

TAX HARMONIZATION AND ECONOMIC INTEGRATION: MERCOSUR*

Fernando Rezende**

1 INTRODUCTION

Thirteen years after the presidents of Argentina, Brazil, Paraguay and Uruguay got together in the city of Asunción to strike a deal on a project to form an economic union, the reality is still far away from what was envisaged. On the one hand, the region's economies were deeply affected by international financial crisis that provoked macroeconomic unbalances and generated an unfavorable climate for economic integration. On the other hand, political enthusiasm with the project faded as the domestic agenda of economic stabilization gave way to conflicts of interest over more immediate goals.

It cannot be a matter of surprise, therefore, that aside some efforts to keep the project alive by sustaining a far from perfect common external tariff, further steps to deepen the economic integration have been postponed so far. Even though the Asunción Treaty mentioned the need to avoid a discriminatory tax treatment of Mercosur products in the domestic markets of its members, tax harmonization remained outside the regional agenda. It is true that the Ouro Preto Protocol contemplates some institutional advances¹ and that further meetings mentioned the need for coordinating macroeconomic policies in the region, but the actual conditions to put into place these recommendations are still non-existent.

Having been elected as the cornerstone of the macroeconomic stabilization policies, the fiscal adjustment brought additional difficulties for harmonizing the tax systems recently. With difference in emphasis and time, every country in the region were forced to raise tax revenues to meet the challenges of reversing fiscal deficits and checking the growth of the public debt to the GDP ratio. In the process, the quality of their tax systems deteriorated as taxes that face lower political opposition and are more easily collected received overall preference.²

* Comments on a first version of this paper by Vito Tanzi, Luiz Villela and Alberto Barreix, as well as by the participants in a workshop on deeper integration in Mercosur, held in February, 4/5 2005 in Washington, D.C., were mostly welcomed.

** Professor at the Brazilian School of Public and Business Administration—Escola Brasileira de Administração Pública e de Empresas (Ebape)—and Director of Fiscal Studies, Getulio Vargas Foundation, Rio de Janeiro and Brasília.

1. Reig (1996) mentions the Trade Commission—Comisión de Comercio del Mercosur (CCM)—the Joint Parliamentary Commission—Comisión Parlamentaria Conjunta (CPC)—and the Fiscal and Economic Consultative Forum—Foro Consultivo Económico-Fiscal (FCES).

2. The paper does not intend to discuss alternatives for fiscal adjustment. What is emphasized is the fact that by relying on tax increases to revert fiscal unbalances and using “bad” taxes—those that are easily collected and face less political opposition—to that end, Mercosur countries increased tax asymmetries and made it more difficult to reach harmonization.

Deterioration in the quality of the tax systems of Mercosur countries generated additional problems for the business sector. Tax differentials did not favor the consolidation of the private sector's interest in the project of economic integration as the possibilities to develop cross border activities within the region were hampered by tax costs. Furthermore, the lack of integration of basic infrastructure raised the barriers to the integration of business activities inside Mercosur borders.

Despite of recent skirmishes over the dominance of Brazilian products in the Argentinean market, there are some prospects for the Mercosur project to regain more space in the regional agenda. On the economic side, recent advances on the macroeconomic stabilization front open up new possibilities for reducing past tensions and increasing regional cooperation. On the political side, new regional political leaders reiterated their commitment with the economic integration project and make it effective through the decision to act as an economic bloc in the most important international economic negotiations – FTAA, WTO and EU. In this more favorable scenario, the issue of tax harmonization may come to the fore as part of newer proposals to deepen the economic integration.

Under this more favorable assumption, this paper aims at appraising alternative scenarios for tax harmonization in the Mercosur and proposing a specific route to be followed. With this goal in mind, it begins by pointing out the most important differences in the tax systems of the member countries (section two) and examining the main challenges they face to harmonize taxation in the region (section three). Being an important reference for Mercosur, the experience of the EU with respect to tax harmonization is the subject of section four. Section five appraises the implications of tax asymmetries for deepening integration in the Mercosur so as to move to the analysis of alternative scenarios for tax harmonization (section six). The final section concludes with the presentation of a route to be followed to achieve the harmonization of the tax treatment in the region.

2 COMPARING TAX STRUCTURES IN MERCOSUR COUNTRIES

A comparative analysis of the tax systems that prevails in Mercosur countries has been the subject of a recent study by Barreix and Villela (2003). Going over an extensive array of information, they show that wide differences in total tax collections do not preclude a remarkably similarity in the structure of taxation.

As the data provided in this study make it clear, while the aggregate tax burden in Brazil is more than treble the same ratio in Paraguay, about one and a half times greater than the corresponding figures for Argentina, and 20% above

the Uruguayan ratio, the participation of the most important kind of taxes in total tax collections do not vary to a significant degree among them.³

A closer look at the specific characteristics of the taxes applied in each case shows, however, that similar structures hide important differences with respect to the economic impact of taxation. To perceive these differences one has to look into the details.⁴

In order to give readers essential information about tax differences within the bloc that is relevant for tax harmonization goals, this section focus on the different approaches to consumption, capital and labor taxes adopted in the region. Each of these main kinds of taxes is dealt with in sequence, following the priorities usually attached to a process of tax harmonization. An appraisal of the main reasons behind differences in the regional tax systems and the difficulties faced to achieve harmonization closes this section.

To assess these differences, it is important to bear in mind that harmonization of indirect taxes is not synonymous to equalization of taxes and of tax rates. It refers to a situation in which consumers' tax costs are the same regardless of where goods and services are produced. That is, taxation is harmonized when a good produced in Brazil and consumed in Argentina is taxed at the same rate applied to a similar Argentinean good and vice-versa. This situation occurs when exports are fully exempted of every tax imposed along the production chain and when imports are taxed at the rate applied in the domestic market. In the case of direct income taxes, though, harmonization implies uniform rules and rates.

2.1 Consumption taxes

Take the broad category of indirect taxes on the production and consumption of goods and services. While Argentina, Uruguay and Paraguay apply a more usual version of a broad basis value added tax, Brazil has three imperfect varieties of this kind of tax: two collected by the federal government (the manufactured goods tax and the social contribution—Contribuição para o Financiamento da Seguridade Social - Cofins)—and other applied at the state level on all kinds of goods as well as on interstate transportation and communication services. Apart from the ones just mentioned, services that are under the tax authority of the municipalities are not integrated into the value added taxes.

Turnover and selective taxes, as well as a tax on financial transactions, are also widely used and experienced a strong increase in recent times. By far, Brazil has

3. The latest figures for the aggregate tax burden ratio (2003) and the respective sources are: Brazil: 35.5% (REZENDE, 2004); Argentina: 23.75% (GONZÁLEZ CÁNO, 2004); Paraguay: 9.9% (ALARCON, 2004); Uruguay: 30.5% (BARREIX; VILLELA, 2004). Data for Paraguay does not include social security contributions.

4. These details have been exposed in the comparative analysis of the Mercosur tax systems carried out by Barreix and Villela (2003) and González Cano (2003). Additional information can be found in the individual papers for each country referred to in footnote 3.

led the wave of collecting taxes that generate fat revenues without administrative effort and political turmoil. Turnover taxes were reintroduced in the Brazilian tax system in 1970 and gained impetus after the 1988 Constitution.⁵ Moreover, since 1993 a tax on financial transactions have been adopted on a provisional basis, but renewed ever since at higher rates. In Argentina, turnover taxes have been applied by the provincial governments for a long time, but have been subjectet to recent changes that attempted to mitigate the economic inefficiencies of this kind of tax, albeit with dissimilar results.⁶ Surfing on the Brazilian wave, the federal government also reintroduced a tax on financial transactions and applied export duties to adjust the fiscal accounts.⁷ Uruguay did the same, albeit in a less distorted manner. In 2001, it introduced a value-added type contribution earmarked to social security—Cofins—that applies to goods and public utilities. Paraguay relied on increases in selective taxes—fuel mainly—to compensate for the deterioration of its tax base over the second half of the nineties. Even then, tax burden ratio in Paraguay remained in the vicinity of ten percent of the Gross Domestic Product (GDP).⁸

Recent changes in tax legislation adopted in Brazil intent to reverse the path followed in the past of a growing importance of cumulative turnover taxes on total tax collections. Bending to pressures from the productive sector and aware of the need to reduce the burden imposed on exports and investments, the Brazilian government enacted new rules for collecting the PIS/Cofins contributions. These rules adopted a value added approach to collect these contributions from big business, but allowed for some sectors, small enterprises and important service activities to be taxed under the old regime. The duality of rules and the innumerous provisions for dealing with those who can and those that cannot deduct the tax paid in previous rounds of the production chain, make it very complex the operation of the new PIS/Cofins, with mixed results from the viewpoint of tax harmonization in the Mercosur.⁹

5. A 0.15% tax on sales of goods and services were introduced in 1970 to support a special Program for Social Integration—Programa de Integração Social. (PIS)—as an indirect way to accomplish a Constitutional provision for workers' participation in business' profits. Since then, turnover taxes in Brazil did not stop to grow, having received a strong impulse with the extension of social rights in the 1988 Constitution. For a chronology of the deterioration in the Brazilian tax system quality (see REZENDE, 2001).

6. González Cano (2004) points out that collection of the provincial tax in Argentina is highly concentrated. The city of Buenos Aires, together with the provinces of Buenos Aires, Santa Fé, Córdoba and Mendoza account for 4/5 of revenues. Besides, successive modifications reduced the rates applied at the lower and middle stages of the production process (primary and manufacturing) at the same time that increased the burden on sales of final goods, in order to attenuate the cascading effect.

7. Tax on financial transactions and export duties now account for 20% of the total federal government revenues in Argentina.

8. It should be noted that half the revenues from the Paraguayan Imposto sobre Valor Agregado (IVA) is collected at customs. The corresponding figure is 50% in Uruguay and 25% in Argentina.

9. Sectors that remained under the old regimen include those for which Cofins were already collected as a one-stage tax (regime monofásico)—the main examples being the automotive, pharmaceutical, food and beverage ones—, services who opted for a presumptive system for appraising their income tax liabilities and small business that adhered to a simplified regimen for paying all federal taxes (Simples). Sales from these sectors or firms do not generate tax credit for those that are covered by the general regimen.

A more distinct situation is encountered when we look at excise taxes. Excises on fuel, electric energy and telecommunications were abolished in Brazil in 1988, as the power to tax these goods and services were transferred to the states making them liable to the states' value added tax. A new federal specific contribution on fuel was reintroduced by a constitutional amendment in 2001.¹⁰ Excises on fuel, tobacco and beverages (alcoholic and non-alcoholic) are a rule in Mercosur countries. Nominal rates vary, with Brazil and Paraguay holding opposite positions with regard to tax rates. The low rates applied in Paraguay to tobacco and beverages may induce cross-border trade and could explain a similar policy adopted by Argentina with respect to alcoholic and non-alcoholic beverages. Low rates for diesel in the region might reflect the importance of road transportation for moving goods and people within each country and across Mercosur borders. We should not assume from the data provided below that fuel in Brazil are taxed at preferred rates since they do not consider the effect of the states' Imposto sobre Operações Relativas à Circulação de Mercadorias e sobre Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação (ICMS) on fuel prices.

