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Tax Policy in Argentina: Between Solvency and Emergency

Oscar Cetrangolo and Juan Carlos Gomez Sabaini

Tax

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Tax Policy in Argentina: Between Solvency and Emergency[1]

Oscar Cetrangolo

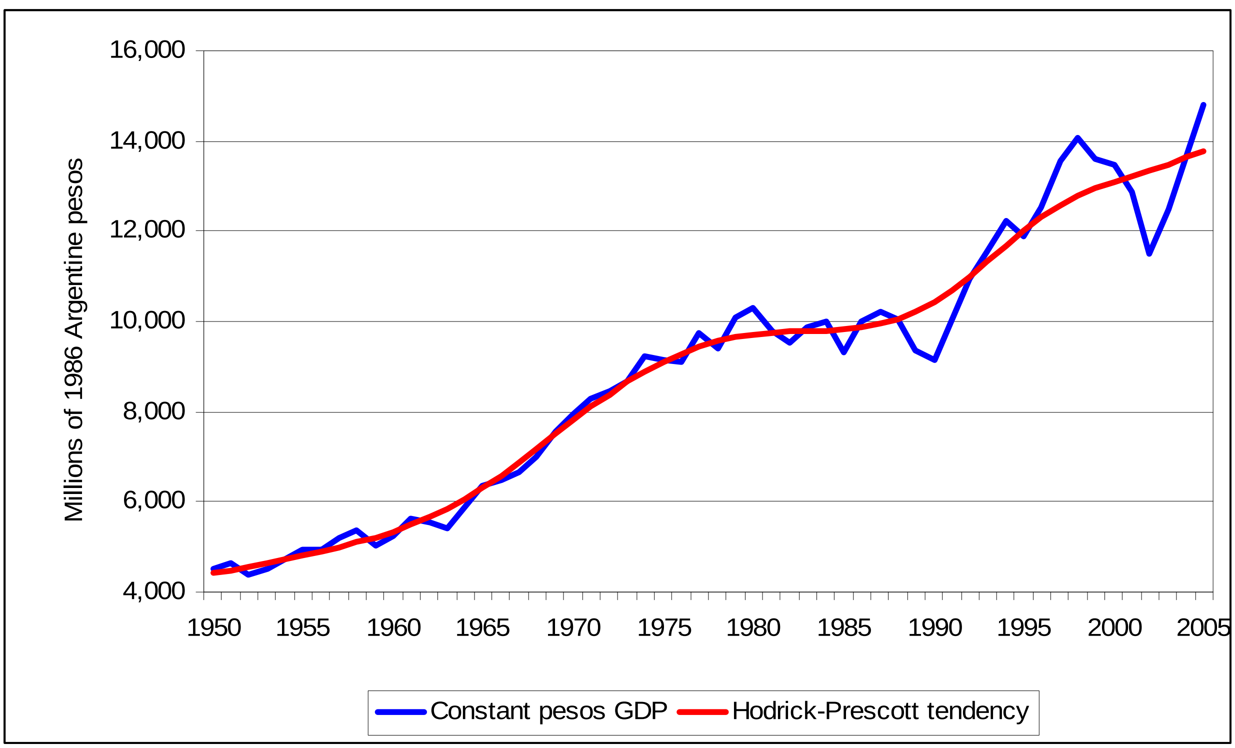
Economic Commission for Latin America and the Caribbean and University of Buenos Aires[2]

Juan Carlos Gomez Sabaini

University of Buenos Aires[3]

At the turn of the century, Argentina experienced a serious economic crisis, brought about by the forced abandonment of the monetary convertibility regime and characterized by sharp changes in relative prices and income, as well as by widespread breaches of contracts.[4] This economic crisis proved to be different from previous crises, however, as Argentina managed to recover quickly and significantly (see Graph 2.1).

Graph 2.1. GDP Evolution, 1950 - 2005



Source: ECLAC, on the basis of data from Secretaría de Programación Económica.

The recovery presents some exceptional features. At few times in Argentina's economic history has Argentina had such external and fiscal surpluses. More importantly, for the purposes of this study, Argentina's tax burden is far higher than ever before. Understanding these historic trends is necessary to our study of the characteristics, strengths, weaknesses and reforms of Argentina's tax system. The second section of this chapter, which serves as an introduction to this study, examines the central features of Argentina's fiscal situation from a historical viewpoint. Next, we present an explanation of the particular institutional characteristics of Argentina's federalism, which is necessary to the study of Argentina's tax system. Lastly, the next section places the Argentine tax system in context, introducing the principal features of taxation in Latin America.

The main body of this chapter includes a detailed analysis of the evolution of Argentine tax level and structure, the key stylized characteristics of this structure, and the principal challenges that Argentina continues to face. Finally, readers who are interested in the specific details of the system will find a more exhaustive explanation of the technical characteristics of the tax system in the Appendix.

The Economic Evolution and Its Impact on the Financing of the Public Sector: the Fiscal Deficit

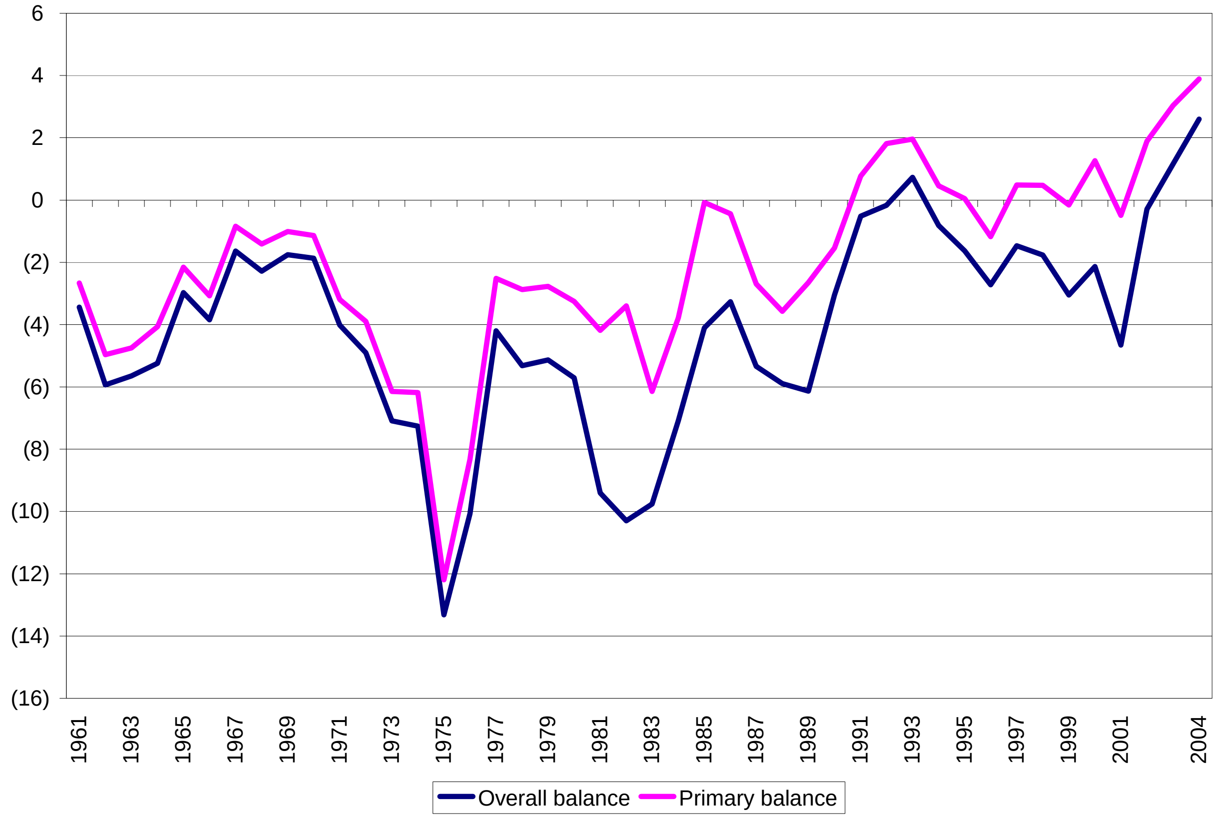
The Fiscal Situation: A Historical Perspective

A proper evaluation of Argentina's fiscal situation in the 1990s requires a wide historical perspective. Argentina's public sector reached the 1990s with longstanding structural imbalances and brief periods of surpluses which, as a result of successful stabilization programs, generally coincided with extraordinary increased revenues. This increase in revenues was due, in large part, to improved tax collection during periods characterized by sharp decreases in inflation rates and some lags in tax payments (the 'Tanzi effect'). Likewise, the highest deficits have coincided with the deterioration of revenues during macroeconomic crises, considering the relative stability of primary spending due to budget rigidity. In sum, fiscal evolution has been closely associated with the macroeconomic evolution.

An examination of the evolution of primary and total revenues since 1961 demonstrates the magnitude of the long-term fiscal deficits. In addition to the deep deficits that coincided with serious macroeconomic crises (1975, 1981-83, 1989-90 and 2001-02), primary and total deficits constituted approximately 2.1 percent and 4.1 percent of GDP, respectively. However, this was due to two clearly different situations.

Until 1990, the deficit without privatizations, with partial financing from the inflationary tax, hovered around 5.8 percent of GDP. During the 1990s, the deficit dropped to 2.1 percent of GDP and revenues from privatizations were 1.7 percent of GDP. At the same time, the primary balance improved from -3.5 percent of GDP for the 1961-1990 period (annual average) to 0.5 percent surplus of GDP. On the basis of the information presented in Table 2.1 and Graph 2.2, it may be concluded that the public sector has shown an important adjustment process of its imbalances in the long term. This does not mean that the persistent imbalances, especially those resulting from debt service, were easier to finance in the convertibility period, when there was no inflationary tax.

Graph 2.2. Non-financial Federal Public Sector Balance
(On an accrual basis, as a percentage of GDP)



Source: Own elaboration on the basis of data from the Ministry of Economy and ECLAC, Buenos Aires office.

