Inter-American Center of Tax Administrations – CIAT

44th CIAT GENERAL ASSEMBLY

"THE ROLE OF TAX ADMINISTRATIONS IN THE GLOBAL CRISIS"

Topic:

THE IMPACT OF THE GLOBAL CRISIS: CHALLENGES AND APPROPRIATE RESPONSES FROM THE TAX ADMINISTRATION

Inter-American Center of Tax Administrations
CIAT

Montevideo, Uruguay
April 12 - 15 of 2010

Conventional facts related to collection in Latin American countries

Introduction

Early last year, after nearly six months from the detonation of the international financial crisis and when the impact on the Latin American economies began to show, CIAT set out to analyze how this impact was reflecting in the tax collection of its member countries, with a view to providing a timely alert on the need to introduce policy and/or tax administration measures required to counteract the generalized loss of resources.

Short-term data were needfully required for this task. However, by then neither CIAT nor any other international body maintained consolidated data on monthly or quarterly collection as a result of the internationally accepted practice of reporting tax statistics annually, once the information was rendered final. So, a new database was required to be built with preliminary information.

The Tax Collection Observatory

If the principles of fiscal transparency had been respected, this task would have appeared fairly easy, for anyone with average training would have been able to consult the Internet or the relevant publications and obtained the short-term statistics required to perform this type of analysis. The experience has shown us that greater efforts are needed in tax transparency policies in the fiscal field, particularly on a sub-national level and in respect of employer's contributions[1], as most countries fail to report this information properly. As a consequence, the work had to focus on the taxes managed by the Central Government (exclusive of employer's contributions).

The central governments of the 17 Latin American countries analyzed in this document (exclusive of Cuba, Venezuela and Haiti), either through their tax administrations or finance ministries, publicize short-term collection statistics of the taxes administered by them, under a cash basis accounting. The problems arise where several entities are in charge of collection, but the situation is fairly manageable. What is true, however, is that the information is usually presented before or after refunds are made, but not under both criteria, thus complicating the analysis on the impact from tax refunds.

On the other hand, the information available on a central government level varies as to the way the tax collection statistics are classified and recorded with respect to the internationally accepted methodology set forth in the IMF's Manual on Government Financial Statistics or that of the OECD. Concepts such as royalties are included as tax revenue, as are penalties too. How payment of tax debts is recorded, tax amnesties or fractioning or simplified systems are all topics for debate.

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[1] Or maybe we have not "googled" correctly.

A proprietary classification was then required. Drawing on the project of the Tax Revenue Classification Manual developed in 2007 by a group of member countries, the CIAT considered it timely and a priority to generate a new manual to support the tax collection quarterly follow-up efforts.

In addition, unlike other bodies, CIAT's new collection statistics allocate collection to that level of government that has tax jurisdiction, regardless of whether such level of government is the one actually using these resources.

The tax collection is recorded on a conventional cash basis, considering not only cash payments but also payment in securities that the central government delivers to taxpayers, for example, in the case of tax refunds.

All the information is rendered preliminary until the country is able to report it as final. This normally occurs 1 or 2 years afterwards. However, when working mainly on variations and not on levels, the differences between the results of preliminary or final information are very little.

What we already knew about tax matters in Latin America before the crisis

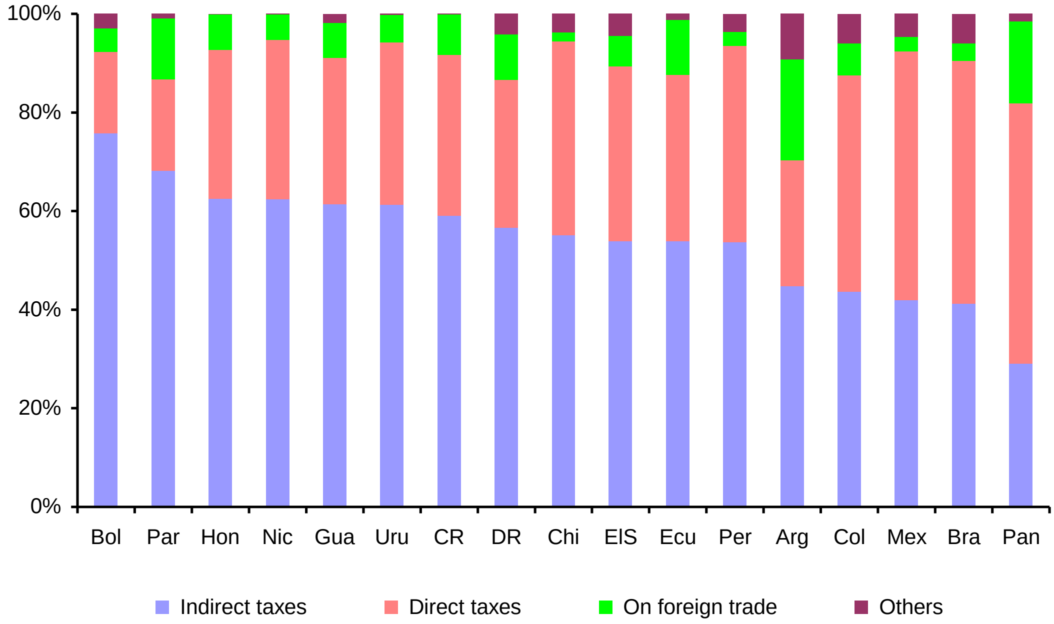
Two of the most recent analyses of the situation of tax revenues in Latin America are one conducted by the ECLAC in 2006 and another conducted by the OECD in LEO 2009. Both used ECLAC's annual data for the period 1990-2006, and both pointed out again at the conventional facts generally accepted by the international fiscal community regarding tax collection in Latin America.

Some of the most known facts in Latin America regarding the taxes administered by the central governments (exclusive of employer's contributions) are:

Even the size of tax revenues is little. Although Latin America has shown some progress over the last decade, as a result of improved macroeconomic policies and the international economic situation, tax collection levels are still low compared to other countries of a similar size.

Besides the little size, the tax composition is too centered on indirect taxes. Latin America has followed the international trend towards expanding the value-added tax, and its taxable base has been expanded progressively as well, especially through the incorporation of services into such base. Its average rate has been increasing too. As for taxes on the consumption of goods and services (ISC, in Spanish), they have concentrated exclusively on products such as gasoline, tobacco and liquors.

Graph N° X
Taxes administered by the Central Governments (exclusive of employer's contributions), 2008
Percentage share by tax type



Source : CIAT

Continued trend towards reducing taxes on foreign trade. This is evidenced in the signature of multilateral trade agreements. It shows the need to discuss probable ways to recover lost resources.

The redistributive effect of personal income taxes is very little. The weak redistributive effect of the fiscal systems in the region is one of the low level dimensions of tax collection.

The impact of the crisis on the collection of taxes administered by the central governments (excluding employer's contributions): recent evidence

