely will remain in place for some time to come.

V. Costa Rica

1. Most of Costa Rica's incentives have been directed toward two key sectors: Manufacturing for export, and tourism. Most Costa Ricans believe that these sectors have benefited from the incentives, but it is also recognized that tax incentives are only one part of the puzzle. There is no consensus as to how much foreign investment would not have been made if one or more of the incentives were unavailable.

- a. Tax Incentives
- b. Analysis of Incentive Prior to Enactment
- c. Effectiveness of Incentives
- d. Epilogue

a. Tax Incentives

2. Costa Rica's incentives can be divided into two general groups: those in force prior to 1992, when there was a comprehensive reform, and those currently in force. The first group provides an excellent example of confusion and abuse. Some of these incentives continue even today because of the general principle found in Latin American legal systems of "acquired rights," meaning that the government cannot take away a right (even those which might be qualified more appropriately as privileges) once granted. The latter group is not without controversy, but the most blatant abuses of the past seem to have been remedied.

3. All incentives are at the national level. As a small country, Costa Rica does not have states. The only sub-national governments are the municipalities. Such municipalities do impose small taxes, but these taxes appear not to be an issue for investors.

Key Incentives Available Prior to the 1992 Reform

4. Tax Credit Certificates ("CATs")- this 1984 law created an incentive aimed at boosting exports. The general concept is simple: the Central Bank issued bearer securities (i.e. freely transferable), for up to 10.5% of the export FOB value (less an adjustment for value attributable to imports).

5. Hotel Investment Credit—this incentive is based on the notion that the hotel sector would lead the tourism industry. Those investing in hotels received a tax credit, which could be used against any tax, equal to 50% of the amount invested. Prior to 1992, approved hotel ventures were also exempt from income tax. This exemption was repealed, but the 50% investment credit still exists.

6. Forestry Incentive- a 100% tax credit for amounts re-invested in a forestry project ("CAF"). As long as an investor wanted to reinvest the taxable portion of his profit, no tax would be paid.

Current Incentives

7. Tax-Free Zones-- available to certain types of business operations since 1990, this incentive survived the 1992 reforms. Included are manufacturing for export, services provided to export companies, scientific research, shipping construction and repair, and trading companies distributing non-traditional products. Up to 40% of production may be sold in Costa Rica (though the corresponding proportion of income is subject to customs duties and income and value added tax).

8. The benefits are sweeping for qualifying companies:

- raw materials and other inputs may be imported free of tax and customs duties
- equipment, machinery and certain vehicles (and items related to the operation thereof) may be imported free of tax and customs duties
- no export taxes are imposed
- a 10 year exemption from taxes on assets, property and real estate transfers
- exemption from all taxes on remittances
- income tax exemptions ranging from 4 to 12 years, depending on the development level of the zone and the industry, followed by a 50% exemption for the following 2 to 6 years, again depending on the development level of the zone and the industry. A provision has been added to allow extension of these periods if there is a sufficient threshold of reinvestment. Free zone service providers are also exempt from income tax
- the government will assume the company's responsibility for Social Security in certain underdeveloped zones (up to 15% of payroll)
- the company benefits from expedited customs rules.

9. Furthermore, the tax free zone concession operator provides the companies with a variety of services. The tax free zones are located in designated areas near sea and air transport facilities, and in some less developed areas of the country. However, if the investment reaches a higher threshold (> \$2 million invested, > 75% of output exported), the government will consider the approval of any facility location as a special Tax-Free Zone.

10. Other incentives are available in all parts of Costa Rica that engage in export of non-traditional products, through "export contracts." Those investing in qualifying export companies that are traded on the local stock exchange receive a tax credit, which may be used against any tax, equal to 50% of the amount invested. This benefit is limited to 25% of the investor's net income. Production may be sold in Costa Rica (though the corresponding proportion of income is subject to customs duties and income and value added tax).

11. Drawback Incentive-- this system is available for all investors, and includes:

- suspension of import duties on raw materials and other inputs

- suspension of import duties on equipment and machinery
- VAT exemption on locally purchased goods.

If a company wishes to sell part of its output locally, it must seek permission from local authorities, and a portion of the foregoing benefits will be taken back.

12. Forestry Incentive-- in exchange for preserving forests, there is an exemption from land taxes. In addition, a marketable tax credit is given in exchange for refraining from lumbering for a minimum of 20 years. The same benefit applies for owners of deforested land that is reforested. There is an income tax exemption for those engaged in lumbering for those not using CAFs (explained above-- though CAFs are no longer available, some are still using this benefit as an “acquired right”).

13. Agriculture Incentives-- no import duties on equipment and machinery. Nearly all agricultural activity is exempt from tax, including income tax.

14. Power Industry Incentives-- sales of electricity are not subject to Value Added Tax, and power companies are exempt from customs duties.

15. Dividend Withholding -- the general withholding rate on dividends of 15% is reduced to 5% for companies traded on a local stock exchange, and can be waived where the recipient demonstrates to the tax authority that no foreign tax credit would be available for tax withheld. Furthermore, sales of shares are not subject to tax.

16. Tourism Incentives: In addition to the 50% tax credit for investment in hotels mentioned above, incentives are available for tourist-oriented industries, such as hotels, tourist agencies and transportation. The incentives include duty free import of equipment, furniture and certain vehicles, and an exemption from property tax for property located outside the capital, San Jose.

b. Analysis of Incentives Prior to Enactment

17. For tax incentives in Costa Rica, 1992 was a watershed year. At that time, the government attempted to create an inventory of tax incentives, and the cost of each. The effort was not completed because the task was overwhelming. Representatives of some affected industries furnished their own analyses of the incentives. The Government study did help to focus attention on the immense revenue loss caused by the incentives, and an attempt was made to wipe the slate clean. Still, those with ‘acquired rights’ were able to keep all or part of their benefits for several more years.

18. Tax Credit Certificates (“CATs”)- There was no meaningful analysis of this incentive prior to adoption.

19. Hotel Investment Credit-- There was no meaningful analysis of this incentive prior to adoption.

20. Forestry Incentive-- There was no meaningful analysis of this incentive prior to adoption.

Current Incentives

21. Tax-Free Zones-- the Tax-Free Zone concept seems to a direct result of competition with other countries. Among the sponsors of the legislation was the Export Chamber of Commerce, who pointed out that other countries, especially neighboring countries, were creating such zones. Panama, which shares a border, has long had tax-free zones.

22. Drawback Incentive—None of those interviewed reported any significant study or analysis of this benefit.

23. Forestry Incentive-- None of those interviewed reported any significant study or analysis of this benefit.

24. Agriculture Incentives-- None of those interviewed reported any significant study or analysis of this benefit.

c. Effectiveness of Incentives

25. The tax incentives described above have cost Costa Rica considerable revenue, in some cases by design and in others because of abuses. However, there is a general consensus that the cost has been worthwhile, especially with most of the abuses eliminated. Twenty years ago, Costa Rica's economy was very dependent on coffee and banana production. Now the economy is more diversified. To curb the abuses, an office of the Finance Ministry authorizes and monitors incentives. The office seems to be free of corruption.