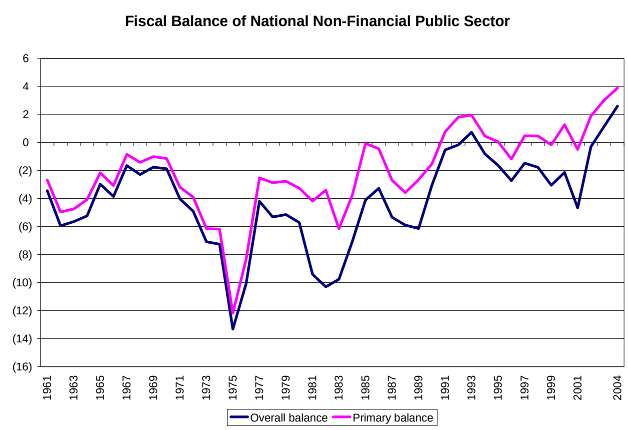
Table 2.1. Non-financial Federal Public Sector Balance, 1961-2000
(Annual average as a percentage of GDP)

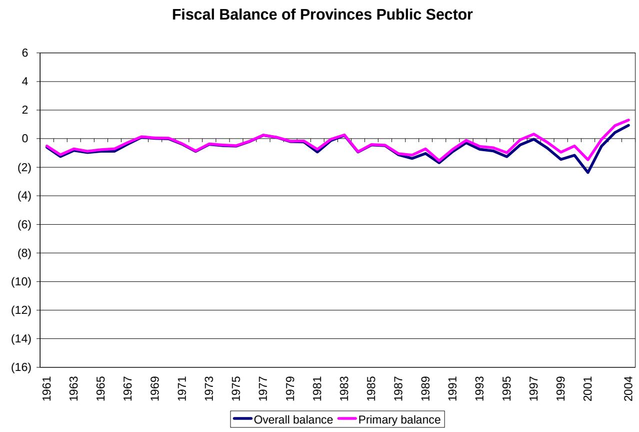
Period	Total	Primary	Total without capital revenue	Primary without capital revenue
1961 - 1970	(3.46)	(2.61)	(3.86)	(3.01)
1971 - 1980	(6.70)	(5.13)	(6.91)	(5.34)
1981 - 1990	(6.43)	(2.85)	(6.61)	(3.03)
1991 - 2001	(1.65)	0.50	(2.14)	0.01
2002 - 2004	1.16	2.94	1.15	2.93
1961 - 1990	(5.53)	(3.53)	(5.79)	(3.79)
1961 - 2004	(4.11)	(2.08)	(4.41)	(2.38)

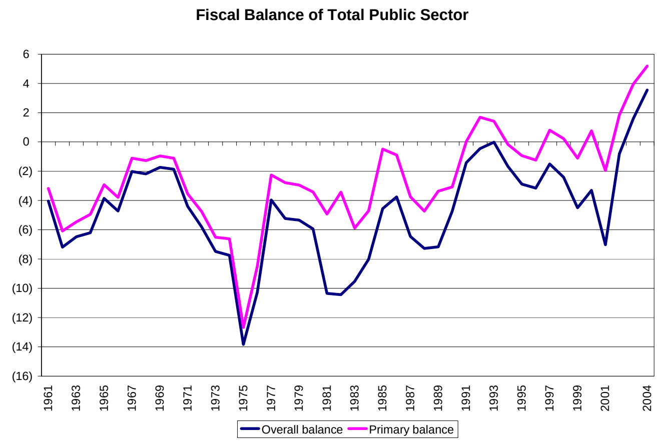
Source: Own elaboration on the basis of data from the Ministry of Economy and ECLAC, Buenos Aires office

Throughout the four decades prior to the 2001 crisis, the government undertook various attempts to restrict the level of capital spending and, in some periods, operating spending (personnel and assets and services).[5] In addition to debt service, there were another two sets of spending that exerted increased pressure: pensions and spending related to fiscal and financial relations with the provinces. Taking into account the federal nature of Argentina, we believe the evolution of federal and province accounts should be disaggregated. Regardless of the seriousness of many fiscal problems affecting the provinces, we can better understand the dominant character of the fiscal evolution of the Central Government through an explanation of the evolution of the consolidated public accounts[6] (Graph 2.3).

Graph 2.3. Evolution of the Consolidated Balance of the Nation and the Provinces
(As a percentage of GDP)







Source: Own elaboration on the basis of data from the Ministry of Economy and ECLAC, Buenos Aires office.

The Fiscal Situation Since the Early 1990s

The evolution of fiscal revenues in the 1990s was a determining factor in the late 2001 economic crisis. But, since fiscal problems cannot be attributed to a single factor, tax policy and traditional difficulties to deal with tax evasion share the menu of fiscal deficiencies together with finances of the provinces, privatizations, pension reform, debt management among others. While the early 1990s were considered a period of sizeable reforms in terms of public intervention, longstanding public policy problems in education, health, the pension system, infrastructure (to mention the most important) persisted. Thus the extent to which reforms helped should be questioned.[7]

In aggregate terms, the following phenomena stand out: the importance of revenues from privatizations in the first half of the 1990s,[8] the growing deficits that began in 1993, and the growing gap between total and primary balance, which highlights increased debt interests.

Some of the macroeconomic factors that helped create a solvent fiscal situation during the early nineties were reversed after 1994 – international interest rates bounced back slightly and the recession, unleashed by the unfavorable external shock that followed Mexico’s devaluation, greatly influenced collection trends, especially as from 1995. However, two other factors closely linked to fiscal policy decisions explain fiscal imbalances. First, the government was unable to manipulate the nominal exchange rate and thus sought to partially offset the trade sectors’ loss of competitiveness by reducing taxes and resuming tax reimbursements on exports. The most important measure undertaken was the reduction in employers’ taxes that financed social security. The second factor resulted from the negative impact of pension system reform, which will be discussed in a later section. Despite these emergency measures and the temporary recovery of the economic activity that began in 1996, the public sector continued to show imbalances that it tried to counter with a series of various and partial tax reforms.

The Fiscal Situation after the Crisis

The features that characterized Argentina’s fiscal policy before the 2001 crisis are different from those that have prevailed in the period after the crisis, during which exceptional growth in the trade balance and in the net fiscal surplus were achieved. In 2004, the public sector's fiscal income showed a surplus at 2.6 percent[9] of GDP and such surplus was estimated to have increased to 3.5 percent of GDP in 2005. These data show the vast improvement in public accounts after the 2001-2002 crisis. In 2002, this improvement resulted from a decrease in spending as a percentage of GDP in proportion to revenue growth. Such spending cuts primarily arose from a reduction in the real value of public sector wages, pension payments and debt interests. The first two changes resulted from the depreciation of the exchange rate that occurred when the convertibility system was abandoned. Between 2001 and 2002, the nominal exchange rate increased by 200 percent and 130 percent in real terms while the public sector's salaries and pension payments remained virtually constant. Improvement subsequent to 2002 resulted from the increased growth of tax revenues relative to spending.

Together, these factors generated the previously-mentioned primary surplus, despite the creation of a new social assistance program to deal with the social costs of the crisis.

Never before in Argentina's history has its tax burden been so high. This is due, in part, to emergency taxes, half of which came from export duties, and overall, which amounted to a total of 4.6 percent of GDP in 2004. However, the significant growth of traditional taxation (e.g., VAT, income, and payroll taxes) confirms the usual assumption that tax administration efforts are more efficient during periods of economic recovery.

Political Structure of the Federal Government: The Tax Powers of Each Level of Government and the Revenue Sharing System

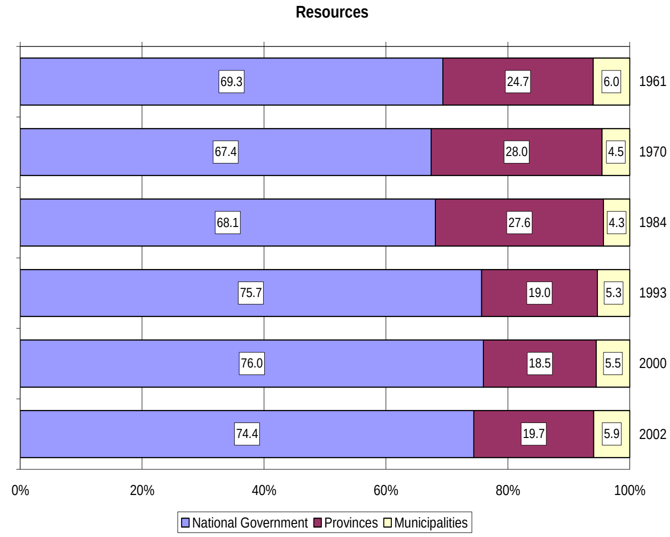
A complete discussion of the Argentine tax system must include certain relevant characteristics of Argentina's institutional organization. Argentina is a federal country comprised of twenty-four highly autonomous provinces, fourteen of which existed before the national organization that occurred in the mid-nineteenth century. Likewise, Argentina's National Constitution sets forth that the provinces retain all powers not specifically delegated to the federal government. As a consequence, the federal government has full responsibility in matters of foreign affairs, minting, trade regulations, domestic and international navigation, and defense. Powers in certain other policy areas – among them, justice, primary education, and social security – are shared. Because the institutional framework is imprecise in its delegation of these powers to the varying levels of government, responsibilities have been reallocated numerous times during the past three decades. These processes of reallocation, not always orderly and transparent, have made the nation-provinces-municipalities relationship more complex.

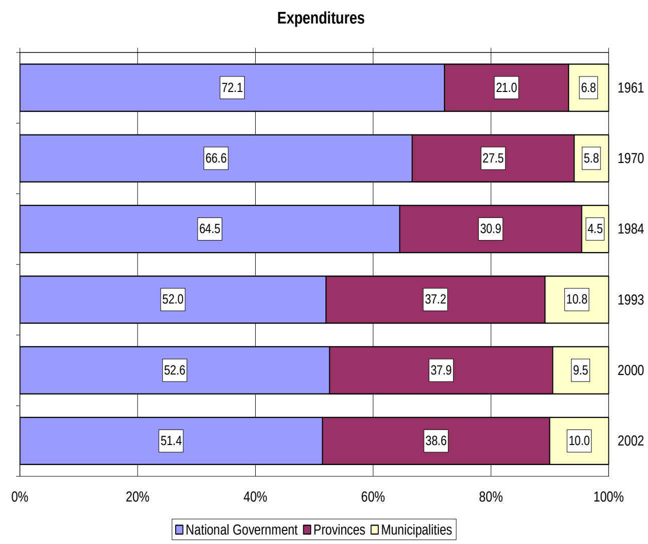
With respect to the powers of taxation, the National Constitution, in article 75, subsection 2, defines federal and provincial tax powers by stating that indirect taxes, with the exception of import and export fees which are exclusively federal, are shared by both levels of government. Direct taxes fall exclusively under the auspices of the provinces, but the federal government is not precluded from levying direct taxes during a limited term and on condition that national security and defense requires it.

In practice, the federal government collects most taxes while revenues are shared. The provinces retain four main taxes (the real estate tax, automobile tax, stamp tax, and gross income tax), which allow them to collect enough revenue to cover, on average, approximately 40 percent of their expenses and finance the rest of their expenses through indebtedness and transfers from the central government. In Argentina, the tax revenue collected by sub-national governments has not grown in proportion to their spending. This has resulted in a growing gap between spending and revenues at a sub-national level, which has increased tensions between the nation and the provinces.

From a long-term perspective, the imbalances between jurisdictional structures of spending and revenues (tax and non-tax revenues) were not very significant up until the 1980s (Graph 2.4). Before the decentralization of schools and hospitals in the late 1960s, the central government collected and spent similar percentages of the total budget. Since the 1980s, however, the highest concentration of revenues managed by the federal government and the decentralization of spending has given rise to pressure on the tax-sharing system and increased tension between the federal and provincial governments, as the federal government controls three-quarters of revenue but only half of consolidated spending.