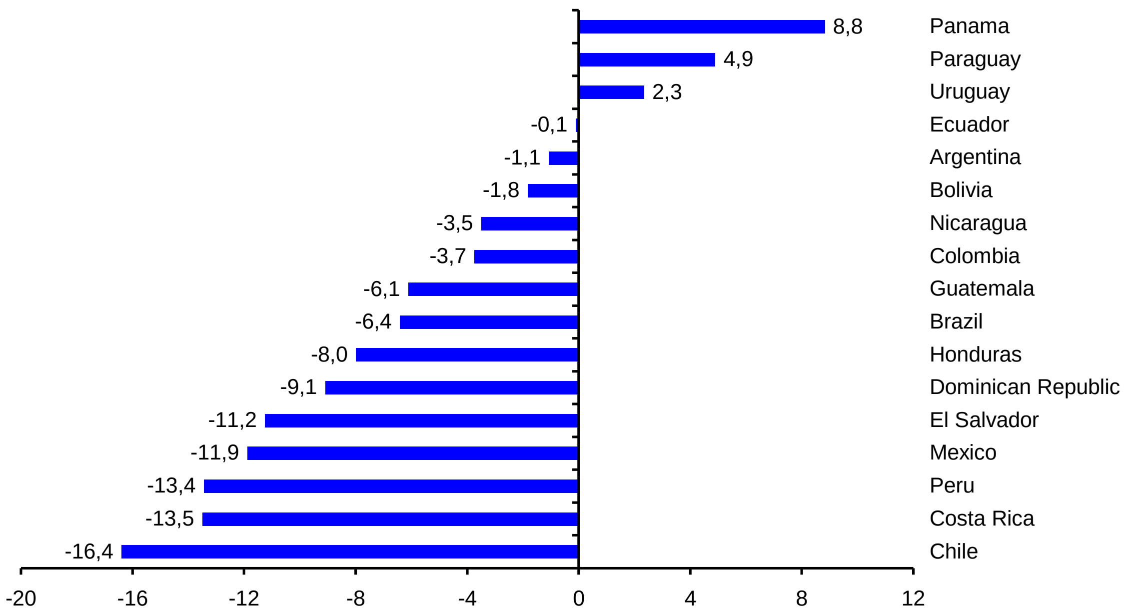
The recent evidence on the impact of the crisis on the tax collection of Latin American countries has not been yet presented in an organized fashion by the international fiscal community. This paper represents a timely effort to fill that gap in respect of the taxes administered by the central governments (exclusive of employer's contributions).

The first indicator used to measure the tax collection performance over one year is the percentage variation in actual terms experienced by it with respect to the preceding year. The CIAT's Observatory shows that in 2009 the collection of taxes administered by the central governments (exclusive of employer's contributions) in Latin American countries has fallen by 7.6% on average[2], in real terms, with respect to 2008.

[2] Weighted average. The same for all average calculations henceforth.

As expected, all countries have recorded falls, except for Panama, Uruguay and Paraguay. In four countries of Central America (Nicaragua, El Salvador, Guatemala and Honduras), the Dominican Republic and Chile, tax collection has fallen in real terms for the second year. The negative trend has been observed in these countries since mid 2008 (most notably in Chile, where inter-annual variations were already negative), but there is no doubt that the impact of the crisis was fully observed in 2009.

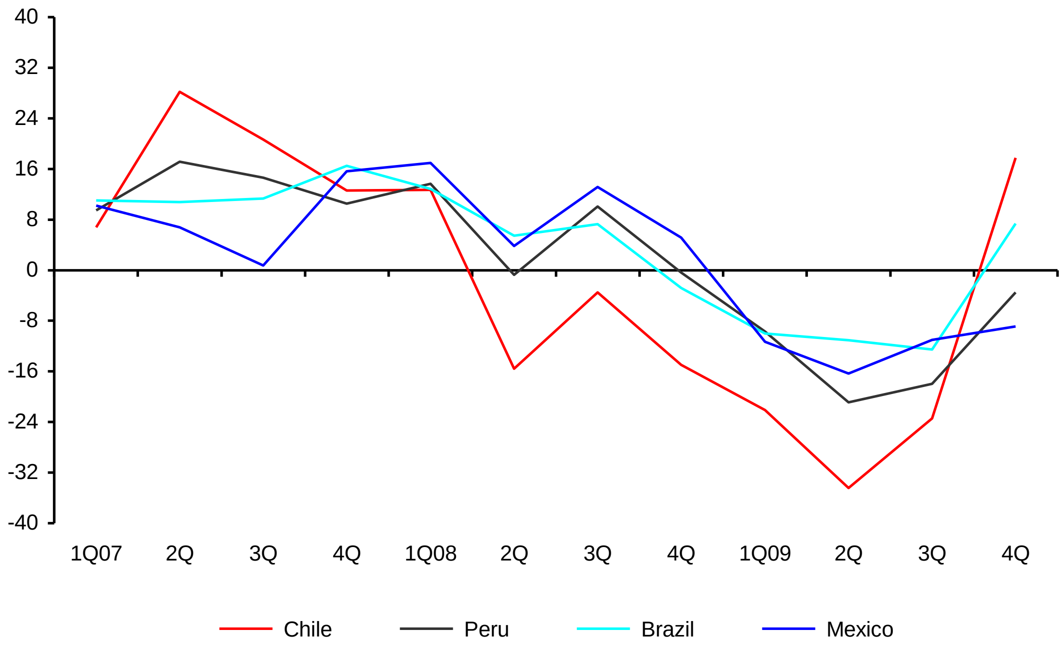
Graph N° X
Taxes administered by the central governments (exclusive of employer's contributions), 2009 (E)
Real inter-annual percentage variations



Source: CIAT

The global result is dominated by the falls in the tax collection of four of the six largest economies in the region (Mexico, Brazil, Peru and Chile). Upon removing the variations of these four countries, the fall would be only by 2.8%, in real terms, with respect to 2008.

Graph N° X
Taxes administered by the central governments (exclusive of employer's contributions), 2007-2009 (E)
Real inter-annual percentage variations



Source: CIAT

Certainly, the main source of the falls has been the extended contraction of exports (as a result of the impact on exchange rates from the reduction in commodity prices) and its cascade effect on production, consumption and investments (including imports).

But they are also the consequence of the application of tax measures adopted as part of fiscal stimulus packages, such as:

Chile: i) provisory reduction in stamp taxes, ii) provisory reduction in monthly provisional payments made by companies based on their profits, iii) early refund of 2010's income tax to natural persons. These measures have supposedly had an annual impact of 300.435 millions from the reduction in PPM, 153.285 from early income tax advances and 500.231 million from stamp taxes.

Brazil: i) reduction in the IPI, mainly automobiles, construction materials, home appliances, capital goods, ii) reduction in IOF from 3% to 1.5% due to credit operations, iii) revision of charts of individuals' income taxes, which created lower tax bases (7.55% and 22.5%) favoring the middle class, iv) reduction in the COFINS rate for motorcycles. These measures resulted in an annual impact of 14,400 million *reais* (0.47 of the GDP). By 2008 the CPMF had already been eliminated.

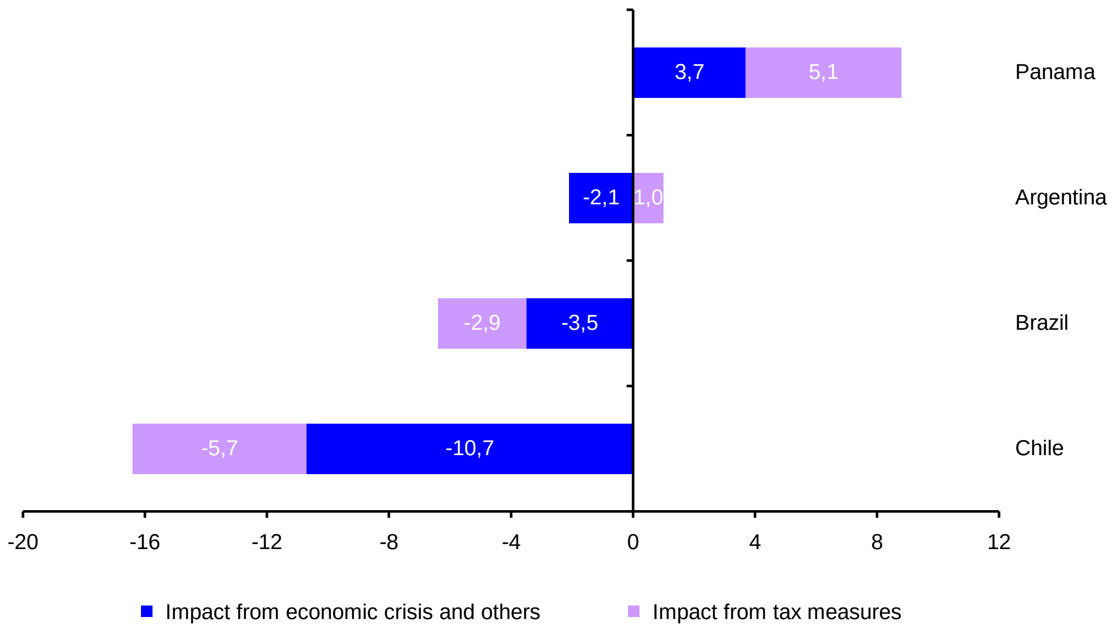
Colombia: the stamp tax was reduced from 1.0% to 0.5%.