TABLE 1
Excises rates for:*
(%)

| | Argentina | Brazil | Paraguay | Uruguay |
|---------------|-----------|--------|----------|---------|
| Tobacco | 60 | 75 | 4-7 | n.a. |
| Whisky | 12 | 130 | 5-10 | n.a. |
| Beer | 4 | 80 | 5-10 | n.a. |
| Wine | 0 | 30 | 5-10 | n.a. |
| Mineral water | 4 | 0-30 | 5-10 | n.a. |
| Gasoline | 62 | 27 | 38 | 48 |
| Diesel | 19 | 16 | 21 | 8 |

Obs.: * Percentages of the sales price. These data are provided by Alarcón (2004).

n.a. = non available.

Despite of policies to mitigate the impact of fuel taxes on transportation, a recent study that measures tax costs as a percentage of the value-added in land transportation activities in Argentina (RESK, 2004) shows interesting results. Taking into account all kinds of federal, provincial and local taxes, as well as fiscal benefits, a typical transportation Argentinean firm support a tax burden that equals 26% of its value-added. This result reinforces the need for further microeconomic analysis of effective tax rates in the region.

Differences are also great in the realm of taxes on external trade. The case in point here is Paraguay, whose fiscal dependence on revenues from export and

10. Import and domestic sales of fuel, as well as natural gas and ethanol, pay a fixed amount per unit (present rates are R\$ 280 per cubic meter of gasoline and R\$ 70 per cubic meter of diesel) and the proceeds of this tax is shared with the states and earmarked to roads and environmental care programs.

import taxes is remarkable. A recent reform in tax legislation aims at improving domestic taxation to open up room for reducing the importance of taxing foreign trade in the government budget, but it is unlikely that significant changes can be achieved in the short run.¹¹ Export and import taxes are of residual significance in Brazil, but that does not mean that foreign trade is practically exempted. Exporters still suffer from difficulties to recovering states taxes on inputs, impossibility of deducting local taxes on services and the duality of the rules applied to the new PIS/Cofins. On the other hand, the incidence of the new PIS/Cofins on imports raised the tax burden on foreign goods and services, even though it contributed to a fair treatment of foreign and domestic goods in the Brazilian market.

In Argentina, the reintroduction of export duties, which applies mainly to agricultural goods, serves a double purpose: to reinforce the federal budget and to induce the aggregation of value to their exports. Under the federal value-added tax exports are exempted and imports taxed at the local rate (destination principle). Exports are indirectly taxed by the provincial governments and by taxes on fuel and electricity, but this burden is partially offset by a federal arrangement to give back money to exporters.¹² The situation in Uruguay is pretty much the same as in Argentina but for the fact that there are no provincial governments in this country.

A recent study (RESK; REZENDE, 2003) on the actual tax burden supported by three important products of the Brazilian and Argentinean agribusiness—soya (beans and oil), chicken and beef—provides empirical evidence of the surprises we encounter when a detailed microeconomic study of tax differentials is made. Contrary to what an observation of the tax legislation in both countries may suggest, taxes on the domestic consumption of beef and chicken is lower in Brazil whereas exports of chicken and soya are more heavily taxed in Argentina. The main explanations for these results are the following:

- a) differences in value-added taxes explain most of the divergences in tax burden on domestic sales. Whilst Argentina adopt a general value added tax (VAT) with few exceptions, the state VAT in Brazil do not cover the service sector and the federal VAT does not apply to the goods concerned. Besides, Brazilian states' VAT varies according to where primary production and final consumption occur, due to differences in rates applied to interstate sales as well as incentives to producers; and
- b) with respect to exports, the higher effective rates for Argentinean products reflect the export duties applied and the provincial turnover tax.

11. A description of the main provisions of this reform can be found in Alarcón (2004). One important aspect of this reform is the introduction of a Personal Income Tax in Paraguay.

12. The reintegros a la exportación are a percentage of the exports fob price set by the Finance Ministry after information provided by business organizations. They cover part of the export tax costs and benefit higher value added products.

TABLE 2
Effective tax burden on agribusiness products*

| Domestic sales | Soya beans | Soya oil | Beef | Chicken |
|----------------|------------|----------|--------|---------|
| Argentina | 0.435 | 0.2273 | 0.2130 | 0.2336 |
| Brazil | 0.1532 | 0.1790 | 0.1093 | 0.1517 |
| Exports | | | | |
| Argentina | 0.2569 | 0.2032 | n.a. | 0.1171 |
| Brazil | 0.0828 | 0.0649 | n.a. | 0.0364 |

Obs.: * Total tax costs as a ratio of sales prices (see RESK; REZENDE, 2003).
n.a. = non available.

2.2 Capital taxes

Every comparative analysis of the use of income taxes in Mercosur calls attention, at the outset, to an important divergence: Whereas Brazil and Argentina tax income both at the corporate and the individual level, Uruguay and, until recently, Paraguay¹³ do not have a comprehensive system of personal income taxation. This fact alone is a major problem in dealing with proposals for harmonizing income taxes in Mercosur.

To Barreix and Villela (2003), this particular situation evidences distinct preferences among big and smaller economies in the region. A greater domestic market may have induced Brazil and Argentina to coordinate capital taxes and development policies in order to attract investments. Uruguay and Paraguay, on the other hand, opted for attracting foreign savings through a favorable treatment of capital income and the maintenance of a regime that protects the investor's actual identity.

This stylized fact tells only part of the story. Differences in approaches to the corporate income tax and in provisions for assessing tax liabilities are of significant importance for investors. Brazil and Argentina tax global income, that is, all local businesses are taxed on income they generate inside and outside of the country, whereas Uruguay and Paraguay tax only income from local sources. Subsidiaries of multinationals are taxed on a same basis in all countries (in Brazil and Argentina they are liable only to the income they generate inside their territories). At first sight, and assuming everything else equal, this could give incentives to foot-loose manufacturing producers and high tech services for moving headquarters to Uruguay or Paraguay in order to benefit from a more favorable income tax environment.

Rates do not differ much,¹⁴ but some provisions that affect the after tax rate of return on investments are worth noting. In particular we should look at:

- a) the method adopted to avoid double taxation through corporate and personal income taxes;

13. A Tax Reform approved in 2004 left Uruguay alone in Mercosur with regard to the non-existence of a personal income tax.

14. Rates are 35% in Argentina, 34% in Brazil and 30% in Paraguay and Uruguay.

- b) the rules applied to capital gains and shares;
- c) the joint corporate and personal income taxes on profit distribution;
- d) provisions for dealing with transfer prices; and
- e) incentives to investment through tax holidays, accelerating capital depreciation or other forms of fiscal benefits.

Apart from the global-source approach divide, there are no significant differences with regard to provisions for assessing taxable profits. Of some importance is the distinct rules applied to interest, dividends, royalties and technical assistance. Brazil and Argentina adopt similar criteria regarding payments to foreigners (dividends, interest and technical assistance) while the other partners apply rates that vary from 10% to 17% (Paraguay) and from 0% to 30% (Uruguay). Uruguay do not tax interest paid to foreigners.

More important, however, are the rules applied to avoid double taxation of capital income. While interest is exempted from the Personal Income Tax in Argentina, it is subjected to a 15% tax in Brazil. Both countries exempt dividends at the personal level so as to avoid double taxation. Capital income received by residents is wholly exempted at the personal level in Uruguay (it doesn't apply a personal income tax) but dividends paid to foreigners are taxed. Paraguay also tax dividends paid to foreigners and will tax capital income received by residents through a new personal income tax.

Differences concerning rules applied to dividends, interest and retained profits are important from the viewpoint of firms as well as of individuals. The way interest and dividends are taxed at the corporate and at the individual level interfere in savings options as well as on the possibilities for inducing market capitalization to finance private investment. By not taxing capital income at the individual level as well as interest paid to foreigners, Uruguay gives a remarkable incentive to financial institutions and to savings. Paraguay have similar rules to the ones applied in Uruguay, but a more fragile institutional setting do not lead to similar effects on its financial system. Taxing interest and dividends at source, as done in Brazil and Argentina, diminish the impact on savings that the Henry-Simons approach to income taxation—add all income sources regardless of their nature before applying the progressive scale for assessing tax due at the individual level—entails.

A reform of the Brazilian income tax laws implemented in the second half of the nineties introduced changes that intended to redress the unbalance in the treatment given to interest and dividends. This reform allowed business to deduct interest on own capital as well as dividends in assessing taxing profits. Therefore, the incentive that previous rules provided for financing new investment through debt disappeared as capitalization and debt financing began to receive an equal treatment

for income tax purposes. Together with the exemption granted to dividends and the sole taxation of interest at source, the Brazilian legislation attempted to reduce the burden on investment and savings.¹⁵

Despite of provisions to avoid the double taxation of capital income, underdeveloped regional capital markets give not much alternative for firms to finance investments apart from the recourse to debt. Big business could also rely on reinvesting their own profits, but this option may conflict with shareholders' interest in receiving dividends. Issue of new shares is constrained by the size of capital markets. Besides narrow options for investment financing, the income taxes applied in the region give additional impulse to borrowing, as interest on debt is fully deductible in assessing taxing profits. The above mentioned reform of the income tax legislation in Brazil attempted to avoid this incentive to indebtedness at the business level, but the lack of adequate conditions for relying on other sources of financing capital enlargement did not change the situation in a visible way.

Incentives to investment have been used widely, notably in Brazil and Argentina but lost importance in recent times as tax rates came down, simplified procedures were adopted to assess and collect the income tax and industrial policies went out of fashion. All Mercosur countries adopt a simplified tax regime for small business, which evolved to a flat rate on total sales that substitute for both consumption and income taxes. But this is not the only case. Brazil enlarged the number of firms entitled to a simplified income taxation system by raising the ceiling for opting to a presumptive regime for assessing corporation income tax liabilities.¹⁶

Shrinking the number of firms that are required to fill out tax returns that show how profits are measured and how the amount of tax due is set, through an enlargement of simplified rules in a time where Mercosur economies lost dynamism, narrowed the room for incentives. Tax holidays for investment in low-income domestic regions continue to exist, but lack of investment meant a low impact on the government purse. Coupled with changes in conditions that have a decisive influence on location decisions of big investment projects, income tax based incentives to investment did not have much influence in the last two decades.¹⁷

Transfer prices are a case in point. Only recently, Brazil and Argentina adopted specific legislation to deal with problems created by the growth of activities of multinational firms in the region. Uruguay and Paraguay have not implemented any

15. Critics of this reform point out to the possibility of shifting tax basis of multinational corporations to their countries of origin.

16. Under this regime firms whose annual sales do not exceed R\$ 24 million (approximately US\$ 8 million) can opt for paying a fixed percentage of its total sales as a substitute for the regular business tax regime.