Graph 2.4. Structure of Revenues and Spending in Percentages by Level of Government



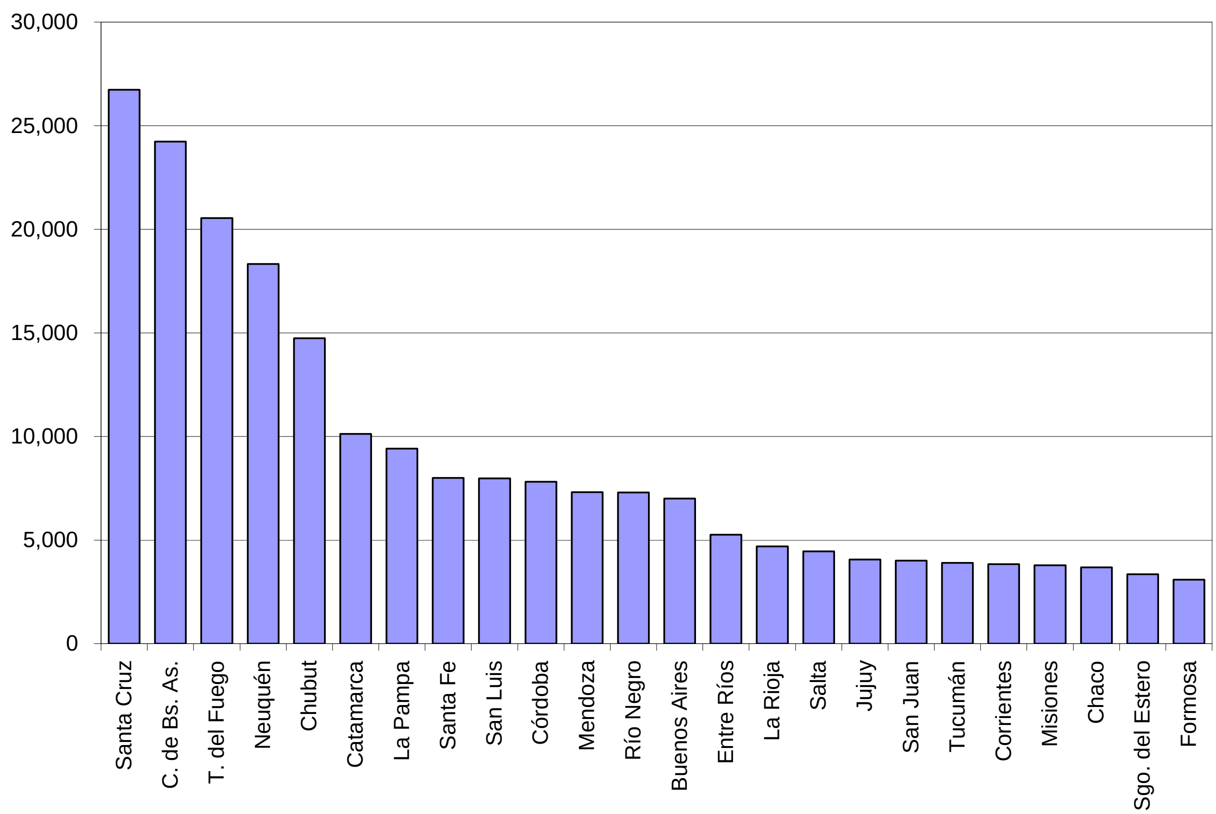


Source: Cetrángolo and Jiménez (2004).

The allocation of taxes between levels of government should attempt to meet the needs of often divergent goals. On one hand, it is true that, in theory, sub-national governments can better meet their citizens' preferences when local taxes allow costs of providing certain assets and services by the local government to be internalized. However, various reasons make it difficult to allocate tax powers to sub-national governments in such a proportion to fully finance their growing delivery of assets and services. Therefore, while there is a theoretical agreement about a necessary symmetry between spending and tax powers, in practice, there are few taxes that can be decentralized without a significant loss of efficiency and fairness.

This point is of particular importance in almost every country in the region, whose economies are characterized by deep regional productivity disparities. As Graph 2.5 shows, Argentina presents an extremely imbalanced regional productive structure.

Graph 2.5. Regional GDP per Capita, 2002

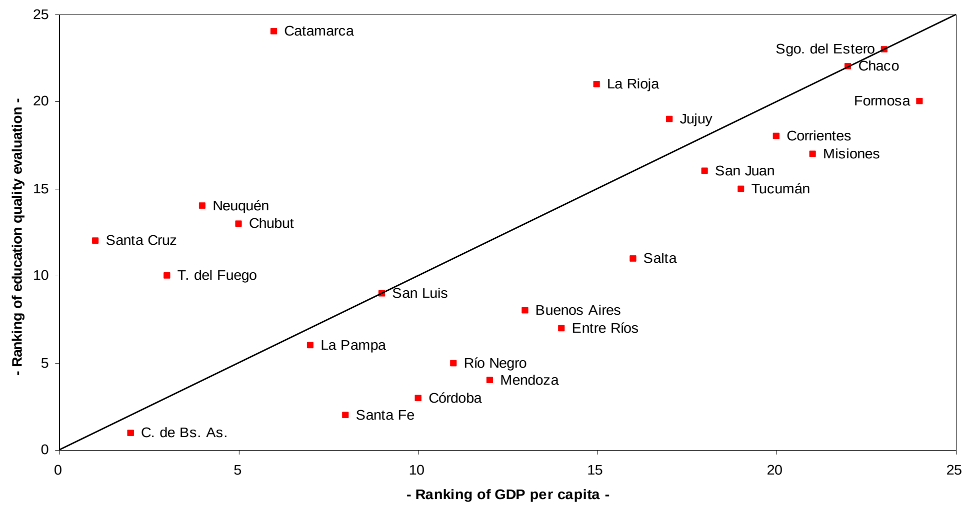


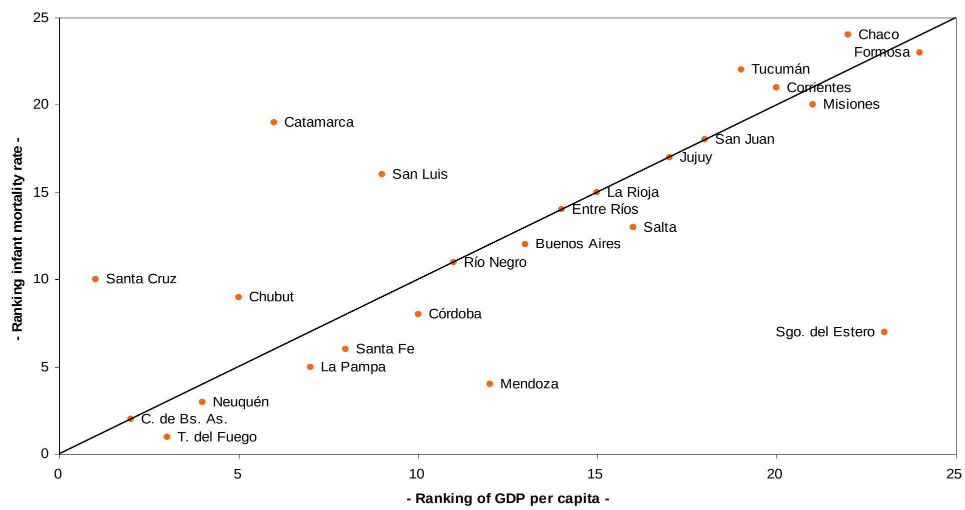
Source: Graphic regional overview. ECLAC, Buenos Aires.

The relation between the per-capita income of the Province of Santa Cruz (the richest in terms of this indicator) and the Province of Formosa (the poorest) in Argentina is 8.6 times.[10] This disparity in regional terms not only impacts the construction of equalization schemes, but also limits certain decentralization attempts. Thus, such disparities among regions translate into different tax bases and institutional capabilities. All these factors highlight the importance of revenue-transfer schemes to sub-national governments.

Additionally, the process of decentralization of social expenditures and the concentration of revenues in the central government exert pressure on financial transfer systems to homogenously provide public goods while paying attention to fairness. These data rule out any attempt to make any headway in fiscal co-responsibility projects (which does not mean ignoring the need to transfer some tax powers to provinces). Graph 2.6 shows the high degree of correlation between the quality standards in the public provision of health and education and the degree of development relative to each jurisdiction.[11]

Graph 2.6. Regional Product and Schooling





Q uality and

Infant Mortality Rate, by Ranking

Source: Own elaboration on the basis of data from the Ministery of Education, Science and Ministerio de Educación, Ciencia y Técnica, Ministerio de Salud y Ambiente de la Nación and ECLAC, Buenos Aires Office.

Consequently, it is essential that any alternative policy attempting to improve fairness in Argentina should include mechanisms that help equalize regional differences, in particular those related to decentralized social spending. An efficient tax-sharing system, with explicit goals and with adequate incentives, can make up for the deficiency present in sub-national tax systems and thus finance the functions assigned to these governments.

In order to complete this introduction to Argentina's federalism, the role of local governments will be briefly mentioned. The National Constitution defines for each province the elements of its own municipal regime. The provinces' constitutions and municipal organic laws set forth different areas of competence for municipalities – the goals and policies of the local governments deal mainly with basic urban services such as garbage collection and public lighting. With regard to taxes, only municipalities of certain provinces are authorized to collect them (see Table 2.2).

Table 2.2. Municipalities' Tax Powers

	Own taxes as % of revenues	Urban real estate	Rural real estate	Automobiles	Gross Income	Others
Buenos Aires	0.0					
Catamarca	0.9					X
Córdoba	5.5			X		
Corrientes	1.3					X
Chaco	12.5	X	X	X		
Chubut	37.5	X	X	X	X	
Entre Ríos	0.0					
Formosa	10.5	X		X		
Jujuy	4.5			X		
La Pampa	0.0					
La Rioja	0.0					
Mendoza	0.0					
Misiones	4.1					X
Neuquén	12.4			X		
Río Negro	0.0					
Salta	8.2	X		X		
San Juan	0.0					
San Luis	0.0					
Santa Cruz	18.8	X		X		
Santa Fe	0.0					

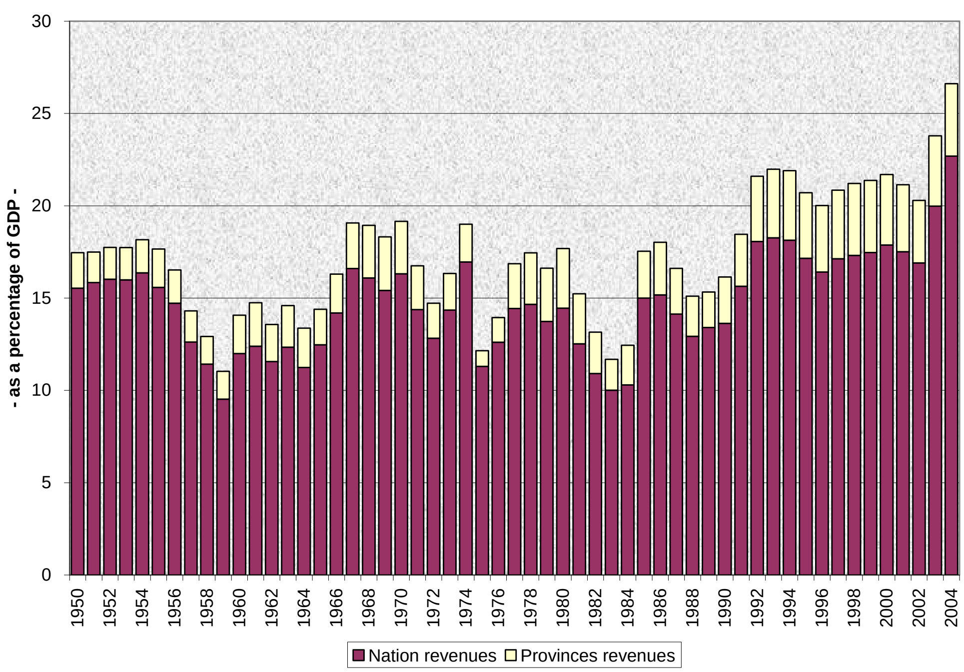
Stgo. del Estero	0.0					
Tucumán	0.0					
Tierra del Fuego	18.5	X		X		
Total	**1.5**					

The Level and Structure of Taxation

A Global Overview of the Tax Burden 1932 and 2004

An overview of the level of the tax burden since 1950 is presented in Graph 2.7, which shows that Argentina may be considered to have a medium to high tax revenue coefficient relative to other Latin American countries, especially until the early 1990s, when it first exceeded 20 percent of GDP. A global analysis of the evolution of Argentina's tax system cannot be performed without taking into consideration tax revenues from sub-national governments, particularly at the province level,[12] which have represented approximately 3.5 percent of GDP and which have exhibited a trend of growth.