Argentina: the tax amnesty went not as well as the whitewash, but was able to collect some 1,300 millions in 2009 in the first one, and some 1,000 millions in the second one (the tax and social security amnesties covered all tax and social security obligations due as of December 31 of 2007; the whitewash would allow reporting goods in the country or abroad and the entry in the country of funds maintained abroad by residents). The withholdings on wheat and corn exports were also reduced (cutting down export rights tax bases applicable to wheat from 28% today to 23%, and corn from 25% to 20%), by one additional percentage point for every million ton in excess of production over the average of the last years, and the withholdings on the exports of all fresh fruits and vegetables were cut down by 50%.

Panama: A tax amnesty was established for debts outstanding as of June 2009, with successful results, collecting nearly B/.129.4 million. The excise tax on cigarettes was raised (firstly from 32.5% to 50%, and then to 100% over the consumer sales price, with a top of 1.50 per pack).

Putting aside the positive or negative impact of these measures, the performance of some countries in 2009 changes, but the trend remains the same.

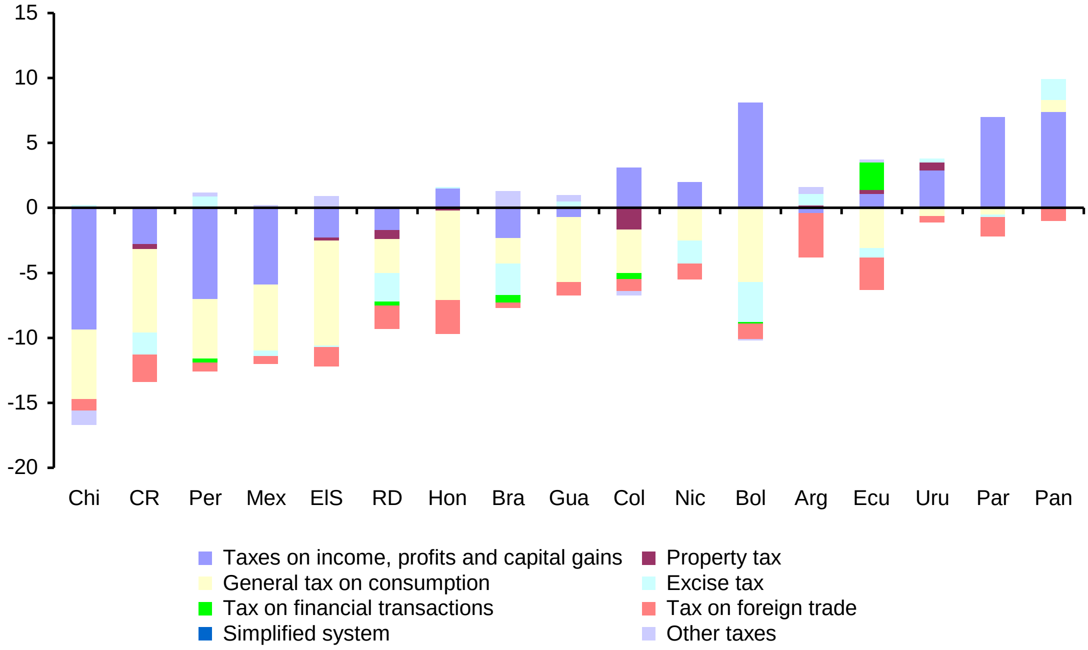
Graph N° X
Taxes administered by the central governments (exclusive of employer's contributions), 2009 (E)
Real inter-annual percentage variations



Source: CIAT

As stated previously, the tax composition in Latin America is excessively centered on indirect taxes. Therefore, it should not be surprising that the taxes that contributed the most to the fall in total collection (excluding employer's contributions) were the general taxes on consumption[3], with the only exception of Panama's ITBMS, followed by income taxes, capital profits and gains; although it should be noted that, alternatively, in many countries this behavior was able to soften the fall in the global collection, as is the case of Nicaragua, Honduras, Colombia, Uruguay and mostly Bolivia, Paraguay and Panama. The fall in foreign trade taxes was also widespread and particularly important in Ecuador, Honduras and mainly Argentina, where rights over exports are charged; wealth taxes and taxes on financial transactions also recorded falls, except for a few cases, as is the case of Ecuador's tax on the exit of currencies.

Graph N° X
Taxes administered by the central governments (exclusive of employer's contributions), 2009 (E)
Tax contribution to real inter-annual percentage variations
In percentage points



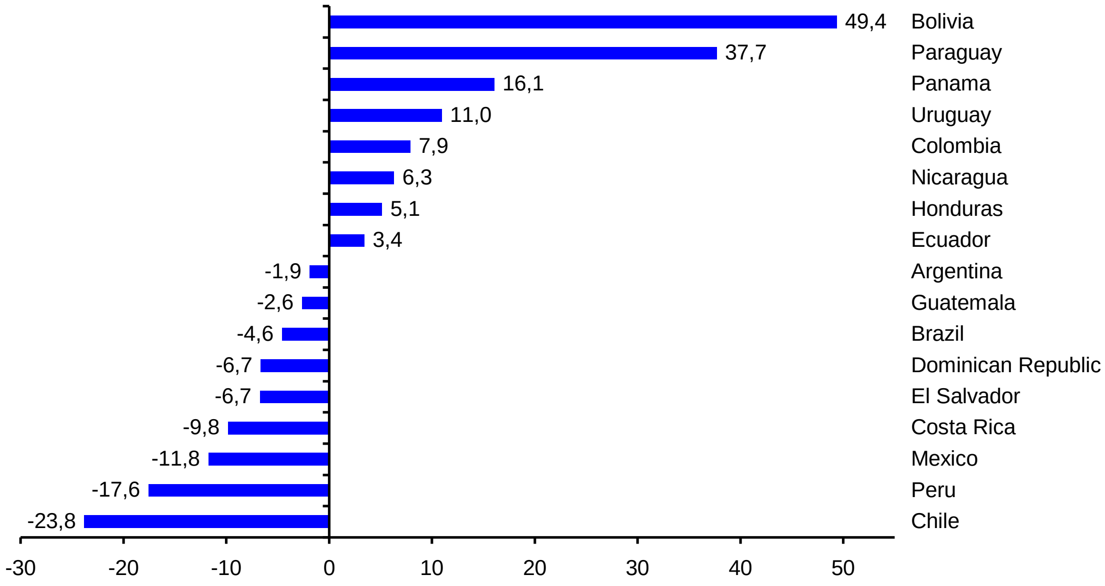
Source. CIAT

<u>Taxes on income, profits and capital gains</u>

The tax on income, profits and capital gains fell by 5.6 on average, in real terms, with respect to 2008, with significant results in Bolivia and Paraguay.

[3] VAT in all analyzed countries - Brazil's ICMS is not included because it is a state tax.