26. Tax Credit Certificates ("CATs")- While some benefit may have been derived from this incentive, the consensus clearly is that abuses overwhelmed any potential benefit. Since the Certificates were transferable, they could be used by anyone. The exporters by and large did export the items subject of the credit, but there was significant fraud. Even where outright fraud was not an issue, it is easy to see how a company might reduce its Costa Rican income liability and then sell the excess credit for a profit. Transfer pricing, which is still uncontrolled in Costa Rica, could be used to inflate the credit (by increasing the transfer price), because the invoice price was rarely challenged as the basis for the export value.

27. Hotel Investment Credit-- Prior to 1992, this incentive resulted in considerable abuse and fraud. The provision allowing tourist-related companies to import inputs free of tax resulted in such companies importing far more than they required, the excess being sold on the black market. Even worse was Article 11 (repealed 1992), the right to take ½ of the investment as a tax credit. The law was not clear, which led to various manipulations to make use of the credit. For example, investors often lent money to the hotel project

and took the credit, or took the credit with respect to investments that would not actually be made for several years.

28. Though the credit provision that enabled the worst abuses has been abolished, some investors are taking credit even today under the old law, as an ‘acquired right.’

29. Forestry Incentive- this incentive probably encouraged the forestry industry, but at an unacceptable cost. Investors generally reinvested the full amount of tax liability, thus avoiding income tax, then subsequently sold the project. The capital gain on the sale was tax free- most likely not the result intended by the original legislation.

Current Incentives

30. Tax-Free Zones-- As one drives between downtown San Jose and the airport, the gleaming Intel plants are in full view. Intel exports already account for 25% of Costa Rica’s exports, and this figure could reach 50%. Other investments, though less dramatic, are obvious. The Intel project employs more than 1000 Costa Ricans in an industry that is viewed as desirable. Educated Costa Ricans speak of the “Intel effect,” that is, the positive impact the Intel operation has had on other parts of the economy.

31. One effect of the Tax-Free Zones that should have been expected is the migration of companies to such zones from outside them. It should be no surprise that many of such companies moving their operations are those that previously benefited from the CAT incentive. The law attempts to forestall such migration by denying the exemption to transfers of existing investments to the Tax-Free Zone. Expansion of an existing investment is not prohibited; of course, it is not always possible to detect the difference. Taxpayers who are not able to benefit from the Tax-Free Zone Law are currently pursuing relief in the judicial system, on the basis that the dual tax system is unconstitutional.

32. Drawback Incentive-- When measured with reference to the Tax-Free Zones, the drawback incentive seems modest. It probably is the bare minimum necessary for firms to think of investing anywhere outside the Tax-Free Zones. No one noted any significant abuses under this regime.

33. Forestry Incentive--Forestry continues to grow as an industry. The current incentive may play a role in this growth, but there is little discussion of this particular incentive.

34. Agriculture Incentives-- None of those interviewed mentioned the impact of this incentive as either particularly positive or negative.

d. Epilogue

35. Costa Rica is an example of a country that generally supports the notion of tax incentives, notwithstanding abuses that have taken place, and indeed continue. The two sectors specially targeted, tourism and manufacturing, have prospered. One can point to

the fact that hotel construction has continued at a brisk pace, even though the associated benefits have been cut back.

36. It is more difficult to dispute the success of the Tax-Free Zone policy. It is possible that Intel and others would have invested in Costa Rica without the incentives. Clearly, other countries offered a similar deal and were not selected, thus demonstrating once again that tax incentives alone are not sufficient to attract investment. Costa Ricans by a wide margin appear to be willing to sacrifice tax revenue for more investment. There is visible enthusiasm when the possibilities are discussed for new investment, including online casinos, call centers, and other such “export services.” International tax advisors did not dismiss the possibility of locating at least part of their operations in the free zones.

37. At the same time, abuses continue, especially from the pre-1992 incentive. This arises from the ‘acquired rights’ that these taxpayers inherited. These rights are gradually expiring. There is a sense that the current incentives, though worthwhile, will not survive more than another 15 years at most. Costa Rica subscribed to GATT in 1989, and a condition of World Trade Organization membership is that tax holidays are not to be allowed after the year 2003. Nevertheless, investors such as Intel hope to benefit from the incentives given prior to 2003 for at least another ten years. This presents an interesting issue of law in Costa Rica: on one hand, international treaties supersede domestic law, and the Intel exemption (under the Tax-Free Zone Law) is a normal domestic law. However, the rights which Intel acquired by law may be constitutionally protected. The Intel agreement occurred after Costa Rica committed itself to eliminate tax exemptions. Therefore, Intel may have a claim against Costa Rica if the exemption is taken away. Costa Rica is hoping to obtain an exemption or extension from the WTO, to avoid such a conflict.

38. Another issue receiving serious attention is abolition of the Income Tax, both at the corporate and personal levels, a move that would eliminate the need for certain aspects of the Tax-Free Zones.

VI. Ecuador

1. Ecuador demonstrates the challenges faced by tax policy makers in a country “blessed” with abundant oil reserves. Like other such countries, recent history has been marked by attempts to diversify the economy (often through tax incentives), inattention to tax policy during periods of high oil prices, and fiscal turmoil (with panicked tax policy) during periods of low oil prices.

2. Booms and crises have been the order of Ecuadorian life. The most recent crisis was caused in part by the decision in late 1998 to eliminate the Income Tax for most taxpayers, and replace it with a 1% tax on financial transactions. Predictably, this tax severely disrupted the economy, and the revenue it generated dropped off within a few months. Accordingly, the Income Tax was reinstated only five months into 1999. The havoc wrought by swinging oil prices, along with irresponsible and corrupt government, led Ecuador to take the dramatic step of adopting the U.S. dollar as its national currency in 2000.

3. Ecuador’s history of tax incentives can be broken into three periods. First is the period prior to 1989, when Ecuador lacked a coherent tax policy. Incentives, like other tax law, were adopted on a case-by case basis. A global reform took place in 1989, with one of the few genuine tax policy debates in Ecuadorian history. Some incentives survived this reform, and others were added in following years. The third period begins with the reinstatement of the Income Tax in 1999. With a few notable exceptions, all incentives have been eliminated. Naturally, these periods are not cleanly divided because some incentives survived even the major reforms, and because many taxpayers continue to enjoy repealed incentives as an “acquired right.” Still, the three-period division is the most logical method of analyzing Ecuador’s tax incentives.

- a. Tax Incentives
- b. Analysis of Incentive Prior to Enactment
- c. Effectiveness of Incentives
- d. Epilogue

a. Tax Incentives

Pre-1989 Tax Incentives-

4. Income tax exemption for industries locating outside Quito & Guayaquil. The most important incentive prior to the 1989 reform was a ten-year income tax exemption for enterprises established outside the metropolitan areas of Quito and Guayaquil. A list of industries qualifying for the benefit was published, and government approval was required. The idea was to spread economic development over a broader area of the country, since virtually all investment had taken place in these two areas.

5. Certificado de Abono Tributario (“CAT”). Tax Credit Certificates, or CATs, were available to certain exporters upon government approval. The certificates (which were negotiable instruments and therefore valuable even to those with no tax liability) were equal to a percentage (50 – 100%) of the value of the exported items, the actual percentage varying according to the product.

6. Other Incentives. In 1971, there were approximately 15 types of tax exemptions that were available for miscellaneous activities. By 1989, this number had grown to approximately 35. These specific exemptions were generally directed toward Ecuadorian taxpayers.