Graph 2.7. Level of Total Collection (Federal and Provincial Revenues Including Social Security Contributions), 1950-2004



From a longer-term perspective, the federal tax revenue[13] remained below 10 percent of GDP until the mid-1940s, moving to a new level of 14 percent between 1950 and 1990 and increasing again thereafter (see Table 2.3). This is in contrast with the early expansion of government activities and the consolidation of the Argentine welfare state throughout the last century. An important aspect that should therefore be pointed out is that such expansion of the State was not in line with a similar evolution in traditional tax collection. Customs revenues, taxes on fuels to finance road building and the construction of hydroelectric plants, the initial surplus of the pension system, the inflationary tax, the indebtedness, and privatization have been, throughout Argentina's history, important sources of revenues that made the expansion of the public sector possible without the concurrent development of tax collection. In the past few years, extraordinary revenue sources gradually faded away, which made it even more important to take steps to strengthen traditional taxes. Export duties may be the last of this kind of resources and will be explained as later on.

	1932-40	**1941-50**	**1951-60**	**1961-70**	**1971-80**	**1981-90**	**1991-01**	**2002-04**
(As a percentage of GDP)								
Income. benefits and capital gains	0.95	2.56	3.37	2.35	1.37	1.02	2.54	3.93
Assets	0.32	0.25	0.47	0.54	0.61	0.54	0.35	0.59
Taxes on goods and services	3.52	3.69	4.73	4.85	5.47	6.17	8.74	9.57
Taxes on international trade and transactions	3.27	1.03	0.44	1.77	1.83	1.73	0.92	2.71
Social security contributions	1.37	3.01	4.86	4.20	4.51	2.94	4.31	2.90
Others	0.00	0.06	0.12	0.15	0.17	0.40	0.49	0.15
Federal gross tax revenues	**9.43**	**10.60**	**14.01**	**13.86**	**13.97**	**12.80**	**17.36**	**19.86**

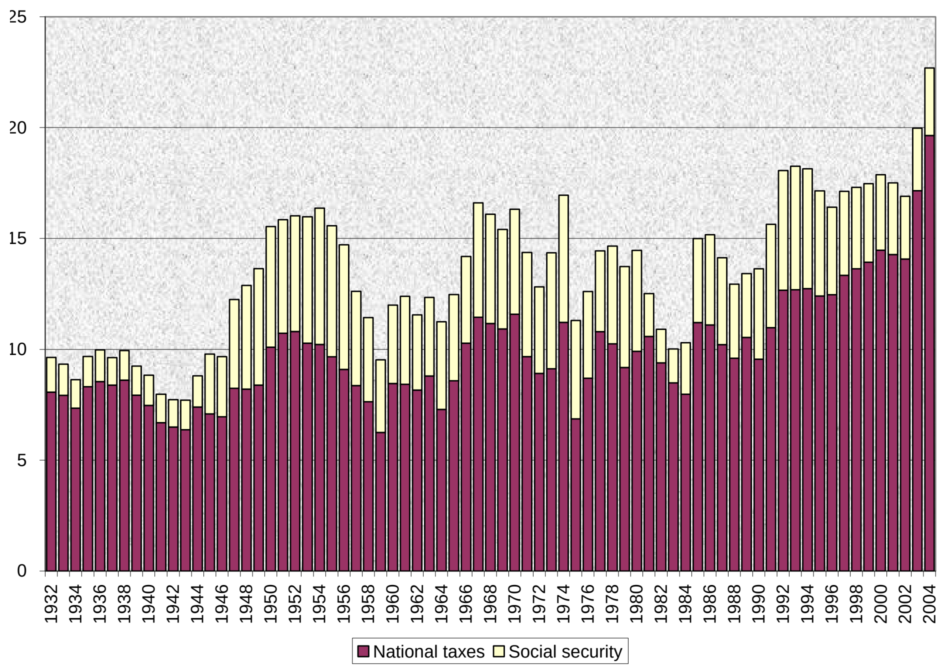
(As a percentage of the total)								
Income. benefits and capital gains	10.0	24.2	24.1	17.0	9.8	8.0	14.6	19.8
Assets	3.4	2.3	3.4	3.9	4.4	4.2	2.0	3.0
Taxes on goods and services	37.3	34.9	33.8	35.0	39.2	48.2	50.4	48.2
Taxes on international trade and transactions	34.7	9.7	3.2	12.7	13.1	13.5	5.3	13.6
Social security contributions	14.5	28.4	34.7	30.3	32.3	23.0	24.8	14.6
Others	0.0	0.5	0.9	1.1	1.2	3.1	2.9	0.7
Federal gross tax revenues	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

After a sharp reduction during the crisis in late 2001, tax revenue showed a strong expansion during 2003 and 2004 (Graph 2.8), due to facts related to the economic policies adopted analyzed in more detail later on, especially regarding export duties and other regulations that impacted corporate income.

Some aspects regarding Argentina’s tax structure should be highlighted (Table 2.3), such as fluctuations in social security contributions, which peaked in the 1950s and the 1970s, after which they declined. These contributions went from 30 percent of total income to a mere 15 percent of present day income. This issue will be dealt with in a later section.

We also can observe that the evolution of Argentina’s income tax, unlike that of other Latin American countries, reached its heyday during the 1940s and 1950s, then virtually disappeared in the 1980s, after which it resumed an upward trend.

Graph 2.8: Level of Federal Collection (Federal Taxes and Social Security), 1932-2004
(As a percentage of GDP)



The Currency Board Period 1991-2001: An Endless Process of Tax Reforms

During the period of the convertibility regime (1991-2001) the federal government’s tax revenue reached around 17 percent of GDP (on average) and the consolidated tax burden – including provinces and municipalities – reached an average of 21 percent, with a decrease after the tequila crisis (1995). Tax revenue subsequently increased to 21 percent of GDP, however, highlighting the fact that collection is very sensitive to macroeconomic shocks.

Since the beginning of this period, tax collection showed a substantial change. Initially, the convertibility plan coexisted with the tax structure resulting from the reforms performed during the hyperinflation years (1989 and 1990), which benefited from the sharp drop in the inflation rate. In subsequent years, economic authorities began introducing constant reforms in the tax system.[14]

In the 1990s, the tax structure was characterized by its deep initial concentration. In 1993, the first main taxes (VAT, income, and contributions to the social security system) represented between 75 percent and 80 percent of the total tax revenues. Of this total amount, VAT represented 40 percent. The most important measures taken in the first years of the 1990s were: the broadening of the VAT base (more widespread than in 1980); low income tax rates; the abolition of taxes on exports; reform of the tax on fuels accompanying the deregulation of the sector (which led to the gradual simplification of the system of specific allocation funds), and the abolition of minor taxes.

As the reforms progressed, the government became more pragmatic. While maintaining the basic orientation, it ruled out the proposal of reducing tax rates inspired in the "Laffer effect" and, on several occasions, increased the rates of VAT and the income tax shared with the most important provinces. As a result, federal tax revenues grew by 64 percent between 1991 and 1992 – VAT collection grew by 160 percent while the income tax quadrupled, encouraging the concentration mentioned before.

In addition, tax reform was sustained by a strengthening program that included information generated by a sales-invoicing system, new penalty provisions, and a broad withholding-at-source system that facilitated the collection of the two taxes previously mentioned. The concentration of collection in these taxes made revenues highly sensitive to the evolution of macroeconomic variables. This sensitivity was costly after 1995, when the domestic economy suffered from the unfavorable external shock that followed Mexico's devaluation.

After mid-1994, a new phase of public accounts started – in the third quarter of 1994, the first negative fiscal results were observed, which coincided with pension reform (which will be dealt with later on) and which occurred months before the drop in traditional tax revenues that was due to the recession.

The federal government was forced to take emergency measures, which in some cases meant reviewing actions previously undertaken. Such measures included an increase in VAT rates (from 18 percent to 21 percent), the partial review of the initial decrease in payroll taxes paid by employers, an increase in imports fees, a reduction of reimbursements for exports and the subsidy on capital assets, and a broadening of the income and personal assets tax base. However, despite these measures and the gradual recovery of the economic activity level which began during half of 1996, the public sector continued to show imbalances. The persistence of the deficit led to additional measures applied mainly to revenues. These measures included an increase in taxes on fuel and the resumption of the tax on diesel fuel. The additional revenues resulting from these reforms were then applied to the social security system. The 1998 tax reform was aimed at strengthening tax revenues. To achieve this goal, the government broadened the VAT base and created taxes on minimum presumed income, on paid interests and on the cost of corporate indebtedness, on automobiles, motorcycles, ships and planes (destined to increase teachers' salaries), and the *Monotributo* (a tax paid by the self-employed). Through this reform, the government could increase tax revenues for an amount closer to 1% of GDP. Although some of the adopted measures have significant importance to enhance taxation (as the broadening of VAT base), others, on the contrary, have to be released sooner or later as they implied an increase in the investment cost for enterprises (tax on paid interests, for example). Additionally, tax on minimum presumed income and *Monotributo* have remained in the tax system, their convenience is highly debatable.

Thus, the initial attempt to create a tax system that concentrated on only a few taxes had to be reversed in order to deal with the fiscal crises. By late 1999, the newly inaugurated government passed a tax package that included several reforms of VAT, which broadened the VAT base and abolished certain exemptions. Additionally, the use of differential rates was extended, levying 10.5 percent on several services. The evolution of this tax during the 1990s shows that once the positive effect in the first years of the decade – coinciding with the launching of the convertibility plan – had passed, the subsequent, significant increases in tax rates and bases only managed to maintain the level of collection.

In 2000, the government reformed the income tax, broadening the tax base through the reduction of the non-taxable minimum income, tax deductions for family benefits, and special deductions. An emergency tax on high income was created and tax rates on personal assets exceeding $200,000 were increased. Additionally, some internal tax rates were increased. These reforms generated additional tax revenues of around 1.8 percent of GDP.

In May 2001, the government introduced new tax reforms whose goals were not quite clear. On the one hand, the government created a tax on debits and credits in current accounts; it simultaneously launched competitiveness plans. These plans were based on agreements signed by chambers of commerce, the federal government and provincial governments, through which some productive activities were aided in order to stimulate the economy, but which reduced collection at a faster pace than the consumption drop. In addition to such plans, the tax paid by sector producing capital assets was reduced by half and the export regime was applied to all the producers of such assets in respect to the VAT tax credit. [1]

In sum, regardless of the Argentine government's initial intention to simplify the tax system, subsequent fiscal emergency situations forced the government to enact several reforms that resulted in a heterogeneous and highly complex tax system, which also affected the distribution of the funds. Both pension reform and the troubled financial relations between the nation and the provinces are two central factors in this story.

Coming out of the Crisis 2002-2004

Beginning in 2002 and continuing to the present day, as a consequence of the measures adopted due to the economic 'crisis' following the recognition of financial insolvency by the government, the Argentine government adopted several tax measures that strongly impacted tax collection**.** These measures moved tax collection from the characteristic 20-22 percent of GDP in the 1990s to 26.5 percent in 2004.

A significant part of this increase is due to the introduction of export duties that generated almost 2.5 percent of GDP. This emergency tax responds to the federal government's need to engage the peso's extraordinary devaluation that occurred after the crisis.

The strong increase in VAT and the broadening of the financial debit and credit tax base and its rate rise also exerted some influence on the increase of tax revenue as a

[1] Cetrángolo, O. and Jimenez, J. P. (2003), Chapter III.

percentage of GDP; other influential measures included a strong increase in the corporate income revenue of around 2 percentage points of GDP. Corporate tax revenue was up by close to 70 percent relative to the pre-crisis period, partly due to the fact that the government refused to apply regulations regarding balance adjustments resulting from inflation in 2002 and to the higher income of oil companies, as a result of an increase in oil prices.