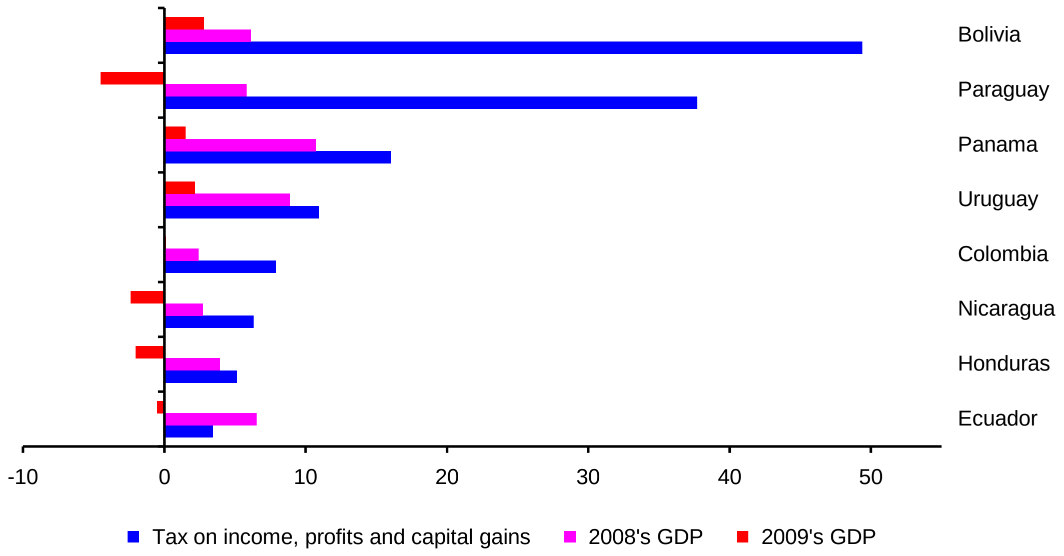
Graph N° X
Tax on income, profits and capital gains, 2009 (E)
Real inter-annual percentage variation



SourceCIAT

These taxes have normally an annual frequency and are less responsive to changes in the economic cycle because usually what is collected over one year is more the result of the performance in the previous year than the performance of the current year. As 2008 was a relatively good year (despite what happened in the second semester) for the group of countries recording positive growth rates (Bolivia, Paraguay, etc.), it may be argued that the impact on 2009's GDP from the widespread contraction of exports was lower in such countries. In particular, Bolivia and Colombia are strongly influenced by the results obtained in 2008 by YPFB and Ecopetrol.

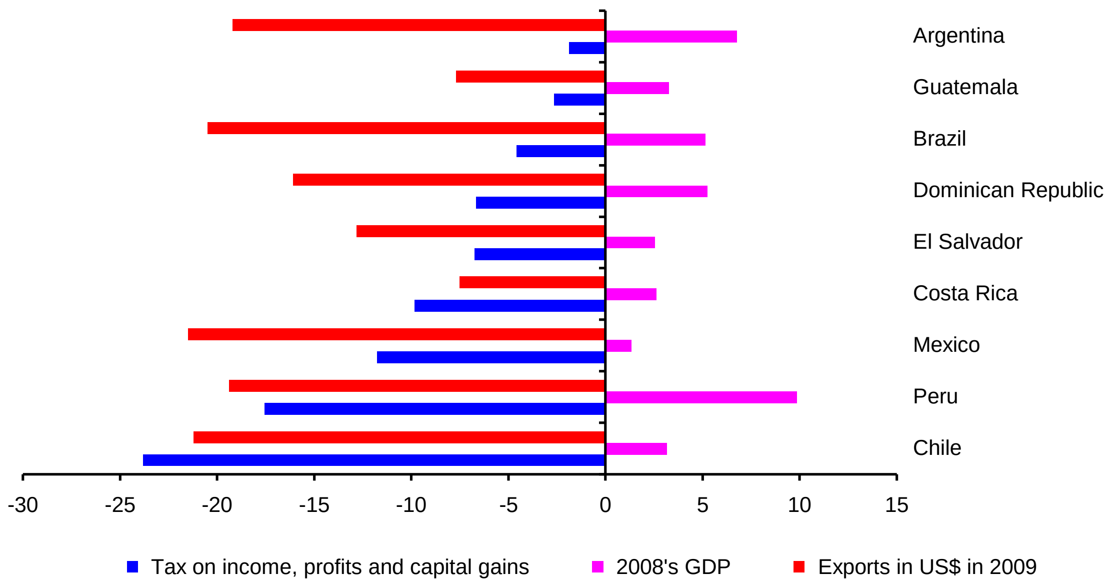
Graph N° X
2008's and 2009's GDP (E) and tax on income, profits and capital gains, 2009 (E)
Real inter-annual percentage variations



Source CIAT

In any case, the contraction of tax advances as a result of the fall in exports, where based on gross revenues, may have influenced more the collection results of the countries recording highest drops in the collection of the tax on income, profits and capital gains, which are in addition the countries most influencing the average results of Latin America. This is the case of commodity-dependent countries (Peru and Chile) and countries dependent on tourism, like Costa Rica, Dominican Republic and Guatemala.

Graph N° X
Tax on income, profits and capital gains, 2009 (E), Exports in US$ in 2009 and 2008's GDP
Real inter-annual percentage variations for the tax on income, profits and capital gains and 2008's GDP, and nominal variations for exports



Source: CIAT

It should be noted that many countries adopted measures for the tax on income, profits and capital gains as part of their fiscal stimulus program, as is the case of Chile, which temporarily cut down the monthly provisional payments made by companies based on their profits, and advanced 2010's income tax refunds to natural persons.

Furthermore, Brazil revised and reduced the charts relative to Individuals' income tax, and fixed lower tax bases (7.55% and 22.5%) that favored the middle class.

Finally, Argentina and Panama set forth tax amnesties for past due obligations, among which stand out those related to the tax on income, profits and capital gains.

As most countries do not apply taxes or assess income and capital gains very little, the collapse in the value of financial assets or profitability had little impact on the collection of the tax on income, profits and capital gains in 2009.

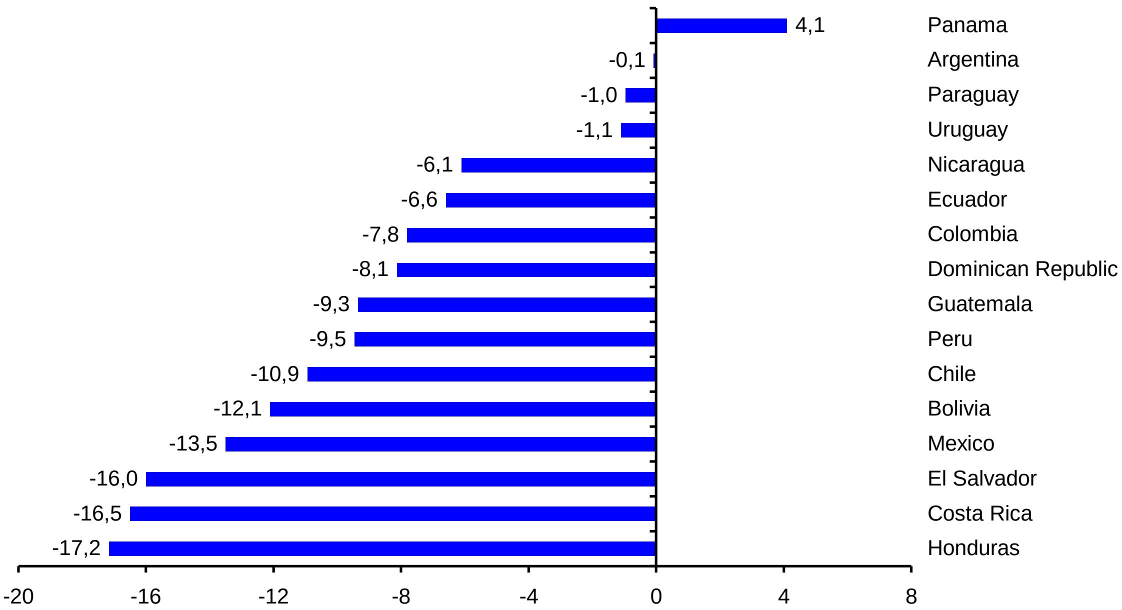
Making a breakdown by taxpayer or income type is not easy because the countries are not good at providing details of such information. A great many improvements are required in this sense; a Working Group is already in place at CIAT working on a project on this regard.

VAT

If we remove the tax on income, profits and capital gains from the total collection, we can see that the general taxes on consumption, which are very sensitive to economic cycles and are of great relevance for the total collection of the taxes administered by the central governments (excluding employer's contributions), were the main cause of the falls in 2009.

The Value-added Tax (VAT), with the only exception of Panama, dropped in all countries, reaching an average drop in Latin America of 9.4%, in real terms, with respect to 2008. The global result is dominated by a strong fall in Mexico, but also by a good performance of Argentina[4].