17. It is important to make it clear that the so-called fiscal war among Brazilian states to attract investments did not rely on income taxes (which are not under the states' fiscal jurisdiction) but instead on the possibilities offered by the mixed origin-destination principle applied to the states' VAT (see REZENDE; AFONSO, 2001).

rule on this subject so far. Critics of the Brazilian legislation point to the arbitrary nature of the rules applied in the country, which deviates from the norms adopted in the United States as well as from those enforced in the EU. The Argentinean legislation resembles the EU, but its implementation suffers, as in Brazil, from lack of experience of tax administrators to deal with a very complex and novelty situation.¹⁸

In general, property taxes have low significance in the region. In Argentina and Uruguay, only, a general type of wealth tax on business and persons is applied. Argentina taxes also assets held in foreign countries (shares, bank deposits, real state...) whether in Uruguay only assets held in the country are taxed. Rates vary from 0.5% to 0.75% (Argentina) and from 0.7% to 3% (Uruguay). The tax on businesses' assets in Argentina can be deducted from the corporation income tax and can be seen as an effort to curb tax evasion. Argentina applies a tax on rural and urban properties at the provincial level. Except for Argentina, urban real state are taxed at the local level in all other countries and gain a particular importance in Brazil due to the high degree of political and fiscal autonomy Brazilian municipalities enjoy. Apart from the burden on big rural landowners in Argentina,¹⁹ that may have adverse impact on rural production, property taxes are not a significant problem for tax harmonization in Mercosur.

2.3 Labor taxes

Labor is taxed in two most important ways: through social security contributions and under the personal income tax. With regard to the former, Argentina and Uruguay reformed their social security systems to cut present and future deficits by limiting the responsibility of the public budget in social security financing. As a result payroll taxes dropped in Uruguay, but remained very high in Argentina, as we can see in the numbers below.²⁰

Putting together the figures for the social security wage tax and the rates for the personal income taxation, we can see that taxation of labor incomes in Brazil, Argentina and Uruguay are as great as one can expect for low income brackets. In Brazil and Argentina wages are taxed at a 26% rate. It is interesting to note that even though Uruguay do not apply a broad base type of personal income tax, labor is taxed at a not very different rate. In fact the top rate for the social security wage tax in this country is similar to the burden imposed on the Brazilian and Argentinean workers.

18. For a brief account of differences between the Brazilian and Argentinean legislation, see González Cano (2001). Also Amaral (2000).

19. Resk and Rezende (2003) show that the tax on rural property accounts for 2.4% of the domestic sale price for beef and 5% of the soya price in Argentina.

20. González Cano (2003) calls attention to the fact that the actual rate can be much lower in some Argentinean provinces as the federal government gave incentives to employment in backward regions through lower payroll taxes (the reduction could be as high as 40%). The extent of the Uruguayan reform can be seen on the high rates for the social security wage tax.

TABLE 3
Payroll and labor taxes*
 (%)

| | Payroll tax | Wage tax | Personal income tax |
|-----------|-------------|-------------|---------------------|
| Argentina | 32 | 17 | 9-35 |
| Brazil | 31.5 | 8-11 | 15-27.5 |
| Paraguay | 16.5 | 9.5 | ---- |
| Uruguay | 18.5 | 19.25-24.25 | ---- |

Obs.:* Data are from González Cano (2003).

2.4 Concluding remarks

As we have seen, indirect taxation in Mercosur contemplates a bunch of taxes that are similar in appearance but distinct in nature. Differences in approaches to VAT and the superposition of other distinct kinds of taxes applied in the region make it impossible to appraise the actual burden imposed on goods and services in the region without a detailed microeconomic study. That being so, tax costs cannot be properly adjusted at the borders, meaning that distortions in intra-regional trade won't be easy to correct. Recent changes in Brazil with regard to the federal social contribution—Cofins—and the prospect for a uniform state value tax in the future give hope for some advances, but we cannot expect a fast move in the direction of a more harmonized system of indirect taxes.

With respect to direct income taxes, a *de facto* distinction between the treatment of capital and labor incomes in the region, albeit with distinct purposes and for distinct reasons, point to a possibility that may reduce the impact of present asymmetries on decisions concerning the allocation of savings and investment.²¹ That will be the case if gradual moves to a Dual Income Tax approach to the income taxes, alongside proposals that are being discussed in the EU, become a reality in the foreseeable future.

Due to a lower mobility, asymmetries in the taxation of labor income are not so important for integration deepening. However, more attention might be need in erasing social security barriers to the mobility of skilled workers within the bloc.

3 MAIN REASONS BEHIND TAX DIFFERENTIALS

The above description of the main characteristics of the tax systems of Mercosur countries included some facts that help the reader to understand the differences

21. It is important to note that the growing importance of multinationals corporations calls attention to the need for common rules to deal with the practice of "transfer pricing". Genschel (2001) points out that even though econometric studies on the effect of high tax rates on foreign direct investment show that this effect is weak in terms of size and statistical significance, "this does not mean that companies do not avoid taxes". They just take another route to avoidance. Instead of relocating real activities to low-tax jurisdictions, multinational companies manipulate commercial and financial exchanges within the company to shift paper profits out of high-tax environments and into low-tax jurisdictions. For example, to reduce the taxable profits of a subsidiary in a high-tax country, affiliates in less tax-heavy locations will charge inflated prices for deliveries to this subsidiary and pay deflated prices for deliveries they receive from it (transfer pricing).

pointed out before. This is not enough however to better understand the challenges that will have to be faced to overcome the barriers that block the path towards tax harmonization. Hence, it is worthwhile to spend some time in uncovering the main reasons for the tax differentials.

Macroeconomic fiscal policy plays an important role in explaining recent changes in Mercosur tax systems. As mentioned before, the fiscal adjustment of the past years relied heavily on turnover, export and other inefficient kind of taxes that make it difficult to appraise the actual tax burden imposed on distinct products and services and renders it impossible to adjust taxation at the borders so that, regardless of origin, goods and services be taxed at same rates in regional and domestic markets.

It is far from clear, at this point, how the requirements for keeping fiscal responsibility will be met in the nearby future. So far, efforts to restore fiscal discipline in Mercosur vary within the region. Only recently, Argentina has adhered to orthodox proposals for generating fiscal surpluses in order to keep public indebtedness at bay. In Uruguay, interest on the public debt trebled since 2000, reaching 6.2% of the GDP in 2003 and adding stress to an already tight budget. Public indebtedness grew also in Paraguay to 45% of the GDP—up from 32% in the beginning of the past decade. Coupled with a deterioration of the tax basis, it contributed to transform a 1990 8% primary surplus in the Paraguayan public accounts into a 1.8% deficit in 2002 (ALARCÓN, 2004). Brazil, that has been following a very conservative fiscal policy since 1999 still did not manage to put the public debt to the GDP ratio on a declining trajectory, despite of achieving even higher primary surplus in the past five years.

High ratios of public indebtedness and uncertainties with respect to domestic reactions to changes in the world economy (United States twin debts and trade protectionism, fears of hard landing in China, oil prices, terrorism)²² may leave not much space for relaxing the fiscal policy in the foreseeable future. Therefore, prospects for reducing the tax burden ratio (Brazil) or avoiding further increases elsewhere are dim. Of course that some room for maneuvering could arise from a strong hand approach to cuts in public spending, but legal entitlements and political opposition do not recommend a high bet on this alternative. Changes in taxes, therefore, may come more from actions to substitute inefficient turnover, export and financial transaction taxes for value-added models of taxation. Higher rates of domestic economic growth may help to improve the quality of Mercosur tax systems and the prospects for tax harmonization in the region.

22. In a recent analysis of the international economic scenario, the director of the Institute for International Economics, Fred Bergsten, put out some reasons to worry about likely impacts of international crisis on emergent economies. See *The Economist*, september 11, 2004.

Fiscal macroeconomics explains the retreat from tax modernization witnessed recently in the region, but there are other important reasons for different approaches to taxation in Mercosur countries. Paramount among them is the peculiar situation of an economic bloc formed by two federal large states and two small unitary countries. Hence, to the usual difficulties faced in uniting economies that present great differences in size, we add the distinct political nature of the Mercosur states and the specific problems it creates for tax harmonization.²³

The constitutional division of tax powers and differences in the degree of sub-national autonomy to tax mean that decisions to harmonize tax systems in Mercosur do not depend on the will of Brazilian and Argentinean federal authorities. Every change in legislation has to be subject to negotiation in the Parliament, where state or provincial governors and mayors have strong influence. The situation is worse in Brazil, given the states' control over the most important VAT tax, the power of the municipalities to tax services and the higher degree of state and local government fiscal autonomy when compared with the Argentinean provinces and, notably, municipalities.

In addition, one has to take into account that in both cases it is not enough to look at the constitutional division of tax powers. The complex nature of the fiscal federalism that prevails in Brazil and Argentina mean that any change in tax legislation has to be also looked from the viewpoint of its consequences for the vertical and horizontal distribution of tax revenues as they affect the transfer of resources within the federation. For example: even though income taxes are the sole responsibility of the federal government, in Brazil as well as in Argentina, any proposition that lead to a fall in income taxes revenues reduce the money that flows into state and local governments budgets, thus facing reactions from their side.

Fiscal federalism is behind structural differences in Mercosur taxation. One important difference is the inverse situation encountered in comparing the two biggest regional economies. In Argentina, a turnover type of tax give support to provincial budgets, whereas the federal government rely more on a broad value added tax. In Brazil, the most important value added tax is in the states' hands, being the federal government dependent on two distinct VAT species to cover for its budgetary needs. The unique position Brazilian municipalities have explain the partition of the tax basis—goods taxed at the federal and state levels and services being taxed at the federal and local levels, which poses a formidable obstacle to the adoption of a uniform broad base type of value added tax in Brazil.

23. It is interesting to note that the German federal regime did not pose much difficult for tax harmonization in the EU given the uniform tax rules applied throughout the German federation and the control of the federal government over tax legislation. Besides, economic disparities among the six original members were not as great as those found in Mercosur. Whereas difference in per capita income among EU countries did not surpass two times in 1962 (Dossier, 1967), recent Economic Commission for Latin America (ECLA) data for Mercosul shows that per capita income in the region differs by six times.

Looking at the case of Uruguay and Paraguay, historical facts and distinct approaches to the role of the state contributed to differences among them as well as with other Mercosur partners. In Paraguay, a less developed economy and a weak state kept the tax ratio at low levels over a period in which many Latin American countries embarked in government sponsored industrialization and copied generous welfare European policies. Hence, foreign trade taxes, the usual budget revenue source in underdeveloped economies, kept its dominant position in Paraguayan public finances despite of attempts to diversify revenue sources. In Uruguay, a developed rural based economy of the past century's first half allowed for the implementation of a very generous welfare state that still impinges on efforts to cut public spending.

More recently, all tax systems in the region were infected with the "easiness" virus. Pressed to restore fiscal discipline and avoid an uncontrolled expansion of the public debt, fiscal authorities, in a context of inefficiencies in tax administration, turned to old fashion tax species, whose main qualities are being easy to collect and less sensitive to political opposition. The options were similar but its consequences were not. Given that it is impossible to assess with a minimum of confidence the effective burden these taxes impose on each good and service in each country, there is no way of achieving a harmonized situation in which cross border trade will allow for resident consumers to pay the same tax regardless of where the goods are produced.

4 TAX HARMONIZATION GOALS AND MERCOSUR CHALLENGES

Tax harmonization processes aim at achieving four important goals:

- a) set the stage for a free movement of goods and services within the region;
- b) avoid interference in decisions concerning the location of economic activities in the region;
- c) erase barriers to labor mobility; and
- d) be neutral vis-à-vis mobility of financial capital

Not by chance, harmonization of indirect taxes on goods and services is seen as the second important movement—after the fall of import duties—towards an economic union. If domestic taxes impinge on free trade within the region, they do not allow the process of economic integration to proceed. That is why the EU put out since the beginning a calendar to harmonize indirect taxes and took energetic measures to assure its implementation.