Tax Incentives, 1989-1998

7. Tourism Incentives-- Adopted in 1996, this incentive consisted primarily of five- and ten- year exemptions from the Income Tax. The exemption applied to various tourism-related sectors, but the primary beneficiaries were hotels, restaurants, and tour operators. Limited tax benefits remain in effect for new investments, but these involve local taxes. The Income Tax must be paid in the case of new investments.

8. Non-traditional exports incentives-- This incentive was adopted in 1994 for investments in non-traditional areas (the traditional areas being oil, coffee, bananas and others). The incentive featured an immediate 100% deduction for the acquisition cost of equipment. After 1996, the deduction was limited to 50% of the prior year’s earnings.

10. Mining Incentives-- numerous incentives were offered in the mining law, most of which concerned local taxes and immediate deductions for certain costs, but not actual exemptions from the Income Tax. An important benefit intended to promote exploration was an exemption from capital gains on the sale of a concession (repealed 2000). Some benefits related to local taxes still are in effect.

11. Publishing incentives-- A ten-year Income Tax exemption (starting the year production began) was offered for book publishers, authors and translators.

12. Agriculture-- Primary agriculture was exempt from all local taxes. Such primary producers were subject to the Income Tax prior to the exemption, but rarely paid anything. Another incentive was available for companies engaged in the processing of Ecuadorian agricultural products. From 1997 on, the incentive allowed a 50% discount from the Income Tax that otherwise would have been payable. Some incentives related to local taxes still are in effect.

13. Provincial incentives-- Starting around 1995, Ecuador began to offer tax holidays to certain remote provinces, either because of depressed economic circumstances, or because of a natural disaster. Before repeal in 1999, the incentives were available in one form or another in: Loja, Esmeraldas, Bolivar, Cañar, Chimborazo and Imbabura. The holidays ranged from ten to fifteen years, and invariably commenced with a 100%

exemption, which scaled down to 75%, and then 50%. The industries that qualified in each province also varied.

14. Capital Markets Incentive-- Between 1993 and 1998, Ecuador encouraged investment in its nascent stock market by offering dramatic tax incentives. Issuers of new publicly traded stock could deduct 50% of the value of the stock issued from taxable income, and purchasers could deduct 50% of the purchase price from their income.

15. Tax Stability Contracts-- Between 1992 and 1996, when such the law authorizing such contracts was repealed, Ecuador offered tax stability by contract with the government. Unlike other countries where the laws at a given moment were “frozen,” Ecuador entered into contracts freezing only the Income Tax rate at the time, or in some cases, stabilized the tax paid for the year in question. In other words, if a taxpayer had paid \$100 in tax for the prior year, such taxpayers’ Income Tax liability would be frozen at \$100. This particular application of tax stability was ruled illegal by the Ecuadorian courts in 1995.

16. Forestry/ Reforestation-- this incentive was similar to the non-traditional exports incentive, offering near-immediate deduction of costs for qualifying investors (those engaged exclusively in forestry).

Current Tax Incentives-

17. “Zona Franca” /Tax Free Zones- Ecuador offers the standard Tax Free Zone concept, with the interesting difference that private concerns, not the government, initiate such zones. A company aspiring to operate such a zone must have the land to operate what is essentially an industrial park, must fulfill various requirements, and receive permission from the government. To date, there are three zones. For investments in these zones, there is no tax of any sort for a period of twenty years-- no Income Tax, Value Added Tax, Import Duty, or local taxes such as Property Tax. It is expected that production will be exported, though production may be “imported” into Ecuador at the prevailing rates for Customs and VAT. It is therefore interesting that most Ecuadorian tax specialists do not initially mention these Zones as a tax incentive. This apparently stems from Ecuadorians’ perception that these zones are international territory, not part of Ecuador proper.⁴

⁴ To qualify, the investment must comply with the following:

1. La actividad a desarrollar en la zona franca;
2. Los productos a elaborar o comercializar o los servicios a prestar;
3. Las materias primas, envases y embalajes a utilizar;
4. Las maquinarias, equipos y más insumos a importarse y su origen;
5. El número estimado y nivel técnico o profesional de trabajadores nacionales y extranjeros a emplear;
6. El plazo de duración de la actividad; y, Otras informaciones específicas como la clase de tecnología a utilizar que permita identificar la importancia de la actividad que se va a instalar.

b. Analysis of Incentive Prior to Enactment

Pre-1989 Tax Incentives-

18. To encourage economic development and independence, Ecuador followed the same United Nations inspired model in the 1960s and 1970s that many other Latin American countries followed. This model involved imposing high import tariffs while granting export incentives. It is fair to state that Ecuador did what other countries were doing, but not because the others were implemented such policies. It is more accurate to state that several Latin American countries were following the same advice.

19. In the period prior to 1989, taxpayers were few in number; foreign companies and those in a few selected industries (oil, cement, beer) accounted for virtually all non-oil revenue. Other taxpayers either persuaded the Ecuadorian legislature to give them relief, or did not comply. Many taxpayers simply did not register with the tax administration, and little was done to rectify this situation.

20. In summary, if any analysis of the pre-1989 incentives was undertaken, it was not serious. In some cases the incentives were designed in accordance with advice from the United Nations, and in other cases the “incentive” was simply a tax break obtained through political influence.

Tax Incentives, 1989-1998

21. By 1989, there was a general consensus that tax incentives were generally unproductive. Nevertheless, as many as nine (of approximately 35) incentives survived the global reform of 1989, and the number doubled over the following decade.

22. Tourism Incentives-- These incentives stand alone as being the product of a cost-benefit analysis. The government requested a private consulting firm to perform the task. This firm studied the laws of other countries and the economics of the tourist industry in general, and determined that a ten-year tax holiday could be justified because of the general seven-year period before hotels become profitable. The increased economic activity and Value Added Tax that would be collected in the meantime were deemed sufficient to offset lost revenue. It appears that the analysis was based on general principles, not numerical estimates.

23. Other 1989- 1998 Incentives-- Numerous other incentives belonging to this period are described above. Persons interviewed had no recollection of any meaningful analysis of the incentives other than those related to Tourism. All other incentives fall into one of three general categories. First are those adopted with a general sense that the incentive would attract investment, but without any serious analysis. The non-traditional exports incentive, the Publishing incentive, the Mining incentive, and the Agricultural processing incentives are generally in this category. Second are those that were sought by specific interest groups for the purpose of their own tax reduction. The Capital Markets incentive may have been pushed through in part by such interests. The third group are those, such

as the provincial tax holidays, that never had any possibility of attracting investment, but which were escorted through the legislature by politicians in an attempt to curry favor with constituents.

Current Tax Incentives-

24. “Zona Franca” /Free Trade Zones- Of all tax incentives implemented over the decades, this incentive seems to be the only one where the example of other countries was a major factor in initiating the incentive. Several experts cited such zones in other countries, or maquiladora type operations, as the reason for Ecuador initiating such zones, and now retaining them at the same time it has eliminated practically all others.

c. Effectiveness of Incentives

Pre-1989 Tax Incentives-

25. Income tax exemption for industries locating outside Quito & Guayaquil. This generous benefit only achieved modest results. An industrial park in Cuenca can be traced to this incentive, and a few other investments (soft drink bottlers, for example) were made on the periphery of the zones excluded from the benefit (Quito & Guayaquil). The benefits were not sufficiently attractive to draw investment for two reasons. First, it was relatively easy to escape taxation even in Quito & Guayaquil, thereby reducing the potential savings. Second, the infrastructure and markets outside the major cities are minimal. Consequently, several of the investments made in response to this incentive were shut down after the benefit expired.