Graph N° X
VAT, 2009 (E)
Real inter-annual percentage variation

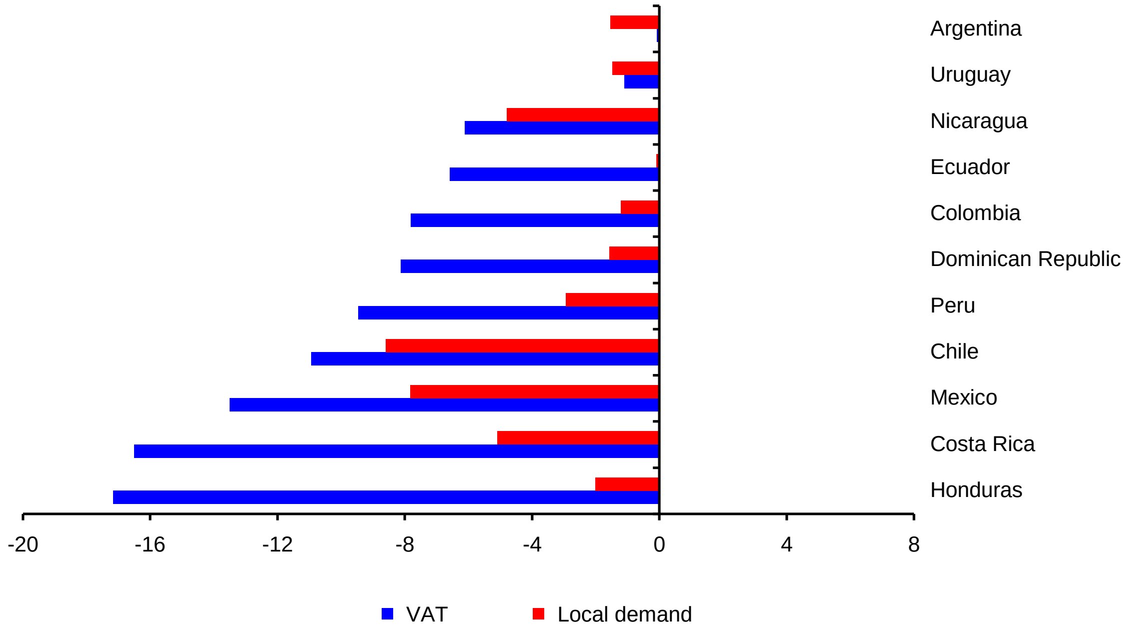


Source: CIAT

These results are tied directly to the drops in the local demand (which include the widespread contraction of imports, mainly capital goods and inputs).

[4] Other general taxes charged in some countries, as the Transaction Tax in Bolivia, followed the same VAT trend.

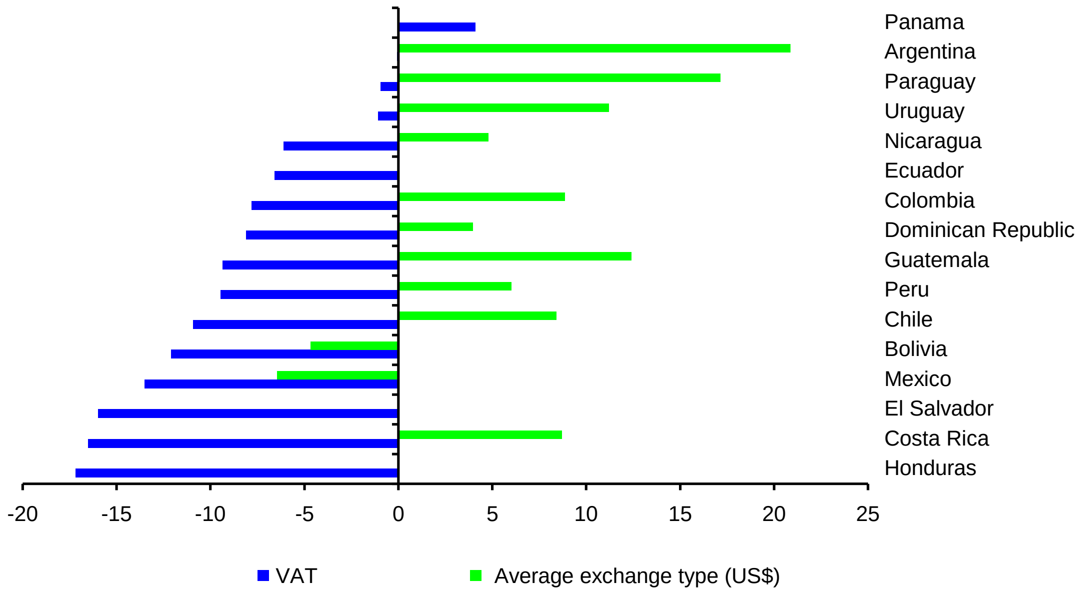
Graph N° X
VAT and local demand in selected countries, 2009 (E)
Real inter-annual percentage variation



Source: CIAT

But since the fall in imports damaged the collection of import VAT severely, the degree of depreciation of some currencies may have also impacted the total fall in the VAT.

Graph N° X
VAT and Exchange type (US$), 2009 (E)
Real inter-annual percentage variation for VAT and nominal variations in exchange type



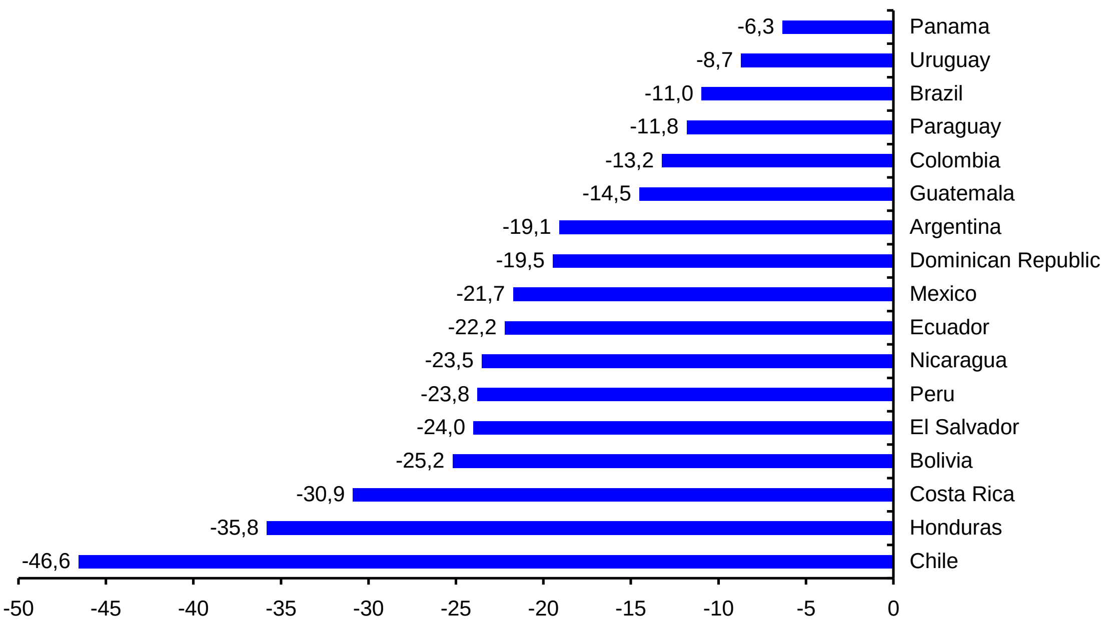
Source CIAT

As for the VAT, the analyzed countries did not introduce significant measures as part of their fiscal stimulus programs. In any case, the tax amnesties in Argentina and Panama may have had some influence. Besides, despite there being not sufficient information to assert a generalization, some countries who manage a VAT-Product could have allowed the immediate deduction of the fiscal credit upon the acquisition of capital goods and hence provided some financial relief to taxpayers, which could have had an impact on collection.

Import rights

Although with decreasing importance in the total collection pie, except in Panama, Paraguay and Ecuador, import rights fell dramatically. Compared to 2008, the revenues from import rights in Latin America went down by 17.9% on average, in real terms. While countries such as Chile, Honduras and Costa Rica show falls in excess of 30%, the little share this tax has in the collection of such countries prevents it from being mainly attributable for the falls.