As has been insistently remembered, harmonization of indirect taxes does not call for a uniform set of taxes neither for uniform rates. It does require that any good or

service be taxed at the same rate applied in the jurisdiction it is consumed regardless of its origin. To this end, all exports have to be wholly exempted from indirect taxes and all imports have to be taxed at the corresponding domestic rate. This is a proposition that can be put in simple terms but that is difficult to implement.

Some of the challenges Mercosur countries faces to harmonize their taxes have been mentioned in the previous section, but it is important to highlight the main ones at this point.

4.1 Macroeconomic fiscal targets

The subordination of tax measures to macroeconomic stabilization policies is the first in a row. The hard budgetary constraints imposed by macroeconomic goals, together with mounting pressures for raising public spending in infrastructure and social programs after years of containment in budgetary outlays, do not give confidence to any suggestion for reducing tax collections, quite the opposite. Apart Brazil, that began to apply conservative fiscal policies early and managed to increase by 10 percentage points the aggregate tax burden over the 1998–2003 period, other Mercosur countries moved slowly or not at all in that direction. Between 2000 and 2003 the ratio of tax revenues to the GDP increased by 2 percentage points in Argentina, whereas in Uruguay and Paraguay the tax burden ratio remained stable.²⁴

Keeping tax revenues at levels required to sustain macroeconomic targets raise the need to face a dilemma. This dilemma refers to the fact that taxes that are efficient from the viewpoint of tax administration—that is those that generates substantial revenues with low administrative and political costs—are very inefficient from an economic point of view, besides not being amicable for harmonization purposes.

4.1.1 Greater reliance on income taxes

One possibility to reduce the dependence on low quality types of consumption taxes without compromising macroeconomic fiscal targets is to make a better use of income taxes. Within the region, income taxes do not have much significance for the public budget—Brazil can be considered an exception—, but their impact on corporations and on decisions to invest can not be easily dismissed. Argentina have adopted recently measures to improve taxation of personal income which did not show a significantly impact on tax proceedings yet. Suggestions for applying a general type of income tax on individuals have been floated in Uruguay, but there is no official proposal for that (BARREIX; ROCA, 2003). Recent tax legislation in Paraguay put into place a personal income tax at modest rates. According to Alarcón (2004), one important goal of this tax is to curb tax evasion by inducing

24. It is not unlikely that those that stayed behind will join the tendency for an increase in the tax burden ratio in the region to fulfill fiscal adjustment targets.

taxpayers to collect receipts on all families' purchases, since these expenses can be fully deducted.

The situation in the area of income taxes is distinct from the one encountered with regard to the indirect taxation of goods and services from the viewpoint of tax harmonization. First of all, full harmonization of income taxes requires harmonization of tax basis as well as of rates. Second, technical conditions to move in this direction are not as difficult as those mentioned for the indirect taxes. Third, political opposition is less difficult to overcome as federalist claims are not strong and equity considerations could provide support. Fourth, new proposals for moving away from the Henry-Simons model for taxing personal income and going back to a schedular regime is gaining adepts.²⁵

New approaches to the income tax arise out of the impact of the globalization of capital markets. For some time now, Norway and Finland adopted a dual income tax regimen by which capital income is taxed to a preferential rate, being not subjected to the progressive scale applied to personal income taxes. High marginal rates for personal income taxes in Nordic countries were the main reason behind this measure, since a higher burden on capital income would lead to capital flight. Proposals for adopting a dual income tax in the EU have been made so as to facilitate the harmonization of income taxes in that region (CNOSSEN, 2003).

The arguments used to sustain the Norwegian position are similar to those echoed in Uruguay and Paraguay: small open economies can not tax capital income under a progressive personal income tax since that will lead to capital flight. Hence, the rate of the income tax at the individual level cannot exceed the rate applied to corporate income. This new approach to capital income taxes opens up possibilities for harmonizing income taxes in Mercosur that have not been envisaged before.

In practice, if not in legal terms, the regime adopted in Uruguay resembles a dual income tax approach. Corporate income is taxed at a rate not distant from the Mercosul average and capital personal income is not taxed. Brazil and Argentina, on the other hand, tax dividends at source only. Interest is exempted from the personal income tax in Argentina. In Brazil it is taxed at source only.

A dual approach to income taxation also diminishes the task of tax administrators. Taxing both labor and capital income at source reduces the cost of administering income taxes and open up more room for harmonizing income tax regimes in economic unions.

4.1.2 Tax harmonization and fiscal discipline

Bearing in mind that harmonization of indirect taxes doesn't imply in unification, the impact of harmonization on fiscal discipline is limited, even though it may

25. His proposition has been made by Vito Tanzi and gained new adepts recently (see TANZI, 1995).

increase as the economies become more integrated. Having a broad-base VAT as the main revenue source throughout Mercosur doesn't impinge on the autonomy of member countries to alter tax rates. Thus, governments can raise revenues by increasing VAT rates to avoid fiscal deficits, provided that tax costs are fully adjusted at the borders. But they can also do the opposite: reduce rates to increase political support in pre-electoral years.

Of course that freedom to change rates has its own limits. If deficits keep growing tax rates cannot rise forever. Besides, if tax costs differ too much producers can move plants to less profligate neighbors provided that transportation costs do not surpass tax gains.²⁶ In addition, as harmonization of indirect taxes close the options to finance a spending spree to win elections through turnover or financial transactions taxes, it can be said that it will contribute to sound fiscal policies in the medium run. The sole space open outside of the VAT territory is the one held by a few excises, which will also have to face the discipline imposed by cross-border trade if difference in rates are large.

With respect to income taxes, two distinct situations should be noted. Full harmonization of the corporate income tax requires equal basis and rates, so when it is achieved no possibility for individual actions will remain. Higher discretion may be applied in the case of personal income taxes, due to low labor mobility. We can say that despite of limiting members' countries autonomy, harmonization of income taxes has more to do with competitiveness and fairness than with fiscal discipline.

4.2 Improve tax administration and exchange information

It should be stressed that the road to tax harmonization intersects, in its very beginning, with immediate actions to improve efficiency in tax administration. Despite of programs that have been implemented in the region to enhance the use of information technology for tax administration purposes, the overall picture is not satisfactory. This suggests that a calendar for harmonizing indirect taxes in Mercosur will have to take administrative improvements into account.

In theory, a broad base value added tax could generate the same revenue collected by means of other less economically efficient taxes on goods and services, provided there is good information to assess the proper rates. In practice, the problem is different. First, the information needed is not available, which makes it difficult to substitute turnover taxes for value added type ones without creating distortions—witnessed the recent Brazilian experience with the implementation of non cumulative rules for Cofins. Second, even if proper information for

26. González Cano (2003) mentions the six directive of the European Commission that imposed restrictions on EU members regarding VAT rates. Basic rate cannot be lower than 15 and the floor for reduced rates applied to basic goods was set at 5%. The average rate is now 19.4%; Luxembourg (15%) has the lowest rate and the Nordic countries (25%) the highest.

simulating the rates could be collected, tax substitution imply a significant change in the distribution of the tax burden—the short production cycles sectors facing a significant increase in taxation to allow for a reduction in the tax burden ratio of long production cycles ones (in general services are severely hit). Thus, political reactions to these changes cannot be dismissed and may provoke ad-hoc adjustments to calm down reactions.²⁷ Third, even if these reactions could be surpassed, the quality of the tax administration is paramount to assure that an overshooting of rates is not used to insure revenues against possible miscalculations. Good administration is even more important when we take into account the importance of small business in Mercosur economies and the difficult to administer a value added tax in such situations,

Wide differences in administrative capabilities are also a source of tax asymmetries. As we have seen, harmonization of indirect taxes asks for a move away from the recent trend in Mercosur for relying on more easily collected taxes to attend to the macroeconomic goals of fiscal responsibility. Substituting a broad-base consumption VAT for the economically inefficient turnover, foreign trade and financial transactions taxes requires a less uneven situation with regard to actual conditions for enforcing a real neutral VAT. It doesn't suffice to achieve harmonization at the legal level. Distortions will arise if taxpayers are not treated in a more or less equal basis.

Two distinct situations can be envisaged. One point to unfair competition in markets for goods and services between organized firms and informal activities usually found in a more favorable environment for the latter to expand by skipping tax obligations. The other refers to an opposite situation: big business can thrive in a context where the sophistication of organizational structures and financial markets face administrations that lack resources and skills to audit accounts properly.

Informal activities may expand In less developed administrative settings, at the cost, though, of leaving governments with a small budget to foster economic development. Besides, bad administration may lead to differences in effective tax rates due to an improper work of the credit mechanism for collecting the VAT, meaning that goods produced in a less efficient environment may loose competitiveness both in domestic and regional markets, since tax costs will not be fully adjusted at regional borders. Different administrative capabilities in a context of harmonized tax legislation may thus lead to higher regional disparities.

Conversely, big business is not constrained by geographic limits to benefit from differences in administrative capabilities. Multinational groups may look for possibilities to enhance after tax profits by moving headquarters to places where

27. Strong reactions from non-tradable service sectors to the first version of the legislation that adopted a value-added mechanism for collecting the Brazilian Cofins extended the list of activities that remained outside of the new regime to avoid substantial increases in their tax burdens. The ad hoc adjustment process meant further economic distortions.

legal practices to reduce the tax basis—transfer prices, for instance—are less subjected to restrictions and controls. Nevertheless, this does not contribute to diminish economic disparities as production location is more concerned with size of markets, quality of the labor force, good infrastructure and better institutions.

The prospect of divergences in tax administration capabilities putting higher pressure on a still huge regional disparities, in the wake of a tax harmonization process, recommend giving top priority to the design and implementation of a regional project to bring convergence in Mercosur countries with regard to administrative capabilities in fiscal matters. To this end, the experience accumulated by the Inter-American Center for Tax Administration (CIAT) may be of great help

In a recent appraisal of inefficiencies Latin American countries faces in the field of tax administration, form director of the CIAT, Claudino Pitta (PITTA, 2004) stresses the importance of a good tax administration in a context of technological changes that create new patterns of production and consumption and give more impulse to economic globalization.

Pitta's report states that improvements in tax administration are a complex matter. It has to be tackled under a broad plan that encompasses distinct dimensions of the problem, such as organization, management, human resources, tax procedures, technology and informational systems, dealing with all of them in a balanced and integrated manner and taking into account the legal framework. In Latin American Countries, according to him, some advances can be perceived with respect to the use of IT for operational purposes, but few results are found in the strategic human resources and management dimensions.