At the same time, experts do not view this incentive to have been costly, again for the simple reason that few investors were paying tax during this era.

26. Certificado de Abono Tributario (“CAT”). For exporters seeking a legal method to reduce their tax burden, CATs were an interesting option. However, they were not widely used (and therefore not an important tax expenditure) because Ecuador’s principal exports were excluded from the program. Furthermore, some exporters who otherwise would have qualified for this benefit did not exploit it because they did not want to register with the tax authorities. To summarize, this benefit is generally considered not to have promoted exports, nor is it viewed as having been costly. Like other incentives of this era, no attempt was made to measure the cost, so this view is subjective.

27. Other Incentives. Numerous other incentives were provided during this period, but they were mostly targeted to specific investors, often as political favors. It is impossible to calculate how much revenue was lost, but it is probable that little additional investment resulted from these benefits.

Tax Incentives, 1989-1998

28. Tourism Incentives-- This incentive is among the few that Ecuadorians view as having accomplished something. There is a perception that an increase in hotel building occurred during the life of this incentive, though others note that the increase was less than had been hoped. As noted, the cost (in terms of Income Tax) was estimated to be offset by increased VAT and other revenue. No data is available to compare the estimates with the actual figures. However, at least one observer supposed that the investment likely would have come anyway; the incentive only accelerated the timetable. Some of the accelerated investment is of questionable value. In at least one instance, a large building already under construction for non-hotel use was converted in order to make use of the incentive.

29. Non-traditional exports incentives-- This incentive is viewed as poorly designed and ineffective. The benefit was not overly generous-- rather than forgiving tax, deductions were accelerated. The limit on deductibility (based on the prior year's income) not only was arbitrary, but also was modified during the short life of the benefit. As with other incentives of this description, the benefit no doubt cost some revenue, but almost certainly did not increase investment.

30. Mining Incentives-- The benefits offered to the mining sector are viewed as being insufficient to draw investment. Even the exemption on transfers of concessions (which potentially could have represented a great tax loss) is not viewed as having promoted exploration. Ecuador's Mining Law has been inadequate in general, and an effort is underway to improve the legal environment for mining enterprises.

31. Publishing incentives-- No one was able to offer an opinion as to the success of this benefit. Any additional publishing activity, and any revenue loss, appears to be incidental.

32. Agriculture—No firm opinions were expressed on agricultural incentives. Since this sector paid little tax anyway, revenue loss was not an issue. No one mentioned any perceived benefit.

33. Provincial incentives-- The experts uniformly believed that these sweeping incentives had not benefited the provinces at all. The exemptions offered were useless, because no industry would be profitable in these areas. The goal seems to have been political (one person referred to the incentives as "demagoguery"). On the positive side, no one was aware of any revenue loss. No significant investor was able to use the incentive, even through chance or fraud.

34. Capital Markets Incentive-- While no data is available, some experts believe that these generous benefits had a significant revenue impact. There appear to have been few benefits. The goal was to spread the ownership of Ecuadorian companies more broadly (in view of the concentrated family ownership that one encounters throughout Latin America). One may question the need to encourage the capital markets in this fashion. In any event, the incentives do not appear to have had a measurable impact. The Stock Exchange is not very active, even if shares are available. Some investors may have

offered shares only for the tax benefit, though little diversification of ownership actually occurred.

35. Tax Stability Contracts-- The short, disappointing history of stability agreements in Ecuador most likely did not have any impact on development. Some local investors may have realized some short-term savings before the agreements were ruled illegal, but investment probably was not affected.

Current Tax Incentives-

36. “Zona Franca” / Tax Free Zones- There are three such zones in Ecuador at present: Manta, Esmeraldas, and Cuenca. No consensus exists regarding these zones. In fact, little thought seems to have been given to them. They are regarded as essential to attract certain investors who would go to tax free zones in other countries if Ecuador did not offer the benefit. No one reports any of the problems associated with such zones in other countries, i.e., there is no reported migration of industry from taxed area to the zones, no contraband problem, etc. It is possible that Ecuador’s evasion problem has been so serious that the tax administration has not been able to detect these problems. It appears that no revenue estimates have been contemplated, in part because most Ecuadorians do not think of these zones as costing Ecuador revenue.

d. Epilogue

37. For a country that has repeatedly flouted the accepted rules concerning fiscal responsibility, Ecuador has made substantial progress. Perhaps because of the crises caused by earlier episodes of irresponsibility (or perhaps because of severe revenue shortfalls), Ecuador has among the fewest tax incentives available in Latin America. More importantly, there appears to be a consensus that tax incentives belong to a bygone era that Ecuador would rather forget. Even members of the Ecuadorian business “plutocracy” have shown a willingness to regularize their tax situation in exchange for less economic turbulence. But the issue of incentives is not dead: a recent Minister of Economy proposed undoing all the reforms that had been passed to eliminate the incentives. His efforts were not successful.

38. It should be noted that Ecuador’s effort to eliminate exemptions has been hampered by the “acquired right” legal principle. Even with most incentives legally repealed, taxpayers continue to utilize them.

39. Legal problems relating to the repeals of various incentives are in the Ecuadorian courts, which are viewed as deficient in several areas. Most notable is the argument that incentives must be expressly repealed, not as an implicit part of a tax reform. This issue will be in the courts for years. And the members of the plutocracy may still be inclined to seek tax benefits in the name of development once the economy improves. Also worrisome is the fact that Ecuador still has no office, or even person, dedicated to the analysis of tax proposals for revenue and economic impact. As long as this situation prevails, Ecuador’s tax policy will be in jeopardy.

VII. Mexico

1. Mexico has the one of the most renowned incentive programs in the world, one that not only has become a model for other countries, but also has introduced a lengthy Spanish word (*maquiladora*) into the vocabulary of countless non-Spanish speakers. It is perhaps surprising, therefore, that Mexico's overall package of tax incentives is relatively modest by comparison to other Latin American countries.

2. Mexico had a more sweeping tax incentive system in the 1970s. There was little control over the incentives in light of the fact that different ministries administered the tax incentive programs and tax collection. In the early 1980s, the undersecretary for tax policy was given control over both functions, and most of the incentives disappeared.

3. As will be observed, many of the incentives listed below were not designed as incentives; rather, they were administrative measures that became incentives unintentionally, and the government has been unable to repeal them. The first four described (maquiladoras, the research and development credit, the partial exemption for certain sectors, and the now repealed immediate deduction for certain investments) clearly qualify as incentives. The others are included because many Mexicans view them as incentives.

- a. Tax Incentives
- b. Analysis of Incentives Prior to Enactment
- c. Effectiveness of Incentives
- d. Epilogue

a. Tax Incentives

4. Maquiladoras- Mexico has approximately 3000 maquiladoras, employing around 1 million workers. The vast majority of production consists of electronic goods and transportation equipment. Collection of income tax from the foreign businesses operating through maquiladoras was not originally a priority: the goal of the program was employment.