We can see, therefore, that the increase in the tax burden is sustained by single-occurrence impacts on permanent taxes (corporate income) or by increases that arise from temporary taxes (export duties and banking debits). This reinforces the thesis that the volatility of the tax system increases in response to changes in macroeconomic circumstances.

Nevertheless, we cannot but mention that since mid-2003, this increase in revenue has been sustained, perhaps as a result of greater efforts in improving the efficiency of tax administration that accompanied the economic recovery.

This long-term analysis allows us to find the structural roots of Argentina's financing problem, from which we infer that the structural imbalances observed from a long-term perspective have not been covered by an adequate tax structure, even with constant and stable revenues over the course of time (Table 2.4).

Table 2.4. Federal Taxes and Social Security, 1932-2004
(Averages in decades)

	1932-40	1941-50	1951-60	1961-70	1971-80	1981-90	1991-01	2002-04
As a percentage of GDP								
Federal taxes	8.07	7.59	9.15	9.66	9.46	9.86	13.05	16.96
Social security	1.37	3.01	4.86	4.20	4.51	2.94	4.31	2.90
Federal gross tax revenues	**9.43**	**10.60**	**14.01**	**13.86**	**13.97**	**12.80**	**17.36**	**19.86**
As a percentage of the total								
Federal taxes	85.52	71.64	65.30	69.72	67.72	77.03	75.18	85.40
Social security	14.48	28.36	34.70	30.28	32.28	22.97	24.82	14.60
Federal gross tax revenues	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Main Features of the Present Situation

Before embarking upon the analysis of the specific challenges that face Argentina's tax system, we turn to a discussion of eight stylized factors that characterized the evolution of the country's tax structure throughout history.

Sustained Growth of Consumers Taxes

Until the 1950s, consumer goods taxes were not highly significant; in time, however, they increased to total approximately 2.0-2.5 percent of GDP in the late 1980s and subsequently increased to a new level, crossing the 6 percent threshold in 1993.

Graph 2.9. Sales Tax and VAT, 1932-2004
(As a percentage of GDP)

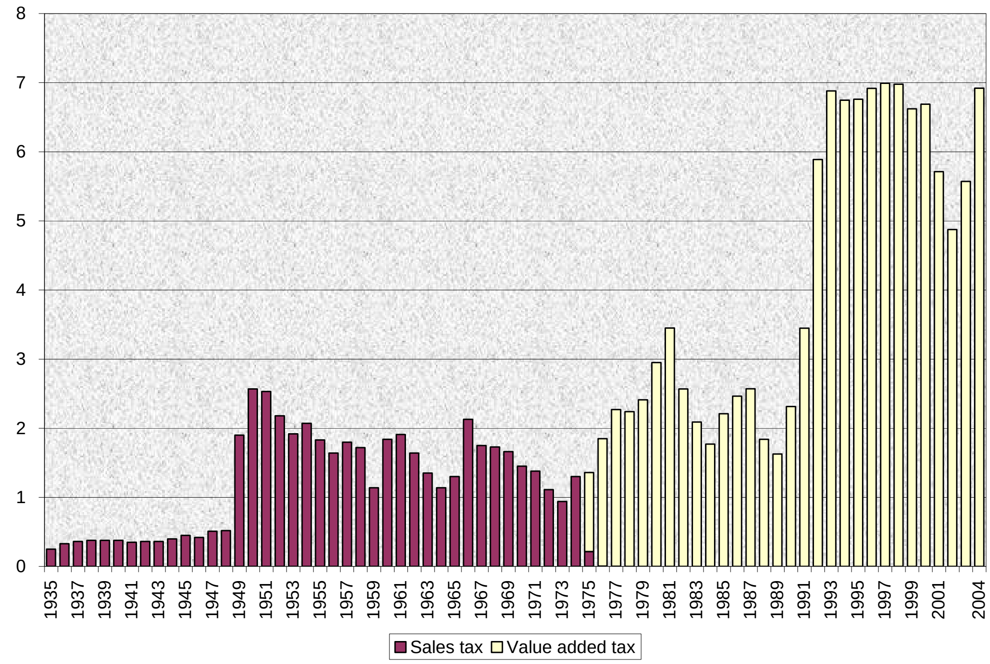


Table 2.5.VAT Productivity,[1] 1991 – 2004

	1991	1994	1997	2001	2002	2003	2004[3]
Revenue (as % of GDP)	3.75	6.75	6.99	5.71	4.88	5.57	6.92
Tax Rate[2] (%)	16.00	18.00	21.00	21.00	21.00	21.00	21.00
Productivity	0.235	0.375	0.333	0.272	0.232	0.265	0.330

Thus, it is clear that the government, when faced with a constant lack of resources, systematically resorted to indirect taxation to improve the level of tax revenues. In this context, we should highlight the behavior of VAT, which, although implemented in 1975, only experienced a dramatic increase in revenues as of 1992.

Since the beginning of 1990, the evolution of VAT rates was dominated by an overall rate, which at that time reached a minimum level of 13 percent, which was around the level established in the first months following implementation of the VAT. In the last few years, the dominant trend in designing the VAT has been towards increasing both its base and rates, allowing revenues to increase significantly, both in absolute terms as well as in relation to other taxes. After reaching 13 percent in February 1990, the tax rate rose to its current 21 percent level in 1997.

As for the tax base, a new reform eliminated almost every tax exemption on goods, with the exception of books, magazines, newspapers, bread, milk, and medicine. The VAT was also extended to services performed by banks and other financial institutions[2], insurance, private health insurance plans, artistic, cultural, sporting and cinematographic events, and personal services related to these events, and transportation of people and freights. Services provided by the state, provinces, municipalities, educational entities, as well as by public health insurance plans and stock exchanges, were excluded.

In recent years, due to a combination of base-broadening and increased tax rates, revenues reached levels close to 7 percent of GDP. In addition, we must mention the relevance of the turnover taxes applied by provincial governments, which are identified as “Impuesto a los ingresos brutos” and are applied to each stage of the production process, with the exception of agriculture and cattle breeding.

Gradual Loss of Resources from Import Duties

The gradual loss of resources from import duties since the mid 1940s, accentuated during the 1950s and, subsequently with the trade expansion, was promoted by the convertibility

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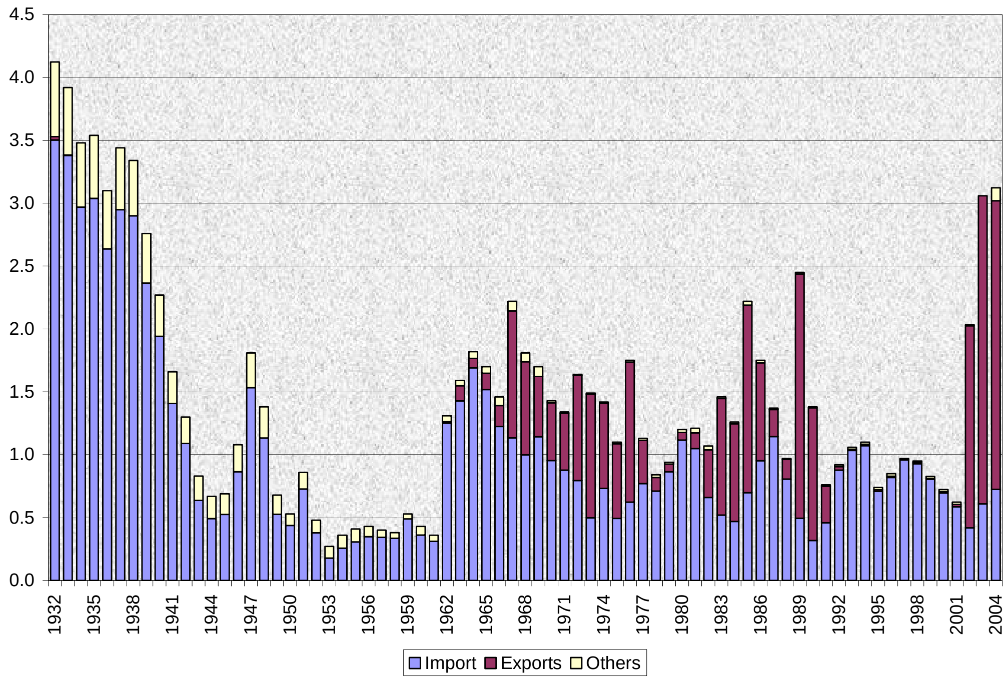
[2] This reform modified the previous system of VAT determination on these institutions. Till then, the tax had been calculated on the basis of the remuneration of factors and the reform implied the adoption of the usual system of determination through debits and credits.

period. This general pattern first occurred in Argentina before occurring in several other countries of the region (Graph 2.10).

Graph 2.10. Foreign Trade Taxes, 1932-2004
(As a percentage of GDP)



Intermittent but Significant Presence of Export Taxes

Throughout Argentine history, revenues resulting primarily from the export of agricultural goods have contributed substantially to the financing of the state. In the days following the 2001 crisis, this took the shape of export duties charged by customs, similarly to other historic periods when the rate of exchange was extraordinarily devalued to meet the foreign crisis, as was observed in Graph 2.10. In other periods of history, the

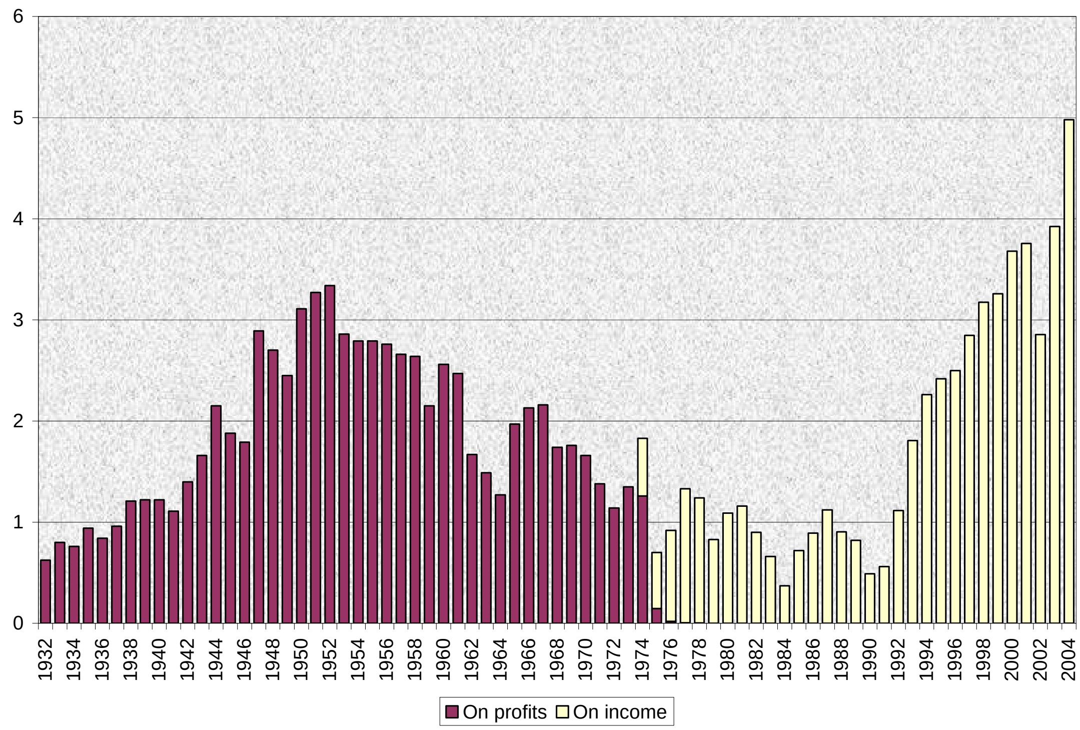
Central Bank generated these resources through the introduction of multiple exchange rates.