Graph N° X
Import rights, 2009 (E)
Real inter-annual percentage variations



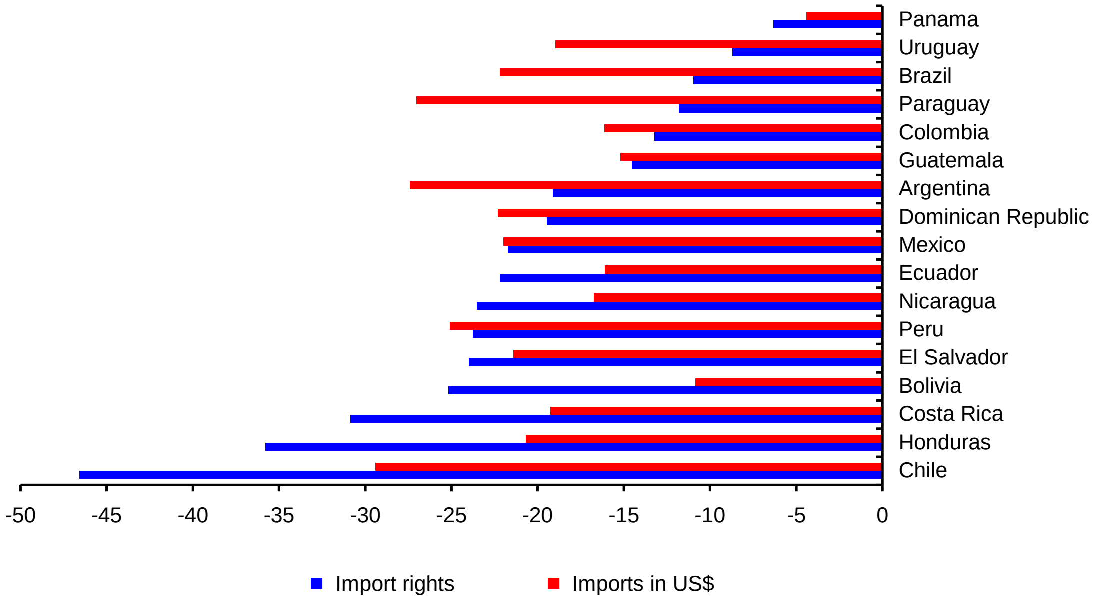
Source: CIAT

Without major variations in the nominal average tariffs, except for cases such as Bolivia (used cars) and Ecuador, the widespread contractions in imports, particularly of finished goods, were the main cause of the falls, since most capital goods are tariff-exempted.

Graph N° X

Imports (US$) and import rights, 2009 (E)

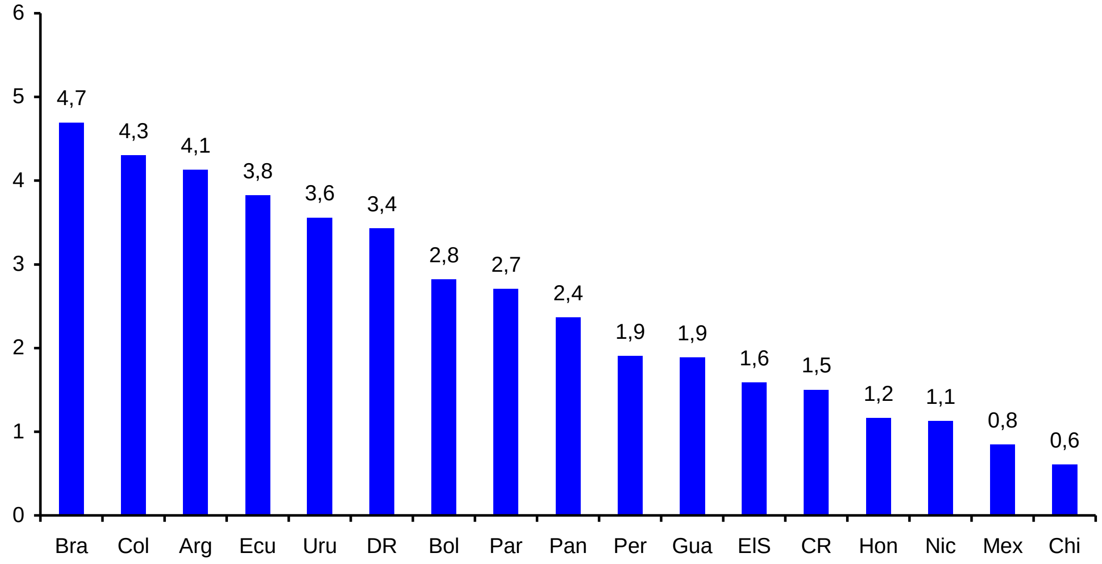
Real inter-annual percentage variations and nominal variations in imports



Source CIAT

As a consequence of the widespread fall in imports, effective tariffs stood eventually at 3.1% on average for Latin America, not showing many changes in the per-country ranking of trade protection in the region.

Graph N° X
Effective tariff, 2009 (E)
as a percentage of imports

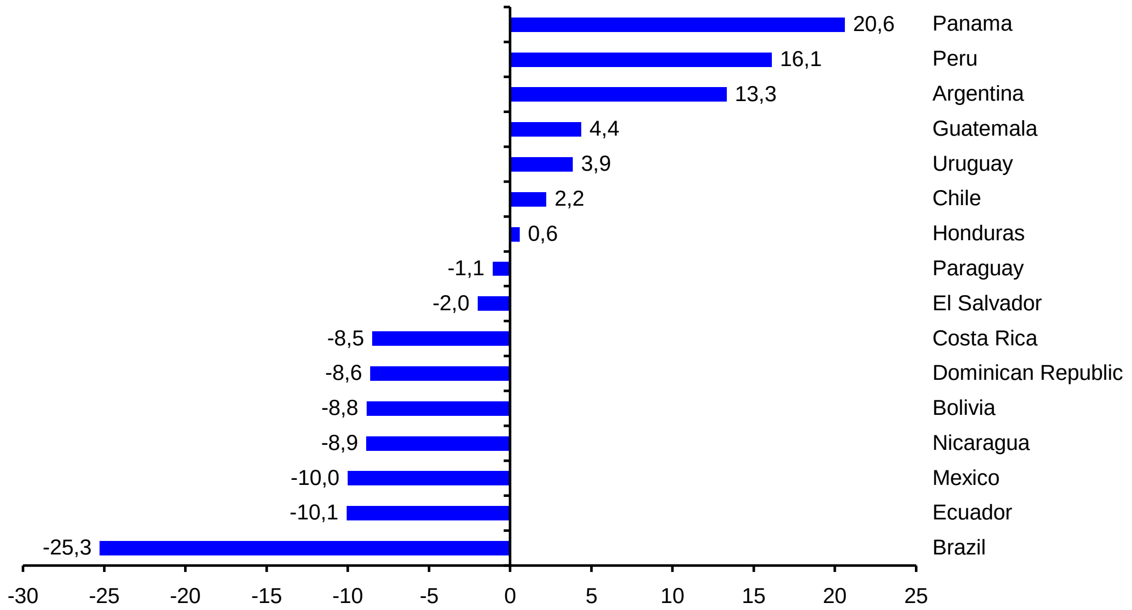


Source: CIAT

<u>Excise taxes</u>

In Latin America, excise taxes fell on average by 10.7%, in real terms, with respect to 2008.

