Fiscal Harmonization in Mercosur: Tax Aspects and Incentives

Executive Summary

In an integration process, the quality of the agreement reached depends on the affinity observed in the domestic strategies and policies. Insofar as they are compatible, the agreement will be successful. Therefore, the harmonization of policies in regional integration agreements is justified. Within the broad spectrum of public policies, fiscal policy is essential and is a powerful element that, if not properly managed, may cause serious problems in the development of regional integration agreements.

In a framework of fiscal interdependence, both domestic and external variables have an influence. Internally, the level and distribution of a country's spending have significant influence on the partner, in the same way as taxes do. The symmetry observed with respect to expenditure and taxes is shown, for instance, by the fact that a subsidy to an enterprise may be granted directly (expense) or by reducing its costs (tax exemption). Although both sides of the fiscal sphere have the same effect, tax reduction does not seem to be so frowned upon by academic circles as direct subsidies. The closest case (in geographical and temporal terms) is that of the fiscal benefits granted by Brazil, which meant the relocation of investments from Argentina.

As regards external variables, although capital flows are not exclusively a part of fiscal policy, to a great extent, they are the other face of it. When faced with the structural existence of fiscal deficits (in which expenditures and taxes are primary determinants) or current account deficits (tax policy being a central element of competitiveness), the economy becomes highly dependent on external saving.

This study focuses on domestic variables and their effects are evaluated both from a theoretical as well as empirical perspective.

In processes of regional integration whose ultimate goal is the establishment of single markets, the impact of differences in tax structures is strengthened. The need to harmonize Mercosur tax structures does not only arise out of the effects inherent to regional integration, but also from the deep changes experienced by the world economy as a result of the development of a process of commercial and financial opening which changes global economic relations. The most significant problems originate in: factor mobility, difficulties in determining and collecting taxes outside a country's jurisdiction and the increased complexity of the tax administration process.

The taxation issue in regional integration processes is similar to the situation that would take place in the tax system of a federal national State where subfederal levels preserve their autonomy in tax determination. In this regard, there is no absolute definition as to which is the best coordination level required, mainly due to the need to preserve a relation between income and expenditure. At the same time, in the case of Mercosur there is a deepening of traditional problems occurring in integration processes, since Argentina and Brazil are federal countries, which presents two levels of potential conflict.

The use of fiscal incentives for investment or exports is an alternative that is reasonable from a national point of view when there are unemployment problems. Nevertheless, when considered from a bloc perspective, its results are ambiguous, and may turn positive or negative according to the way they are structured. The assumption on which the study is based is that, when applied in an uncoordinated way, competitiveness schemes develop which may impair fiscal stability without fulfilling their goal of attracting more investments.

This conclusion is borne out when considered from a theoretical point of view (using Game Theory developments) as well as from an empirical perspective (using a macroeconomic general equilibrium model).

The conclusion does not change in any case: the paretian[1] balance is reached only when incentive policies are coordinated.

Since the importance of fiscal coordination in integration process has been highlighted, the international experience must be reviewed and, in this regard, the European Union is an unavoidable reference. Reaching higher fiscal coordination levels was an objective from the very beginning of the integration process. Nevertheless, progress was not made in the same way as observed in the consolidation of a single economic area. The reasons for the slow progress in the field must be taken into account when assessing the feasibility of harmonizing taxes in Mercosur. Institutionalism for decision-making (unanimity hinders negotiation) and the lack of a global perspective to overcome economic problems (an exacerbated defence of domestic interest) are factors which must be considered if the wish is to make Mercosur progress.

In this study, the analysis of fiscal interdependence focuses on taxes, and the expenditure issue is only referred to when dealing with incentives.

When revising the compatibility of Mercosur tax structures, it is found that on the surface they are compatible structures, but when observed at a deeper level differences begin to appear.

With regard to taxes on consumption, it may be pointed out that all four countries have value added taxes or their equivalent. However, three main differences emerge: these taxes exist at different government levels (state and municipal in Brazil); multistage accrual taxes in Argentina (gross income) and Brazil (CPMF) and selective taxes which may be a potential cause of conflict.

With regard to income tax, there are compatibilities, such as the fact that all four countries apply income tax to legal persons, and that there is rate consistency. However, there are important differences in three aspects: income tax for natural persons only in Argentina and Brazil; worldwide income principle in Argentina and Brazil and principle of source in Paraguay and Uruguay; proportional rate in Argentina, Paraguay and Uruguay and a slightly progressive rate in Brazil.

In social security, the four countries coincide in that they have problems to finance current and future liabilities. The differences are that Argentina and Uruguay have a mixed retirement system, Brazil a fully state-based system and Paraguay a state- based system although progressing towards the implementation of a mixed system.

Among other issues, there are insufficient links between the countries. There are tax treaties only between Argentina and Brazil and the links between the tax administrations are limited. Finally, it should be noted that Argentina and Brazil apply taxes on financial transactions, and Argentina applies export taxes as well. A potential elimination of these taxes would cause “negative” effects on the competitiveness of the bloc’s smaller countries.

As regards export incentives, although scarce in the four countries, mainly due to the World Trade Organization rules in force, two problems can be pointed out. On the one hand, the Argentine and Brazilian Duty Free Zones (Tierra del Fuego and Manaos) may enter products into the markets of both countries without paying CET until 2013, which is not the case with Uruguay and Paraguay. On the other hand, there are problems in tax refunds, mainly for accrual taxes.

As to production and/or investment incentives, a reduction in amounts is noted, although the survival of regional and sectorial tax expenses is seen in Argentina and mainly in Brazil, with the federal systems of Argentina and Brazil allowing the provinces or states to have their own incentive systems, which are not easy to modify.

Considering the little progress seen in Mercosur tax harmonization and the importance of assessing such a process in the South American bloc, this study proposes specific elements to contribute to discussions on the matter. This proposal, which is essentially a gradual one and focuses on harmonization rather than in uniformity, seeks to be a reasonable alternative to enable, without excessive ambition, the materialization of a significant step in Mercosur.

[1] A balance in which no country may improve without another getting worse.