5. (Intentionally left blank).

6. The Mexican Finance Ministry has applied steady pressure to curtail the maquiladora tax advantages. For example, the Mexican negotiating team ensured that no explicit or implicit protection for the maquiladoras would be included in the U.S.- Mexico Tax Treaty (other than the ordinary terms of the OECD Model). The effort to eliminate special treatment has evolved over the last few years. In years past, it was relatively easy to avoid all Mexican income taxation. The current rules require maquiladoras to comply with ordinary income tax rules and especially the transfer pricing rules. The maquiladoras are given a slight reduction in Assets Tax. Furthermore, maquiladoras pay no customs

duties or VAT on temporary imports, which constitutes the majority of items. Suppliers to maquiladoras also receive a zero rating on VAT, on the assumption that such inputs will be exported.

7. Research & development credit- This tax credit has been available for two years. In general terms, a 20% tax credit can be taken for research and development expenses to the extent such expenditures exceed the average of research and development expenditures over the prior three years.

8. Agriculture, fisheries, forestry & publishers- Through 1987, taxpayers in the areas of agriculture, fisheries and forestry received variable tax treatment depending on their size. Since then, special treatment has been extended to all persons in these sectors. The general benefit is a 50% reduction in Income Tax for agriculture, fisheries and forestry. Those who “market” or “process” such output only receive a 25% discount. Publishers receive a 50% discount from Income Tax.

9. Immediate deduction for investments- This incentive, which has now been repealed, allowed the equivalent of immediate deduction by increasing the amortized deduction according to a net present value calculation. The discount rate used was gradually reduced, and the incentive has now been repealed.

10. Simplified regimes- In 1991 a simplified regime was introduced for agriculture, fisheries, forestry, transportation and small taxpayers (such as small businesses, services and micro-industry). The simplified system is based on cash flow, with amounts subject to tax only when taken out of the business. The system also allows simpler compliance and more relaxed payment terms. A reduced, fixed-rate tax is allowed for workers. Finally, certain “blind,” or automatic, deductions are allowed without any substantiation. This deduction is 15% for national cargo transport, 10% for tourism transport, and 60% for urban transport. Along with other benefits, the simplified regime results in a tax rate of zero for many persons in the sector. The included sectors account for 16.3% of Mexico’s GDP, yet accounted for revenue amounting to only 0.022% of GDP.

11. Insurers- The Income Tax Law allows insurers to defer accumulated income from inflationary gain indefinitely. At the same time, the regulations allow a deduction for the inflation adjustment of their principal reserves, even though the law requires insurers to include as income only actual income earned, meaning that the inflation adjustment deduction is unnecessary. The result of this system is that practically exempts insurers from tax-- data recorded between 1989 and 1996 suggests an average income tax paid of 0.1% of income.

12. Consolidation- Unlike most Latin American countries, Mexico allows consolidation. This is not normally viewed as an incentive, but the breadth of the consolidation (generally 50% common ownership) encourages consolidation more than other countries.

b. Analysis of Incentives Prior to Enactment

13. A recurring theme in Mexico is the complete lack of cost-benefit analysis prior to adoption of tax incentives. It is important to note that, until recently, the Partido Revolucionario Institucional (“PRI”) was a monolithic political force. Most policy, including tax policy, was generated within the executive branch and passed by the Congress with little scrutiny. It is the opposition of Finance Ministry technical personnel that has limited the use of tax incentives. When incentives were submitted to the legislature, they have been enacted on the basis of superficial analysis and political considerations.

14. Another key aspect of the Mexican experience is the fact that benefits are often granted or repealed in accordance with short-term revenue expectations. This alone is not unusual. Mexico is different because petroleum continues to be a major source of government revenue, and such revenue expectations swing unexpectedly in response to world oil prices.

15. Maquiladoras- At the inception of the maquiladora program, Mexico was a closed economy pursuing import substitution. The goal was to employ Mexican workers without jeopardizing Mexican companies. Therefore, all production had to be exported. There appears to have been no cost-benefit analysis. Those surveyed recall no case of other countries’ incentives being used in an attempt to convince the Mexican government that Mexico should do the same. Nevertheless, in the case of maquiladoras, there has been steady pressure from the beneficiaries. They regularly threaten to leave Mexico in favor of other countries (in Southeast Asia, primarily) where labor and taxes are less costly.

16. (Intentionally left blank).

17. Research & development credit- this incentive has been on the books for only two years. There seems to have been no analysis of the measure prior to adoption. At the time, the PRI held the Presidency, but had only a minority in the Congress. The opposition Partido de Accion Nacional (“PAN”) conditioned support of a tax reform on inclusion of the research & development credit. There is no evidence that any analysis was undertaken.

18. Agriculture, fisheries, forestry & publishers- There is a perception that no legitimate analysis was performed.

19. Immediate deduction for investments- The immediate deduction for investments clearly was intended as an incentive. Nevertheless, no revenue analysis was performed. Rather, the officials at the Ministry considered this to be the technically correct approach. The benefit was scaled back not because of any retreat from this position, but rather because of revenue shortfalls.

20. Simplified regimes- again, this system was not intended to be any sort of an incentive; rather, the goal was administrative simplicity. Accordingly, no serious analysis of the revenue implications was carried out. The result has been a giveaway.

21. Insurers- this tax break is the result of a technical error. The provisions that result in such a low tax burden were the result of an oversight. Therefore, no analysis was undertaken. When the Ministry of Finance studied the issue to correct the oversight, the insurance industry convinced the Minister that the Insurance Commission required profits to be added to reserves, and therefore there should be no tax on such profits. However, the companies have found other ways to distribute profits.

22. Consolidation- the decision to permit consolidation was taken for several reasons: first, to be consistent with other OECD members; second, in recognition that consolidation is economically sensible; and third, to encourage business consolidation. No one recalls that any analysis was undertaken.

c. Effectiveness of Incentives

23. Maquiladoras- At least superficially, the maquiladora program has been a spectacular success for the Northern border region of Mexico. What had been an underdeveloped backwater has been booming for many years. The internal migration from other parts of Mexico continues. However, many factors can be cited for the success of the maquiladora program, such as the favorable trade rules and proximity to the U.S. market. The tax component is questionable. In recent years, the income tax benefits have been virtually eliminated, and the investment in the maquiladora program continues at a brisk pace. But the public and press do not dismiss the increased taxation. There are reports of investors choosing to move to or expand in China because of lower costs, and income taxes are cited as a cost of doing business in Mexico.

23A- For at least ten years, the maquiladora program has been scrutinized and undermined by the Mexican Ministry of Finance (SHCP). From a trade perspective, the benefits of the North American Trade Agreement undermine the preferential access to the U.S. market historically enjoyed by maquiladoras. From a tax perspective, Mexican officials became aware of the operation of the U.S. foreign tax credit, and believe that maquiladora tax incentives benefit the U.S. Treasury more than the maquiladora operators.

24. Research & development credit-- this incentive has been in effect only a short time. There is little information as to the revenue cost, or if the amounts taken as research and development are genuine. These issues should become more prominent as the relevant tax years are audited.

25. Agriculture, fisheries, forestry & publishers- None of those surveyed considered these incentive to have benefited Mexico significantly. Nor are these incentives viewed as costly or fertile territory for fraud.