Graph N° X
Excise taxes, 2009 (E)
Real inter-annual percentage variation



Source: CIAT

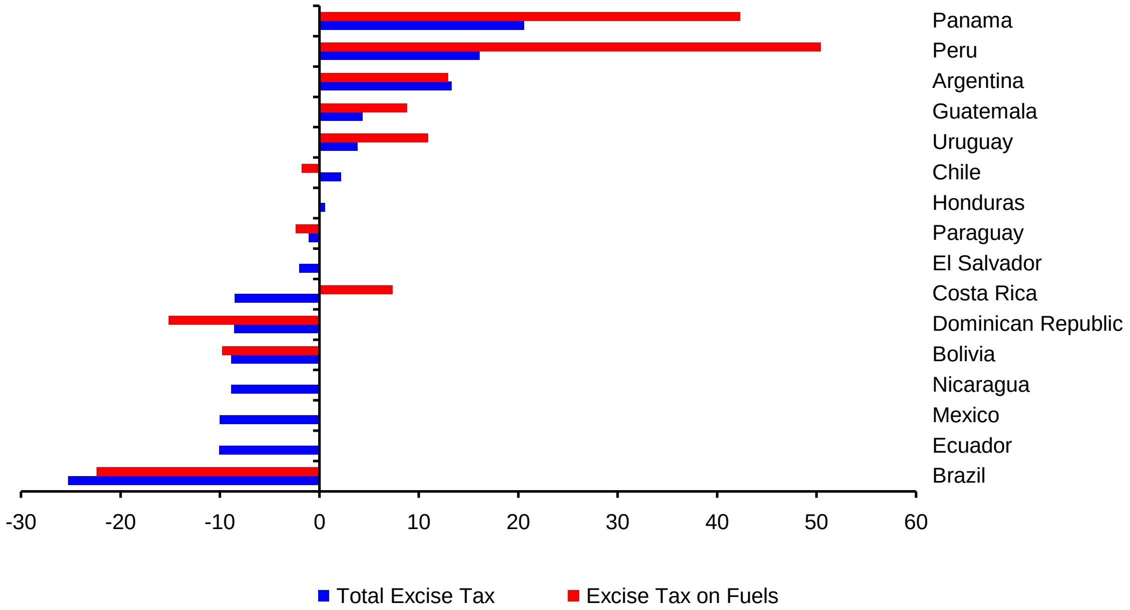
While this behavior is a reaction to the generalized contraction of the local demand, it also reflects the application of tax measures and, most of all, the impact from the recovery of fuel prices with respect to 2008 in many countries.

In the first case, it should be remembered that early this year, Brazil cut down the IPI, mainly on automobiles, construction materials, home appliances and capital goods. Panama also raised excise taxes on cigarettes (firstly from 32.5% to 50% and then to 100% over the consumer sales price, with a top of 1.50 per pack).

In the second case, Panama, Peru and Argentina phased out the subsidies on the price of fuel in 2008 and others left it to float freely.

Many reforms in excise taxes have become effective in 2010.

Graph N° X
Total Excise Tax and Excise Tax on Fuels, 2009 (E)
Real inter-annual percentage variation



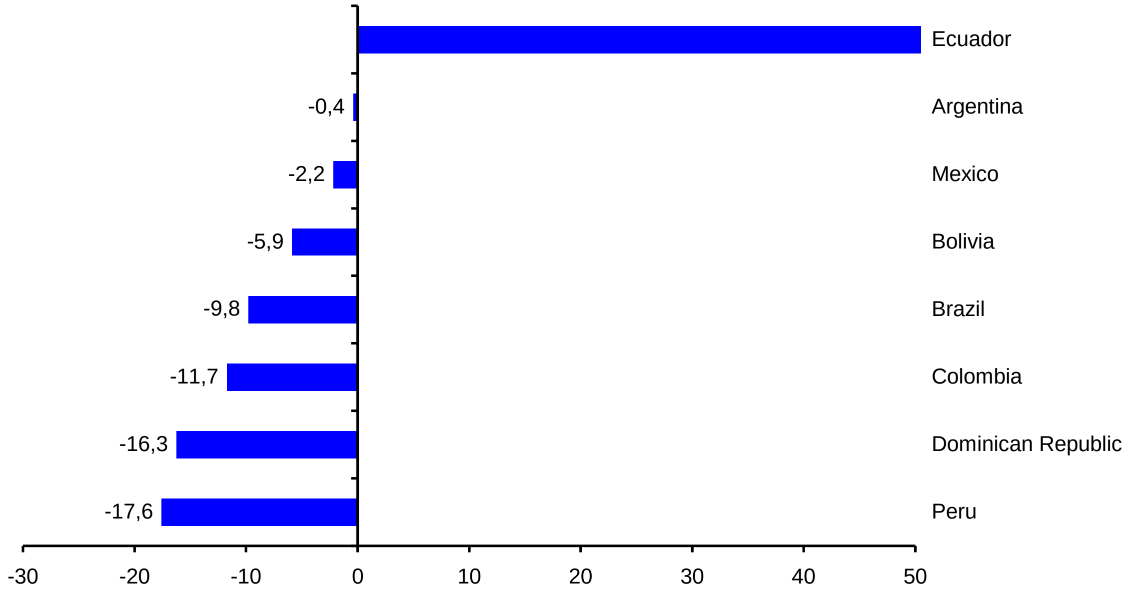
Source: CIAT

Other taxes

The crisis also affected the countries that levy taxes on financial transactions (exclusive of the taxes on juridical acts), observed in the contraction of the volume of operations in the financial system, except in the case of the tax on exit of currencies in Ecuador.

Once again, in the case of Brazil it should be remembered that there was a reduction in the OIF from 3% to 1.5% for credit operations, etc., as part of the fiscal stimulus package. The CPMF had already been abolished in 2008.

Graph N° X
Taxes on financial transactions, 2009 (E)
Real inter-annual percentage variation



Source: CIAT

In countries taxing juridical acts, the application of measures as part of their fiscal stimulus programs had a strong impact, particularly in Chile and Colombia. In Chile there was a provisional reduction in stamp duties, while Colombia cut down the stamp duty tariff from 1.0% to 0.5%.

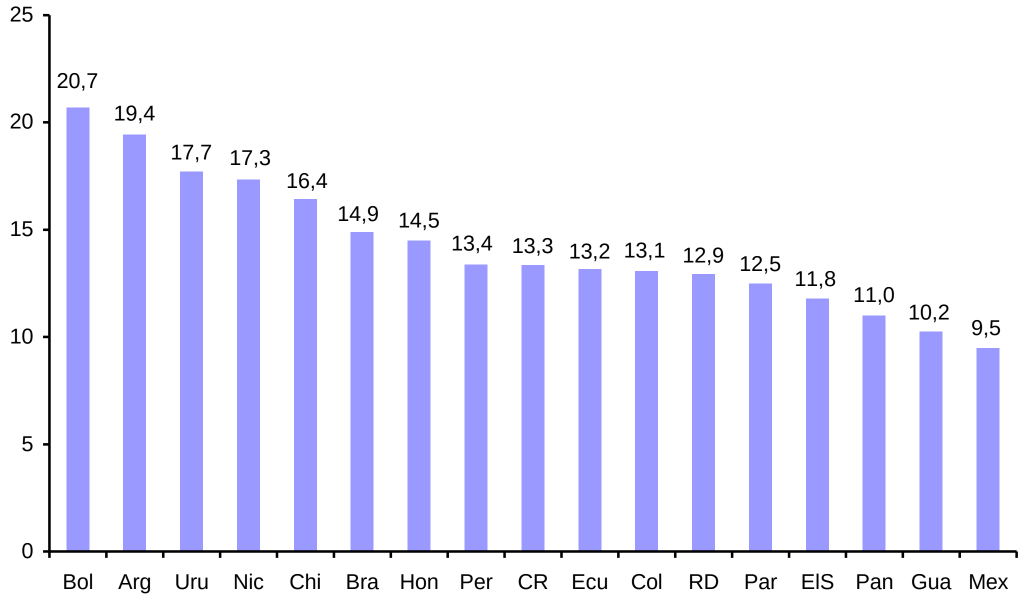
Among the countries taxing exports, the most important (or, rather, the only one) being Argentina, it should be remembered that the withholdings on wheat and corn exports were reduced (the tax base of export rights applied to corn was down from 28% to 23% and corn from 25% to 20%), as well as the withholding taxes on the export of all fresh fruits and vegetables.