One specific issue to be addressed, with respect to the role of administration in tax harmonization, is the exchange of information and the integration of registers. Wherever the procedure to be adopted to adjust the fiscal burden on the borders—a full destination principle or an origin principle coupled with a clearing mechanism to redistribute tax collected at the border—having common informational systems and access to them by Mercosur tax authorities members is an important condition for making tax harmonization work properly.²⁸

The call for tax administrators to exchange information has become louder as globalization advances and multinational enterprises expand their activities worldwide. Several attempts have been made to design models containing rules for information exchange, either by means of bilateral or multi-lateral agreements. Four of these models have been analyzed: the ones produced by the OECD, the UN, the Andean Pact and the CIAT (PITTA, 2003). Over time these models evolved

28. It is worth noting that in moving toward deeper integration Andean countries took concrete steps for harmonizing VATs and excises in the region (GACETA OFICIAL, 2004) and are paying special attention to the role of the interchange of information in this process. Uruguay will have to change its Tax Code to allow for the exchange of information within Mercosur.

from being concerned mainly with an old issue of avoiding double income taxation to add an increasing awareness with tax avoidance and evasion. Notwithstanding this advance, information exchange remained limited to taxes that are the specific object of these agreements.

New economic realities and deeper economic integration recommend a step forward: agreements that are primarily concerned with the exchange of information on all taxes as well as with the interchange of information on methods and techniques to deal with the challenges globalization pose to tax administrators and with an increase sophistication of procedures to evade tax obligations. Besides, as Pitta points out, international agreements designed to avoid double income taxation add clauses for exchanging information on matters related to income and property taxes, leaving aside the field of indirect taxes that are of surmount importance for economic integration.²⁹

In moving towards deeper economic integration Mercosur countries need to take immediate steps to strike a multilateral agreement on the exchange of information. To this end, it can profit from the work done so far by the CIAT. For two decades now CIAT have joined experts in the area to devise a general framework for a broad agreement on information exchange to be used throughout Latin America and Caribbean countries. This framework is under the scrutiny of a permanent working group that could advise Mercosur on this matter.

An important contribution to a project for exchanging information is the establishment of a common informational system based on compatible technological platforms. In this respect, Mercosur will have to deal with additional problems that arise out of the federal structure of its two bigger partners. The Brazilian situation is unique: taxpayers face several tax jurisdictions each one of them having their own rules regarding taxpayers' identification and accessory obligations, as well as for auditing tax returns. So far, attempts to integrate federal and state tax administrations failed. Lack of integration and cooperation among federal and provincial tax authorities is also the case in Argentina, but the smaller importance of the provincial taxes in the Argentinean public finances render them less harmful for tax harmonization.

All considerations regarding the challenges Mercosur face to embark on a smooth tax harmonization path boils down to tax administration. Without initial steps to disclose and share information, improve the training of tax administrators, expand the use of information technology and generate better conditions for enforcing tax laws, the process might evolve, but at a very low speed and with uncertain results.

29. Pitta note some recent advances in this direction: the 1988 OCDE Multilateral Agreement. The 1991 Nordic Agreement, the 1990 Mexico, Canadian, United States of America Agreement and some bilateral agreements Central America and Caribbean Countries with the United States.

4.3 Federalism and regional disparities

Fiscal federalism, together with regional domestic inequalities in the major Mercosur economies, poses a big challenge for tax harmonization. The difficulties mentioned to advance towards a uniform value added tax on consumption of goods and services in Brazil have to be appraised under a background of strong antagonisms in the federation. Two main divergences surface: distinct preferences of developed and less developed states and municipalities, with respect to the proper balance among tax powers and transfers in sub-national finances, and the competition among states and local governments for attracting economic activities through tax benefits. A shared uniform value added tax might solve these conflicts, but it is not feasible in the absence of a profound reform of the Brazilian fiscal federalism and a new approach to regional development policies.³⁰ Regional disparities are almost as great in Argentina, but its provinces having less autonomy to tax, together with the very small role played by the Argentinean municipalities, leave the federal government there with freer hands to push for harmonization. Nevertheless, the difficulties faced by the federal government to negotiate changes in the co-participation law make it clear that fiscal federalism in Argentina also poses important threats for tax harmonization in the region.

Centrifugal forces that arise out of economic openness and financial globalization will push the regional inequalities issue up in the agenda for a deeper integration. Two studies on the prospects for an increase in regional disparities in Brazil and Argentina under this new international scenario should deserve a careful attention. Haddad (2001) analyses the Brazilian case to call attention to the prospect for the Brazilian regions moving away from the convergence in per capita incomes witnessed up to middle eighties. From a different standpoint Kacef (2002) shows that the impact of the FTAA and integration to the UE will not change the already high concentration of economic activity in Argentina, which could even rise due to the regional concentration of imports. To put it shortly: fiscal federalism and regional policies need to be treated as intertwined issues.

Federalist grievances are reinforced by asymmetric economies. Both make it hard to harmonize taxes, but at the same time are negatively affected by the lack of harmonization. Present situation regarding differences in taxation contribute to the concentration of production units in large markets to profit from economies of scale that may allow them to compete outside domestic borders. If goods and services were allowed to move freely inside the region the relevant market for investment decisions would be the region as a whole, making it irrelevant the size of domestic markets.

30. Successive failures of proposals to apply uniform rules for the states ICMS can be ascribed to fears of opening a sensitive debate on the pitfalls of the Brazilian fiscal federalism system. The present system is rooted in the 1967 Tax Reform but partial changes over the last four decades brought vertical unbalance and an erratic horizontal fiscal disparities. To accomplish better and faster results in further tax reform rounds a full revision of the fiscal federalism model will have to be considered.

Up to now smaller economies try to counteract the advantages larger economies offer to attract investments with special tax regimes for capital income that benefit financial activities but have little effect on the economy as a whole. So, the real question is what should they do while the region move ahead towards deeper integration. Should they stick to this policy until Mercosur reaches a fairly free regional market? In the past, the answer would be yes. Nowadays, one cannot be so sure. Liberalization of capital markets and competition for attracting foreign capital may render ineffective development policies that generate a sort of enclave and that do not bring long run benefits.

To deal with the challenges Mercosur faces to achieve deeper integration, tax harmonization will have to tackle indirect and direct taxes at the same time. Indeed, a similar treatment to capital income under the dual income approach to income taxes referred to above may enhance the possibilities for a faster advance in removing indirect taxes barriers to a free circulation of goods and services in the region. In addition, a supranational regional development policy should be implemented alongside the process of tax harmonization, with the main goal of helping smaller economies, as well as laggard regions in bigger ones, to catch up with the most dynamic areas of the bloc.

5 LESSONS FROM THE EUROPEAN UNION

The model for appraising the possibilities and the shortcomings of tax harmonization processes is the EU. Being the most important example of uniting the economies of countries that accumulated a long history of military conflicts and were very distinct in size and culture, the EU provides an unique experience of overcoming prides and prejudices in name of a common political project to build a union of nations with enough economic power to rival the major players in the international arena.

Looking back in history, the results achieved by the EU are amazing. In little more than half a century the EU added more members, harmonized general consumption taxes, reinforced the supra-national institutions and adopted a common currency. Tax harmonization is still far from complete, but the process is under close scrutiny and is focused now in alternatives for harmonizing excises and income taxes.

At the very beginning, the studies undertaken to advise the design of tax harmonization strategies navigated on an uncharted ground. In a pioneer study, Douglas Dosser (1967) argued that:

Theoretical studies of tax harmonization involve the theory of two fields of economics which have, in practice, proceeded quite separately, namely, public finance and international trade. The theory of public finance is commonly confined to a close economy, as can be seen from Musgrave. International trade theory often disregards the public sector; (...) The possibilities for cross-fertilization of public finance theory and international trade theory are great and, indeed, are necessary for the study of tax harmonization.

To a slight extent, customs union theory involves both areas, but is highly circumscribed on the public finance side since only one tax is considered, and the tariff in any case is a tax which is not usually looked at as a weapon for the multifarious functions and objectives of the modern budget, such as growth, stabilization and redistribution. Hence tax harmonization studies can be viewed as developing out of customs union theory, but with a much greater variety of budget policies allowed for, besides just tariff changes. Alternatively, it can be seen as a development of public finance theory given a set of economies in open relationships with one another. Which path one takes or rather which point of departure in standard theory one chooses tends to color one's views on the basic meaning of tax harmonization, as we shall see later.

The tax systems of the first six countries that got together to form the EEC—now the EU³¹—presented important dissimilarities. The contribution of general sales taxes to total revenues varied from 16% in Luxembourg to 35% in France. Differences were also great with regard to the importance of excises and income taxes in each country as the data below allow us to see. What comes out of these data, when we look at the situation found in Mercosur nowadays, is the weight of income and excises and the small contribution of customs for the public revenues of the European pioneers.

TABLE 4
Aggregate tax revenues in EEC countries—1959*
(%)

| | Sales | Excises | Customs | Income and wealth | Total |
|-------------|-------|---------|---------|-------------------|-------|
| Belgium | 29 | 19 | 5 | 34 | 100 |
| France | 35 | 23 | 2 | 23 | 100 |
| Germany | 25 | 18 | 4 | 33 | 100 |
| Italy | 20 | 40 | 6 | 23 | 100 |
| Luxembourg | 16 | 15 | 4 | 49 | 100 |
| Netherlands | 19 | 13 | 8 | 54 | 100 |

Obs.:* Data are from Sullivan (1967).

The harmonization of indirect taxes was seen as the main priority given the need to demolish the barriers to trade of goods and services within the bloc. Despite of that, advances were slow in the beginning, but gained some speed afterwards. By late seventies, a fairly harmonized general value added consumption tax was in place in the EU. Following technical recommendations, the European VAT adopted the destination principle as a solution for a perfect adjustment of tax burdens in cross borders transactions, which solved the fiscal problem, but required the preservation of physical controls at the borders.

Control at the borders did not fit, however, with the full implementation of the principle that goods, services and people should be allowed to move freely in the

31. France, Germany, Italy, Netherlands, Belgium and Luxembourg.

EU territory. Hence the search for an alternative to remove border controls without harming the adjustment of taxes in commercial transactions among EU members.

After the abolition of border controls in 1992, a transitional regime was put into place, by which controls were shifted to the first purchaser in the importing country and became dependant on a reliable interchange of information. Being vulnerable to frauds, the search for alternatives have been on the European agenda ever since. After appraising these alternatives, Cnossen (2003) concludes that they either violate subsidiarity or lack a proper enforcement. Besides, he argues that insofar as none of them give evidence that the transitional regime involves unmanageable frauds it deserves to be enthroned with improvements in the interchange of information.

Some progress was achieved with regard to excises. In 2002, ninety percent of total excise revenues came from three products: tobacco, alcoholic beverages and fuel. Further harmonization of excises raise questions of tax autonomy and environmental policies, even though present differences entail cross-border shopping. Taking into account these questions is unlikely that excise harmonization will gain priority in the EU tax harmonization agenda.

This position is now held by the income taxes. If harmonization of taxes on income were not a big issue by the time the EU started their process for unification, nowadays differences in the tax treatment of capital became a hot issue. Globalization of financial markets allow for an instantaneous arbitrage of financial gains in which taxes play an important consideration. As mentioned before, this new reality is prompting a wave of reconsideration over old proposals for a global progressive taxation of income and has already provoked some changes.