26. Immediate deduction for investments- As noted, the immediate deduction for investments was reduced over the years (by reducing the discount rate applicable to such items), and eliminated two years ago. There is a perception that this benefit did increase investment marginally. No effort to analyze the effect was undertaken (other than subsequent static measures of revenue loss). Perhaps because of the complexity of the rules, there seems to have been little importance attached to the incentive, either while it was in force or when it was rolled back.

27. Simplified regimes- At least some Mexicans believe the simplified regimes to have strengthened the affected sectors. One former official described this as an obvious consequence of favored taxation. However, this was not the goal of the simplified regimes. Now that they are in place, it is exceedingly difficult to roll back the unintended benefit. The principal beneficiaries are transport companies. Such companies traditionally have aggressively defended their benefits, and the Mexican government anticipates a forceful response (perhaps an attempt to paralyze transport in the country) should elimination of the benefits be proposed.

28. Insurers- while the revenue cost has been substantial, there is no evidence that any benefit has been achieved. Mexican insurance companies are likely in a stronger financial position than they would have been otherwise.

29. Consolidation- Mexico's attempt to be like the other OECD countries in the area of consolidation is viewed by the government to have been a failure. No one seems to know how much revenue has been lost. However, there is agreement that the rules permitted far too many taxpayers to consolidate, and that the complexity of the rules have been an administrative nightmare. As a result, there are proposals to limit consolidation, perhaps following the U.S. rules.

d. Epilogue

30. Though overly generous tax incentives were regularly allowed in the past, it seems that Mexico is on the way to eliminating the most dubious types of tax benefits. Much of the credit must be given to Francisco Gil Diaz, current Minister of Finance and the most influential person in Mexican tax policy for the last fifteen years. Mexico also has made a much greater investment in training and education of its tax officials than other countries in the region. It is not coincidental that many tax trends seen in Latin America over the last twenty years (assets tax, tax treaties, anti-tax haven rules, etc.) originated in Mexico.

31. It must be noted, however, that President Fox has mentioned the possibility of tax free zones or other incentives to spur development in the poor Chiapas area, where subversive groups have operated for several years. It remains to be seen whether this policy will materialize.

VIII. Peru

1. Peru is one of the few countries in Latin America where the tax incentive mindset remains largely intact. Tax policy commentators often criticize Peru's tax incentives, and the press periodically mentions the fraud and revenue loss associated with incentives. Indeed, the stories of abuse go back decades. Nevertheless, the new Toledo Government has expressed an intention to cut back on incentives.

- a. Tax Incentives
- b. Analysis of Incentives Prior to Enactment
- c. Effectiveness of Incentives
- d. Epilogue

a. Tax Incentives:

2. Amazon Law-- the Amazon Law is a comprehensive set of tax exemptions covering Income Tax, Value Added Tax, Excise Taxes, and Customs Duties. The exemptions are available only in certain Departments (like U.S. states) in the Amazon region of Peru, with respect to certain industries that are considered native to the zone. The Amazon Law went into effect at the beginning of 1999. However, the Amazon region has long been a favorite for tax incentives. The 'Jungle Law' of the 1970s gave very broad tax exemptions, and a mentality that the Amazon should be a tax-free zone has remained.

3. Frontier Incentives-- There is a series of incentives that are allowed in frontier zones, including Ilo, Tacna, Paita and the Amazon. Certain areas are known as "Free Zones", and "Industrial and Commercial Transformation Centers". The incentives include an exemption from income tax, value added tax, excise taxes and customs duties; certain customs benefits apply to merchandise entering other parts of Peru through these zones. The nature and extent of these incentives have varied substantially over the last thirty years. Even today, the benefits vary from region to region, and the Amazon has two zones, one with more benefits.

4. Tax Stability Contracts-- There are three types of stability contracts, each of which has a tax component. First, an "Investor" Stability Contract is available to foreign investors whose investments amount to more than \$10,000,000 (or \$2 million where a threshold level of job creation is promised). The tax component of this contract is limited to dividend payments: since the current tax law exempts dividend payments for withholding, an Investor Stability Contract freezes this exemption for ten years. A "Legal Stability Contract" applies to the actual commercial activity of business investments that meet certain criteria. The tax provisions ensure that all business income tax provisions, including the tax rate, are frozen for the ten-year period of the contract. Therefore, a business can make its projections on the assumption that the calculation of the tax base and the tax rate will remain the same. A Mining Stability Contract is similar to a Legal Stability Contract, but it applies for a longer period of time (15 years, renewable) and applies to taxes and tariffs other than the income tax. Though clearly a

benefit, such stability contracts do not confer any tax relief. In 2000, Peru introduced a "toll charge" of 2% above the stabilized income tax rate (i.e. if the prevailing rate is 30% at the time of stability, the taxpayer will have to pay 32% for the duration of stability).

5. Merger/ Division Basis Step-up-- This peculiar law was passed in 1992, with the goal of encouraging Peruvian companies to restructure themselves in order to become more competitive. Even though the Income Tax Law already provided that mergers and divisions would not be realization events, an additional incentive was added: assets owned by the businesses involved in the re-organization could be "revalued" to their market value for accounting and tax purposes. The logic of this rule has never been made clear: some have explained the rule has a response to the hyperinflation experienced by Peru in the 1980s; others note that Peruvian law had encouraged a proliferation of companies for tax avoidance reasons. However, the inflation adjustment and other non-realization provisions should have covered these problems. One thing is clear -- many businesses carried out mergers or divisions in order to re-value their assets and depreciate the higher basis.

6. Mining Incentives-- Mining is one of Peru's major industries and its most important export industry. As a consequence, the mining industry is highly organized and influential. It also has the resources to follow legal trends in the region and around the world. The mining industry's efforts are channeled through the Mining Society. In addition to Mining Stability Contracts, the mining industry has arranged for itself numerous benefits, such as accelerated depreciation, early refund of value added tax input credits for export industries, drawback of customs duties, etc. Yet the mining sector has no exemptions of any sort, and even supports some unfair provisions. For example, Peru only allows taxpayers to deduct reclamation expense as incurred. Many countries have the sensible rule that anticipated closure and reclamation expenses can be deducted earlier in the life cycle of the mine, when such deductions can offset income. Since Peru has no such rule at present, such deductions are useless if the mining company does not have income other than that from the mine that is being closed down.

b. Analysis of Incentives Prior to Implementation

7. Amazon Law -- Although this law was introduced at the end of 1998, there is an astonishing lack of information about its origin. Several government officials and private sector tax professionals were asked, and the only explanation they could give for this law is that it originated in the office of then President Fujimori, and that "it was felt that something had to be done for the people of the Amazon region to persuade them to support the peace treaty with Ecuador." One former tax administration official put the blame squarely on then Minister of Economy Victor Joy Way (currently facing corruption charges), who allegedly dismissed the objections of government tax officials. In any event, there seems to have been no public support for the tax measures from taxpayers or the legislature, and no arguments submitted in favor of the measures (other than general platitudes about economic development), and such measures were passed by the legislature, along with the rest of the Amazon Law, with little debate.