There is not much to be said about tax refunds in the absence of detailed information, as stated previously, which is expected to be improved with the above cited Working Group. On the one hand, it is concluded that the VAT on exporters went down, but on the other hand, the acceleration in refund procedures may have raised them. In Peru, the refund of import rights to exporters was increased from 5% to 8%.

Some projections for 2010

The behavior of taxes led the fiscal pressure of the taxes administered by the central governments (excluding employer's contributions) in Latin America to 13.7%, on average, in 2009, without showing many changes in the per-country ranking of fiscal pressure in the region.

Graph N° X
Taxes administered by the central governments (exclusive of employer's contributions) in Latin America, 2009 (E),
as percentages of the GDP



Source: CIAT

Taking into account that the negative trend of tax collection has been phasing out since the third or fourth quarter of 2009 (statistical rebound) in the large economies that were most harmed this year, in the small economies that were most harmed this year and in middle-sized economies which showed the best performance in 2009, a better performance is expected for 2010, mostly in the case of the VAT, as the local demand recovers overall, and in the case of excise taxes, particularly the excise tax on fuels. In the case of the tax on income, profits and capital gains, the results are expected to be just middle favorable, especially in countries that showed better growth rates in 2009.

Graph N° X
Taxes administered by the central governments (exclusive of employer's contributions) in Latin America, 2007-2009 (E)
Real inter-annual percentage variations

Source: CIAT

Additionally, many new tax measures have been approved for 2010.

In the case of the VAT: i) Mexico raised the VAT base from 15% to 16% , and from 10% to 11% in the border zone; and ii) Panama expanded the taxable base of the ITBMS (including bank and financial service commissions, commissions paid to personal and real property brokers, professional services provided to persons domiciled abroad, fixed telephony for commercial use – the residential rate remains exempted), and could raise the overall rate of the ITBMS 5% to 8%.

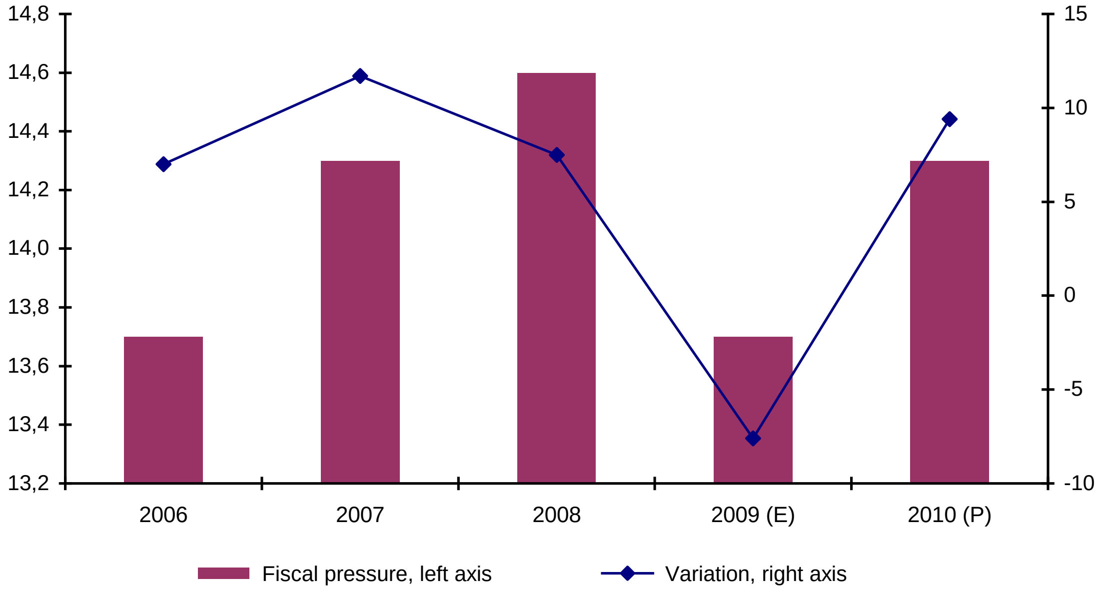
In the case of the tax on income, profits and capital gains: i) Ecuador will tax the distribution of profits (fully integrated with the deduction of payments on company level), but this will have an impact in 2011, ii) Panama introduced withholdings as payment on account for the disposal of real property (3% of the disposal value, with the possibility of becoming a final withholding), and taxed the value of lands in condominium holding attached to above-and under-ground property, iii) El Salvador has introduced a 10%-income tax on the interest of saving deposits in excess of a threshold and on the first sale of real property in excess of a threshold, iv) Nicaragua has established a final 0.6%-withholding on the interest of deposits in the financial system, and extended the individual's income tax exemption trench, which will result in collection losses in 2010, v) Peru has fully enforced the new dual taxation over individual's income, which will tax the income and capital gains by 5%, which had been exempted for two decades; vi) in Mexico, withholdings on salaries have increased in line with the provisional increase in the maximum marginal rate from 28% to 30%, vii) in Ecuador, the income tax advance that was effective has been transformed into a minimum tax, viii) in Colombia, the deduction from the gross income applicable to the purchase of production assets has been reduced from 40% to 30%, and certain benefits have been removed in duty-free zones, and the impact from the reduction in the income tax from 34% to 33% will be noted in 2009's fiscal year, ix) in Mexico the corporate tax rate has been raised provisionally from 28% to 30%, which will have an impact in 2011, x) in Nicaragua, the manner to determine the advances of corporate taxes (minimum payment) was modified, from 1% on assets to 1% on gross income; also, a final withholding of 0.6% has been fixed on the interest of the financial system's deposits; xi) El Salvador has introduced a 10%-Income tax on the interest of saving deposits in excess of a threshold; and xii) Panama has introduced changes in the companies that operate in the Colón Free-Trade Zone.

As for excise taxes: i) Mexico cut down the IESP on services provided through a public telecommunications network (except for Internet, public and rural telephony and interconnection services) by 1 percentage point (3% now); the IESP on beer has been reduced from 28% to 26.5%; the IESP on liquors over 20° GL was increased from 50% to 53%, the IESP on gambling and lottery was up from 20% to 30%, and the rate applicable on cultivated tobacco was raised (it is now 0.8 pesos per gram of tobacco or pack), ii) El Salvador has introduced changes in the excise taxes on liquors and tobacco; additional taxes have been introduced on calls made outside El Salvador as they are considered export goods. Hence, international incoming calls, which in 2008 were up 35% as a result of the $0.04-tax per minute, will now have an additional payment of 13% on the cost of the minute. In this way, if the minute is $0.12, it will now be increased by 13% of the VAT ($0.0156) plus $0.04 of the tax. If a Salvadorian located abroad speaks with their family for 30 minutes, they will pay $3.60 for the 30 minutes, plus $0.46 for the 13%-tax and $1.20 for the $0.04 tax per minute, which totals $5.26, of which $1.66 are taxes.

In the case of other taxes: i) Ecuador raised from 1% to 2% the tax on the exit of currencies, but the threshold is increased from 500 to 1000 dollars, ii) in Colombia the term of the Wealth Tax was extended to 0.6%, but a higher rate of 1.2% is fixed for net wealth in excess of 5 billion pesos, iii) in Mexico, the IDE rate was increased from 2% to 3% and the monthly threshold was reduced from the point where the 25,000 peso-withholding is applicable, to 15,000 pesos, and iv) in Panama, there is an outstanding balance of B/.70.6 million in payment settlements that expire on June 2010. Also, the maximum amount payable for the Notice of Operation tax has been raised from US$ 40,000 to 60,000 (US$ 50,000 in the Free-Trade Zone), at a rate of 2% over capital (1% on the Free-Trade Zone), and the real property tax was raised through a new calculation chart.

For all this, the collection of taxes administered by the central governments of Latin America (exclusive of employer's contributions) is expected to go up by 9.4% on average, in real terms, with respect to 2009, and will reach, on average, 14.3% of the GDP in 2010.

Graph N° X
Taxes administered by the central governments (exclusive of employer's contributions) of Latin America, 2010 (P)
As percentages of the GDP and real inter-annual percentage variation



Source: CIAT