It will be interesting to see how the EU will deal with the impact of the enlargement on matters of tax harmonization. Whereas the dissemination of value added taxes in East European countries in the recent past makes things easier with regard to indirect taxes, the field of income taxation is more prone to conflicts. Already, older members are complaining that low rates of corporate taxes applied in countries that are joining the union provoke an unfair competition for new investments. A recent account of corporate tax rates in the EU (see *THE ECONOMIST*, July 24th-30th, 2004). mention that Poland and Slovakia reduced their basic rate to 19%, down from 27% in the former and from 25% in the latter. Hungary has a 16% rate and Estonia doesn't even levy corporate tax on reinvested profits. These rates are about half the ones applied in German and France.

Besides differences in rates, corporate income taxes in the EU diverge with regard to the tax base. Dividends and interest received by residents are increasingly taxed at schedular personal income tax rates in the form of final withholding taxes (the joint taxation of capital and labor income at the personal level is losing ground). Cnossen (2003, p. 638) lists some conditions that affect the effective tax rate on investment

returns: the choice of financing (debt or equity), the corporate dividend policy, the form by which investment is undertaken (the corporate or the non-corporate form), and the tax status of the recipient of the return (liable to personal income tax and/or the corporation income tax, or exempt). He concludes that in the EU debt financing appears to be favored and individual investors are discriminated against.

An alternative for dealing with this situation—the adoption of common tax base for corporation incomes across the EU—object of the Bolkestein Report have been dismissed by Cnossen on several grounds. To him, a dual income tax would be a much better option (CNOSSEN, 2003, p. 639-641).

The new international economic scenario makes things a little more difficult for Mercosur. Whereas the EU could pursue tax harmonization in stages and at a low pace, Mercosur faces pressures to move fast and fight simultaneous in distinct fronts. Harmonization of indirect taxes in Europe took two decades to achieve good results and is not still completed. With respect to direct taxes, no progress has been accomplished so far.

One important difference, when we attempt to appraise the Mercosur case against the EU experience, is the importance for emerging economies of having access to foreign direct investments as well as to external capital to finance current account deficits in their balance of payments. Besides, the vulnerability to international financial crisis turns Mercosur countries more sensitive to the flows of short-term money that may be needed to sustain confidence in their currencies. In a context of free movement of capital around the globe, emerging economies face strong pressures to avoid any aspect that may jeopardize their access to foreign capital.

Another important difference arises out of technological changes that interfere on traditional tax basis. In a recent presentation, Tanzi (2004) calls attention to the erosion of these traditional basis for applying taxes provoked by the silent work of fiscal termites. These changes are related to the advance of information technology in distinct economic fields, such as:

- a) domestic and foreign trade—e-commerce;
- b) electronic financial transactions;
- c) off-shore financial centers; and
- d) tax havens and asset holdings.

Such events, says Tanzi, mean that the fiscal basis of a country is no longer restricted to the local economy as it may reach parts of the global economic environment. Examples are the possibility of a country taxing foreign consumers and capital income as well as foreign capital gains of their own citizens. Hence, a country can export part of its fiscal burden. A small country, in particular, can explore the fiscal basis of others.

One neglected aspect of the European experience with tax harmonization, when it is used as a reference for Mercosur, is the connection of the tax harmonization calendar with a strong policy for promoting the convergence of regional incomes within the EU. The regional policies of the EU helped to reconcile the immediate goals of free access to the unified market with the desires of low-income countries and regions to be able to gain from the economic union. Thus, while the more developed countries were prepared to extract immediate benefits from trade, the less developed ones would improve their economic prospects by having access to capital to improve economic and social infrastructure to modernize their economies at very favorable conditions. It is possible to argue that in absence of a regional policy to add economic substance and bring business support to a political project, the road to economic union and the calendar for tax harmonization would have been much more difficult to proceed.

6 TAX ASYMMETRIES AND INTEGRATION DEEPENING

Tax asymmetries distort trade, affect investment decisions, aggravate regional disparities and generate conflicts that may block the way towards deeper integration. Previous analysis of the tax systems in Mercosur countries permit to extract the main asymmetries that affect trade and investment in the region. In order to move in the next chapters towards specific proposals for removing these asymmetries, it is important to analyse, briefly, the most important ones.

6.1 Trade distortions

Trade distortions arise out of the impossibility of achieving a perfect adjustment of the tax burden on cross-border transactions. A perfect adjustment requires that all exports from one country to another be completely exempted from any taxes that impinge on export costs at the same time that all imports might bear the same tax burden applied to local production.

Exports can be tax directly via recourse to the traditional export tax—or duties—or indirectly, through turnover and financial transactions taxes as well as through an imperfect working of the tax credit mechanisms used in value added kinds of taxes. The direct taxation of exports has been abolished in most cases with the exception of the reintroduction of export duties in Argentina. The indirect burden on exports is, however, a matter of great concern.

There is no way of assessing the actual tax costs each Mercosur country impose on their respective exports given the erratic impact of turnover and financial transaction taxes on distinct goods and services. Taking into account the nature of the taxes and the distinct economic structure of Mercosur countries, it is possible to say that differences at the microeconomic level can be great. In fact, the Resk

and Rezende (2003) study above mentioned shows that the hidden tax costs differ according to tax legislation and production conditions. Brazilian exports of soybeans and beef carries a tax cost lower than the corresponding Argentinean product, the opposite being true with reference to chicken. The main explanation for these differences is the exemption of primary goods from the state tax in Brazil while Argentina applies a surcharge on exports of these same goods. As for chicken, Brazilian exports compare unfairly with those from Argentina due to the cumulative effect of federal turnover taxes.³²

Difficult to appraise the actual impact of taxes on Mercosur exports do not preclude, however, an evaluation of the distortions it create. On the one hand, taxing exports distorts intra as well as extra regional trade. When applied to commodities, what is generally the case of direct export taxes in Mercosur, the costs of taxes on exports are less felt in high international prices cycles.

One argument for keeping taxes on exports of commodities, besides the importance it may have for public revenues, is the likelihood of the benefit of erasing these taxes being shifted to international buyers and not appropriated by local producers. Even so, taxing exports impinges on the goals of an economic union.

The effect of export taxes on Intra-regional trade is symmetric to an import duty. Whereas an import duty generates inefficiency in the import country, export taxes do the same for the export country. As a result, intra-regional trade is twice affected, which does not favor economic integration. Comparing with alternatives to buy or sell goods and services among its partners or search for short term gains elsewhere, producers may prefer the latter, weakening the prospects for further integration.

Similarly to exports, imports can be taxed directly through tariffs³³ and import taxes or indirectly via domestic taxes. Harmonization of tariffs is the first measure adopted in processes of economic integration. This is accomplished by applying a zero tariff for intra regional trade and a common tariff for extra regional trade. To account for regional economic differences in size and structure, provisional exceptions to the common tariff are negotiated. Exceptions from the common Mercosur tariff have been in place since its beginning and are subjected to frequent adjustments.

Indirect domestic taxes affect imports in Mercosur in two ways: via the collection of VAT type of taxes at the borders and by means of further incidence of turnover taxes over the production and distribution chain of goods and services. Imperfections in the workings of the tax credit mechanism applied to VAT collections—that is when credits can not be fully deducted from tax due at the next

32. We should not that this study was made before the recent changes in the Brazilian Cofins.

33. Non-tariff barriers are a case in point.

production stage—and the incidence of cumulative taxes mean that intermediate and capital goods face an unfair situation in intra regional trade, when compared with final consumption goods. Whereas intermediate and capital goods will incur in additional tax costs when moving up the production and distribution chain inside the importing country (due to imperfect VATs and cumulative taxes), final consumption goods goes directly to the wholesale or retail stages. The longer the production and distribution chain, the higher the disincentive to move intermediate goods inside the bloc.

The peculiar situation related to the dual imposition of the CET creates additional difficulties for integrating economic activities in the region. Extra regional imports are twice taxed when moving inside Mercosur: the CET applies when goods cross any Mercosur border and again when moving to a second country in the region.³⁴ As a result, the intra regional flow of intermediate and capital goods is hampered by tax costs. Needless to say that this particular situation makes it very difficult to form regional manufacturing chains that would benefit from comparative advantages encountered in member countries.

The joint effect of tax costs on imports and exports make things worse for integration aims. Taking for granted that economic integration deepens when the political project is reinforced by the business sector having a common interest in the economic union, the disincentive to the movement of intermediate and capital goods is an important obstacle to surpass.

Tax costs on intra regional trade may induce individual policies concerning extra regional trade. Not by chance, exceptions to the common external tariff remained in place and kept changing over time.³⁵ If the cost of regional produced capital goods surpass equivalent ones from abroad, by reason of higher taxes, it is not possible to induce producers to opt for them. On the other hand, extra regional imports of intermediate goods will favor the implementation of individual industrial policies if they are kept outside the CET due to the double incidence of the TEC and the higher tax costs on imports of these goods from the region.

Apart from the impact of the general consumption taxes, the consolidation of business sector interests in Mercosul may be also affected by selective taxes on basic inputs. As already mentioned, inefficiencies in tax administration pushed Mercosur countries away from modern taxes and closer to more easily collected ones. From this standpoint, highly concentrated industries—tobacco, beverages, oil, telecommunication and electricity—are obvious targets for tax administrators.

34. For an interesting analysis of the double incidence of the CET in the region, together with proposals to change this situation (see VAILLANT, 2004).

35. Exceptions granted to capital goods in 1995 should last for five years. For telecommunications and IT exception from the TEC was intended to remain in place for ten years.

Differences in fuel taxes are not in the priority list for tax harmonization, since distances and regulations pose a natural barrier to cross-border shopping. Telecommunication and electricity, however, should be a matter of concern, since they are crucial for high tech industries and modern services. Notwithstanding the actual burden Mercosur countries impose on these inputs cannot be properly assessed without a microeconomic study.³⁶

Advance towards a free movement of goods and services in Mercosur will face great difficulties in the absence of policies aimed at fostering complementary economies in the region. Hence, an important point to keep in mind, with respect to distortions provoked by taxes that interfere on trade among Mercosur countries, is the negative stimulus they generate for consolidating business interests in deepening the economic integration. Therefore, in design strategies for removing tax barriers for deeper integration, priority should be given to changes that contribute to remove this disincentive.

6.2 Investment decisions

In general, investment decisions with respect to the location of new investments are influenced by policies related to the taxation of capital income. Nevertheless, tax benefits that reduce production costs can also influence business investors. That is the case, for instance, of preferential rates for producing manufacturing goods in specific regions, quite often used to foster development in backward zones. When coupled with income tax incentives to invest, special advantages granted to production magnify the impact on investment decisions,

Special benefits for regional development purposes have been used in Brazil and Argentina for quite a long time, but lost some ground after economic openness and the submission of domestic industrial policies to international rules. The main exception is the Free Zone of Manaus and the special industrial zone in Terra del Fuego. Under Mercosur regulations, goods produced in these zones should be given the same treatment applied to extra zone ones, but a temporary agreement between Brazil and Argentina suspended the enforcement of this rule in bilateral trade.