This emergency tax has two additional advantages: first, it reduces the impact of devaluation on the domestic price of commodities, many of which make up a substantial part of the mass consumer basket. This results in the improvement in real wages. Second, due to the fact that these revenues are, in accordance with the Constitution, not shared with the provinces, they bring quick relief to the central government's accounts.

Poor Performance of Income Taxation

Despite possessing an expanded middle class, a high level of urban concentration, a reasonable level of income per capita, and a Gini coefficient below 0.4, Argentina has never managed to develop an income tax that generates much revenue (Graph 2.11). Although it pulled some weight between 1945 and 1955, this tax lost its participation in the taxation structure following that 10-year period and for the next three decades and only began to recover its standing in the nineties. Nevertheless, we should note that a substantial portion of the growth of this tax is due to income derived from privatized companies.

Graph 2.11. Income Tax, 1932-2004
(As a percentage of GDP)



Likewise, and considering it is a common characteristic in the whole region, the weight of the income tax burden has rested primarily on the strong participation of corporate income tax, and as regards to the personal income tax, most of its revenue comes from wages. Then, income from financial activities (dividends, interests and others) have scarce participation in total personal income tax. Table 2.6 describes this phenomenon and evidences the weakness of the system in achieving its goals in respect of income distribution, since there is not much that the state can do with a personal income tax that has no incidence on non-wage income.

Table 2.6. Personal and Corporate Income Tax, 1992-2004

Tax Revenues[1]	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004[2]
As a percentage of GDP													
Taxes on income, profits, and capital gains	1.61	2.03	2.44	2.51	2.57	2.90	3.21	3.56	3.98	3.99	3.04	4.30	5.26
Individuals	0.33	0.57	0.75	0.79	0.98	0.92	0.99	1.08	1.39	1.38	1.13	1.33	1.38
Corporations. and other enterprises	1.21	1.35	1.56	1.58	1.49	1.78	2.00	2.18	2.31	2.32	1.56	2.64	3.64
Others unidentifiable	0.07	0.11	0.13	0.14	0.10	0.20	0.23	0.30	0.28	0.29	0.35	0.33	0.24
As a percentage of total taxes on income, profits, and capital gains													
Taxes on income, profits, and capital gains	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Individuals	20.3	28.2	30.6	31.4	38.1	31.9	30.8	30.3	34.8	34.5	37.2	30.9	26.2
Corporations and other enterprises	75.3	66.5	64.0	63.0	58.2	61.3	62.1	61.3	58.2	58.2	51.4	61.4	69.2
Others unidentifiable	4.4	5.3	5.4	5.6	3.7	6.9	7.0	8.4	7.0	7.2	11.4	7.7	4.6
Individuals													
As a percentage of total gross tax revenues													
Taxes on income, profits, and capital gains	7.5	9.2	11.1	12.1	12.8	13.9	15.2	16.6	18.3	18.9	15.0	18.1	19.8
Individuals	1.5	2.6	3.4	3.8	4.9	4.4	4.7	5.0	6.4	6.5	5.6	5.6	5.2
Corporations and other enterprises	5.6	6.1	7.1	7.6	7.5	8.5	9.4	10.2	10.7	11.0	7.7	11.1	13.7
Others unidentifiable	0.3	0.5	0.6	0.7	0.5	1.0	1.1	1.4	1.3	1.4	1.7	1.4	0.9

Source: Based on data from Direccion Nacional de Investigaciones y Analisis Fiscal (Ministry of Economy).
[1]Based on IMF-Government Finance Statistics Manual classification.
[2]Provisional data.

Irrelevance of the Wealth Taxes

As in most countries in the region, taxes at the federal level levied on personal assets have not had substantial significance, although to judge their impact, we must also consider the role played by provinces and municipalities in this respect. Property taxes or taxes on the holding of real estate account for 25 percent to 30 percent of revenues at the lower levels of government, demonstrating that the weight of these provincial taxes on personal assets is close to 1.5 percent of GDP.

Table 2.7. Provincial Taxation, 1990-2004
(As a percentage of GDP)

Year	Gross income tax	Real State tax	Automobiles tax	Stamp tax	Others	Total
1990	1.32	0.64	0.21	0.25	0.07	**2.48**
1991	1.51	0.66	0.29	0.31	0.06	**2.82**
1992	1.95	0.66	0.31	0.37	0.24	**3.54**
1993	2.12	0.63	0.31	0.40	0.25	**3.72**
1994	2.14	0.64	0.33	0.40	0.26	**3.76**
1995	2.02	0.61	0.31	0.35	0.26	**3.55**
1996	2.02	0.60	0.30	0.35	0.33	**3.60**
1997	2.05	0.62	0.32	0.32	0.41	**3.72**
1998	2.19	0.63	0.33	0.33	0.42	**3.90**
1999	2.20	0.63	0.32	0.32	0.43	**3.90**
2000	2.15	0.64	0.29	0.28	0.46	**3.82**
2001	2.08	0.61	0.29	0.28	0.37	**3.64**
2002	1.97	0.53	0.21	0.23	0.46	**3.39**
2003	2.35	0.58	0.23	0.27	0.37	**3.81**
2004	2.58	0.59	0.23	0.29	0.35	**4.04**

Source: Based on data from Dirección Nacional de Coordinación Fiscal con las Provincias (Ministry of Economy).

Loss of importance of the payroll taxes

After an important increase in payroll tax revenue from the 1930s to the mid-1980s, it began to decrease, partly due to the growth of the informal employment market and the structural reform to the pension system that introduced individually capitalized accounts in 1994. This point is entered into in more detail later on.

Notwithstanding, this factor of production should be examined, since it is not only taxed by social security contributions, but also, the main weight of the tax on personal income is levied almost exclusively on salaries.

Table 2.8. Taxes on Wage and Salaries, 1992-2004

Tax Revenues	1992		1996		2000		2004	
	% of PIB	% of total	% of PIB	% of total	% of PIB	% of total	% of PIB	% of total
Total taxes on wage and salaries	5.72	100.00	4.93	100.00	4.79	100.00	4.42	100.00
Personal income tax	0.33	5.71	0.98	19.85	1.39	28.93	1.38	31.18
Social security contributions	5.39	94.29	3.95	80.15	3.40	71.07	3.04	68.82

The Use of Emergency or Extraordinary Taxes

The structural weakness of traditional taxes to obtain sufficient revenues to ensure fiscal solvency has resulted in the search for emergency or extraordinary revenues by means of non-traditional sources. These supplementary taxes, such as taxes on corporate assets and financial transactions, have been an important source of financing for Argentina's public sector at various times in history. This use of supplementary taxes is shared by many countries in Latin America, as was explained previously. This issue is also treated in more detail in a later section.

Significant Tax Expenditures

Another characteristic of the Argentine tax system is its lack of transparency in providing promotional tax measures. The amount of benefits granted, which are significant in terms of the country's tax burden, and the methods employed – which include the approval of private sector projects, the application of tax deferrals, and the inclusion of VAT among the various tax measures implemented – have made the system highly vulnerable to evasion and corruption. Moreover, while determining the tax impact of the different systems employed is a complex task, it is even more difficult to identify the effects that arise from those regimes, since they have never been subject to careful scrutiny and evaluation.

The Six Main Challenges of Argentina's Tax System

We identify six challenges that future Argentine tax discussions must resolve. To ensure long-term solvency, the government must undertake the following:

a. providing an adequate response to problems related to the financing of the social security system;
b. replacement of emergency taxes on corporate assets and taxes on financial operations;
c. substitution of export taxes;
d. reduction of tax expenditures;
e. strengthening of the fairness and equity of the tax system;
f. strengthening of the tax administration.

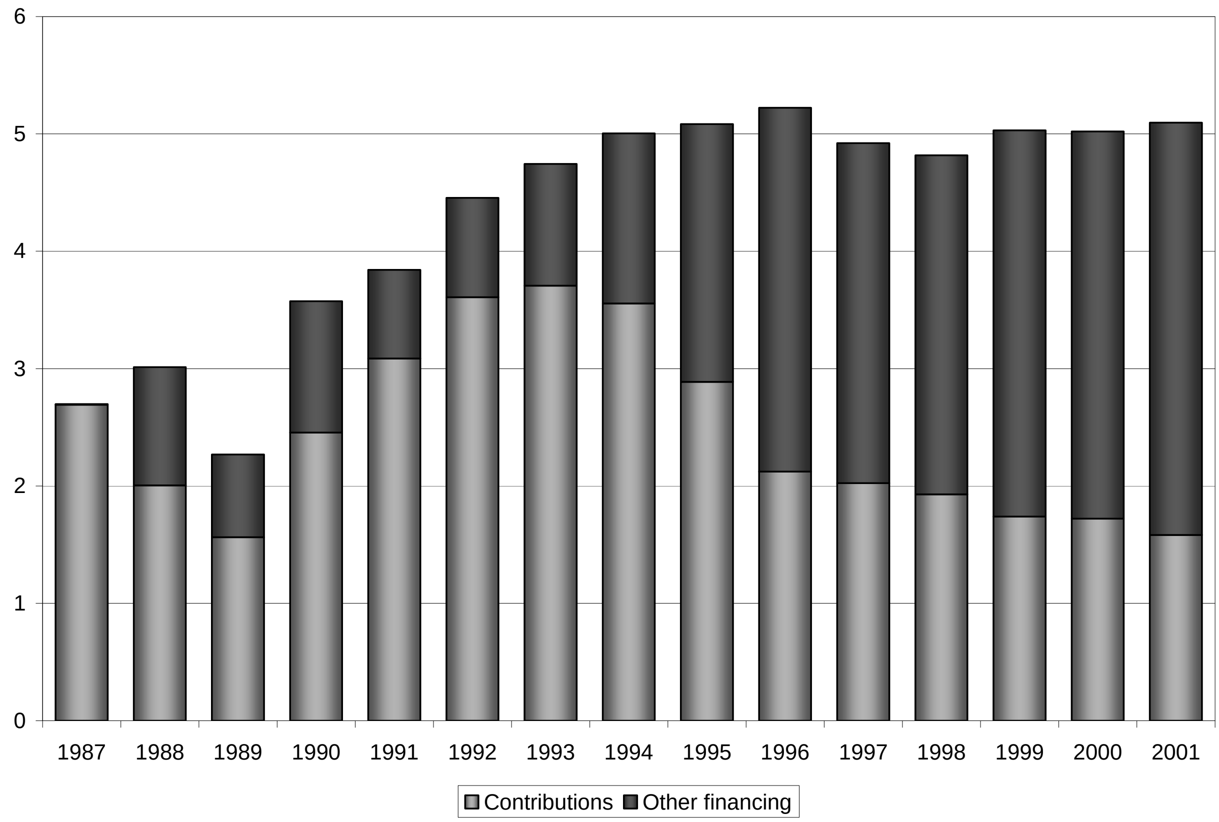
Providing an Adequate Response to Problems Related to the Financing of the Social Security System

Of the Latin American countries, Argentina was one of the first to develop a contribution-based social security system that was financed by payroll taxes. The system consists of retirement contributions, unemployment insurance, family subsidies, and health plans for active and passive employees and their families. Until 1984, when a major tax reform was introduced, total charges against salaries for social security financing (including employer contributions and employee deductions) added up to 50 percent of the gross salary.