8. Two things should be noted to understand the foregoing. First, the Peruvian Congress for most of the past decade was dominated by supporters of President Fujimori, and often called a "rubber stamp." Therefore, it is not surprising that there was little debate. Second, the Peace Treaty with Ecuador (which resolved a territorial dispute with a history of 50 years, including armed conflict as recently as 1997) was one of the Fujimori administration's principal achievements. Since people in the Amazon region of Peru tended to be against the terms of the Peace Treaty, it was felt that a broad package of economic incentives would placate them.

9. There was significant commentary in opposition to the tax provisions of the Amazon Law in the Peruvian press. Interestingly, some of the harshest criticism came from two former directors of Peru's tax administration under President Fujimori: Adrian Revilla and Sandro Fuentes.

As noted, there was little debate regarding the tax provisions in the Amazon Law, and no record of similar provisions in neighboring countries being used as an argument in favor of the incentives.

10. Frontier Incentives -- These incentives have been in existence, in one form or another, for decades. Though these incentives have been put together on a piecemeal basis, there are certain recurring themes that explain their existence. First, legislators from the frontier regions have made efforts on an ongoing basis to preserve or expand the benefits for these zones. Other legislators have been sympathetic because they feel that these frontier zones have been neglected. Second, the traditionally high level of contraband in the frontier areas introduces the argument that frontier zones should be tax free and duty free and order to have "legal" competitive economic activity. Complicating this issue is the fact that the military often has been involved in the contraband trade as a manner of supplementing low wages.

11. Since they originated many years ago, it is not surprising that there was little specific analysis of the revenue implications of the Frontier Incentives. Though similar incentives are available in other countries, no one recalls the Frontier Incentives to have been issued in response to such neighboring countries.

12. Tax Stability Contracts-- Tax stability contracts have been a fundamental part of Peruvian investment law for decades. Both public and private sector tax experts view these contracts with respect, noting that Peru has never violated its international obligations. This is no small achievement considering some of the irresponsible conduct of Peruvian Governments in the 1970s and 1980s.

13. If there ever were concerns about the administrative difficulties or policy constraints presented by stability contracts, they have been long forgotten. Few dispute the wisdom of the policy; in fact, the constant changes in Peru's tax laws are given as the reason why such contracts must be offered. It is ironic that the government recognizes tax stability as an important condition to attract investment, yet is unable to resist tampering with the tax law.

Stability Contracts are more widely used in Peru than in any other country. Accordingly, supporters of this incentive are not in a position to use the example of other countries as support.

14. Merger and Division Incentive -- This incentive, which lapsed at the end of 1998, was introduced in 1994, as an incentive to restructuring corporations. No one seems to recall the debate, if any, regarding the tax effect of this provision. In fact, there are some questions as to whether the extent of the benefit was fully understood by the government. The law, like many Peruvian laws, was a "temporary" law, meaning that it would have effect only for the year it was passed. However, also like many other Peruvian laws, the "temporary" law was extended yearly for four additional years. Each year, when legislators proposed extending the law, Peru's tax administration voiced its opposition; until the end of 1998, however, the tax administration seems not to have provided any statistical information. Only in 1998 was an office formed with the resources to evaluate the revenue impact of such laws. It was a shock to the Peruvian government to discover the revenue loss associated with this incentive, and the law was not renewed.

Strangely enough, similar opportunities to step up a basis for tax purposes exist in other Latin American countries, albeit for other reasons (though for reasons no more rational than merger or division).

15. Mining Incentives -- Because the mining sector is of such importance to Peru, there has been an effort by Peru to be "competitive". Lobbying efforts in Peru are not supposed to be made by individual taxpayers; instead, taxpayers are expected to make their case through the appropriate trade association ("gremio"). The Mining Society is very influential. Furthermore, the Mining Society is a member of the Latin American Mining Society, which meets periodically, and the Mining Society's membership is increasingly dominated by international mining companies with operations in neighboring countries. It is therefore not surprising that benefits available in other countries are often brought to the government's attention.

16. As with the foregoing incentives, it is reasonable to conclude that no scientific cost/benefit analysis has been undertaken for any of the various incentives allowed to the mining sector. Nevertheless, the Mining Society has been active in bringing in foreign experts to assess Peru's tax regime, and how Peru compares to neighboring countries. Where neighboring countries appear to have a more favorable rule, the Mining Society generally has been successful in convincing the government to implement a similar rule. Most recently, such pressure appears to have been useful in persuading Peru to allow an early refund of Value Added Tax in the case of export oriented projects that are several years in the development stage.

17. It must be recognized as well that several wealthy and influential Peruvians are active in the mining industry. It is possible that certain incentives that have been proposed in the past were viewed more sympathetically because of a personal relationship between mining executives and government advisors.

c. Effectiveness of the Incentives

18. Amazon Law -- None of those interviewed was willing to defend the Amazon Law as a mechanism for spurring economic growth. To the contrary, several experts mentioned the fraud and abuse that took place under an antecedent of the Amazon Law that was in effect in the 1970s. In other words, the new Amazon Law was passed notwithstanding the vivid memories of past abuses, i.e. Peru did not even have to look at the case of Brazil to be forewarned that there might be serious revenue consequences. Yet some Peruvian officials believed that narrow drafting, together with improved tax administration, would limit abuse.

19. There is broad consensus that the Amazon Law has had absolutely no effect on economic development in its initial phase. At the same time, however, there have been reports of abuse. An early newspaper account suggested that US\$ 300 million in lost revenue had occurred because of contraband alone. More recent analyses confirm that the Amazon Law continues to be a major revenue drain.

20. Frontier Incentives -- These incentives provide several textbook examples of unintended, inefficient activity. Two cases illustrate the effect of incentives. First, certain frontier regions developed an industry for importing used cars that were reconditioned and sold within Peru. Because of the incentive, profits were tax-free; because of unrelated laws, the cars could be sold in Peru without paying most import duties. This, of course, was not the desired type of economic activity -- the income tax exemption was intended for products that were going to be exported from Peru. Second, one major bottling company took advantage of the 1982 version of the frontier law and located a plant in the Amazon region (the Amazon region also is considered a frontier region). Among other benefits, the 1982 law granted an exemption from Value Added Tax and excise tax, which under current law amounts to a total of 35 percent. The 1982 version of the law allowed this exemption from VAT and excise tax for beer, soft drinks and cigarettes sold anywhere in Peru, as long as such products were produced in the specified region (this is broader than the new Amazon Law, which only exempts specified goods produced in the region and goods consumed in the region). Needless to say, the plant in the Amazon has always been disproportionately profitable, and always runs at full capacity. The other major bottler did not invest in the frontier region at the right time, and therefore does not have these exemptions locked in. As a consequence, it was this other bottler that waged a fierce campaign to ensure that its competitor's benefit was not extended.

21. One surprising event from the 1980s relates to local authorities' willingness to undercut a federal policy for their own benefit. When the VAT was suspended, the local Amazon authorities temporarily imposed their own sales tax ("IPM") on certain items, equal to the VAT that was forgiven. The development goal was undercut, but local finances were enhanced.