The most commented example of production tax breaks that interfere in decisions concerning the location of new investments is the wave of benefits granted by Brazilian states to attract manufacturing industries, mainly automotive assembly plants. Surfing on a wave of foreign direct investments that took place in Brazil in the second half of the past decade, some states, namely Paraná, Goiás, Bahia, Rio de Janeiro and Ceará, offered special advantages with regard to the ICMS—the state value added tax—and managed to reap some fruits from

36. Harmonization of fuel taxes may be important, since they affect production costs, specially in the agribusiness sector. It could not be put in the priority list, however, for other reasons, among them differences in environmental policies and importance for the budget.

that strategy. To that end, those states could benefit from the peculiar situation created by the mixed origin-destination principle applied to interstate trade. Basically, these benefits were conceded at the expense of the State of São Paulo, the main consumer market for manufacturing goods. As São Paulo is required to grant credits to goods imported from other states, the so-called fiscal war in the Brazilian federation accentuated interstate antagonisms and called for a constitutional reform to put an end to it.

It is unlikely that the events of the second half of the nineties will be reproduced. It is true that the dispute for investments among Brazilian states lost impetus in recent years due to a decrease in foreign investments and a paralysis of domestic ones. But antagonisms within the federation reached a point that led everybody to agree on the need to change.³⁷ For the first time in many years, the states embarked on a serious debate over a proposal to change the Constitution, so as to uniform the rules applied to the ICMS all over the country, and to move gradually towards the implementation of a full destination principle in interstate transactions. Even though this proposal have not got a final approval in the Parliament yet, it is a positive sign. Furthermore, recent changes in federal tax legislation that led to value added rules applied to Cofins will increase the pressure for the states to agree on a unified legislation for the ICMS in order to be able to joint defend a more favorable division of a common tax basis.³⁸

In addition, under new requirements for attracting modern industries it is unlikely that traditional tax incentives to production will be decisive to interfere in business decisions regarding location of new investments. Modern infrastructures, quality of the labor force, easy access to raw material and main consumer markets, good governance and environmental care may be of greater importance. For no other reason, the Brazilian states that managed to lure foreign investors to install new plants inside their territories presented all or some of these characteristics.

Under this new scenario, competition for investments in Mercosur may focus attention on income and excise taxes. With regard to income taxes, differences in assessing the tax basis and in rates applied to corporate income are the first thing to be looked at. Information contained in section two shows that rates of corporate tax for big business do not differ to a significant degree in Mercosur countries, but that some rules applied to assess the tax basis do.

37. A recent measure adopted by the state of São Paulo, that decided, unilaterally, to disregard tax credits when goods sold in that state benefited from fiscal incentives in the origin, may mean that the tax war can be no longer sustained. The outcry over such decision led the states to reactivate the debate on the proposal for a uniform ICMS across the country.

38. An informal agreement reached in the Senate pointed to a calendar for future tax reform rounds in which further steps, after a unified ICMS, should contemplate the fusion of Cofins and IPI to form a broad base federal value-added tax. This will expose a dispute for a common tax basis to be shared by the federal and the states governments.

The main point of concern is differences in rules that interfere on investors' decisions by affecting the after tax rate of return on investments. Taxation of interest, dividends and capital gains, as well the rules applied to payments to non-residents, deserve special attention. A focus on foreign investors is justified given the importance FDI has on development prospects for Mercosur.

Other aspect that deserves scrutiny is the distinct situation with respect to transfer prices. Different criteria for avoiding the practice of transfer prices to reduce taxable profit of multinational enterprises will be of great importance in the future. Thus, the mixed situation encountered in Mercosur will have to change. Argentina, that adopted legislation in line with OECD rules are in better position than Brazil that opted for enacting its own rules. Both, however, are in an unfavorable condition when we pay attention to the non-existence of any rule for dealing with transfer prices in Uruguay and Paraguay.

Investment decisions are also influenced by tax policies applied to major institutional investors—pension funds and insurance companies, for instance. Foreign investors may not favor countries that tax interest and dividends at source when they are exempted at home. The Brazilian government decision to tax pension funds incomes shows that domestic institutional investors also react against such measures.

Capital gains taxes on shares also differ in the region. The global income approach to the personal income tax adopted in Brazil an Argentina, which leads to treating capital gains as any other income source, contrast with the position of Uruguay and Paraguay that adopt distinct rules.³⁹

The influence of capital tax benefits on investment decisions concerning the location of manufacturing plants and modern services is conditioned on facilities for the circulation of inputs and final goods within a common market. That is, infrastructure matters and is an important barrier to deeper integration. Differences in communication costs due to higher taxes may induce the dislocation of foot-loose activities such as modern services. Energy intensive activities are affected by higher energy taxes, while fuel taxes hinges upon the circulation of merchandises with deleterious impact on the regional integration of production chains. Hence, the need already noted to appraise the effective rates of taxes on fuel, energy and telecommunications in Mercosur.

7 ALTERNATIVE SCENARIOS FOR TAX HARMONIZATION IN MERCOSUR

The usual sequence of tax policies to proceed towards full economic integration gives priority to the harmonization of indirect taxes so as to abolish tax impediments

39. The impact of capital taxes on investment has been focused on decisions concerning the creation or expansion of economic activities. Emerging economies need to pay attention also to tax implications for short run capital movements.

to the free flow of goods and services in the region. Once a free market is established, capital taxes harmonization become more important in order to avoid production inefficiencies that are artificially sustained by a preferential treatment of capital income in some union members. Labor taxes come next and are not seen as having much importance—apart special cases (sports and artistic stars, liberal professionals...) since language, culture and family ties pose an important barrier to migration of ordinary people.

The European experience is the paradigm. Economic logic, political reasons and a different global economy context were behind the path followed by the EU. Economic logic tells us that if goods do not move freely across members' borders investment decisions will not differentiate the regional market from the international market as a whole and, therefore, differences in capital income taxes would not be important until that condition is satisfied. Direct income taxes are more sensitive to political and ethical reasoning. Besides, before economic globalization reached present levels, capital flows were subjected to restrictions that diminished the importance of capital tax harmonization.

The first question to be asked, thus, is if Mercosur should adhere to the above sequence in designing strategies for harmonizing its members' tax policies. Some considerations already raised (see section three) give hints that it should not. Further thoughts are in need.

Consider the tax problems that affect businesses' interest on the Mercosur project. If all efforts are directed to erase every barrier to trade, economic disparities will increase in the region, conflicts of interest will rise and the political will to proceed will be negatively affected. Asymmetric initial conditions related to size of the economies, growth potential and institutional development aggravate the prospect for lack of support to integration deepening in the absence of countervailing measures.

The joint implementation of a powerful regional policy would help to reduce tensions that tend to mount if disparities increase as integration proceeds. In this respect, the experience of the EU is worth copying, with an important difference, however. The European project counted on a strong political will, a handful of powerful economies and a firm conviction on the long term benefits from integration. These conditions made the big four in the lot to open their purses in order to form a common investment fund to bring economic laggards close to the regional average.

Although Mercosur do not fulfill these conditions, the need for a regional development fund should not be overlooked. The IIRSA project designed by the Inter American Development Bank is an important initiative, but is far from what is needed. Besides basic infrastructure, that in many cases will also demand

non-reimbursable funds, human capital and institutional development, as well as infrastructure for C&T, require financing that cannot be provided through traditional financial institutions.

To reinforce political will in Mercosur, by means of a common business sector interest in further integration, it is necessary to give the formation of regional productive chains a full priority. Already, public authorities in Brazil and Argentina have recognized the importance to move in this direction. If this is so, creating a better tax environment for facilitating this outcome gain preeminence in tax harmonization policies. Hence, the main trade-off in looking at alternatives for tax harmonization in Mercosur is not the preference for tackling first direct or indirect taxes. It is the trade-off among choices that may facilitate the advance of integration and the ones that may leave the project at it is.

Paramount among measures to induce the consolidation of regional productive chains is the elimination of the double imposition of the common external tariff. As mentioned, this procedure block the improvement of efficiency in regional production by imposing a high cost to the manufacturing of goods in places other than the country of the first entry port. Even though the removal of this abnormality hits the Paraguayan public finances in the short run, this country is the most affected since its inland condition make it dependant on the others to have cheaper access to imports. Proposals to solve this problem have been advanced by the study sponsored by the Technical Secretariat for Mercosur mentioned above.

On the tax side, priorities for harmonization should give a simultaneous look to proposals for facilitating the adjustment of tax costs at the regional borders, as well as for removing tax induced distortions in the location of new investments. The technical recommendation for a fair tax treatment to goods and services in regional economies that embark on an integration process is to substitute a broad base value added consumption tax for other less economic efficient kinds of taxes. Nevertheless, for reasons that were advanced in section three, this alternative is not feasible in the short run. In the meantime other options should be appraised. Measures to attenuate the cumulative effects of turnover taxes, as the ones adopted in the most important Argentinean provinces help, as well as the recent change in Brazilian legislation for collecting social contributions (PIS/Cofins)

Exchange of information and harmonization of administrative procedures could bring invaluable benefits. If confidence on tax audits and on the working of tax administrators could be built fast, administrative controls could help to remove barriers to the formation of regional productive chains in more sensitive sectors.

Consolidation of regional production chains depends not only on indirect taxes barriers but also on differences in income taxation that affect investments.

For big multinational investors, the present situation with respect to transfer prices policies acquires great importance. Difference in the norms applied to the taxation of interest and dividends also have important influence on the attraction of institutional investors. Given that foreign capital play a key role in accomplishing targets for raising investment ratios in the region, the differences noted above with respect to the income taxes of Mercosur countries may hamper the inflow of foreign capital at the same time that generate distortions in its allocation.

Taxing retained earnings at the corporate level at distinct rates and having asymmetric provisions for capital depreciation and past losses also impinges on the efficiency in capital allocation. Thus, the harmonization of rules that interfere in the post tax rate of return on investments should proceed along with measures to advance in the equalization of tax costs at the Mercosur regional borders.

The general adoption of a dual income approach to the income taxes DIT, alongside the recommendations that have been recently made for the EU, can make the harmonization of capital taxes much easier. For once, the main problem pointed out by those who produced pioneering studies on the theme of tax harmonization in Mercosur, Jorge Macón and Hugo González Cano, that is the peculiar situation of Uruguay and Paraguay with respect to capital income not being taxed at the personal level, become less relevant. In addition, some features of the DIT model are already present in the Brazilian and Argentinean tax legislation, and to some extent in Uruguay and Paraguay, which may facilitate the transition.

Harmonization of excises on basic inputs is more difficult to accomplish in the short run—even though they are particular important for the consolidation of regional production chains—due to two important factors. First, their importance for the Mercosur countries' budgets.⁴⁰ Second, they being mostly under the states' jurisdiction in Brazil.

The goal of moving towards the substitution of a broad base value added tax on goods and services for the present reality of indirect taxes in the region should be kept in focus, but the difficulties already mentioned for this goal to be accomplished have to be taken in due account. Even if the debate on the Brazilian Parliament have raised for the first time in the last two decades the need to submit the states' ICMS tax to an uniform national legislation, and contemplated the possibility of advancing further in merging federal, state and municipal indirect taxes in a sole national value added tax, the time required to achieve such a situation will not be short. Before reaching such an ambitious goal, we will have to wait for the full implementation of uniform rules for the ICMS contemplated in the last version

40. Even though the contribution of selective taxes to the public purses has dropped recently, they still are in the vicinity of 10% of total tax collections in Mercosur.

of the constitutional amendment that waits for a final approval in the Brazilian Parliament. One sensitive point is the negotiation over who will cover for the benefits already given to private investors. In the same proposal for amending the Constitution, the fruition of these benefits should last for another eleven years.