It is impossible to understand the dynamics and magnitude of the Argentine fiscal crisis in the last quarter century without including a careful analysis of the retirement crisis.[15] We must emphasize the importance of tax resources reassigned to financing the retirement system, due to insufficient revenues collected from specific charges and, at the same time, to the impact of these allowances on sub-national finances and the conflict between the State and the provinces.

Several tax assignments for the financing of retirement pensions were introduced to improve the sector's financial situation. During the 1990s, a significant portion of tax revenues were assigned to finance the retirement system, substantially affecting tax co-participation. In Graph 2.12, we see the evolution of retirement contributions as of 1987, when they were entirely financed by payroll contributions and deductions. We observe both an important increase in retirement expenses during the first years of the decade and a significant loss experienced by taxes against salaries for the financing of retirement payments.

Graph 2.12. Retirement Payments and Their Financing
(As a percentage of GDP)



Source: Cetrángolo & Grushka (2005).

In the last years of the convertibility program, almost 70 percent of social security expenditures were financed by taxes other than payroll taxes. The gap between revenues from the taxes intended to finance the social security system and the expenditures of the system was one of the primary causes of the solvency problem of the public sector. To clarify this point, Table 2.9 shows a decomposition of the deficit of the social security system into several sources. It can be seen that the transfer of funds (employee contributions) to the new capitalization scheme and a reduction in employer contributions, together account for close to 3 percent of the GDP deficit.

Table 2.9. Determining Factors of the Pension System Deficit, 2000

	Billion $	% of Total	% of GDP
Pension system deficit	9.4	100.0	3.30
Capitalization system	4.3	45.9	1.52
Reduction in Contributions	3.8	40.6	1.34
Other reasons	1.3	13.5	0.44

Source: Cetrángolo and Grushka (2005).

The future configuration of the retirement system and its impact on public accounts has yet to be defined – in particular, the real level of public sector benefits and the future coverage of the senior population. At the time of the reform of the system, it was officially expected that coverage would increase. Instead, however, this coverage dropped from 39 percent in October 1994 (measured by the percentage of contributors to the system against employment) to 36 percent in May 2000. Consequently, it has become imperative to come up with alternative sources of financing.

Replacement of Emergency Taxes on Corporate Assets and Taxes on Financial Operations

An aspect particular to Argentina's tax system, which also reflects a more general trend observed in many countries in the region, is the use of extraordinary taxes in emergency situations. The structural difficulties faced by Argentina's tax situation – which has been highlighted by both the lack of sufficient revenues for the financing of expenditures and for the unsatisfactory development of tax on income, as well as for the difficulties in improving efficiency – has led different administrations to resort to the application of extraordinary or emergency taxes, such as the tax on corporate assets and the tax on financial transactions.

Emergency Taxes on Corporate Assets

Attempts undertaken by Argentina to increase the collection of corporate income tax have resulted in extensive legal and administrative difficulties. As a result, Argentina and several other countries in the region have implemented alternative determination methods that, in some cases, will substitute or complement the assessment of the corporate tax base, with the purpose of improving revenues.

In certain instances, these alternative methods have been based on the application of a minimum tax based on assets or, more recently, on gross sales[3]. As a result, a larger fraction of economic activity is subject to the corporate tax, with the individual tax applying virtually exclusively to revenue from personal work at a company.

While in most cases, a rate of around 1 percent on the value of gross assets has been used (see Table 2.10), more recently the use of the value of sales or gross income as a substitute base has been favored, which has given rise to even more discriminatory treatments than the tax itself created.

[3]In practice, the corporate income tax is a payment in advance of those taxes, in order to allow transnational enterprises to fully use the tax credit granted by foreign tax authorities. In other circumstances, and especially in more recent experiences, these alternative methods have tended to provide options to the taxpayer as to the criterion of the determination to be used, with prior authorization from the tax authority.

Table 2.10. Tax on Net Worth, Assets, and Gross Income
(In percentage points)

	1986	1992	1997	2000	2001	2004
Argentina	1.5 on net wealth	2 on gross assets	1.0 on assets	1.0 on assets	1.0 on assets	1.0 on assets
Brazil	-	-	-	-		
Chile	-	-	-	-		
Colombia	8 on net wealth	7 on net wealth	5 on net wealth or 1.5 on gross wealth	5 on net wealth	5 on net wealth	5 on net wealth
Costa Rica	0.36-1.17 on fix assets	0.36-1.17 on fix assets	1.0 on assets	1.0 on assets	1.0 on assets	Rebated
Ecuador	0.15 on assets	0.15 on net wealth	0.15 on net wealth	0.15 on net wealth		
El Salvador	0.1-1.4 on net wealth	0.9-2.0 on assets	-	-	-	-
Guatemala	0.3-0.8 on unmovable wealth	0.3-0.9 on unmovable wealth	0.2-0.9 on unmovable wealth	1.5 on assets	0.2-0.9 on unmovable wealth and 3.5 on assets	Rebated and substituted by a 5% on gross incomes in place of the corporate income tax.
Honduras	-	-	-	0.75 on assets	0.25 on assets	1.0 on assets
Mexico	-	2 on gross assets	1.8 on assets	1.8 on assets	1.8 on assets	1.8 on assets
Nicaragua	1.0 on unmovable wealth	1.5-2.5 on net wealth	1.0 on unmovable wealth	1.0 on unmovable wealth	1.0 on unmovable wealth	1.0 on assets
Panama	1.0 on net wealth	1.0 on net wealth	1.0 on net wealth	1.0 on net wealth	1.0 on net wealth	2.0 on net wealth
Paraguay	1.0 on unmovable wealth	1.0 on unmovable wealth	1.0 on unmovable wealth	1.0 on unmovable wealth		
Peru	1.0-2.5 on net wealth	2 on net wealth	0.5 on net wealth	-		
Dominican	-	-	-	-	n/a	1 on assets

Rep.						
Uruguay	2.8 on net wealth	2 on net wealth	1.5-3.5 on net wealth	1.5-3.5 on net wealth		
Venezuela	-	-	-	1.0 on assets		

Source: Gómez Sabaini (2005).
Note: (n/a) Not available.

In practice, the application of these taxes is the undeniable result of the limitations Argentina has faced in enforcing the corporate tax. In practice, these minimum taxes largely replace the corporate tax, making allocation problems and efficiency worse.

On the other hand, the strengthening of the income tax would require the ability to broaden the base of such tax through the elimination of exemptions and discriminatory treatment benefiting certain individuals and/or sectors of activity and the creation of an improved tax administration.

Taxes on Financial Operations

Argentina was one of the first countries to implement a tax on **‘**banking debits**’** when it did so in 1983 and again in 2001; other countries in the region (Peru, Brazil, Venezuela, Colombia, and Ecuador) followed shortly thereafter.[16] Table 2.11 shows the evolution of the rates applied in these countries. Additionally, it should be mentioned that in some cases, such taxes were applied both to debits and credits, which explains why the collection of this type of tax varies between 0.3 percent of GDP for Argentina in 1990 or 1992 and 3.5 percent for Ecuador in 1999.

These taxes have essentially been used as an easy source of revenue, transferring collection responsibility from the government to financial institutions, so that fiscal administrators play a minor role in its collection. While such taxes were introduced with the specific purpose of improving revenues in the short term and had an emergency nature, their success in generating revenue has resulted in their continued use.

As pointed out by Coelho, Ebrill, and Summers,[17] however, the market response shows that there are adverse effects, including a significant degree of financial disintermediation. In the case of Argentina, for example, the tax administration found that some large companies were using armored trucks to make payments of large amounts of money in cash in order to avoid paying this tax. The information presented in Table 2.11 refers to the different collection productivity in those countries that applied such a tax. In this sense, Brazil, Colombia, and Ecuador have managed to obtain results substantially higher than those obtained by Argentina (although in 2001 collection productivity improved), Peru, and Venezuela.

Table 2.11. Debit and Credit Operations Taxes

Country/year	Rate	Revenue[1]	Productivity[2]
Argentina			
1989	0.70	0.66	0.94
1990	0.30	0.30	0.99
1991	1.05[3]	0.91	0.86
1992	0.60[3]	0.29	0.97[4]
2001	0.60[5]	1.46[4]	2.43
Brazil			
1994	0.25	1.06	4.24
1997	0.20	0.80	4.00
1998	0.20	0.90	4.50
1999	0.22[3]	0.83	3.79
2000	0.34[3]	1.33	3.96

2001	0.36[3]	1.45[7]	3.97
Colombia			
1999	0.20	0.73	3.66
2000	0.20	0.60	3.00
2001	0.30	0.76	2.53
Ecuador			
1999	1.00	3.50 [6]	3.50
2000	0.80	2.33 [6]	2.91
Peru			
1990	1.41[3]	0.59	0.42
1991	0.81[3]	0.46	0.57
Venezuela			
1994	0.75	1.30	2.60[4]
1999-2000	0.50	1.12	2.24
2002	0.75	1.07	1.43

Source: Kirilenko and Summers. in ‘Taxation of Financial Intermediation: Theory and Practice for Emerging Economies,, edited by Patrick Honohan. World Bank, June 2003.
[1]In percentage of GDP.
[2]Tax revenues in percentage of GDP divided by average legal tax rate.
[3]Average of rates adjusted by the time that each rate was valid.
[4]Adjusted by the time that each rate was valid.
[5]On each side of a transaction. Total rate is 1.2%.
[6]The tax applied to debits and credits.

There are several reasons for this behavior. First, the productivity ratio seems to be in inverse proportion with the rate. Second, revenue will be lower when there are close substitutes abroad for domestic banks, as in the case of Uruguay for the Argentine financial market. Tax avoidance is also more difficult when the use of bank checks as a form of payment is more entrenched, as in Brazil.

While this tax has not proved to be so effective as a revenue source, at present, tax authorities consider it an efficient way to capture useful information to control other taxes. Essentially, this tax is a selective tax applied to a specific activity – the use of the bank checks – though in Argentina, it has come to include not only bank debits but also credits with the financial system. This characteristic affects the productivity of the tax since in an operation of transfers among accounts, one transaction is being taxed twice, which increases collection.

Experience has shown that as the tax is maintained in the short term, its rate is low, and there is a low elasticity in the use of the check, then attempts to avoid such tax are expected to be few and far between. If there is a perception that such tax will become permanent and rates will be increased, however, the economic "damage" will be significant and the number of transactions performed in cash will increase. In turn, this has led governments to adopt measures to counteract these deviations, such as the limitation of banking endorsements, by establishing maximum amounts for the operations of recorded assets and other measures that finally affect the efficiency of the economy.

Substitution of Export Taxes

Argentina has often used export taxes to soften the domestic impact of currency devaluations on the price of goods and salaries or to prevent the export sectors from reaping extraordinary benefits. During some periods, these resources were not considered taxes, but were the result of the introduction of multiple foreign exchange schemes that generated quasi-fiscal income in the hands of the Central Bank.

Although these measures represented considerable fiscal income (see Graph 10), they have never generated the massive fiscal revenues such as those revenues collected following the 2002 currency devaluation, which increased the rate of exchange from one to three in respect of the US dollar.

The elimination of this extraordinary source of revenue, which amounted to almost 3 percent of GDP, poses a serious challenge for the next few years and will also impact provincial finances, since, while export duties are only collected by the state treasury, all other taxes are subject to a co-participation system and thus affect both the national and provincial spheres.