22. Tax Stability Contracts-- Though it is impossible to demonstrate, there is a perception in Peru that Stability Contracts have attracted investment to Peru. There is no doubt that investors are delighted to have their tax system frozen, even though there is no indication that tax rates are trending upward; in fact, the top tax executives from Peru's largest investors have emphasized the importance of Stability Contracts at conferences and to the press. No doubt other foreign investors feel the same way. Mining companies in particular appreciate Stability Contracts because of the substantial investment at the outset, and the fact that mining investments normally involve a 10, 20, or 30-year commitment. Stability Contracts are especially welcome because of Peru's variable, and often irresponsible tax policy. It is also possible that Stability Contracts are particularly important in an environment where there are no tax treaties; in the absence of tax treaties to provide certain safeguards, Stability Contracts offer even broader protection.

23. Even though Stability Contracts are viewed as something of a sacred cow, there are unintended consequences. Tax advisors have used combinations of Stability Contracts and other incentives to their advantage. As noted above, an important bottler used a Stability Contract to preserve a particularly favorable version of the frontier incentives.

24. Merger/ Division Basis Step-up-- As noted above, the Peruvian Legislature appears to have been in a state of blissful ignorance for several years with respect to the revenue cost of the merger/division incentive. Then, in 1998, Peru became aware of the potential revenue cost and did not renew the law. It is possible that this incentive will cost Peru many millions of dollars, all to encourage economic activity of dubious merit. Many of the investors taking advantage of this incentive also have Stability Contracts, which means that they will enjoy the benefits of the merger/division incentive for many years to come.

25. Mining Incentives--The mining sector is viewed as a special case in Peru, and it must be also for purposes of this analysis. Peru considers mining to be of particular importance because it generates nearly half of Peru's foreign exchange. Furthermore, there is the traditional notion (found throughout Latin America) that natural resources belong not to the owner of the land, but to the state, or "the people." Mining is also different, at least in the case of large projects, in the sense that mining companies spend months generating sophisticated cash flow models in order to determine the profitability of potential projects. Tax incentives often are incorporated into these models. Furthermore, at least some of the mining companies are able to defer repatriation almost indefinitely, making local tax savings especially attractive. Though it might be difficult to identify a single project whose fate depended on a particular incentive, it is clear that some mining projects would not be undertaken if not for the general tax incentive scheme.

26. Regarding the more routine incentives, such as accelerated depreciation, zero-rating of exports, amortization on the basis of mineral depletion, etc., it is generally thought that the revenue cost is not significant compared to the potential benefit of increased investment. It appears that no serious effort has been undertaken to measure the cost or benefit of the incentives -- perhaps in recognition of the futility of such an exercise. For

more interesting is the attitude toward advanced refund of Value Added Tax related to exports of certain large-scale projects.

27. Peru's recent economic history has been dominated by plans for three "mega-projects." Two of these, Antamina and La Granja, are massive copper projects, and the third, Camisea, is an oil and gas project. All three involve an investment of \$3 - \$5 billion. Several years ago, there was widespread optimism that the influx of capital for these three projects would significantly boost Peru's economy as a whole. However, both copper and oil prices fell (copper prices still have not recovered), and all three projects are characterized by immense quantity, but marginal quality (i.e. high operating costs). All three projects involved protracted negotiations with the government, and tax incentives have been a major issue in such negotiations.

28. There appears to have been no discussion of a tax holiday for any of the projects, notwithstanding their marginal nature. The incentives given with respect to these projects (effectively limited to mega-projects by the fact that such incentives are available only where a project is at least three years in the development stage and is carried out pursuant to a contract with the government) are not objectionable; in fact, it may be argued that the concessions given should apply to all taxpayers. They are: early refund of exports related Value Added Tax, and an exemption from Assets Tax until the time there is a sale of copper or hydrocarbons (for other taxpayers, Assets Tax begins at the time of the first sale of any type, thus creating a trap for the unwary if an incidental sale is realized.)

29. To Peru's great chagrin, only one of the three projects is currently moving ahead at full speed. The hydrocarbons project was originally to be carried out by Shell and Mobil, but an agreement could not be reached. Failure to give greater tax incentives has not been mentioned as a reason for the failure of the negotiations. As the process moves forward it will be worth observing whether other potential investors focus on tax incentives. One of the copper projects is on hold because of the low grade ore and low world copper prices. It must be noted that the project that is moving ahead, Antamina, appears to have been made possible because of several government concessions, including the VAT and Assets Tax incentives discussed above. Again, it is impossible to know whether the project would have moved forward without such tax incentives.

These projects demonstrate how tax benefits can make the difference in the viability of a project, but cannot rescue a project rendered uneconomic by market factors.

d. Epilogue

30. The Fujimori Government did little to curtail tax incentives, but (at least over the last two years) the tide has turned against incentives in general. There is discussion of repealing some of the more egregious incentives, but this ultimately will depend on the next Government.

31. Amazon Law-- Notwithstanding the criticism of the Amazon Law, there is little movement to eliminate it; in fact, the law by its terms calls for the incentives to last 50 years. Furthermore, there is no constituency to repeal the law. There was even some concern in 1999 that the incentives would be extended, either geographically, or to promote investment more "effectively" by broadening the application of the incentives.

32. Frontier Incentives-- The frontier incentives are being scaled back, but elimination of them is still seen as a long-term goal. Several people mentioned that the incentives are now viewed as a right, and that the frontier areas expect to be compensated with some other benefit as these incentives are withdrawn. The dubious role of the military is difficult to measure. Although Peru is evolving rapidly, the military still wields enormous power. Of course, all such power is exerted behind closed doors, so it is impossible to assess the debate. It is possible that the new Tax Analysis Unit will be able to quantify the revenue loss arising from the frontier incentives, which creates the possibility that something will be done.

33. Tax Stability Contracts-- Only recently has there been some discussion concerning the elimination of Stability Contracts. Such discussion has arisen because of recent cases where companies locked themselves into extremely favorable tax rules for the duration of a Stability Contract. An attempt to scale back Stability Contracts was attempted in 2000, but defeated. Still, the law was reformed to require an extra two percentage points of income tax to be paid by new investors entering into such Contracts. Some have made the argument that tax treaties might be a substitute for Stability Contracts. Nevertheless, Stability Contracts remain a delicate subject, and it will be at least two or three years, and perhaps much longer, before there is another serious attempt to eliminate them.

34. Merger/ Division Basis Step-up-- As noted above, this incentive has been eliminated. Though it is unfortunate that this poor tax policy was extended every year for five years, and then repealed when the government became aware of the alarming revenue loss, this case shows the value of the Tax Analysis Unit. If the investment in such a Unit had been made earlier, several years of revenue loss may have been avoided.

35. Mining Incentives-- The mining tax incentives are those that have been most influenced by developments in neighboring countries, but at the same time are those that make the most sense. Accelerated depreciation, early refund of VAT, certain exemptions from customs duties, etc., are all within the realm of reason. In fact, the mining community has not been able to convince the government to give them a reasonable provision regarding closing and reclamation costs (noted above). Mining companies have benefited from other tax incentives, such as the merger/division benefit, Stability Contracts, etc., but these benefits are not limited to mining.

36. In its attempts to change the tax law, the Mining Society definitely looks to the laws of neighboring countries, and uses the example of other countries to make the "competitiveness" argument. More surprisingly, the Mining Society also studies the revenue consequences of some legislative proposals. In the recent case regarding closure

and reclamation costs, the Mining Society hired Peru's most highly regarded economic consulting firm to estimate the costs and benefits.