8 A CALENDAR FOR TAX HARMONIZATION

The arguments exposed above help the task of advancing some recommendations that can be used in the preparation of an official calendar for tax harmonization in Mercosur. Needless to say that this is a very risk task. The reader must be aware that what follows is a mixture of technical reasoning, political evaluation and personal prejudices. Therefore, it is subjected to all sorts of criticisms. The sole purpose of ending this paper with such a proposal is to contribute to a debate that may help to form a consensus in designing a strategy for tax harmonization in Mercosur.

This calendar sets three stages to be tackled in sequence. In suggesting some dates for completing each stage, we take into account the fact that the pace of tax harmonization in Mercosur cannot follow the cadence adopted by the EU. New and strong international pressures put in motion centrifugal forces that may lead to loosen regional economic ties in the absence of immediate gains in consolidating a common economic interest in the Mercosur project. Instead of the two decades that took for the EU to achieve a reasonable harmonization of indirect taxation, Mercosur should aim to obtain similar results in one decade. On the same account Mercosur does not have the option of waiting for the harmonization of indirect taxes to advance to begin the harmonization of direct income taxes. For both reasons, accomplishing tax harmonization in Mercosur requires firm political commitment, a highly qualified technical support and a lot of energy devoted to complex negotiations.

First stage: 2005-2006

This stage may set the ground for fast advances in the second half of the decade. Therefore, it should give priority to the officialization of a tax harmonization project and the creation of facilities for it to be implemented. These include resources to conduct in depth studies, to support a technical advisory board, to maintain a forum for negotiations, to propose a formal strategy and to set up a common negotiated calendar.

In addition, some specific measures could be adopted, with special consideration given to:

- a) elimination of the double imposition of the CET;
- b) agreement on the interchange of information coupled with a joint project for a common informational technology for tax administration purposes;

- c) adoption of uniform rules for dealing with the transfer price issue;
- d) consolidation of efforts to suppress or mitigate the negative impact of cumulative taxes in the regional trade of intermediate and capital goods, such as those entailed by the Brazilian federal government and some Argentinean provinces;
- e) design a uniform regional agreement to avoid the double imposition of income taxes in Mercosur;⁴¹ and
- f) design and appraise the feasibility of a regional development project alongside the lines of the EU experience.⁴²

Second stage: 2007-2010

By this time, it is hoped that the economies of Mercosur countries have surpassed present difficulties so as to relax macroeconomic restrictions to deeper changes in taxation. It is also hoped that the unification of the ICMS and improvements in federal social contributions (PIS/Cofins) in Brazil, as well as further modernization of the Argentinian provincial taxes, out of negotiations on the co-participation law, will make it easier to move towards a reasonable adjustment of indirect tax costs for goods crossing Mercosur borders. In the realm of income taxation, it is expected that a better understanding of the advantages of a dual income tax will allow for reducing present asymmetries.

Under these assumptions, it can be expected to:

- a) erase the most important hidden tax costs that impinges on the formation of regional production chains, such as the accumulation of tax credits, the incidence of export taxes and the increase in the cost of regional produced capital goods due to high taxes;
- b) adopt a common technological platform for tax administration purposes in all Mercosur countries to facilitate the interchange of information and allow for joint auditing of regional transactions;
- c) put into place a regional development policy to bring convergence of regional incomes and favor the deepening of economic integration;⁴³

41. The agreement between Brazil and Argentina on double imposition of income taxes dates back to 1982 when both countries still applied corporate income taxes on a source basis.

42. Since the bigger Mercosur economies cannot play the role powerful nations fulfilled in supporting a regional development policy to bring convergence in per capita incomes in the EU, multilateral organizations should consider the possibility of having initiative in this respect.

43. The recent creation of the Fundo para a Convergência Estrutural do Mercosur (FOCEM) is a good start. According to the stated rules an annual sum of US\$ 1 hundred million shall be allocated to this fund with Brazil (70%) and Argentina (27%) being the main contributors. Conversely, Paraguay (48%) and Uruguay (32%) shall get the lions' share. It is still a small sum but this fund may get support from multilateral institutions in the future.

- d) apply common rules to corporate income taxes so as not to distort investment decisions with regard to the location of new investments;
- e) establish common rules to be observed in giving tax breaks for production taxes until the region reaches full harmonization;⁴⁴ and
- f) reduce differences in taxation of basic inputs (telecons and electricity) focusing on priorities for the integration of regional production chains.

Third stage: 2011-2014

If partial success is achieved in the previous stages, the chances of reaching a acceptable degree of tax harmonization by the beginning of the next decade will be enhanced. Pending on a favorable regional economic and political scenario, we could hope for the following situation:

- a) prevalence of a national consumption VAT in all member countries as the major contributor to the public finances; and
- b) implementation of a dual approach to the income tax alongside the proposals that are being made for the EU.

The proposed calendar looks ambitious and perhaps unrealistic under present conditions. However, the challenges Mercosur face to consolidate the economic integration project do not give much time for delaying initiatives that are of great importance for the goal established in the Assunción Treaty to be accomplished.

9 CONCLUDING REMARKS

If the political project to transform Mercosur into a de facto economic union is to become reality, the adoption of a negotiated calendar for harmonizing taxation in the region is a prime necessity. Under present conditions, tax asymmetries within the bloc are a strong impediment for private business to cooperate with political leaders in a way to restore public confidence in the project.

Public confidence is necessary to support a deeper integration. Due to old rivalries and more than a decade of economic crisis and social frustrations, citizens of Mercosur countries did not develop any sense of having a common identity. Thus, the lack of public support adds to the economic difficulties for consolidating the Mercosur project.

44. Suggestions for the imposition of limits on fiscal incentives have been floated in the press, but they are hardly politically feasible. In this respect it is worth noting the rules approved by the EC in 1998 to avert harmful tax competition.

The presentation of a official calendar for harmonizing taxation could be an opportunity for launching a campaign aimed at building business and public confidence in the medium and long run benefits of economic integration.

REFERENCES

- ALARCÓN, M. Impuestos indirectos y incentivos en el Paraguay. In: SEMINÁRIO SOBRE TIBUTACIÓN PARA LA INTEGRACIÓN DEL MERCOSUR. 2004. Mimeo.
- AMARAL, A. C. O preço de transferência no Mercosul. In: CAMPOS, D. de (Ed.). *O sistema tributário e o Mercosul*. São Paulo: Editora LTR, 1998.
- _____. Visão global da fiscalidade no Mercosul: tributação do consumo e da renda. In: MARTINS, Y. G. (Ed.). *O direito tributário no Mercosul*. Rio de Janeiro: Editora Forense, 2000.
- BARREIX, A.; VILLELA, L. *Tributación en el Mercosur: evolución, comparación y posibilidades de coordinación*. Washington, DC: Banco Interamericano de Desarrollo e Intal, 2003
- BARREIX, A.; VILLELA, L. Tributación en el Mercosur y la necesidad de coordinación. In: DIÁLOGO REGIONAL DE POLÍTICA, 2004, Buenos Aires. *Anais...* Buenos Aires, BID, 2004.
- BARREIX, A.; ROCA, J. Sistema tributario: condiciones actuales y propuesta. *Revista Eletrónica FCE*, Montevideo, Universidad Católica del Uruguay, sep. 2003.
- CNOSEN, S. How much tax coordination in the European Union? *International Tax And Public Finance*, v. 10, Nov. 2003.
- DOSSER, D. Economic analysis of tax harmonization. In: SHOUP, C. (Ed.). *Fiscal harmonization in common markets*. Columbia University Press, 1967.
- GACETA OFICIAL. *Acuerdo de Cartagena*. July 2004.
- GENSCHEL, P. *Globalization, tax competition, and the fiscal viability of the welfare state*. Cologne: Max Planck Institute for the Study of Societies, 2001.
- GONZÁLEZ CANO, H. *Imposición y concurrencia fiscal en los procesos de integración económica*. Buenos Aires, 2001. Mimeo.
- _____. A situação atual da tributação nos países membros do Mercosul. In: REZENDE, F.; OLIVEIRA, F. (Orgs.). *Federalismo e integração econômica regional*. Rio de Janeiro: Fundação Konrad Adenauer, 2003.
- _____. *Análisis de la armonización tributaria en el Mercosur desde la situación y perspectivas de Argentina*. Buenos Aires, 2004. Mimeo.
- HADDAD, P. R. *Clusters e desenvolvimento regional no Brasil. Cluster. Revista Brasileira de Competitividade*, Belo Horizonte, ano 1, n. 2, p. 44-54, ago./nov. 2001.
- HADDAD, E. A.; DOMINGUES, E. P.; PEROBELLI, F. S. Regional effects of economic integration: the case of Brazil. *Journal of Policy Modeling*, 2002.
- KACEF, O. *Una evaluación de distintos escenarios de integración para la Argentina*. Buenos Aires, 2002. Mimeo.
- PITTA, C. El intercambio de información. In: UCKMAR, V.; ALTAMIRANO, A.; TÓRRES, H. *Impuestos sobre el comercio internacional*. Buenos Aires: Editorial Ábaco de Rodolfo de Palma, 2003.

_____. Las tendencias actuales en la modernización de la administración tributaria. Buenos Aires, 2004. Mimeo.

REIG, E. El Mercosur: armonización en general y en particular – aspectos institucionales de implementación necesaria. *Revista Latinoamericana de Derecho Tributario*, dec. 1966.

RESK, E. *Tributación del sector transporte en Argentina*. BID, 2004. Mimeo.

RESK, E.; REZENDE, F. Estudios en competitividad: incidencia fiscal setorial en el Mercosur. In: VILLELA, L.; BARREIX, A.; TACCONE, J. J. (Eds.). *Mercosur: impacto fiscal de la integración económica*. Buenos Aires: BID/Intal/ITD, 2003.

REZENDE, F. O Brasil na contramão: ajuste fiscal e deterioração da qualidade do sistema tributário brasileiro. In: THE CONGRESS OF THE CONSEJO PROFESIONAL DE CIÊNCIAS ECONÓMICAS DE LA CAPITAL FEDERAL, 2001, Buenos Aires, *Paper...* Buenos Aires, 2001.

_____. *Integração regional e harmonização tributária: a perspectiva brasileira*. Tributación para la Integración del Mercosur, BID, Diálogo Regional de Política, 2005.

REZENDE, F.; AFONSO, J. R. *The Brazilian federation; facts, challenges and perspectives*. Stanford University: Center for Economic Policy and Development Recommendations, 2001.

SULLIVAN, C. Indirect taxation and goals of the European Economic Community. In: SHOUP, C. (Ed.). *Fiscal harmonization in common markets*. Columbia University Press, 1967.

TANZI, V. *Taxation in an integrating world*. Washington: The Brookings Institution, 1995.

_____. *Sistemas fiscales en un mundo globalizado*. Buenos Aires, 2004.

VAILLANT, M. Problemas de la libre circulación en el Mercosur ¿ Cómo transitar un camino hacia la unión aduanera? *Estudos Econômicos*, n. 1, 2004.

VALLARINO, H. *Breve historia fiscal reciente del Uruguay*. Washington: BID, 2004. Mimeo.