Reduction of Tax Expenditures

It is evident that tax expenditures in force modify tax fairness and equity. They create regional or sector “fiscal paradises,” they arbitrarily transfer the tax burden from one group of economic agents to others (who are not necessarily in a better position), they undermine the ability of some non-promoted provinces to obtain financing, and they open the door to tax evasion and fiscal fraud, all of which complicate tax administration.

Not withstanding this group of provisos, Argentina has made substantial use of tax policy, granting some economic sectors (automotive, paper, aluminum, and steel industries) and other regional advantages to certain areas of the country, often on the basis of geo-political or social reasons (provinces of La Rioja, Catamarca, San Luis, San Juan, Tierra del Fuego, among others).

Unlike promotion systems granted by developed countries (Table 2.12), Argentina’s policies have been based on the VAT, shifting the neutrality of the tax and opening opportunities for fiscal fraud, which has been substantial in recent times. Originally, the system of granting tax benefits was established on the basis of the approval of specific projects, instead of utilizing automatic mechanisms, which has encouraged administrative corruption and weakened the transparency of the system. Likewise, we cannot avoid mentioning that, within the provincial systems, local authorities responsible for the application of these projects have often been the very same provincial entities that gain from the tax incentives. In fact, they converted them into a method for transferring revenues that accounts for one of the more complex aspects of the Argentine federal regime.

Table 2.12. FDI Incentives in Developing Countries and Members of the OECD

FDI Incentive	**% OECD Countries**	**% Developing Countries**
Capital goods import duties exempted	5	56
Tax exemption/holiday	20	55
Investment/reinvestment allowance	30	49
Lower tax rate	5	45
VAT exemption for capital goods	0	34
Accelerated depreciation	30	30
Raw material import duties exempted	5	30
VAT exemption for raw materials	5	24
Duty drawback	5	24
Export income treated preferentially	0	20
Loss write-off	0	18
Reduction in local. municipal taxes/duties	30	18
VAT exemption on exported inputs	10	18
Subsidized loans	45	18

Source: Goodspeed (2004).

From the aforementioned, we can conclude that the fiscal cost of promotion (in terms of decreased potential revenues) is merely one of the problems the tax system generates and is not the most significant one. Non-compliance, fiscal fraud, modifications to economic neutrality, and the negative impact on the relative price of factors (effectively lowering the relative cost of capital) constitute economic effects that have not been quantified but are, in the long run, much more important than the loss in fiscal revenues.

We therefore consider it necessary to sanction, in an especially vigorous way, all detected non-compliance and, at the same time, avoid new investments through dossiers that belong to old projects whose benefits have supposedly lapsed. In order to achieve this, substantial changes should be made, such as, the establishment of the Argentine Ministry of Economy as the regulatory authority for the entire promotion system regarding all matters related to taxation. Through the tax collection agency (AFIP), the Ministry should exercise the primary faculty of establishing information criteria, performing inspections and controls according to estimates, initiating legal proceedings, and sanctioning non-compliance. At the same time, it must reorganize the administrative entity and establish a department specializing in the control of promoted companies nationwide. It is fundamental to ensure that tax administrators have appropriate incentives because the control of promoted activities, although not conducive to immediate fiscal revenues, is the only way to ensure that these benefits produce the desired effects and do not simply become tax evasion pockets.

With relation to tax deferrals, required warranties should be adopted to ensure future payments. Such an undertaking demands the dedication of a great number of people and substantial resources. Thus, an alternative to the granting of tax deferrals should be found – a more transparent means that will not hinder administrative actions.

Beyond these general considerations, an in-depth, detailed analysis of the existing situation should be made, since the matter is an administratively complex one and, additionally, a series of anomalous situations have appeared and continue to appear in this field (e.g., as granting benefits by decree, the ‘substitution’ of beneficiaries and objectives in the approved contracts, the ‘renegotiation’ of benefits originally granted, and a long series of political, regulatory, and administrative anomalies that justify evaluation and an in-depth audit).

Table 2.13. Tax Expenditures in Selected Latin American Countries

Countries	Year	Total Tax Revenue (A)	Tax Expenditures (B)			(B)/(A)
			Total	Direct Taxes	Indirect Taxes	
		(% of GDP)	(% of GDP)	(% of total)	(% of total)	(%)
LATIN AMERICA						
Argentina[2]	2001	17.3	3.0	36.1	63.9	17.5
	2003	19.6	2.5	32.7	67.3	12.8
	2004	22.6	2.4	27.4	72.6	10.5
	2005[4]	22.4	2.6	28.6	71.4	11.4
Brazil[2,3]	2001[1]	13.5	1.5	66.7	16.7	11.1
	2002	15.3	1.8	65.2	34.8	11.6
	2003	16.0	1.7	65.3	34.7	10.6
	2004	16.5	1.4	68.6	31.4	8.5
Chile	1998	17.8	4.2	73.8	26.2	23.6
	2002	18.1	4.2	74.0	26.0	23.2
	2005[4]	17.8	4.2	79.0	21.0	23.6
Colombia	1998	14.4	7.4	35.0	65.0	51.4
	1999	14.2	9.2			64.8
Ecuador	2000	11.6	4.9	47.0	53.0	42.1
Guatemala	2000	9.7	7.3	28.0	72.0	75.2
Mexico[2]	2002	13.2	5.3	51.0	49.0	40.2
	2003	12.6	6.3			50.0
	2005[4]	10.9	6.7			61.5
Peru	2003	14.7	2.5	34.0	66.0	17.0

Uruguay	1999[1]	24.1	6.6	20.0	76.0	27.4
	2000	23.6	5.3	11.0	89.0	22.3
OECD						
Australia[2]	1999-2002	24.2	4.3			17.8
Canada[2]	1999-2002	17.6	7.9			44.9
USA[2]	2001-2004	18.5	7.5			40.5
Netherlands	2002	39.2	2.4			6.1

Source: Gomez Sabaini (2005). "Evolución y situación tributaria actual en América Latina: Una serie de temas para la discusión."

[1]The sum is less than 100% because there are tax expenditures included as other taxes.

[2]Does not include tax expenditures other than federal government.

[3]Direct taxes includes Income Tax. CSLL and CFSS.

[4]Forecasted.

Some countries in the region have begun to include an official estimate of so-called tax expenditures in their annual budgets, even when their comparison in time and among countries is limited by the different methodologies adopted and the quality of the data utilized. Therefore, Table 2.13 provides only a rough comparison of the magnitude of tax expenditures in the countries in the region, both relative to GDP and relative to total revenues. To illustrate this further, we include information on some OECD countries, where this type of tax expenditure also seems to be significant.

In Table 2.14, we observe the disaggregation of the calculations for Argentina and the significance of tax expenditures related to VAT, which account for 50 percent of the total estimate. For this purpose, tax expenditures are defined as the amount of tax revenue that the government set aside to obtain as a consequence of a special treatment to specific areas, economic sectors, or certain taxpayers. Estimates of tax expenditures are computed on a cash basis, meaning that the revenue loss is only related to the fiscal year.

The information presented leads us to enquire about the consequences of promotion regimes in force in the region during the last decade; further studies of these expenditures are clearly needed.

Table 2.14. Tax Expenditures in Argentina

Tax	2003		2004		2005	
	Thousands of $	% of GDP	Thousands of $	% of GDP	Thousands of $	% of GDP
TOTAL	9437	2.51	10096	2.37	12157	2.55
Included in the tax laws	7360	1.96	8040	1.89	8946	1.88
Included in incentives laws	2077	0.55	2056	0.48	3211	0.67
VAT	4493	1.20	4941	1.16	5924	1.24
Included in the tax laws	3115	0.83	3709	0.87	4103	0.86
Included in incentives laws	1378	0.37	1232	0.29	1821	0.38
INCOME	2254	0.60	1767	0.42	2392	0.50
Included in the tax laws	2122	0.56	1640	0.39	1765	0.37
Included in specific incentives laws	132	0.04	127	0.03	627	0.13
FUELS	1287	0.34	1662	0.39	1910	0.40
Included in the tax laws	1287	0.34	1662	0.39	1910	0.40
SOCIAL SECURITY CONTRIBUTIONS	763	0.20	935	0.22	1067	0.22
Included in the tax laws	763	0.20	935	0.22	1067	0.22
INTERNATIONAL TRADE AND TRANSACTIONS	253	0.07	315	0.07	336	0.07
Included in incentives laws	253	0.07	315	0.07	336	0.07
PERSONAL GOODS	44	0.01	59	0.01	62	0.01
Included in the tax laws	44	0.01	59	0.01	62	0.01
EXCISES	30	0.01	34	0.01	38	0.01
Included in the tax laws	30	0.01	34	0.01	38	0.01
PRESUMED MINIMUM INCOME	90	0.02	21	0.01	24	0.01

Included in incentives laws	90	0.02	21	0.01	24	0.01
OTHERS	224	0.06	362	0.09	403	0.08
Included in incentives laws	224	0.06	362	0.09	403	0.08

Source: Dirección Nacional de Investigaciones y Análisis Fiscal.

Need to Strengthen Fairness and Equity of the System

Income inequality has increased in this area since the Second World War, and since the 1990s this tendency has not been uniform among countries. On average, inequality has increased in South America but has remained stable in Central America and the Caribbean, as we can observe in Table 2.15. Evidence suggests that there is a converging movement towards unequal income in the entire region. We can likewise observe that among the countries included here, Argentina is the country with the highest increase in inequality (measured through Gini coefficients), moving from third place in the early 1990s to seventh place in the region at the beginning of the current decade.

Table 2.15. Gini Coefficients: Distribution of Equivalent Family Income in Latin American Countries

Country	Early 1990s (A)	Mid 1990s (B)	Early 2000s (C)	Variation (D)=(C)-(A)
Argentina	0.426	0.458	0.504	0.078
Bolivia	0.543	0.558	0.559	0.016
Brazil	0.595	0.583	0.572	-0.023
Chile	0.547	0.549	0.561	0.014
Colombia	0.559	0.543	0.558	-0.001
Costa Rica	0.439	0.440	0.446	0.007
El Salvador	0.505	0.494	0.518	0.013
Honduras	0.556	0.541	0.530	-0.026

Jamaica	0.496	0.515	0.490	-0.006
México	0.539	0.525	0.527	-0.012
Nicaragua	0.542	n/a	0.541	-0.001
Panamá	0.547	0.540	0.544	-0.003
Perú	0.457	0.464	0.477	0.020
Uruguay	0.408	0.409	0.425	0.017
Venezuela	0.417	0.445	0.455	0.038
Simple average	**0.505**	**0.507**	**0.514**	**0.009**
Weighted average	**0.519**	**0.512**	**0.515**	**-0.004**
Rep. Dominicana		0.502	0.481	
Ecuador		0.530	0.543	
Guatemala		n/a	0.560	
Paraguay		0.578	0.549	

Source: Gasparini (2003).

It is a well known fact that in Latin America, the effects of the tax system on income distribution have always been an issue that presents great conceptual and methodological problems. Perceptions of the role of taxation on income have not only changed during the past decades, but the effects of taxation policies continue to be discussed, since many studies of such policies have encountered great conceptual and empirical limitations.

Answering the question “Who pays taxes?” is difficult, despite the decades of work in this field.[18] As indicated further along, a more optimistic message can be obtained from the economic policy viewpoint: it is more convenient to analyze the marginal effects of tax reforms than to look at the average of existing structures.

In the case of Argentina, several studies indicate that progressiveness has declined over the years – trend that is contrary to expected changes in income distribution.[19] In this sense the ‘tax structure’ is the most important factor which determines this result, since taxes on income are basically progressive and taxes on consumer goods are not. Although the global level of taxation has increased throughout the last few decades, as indicated previously, taxes on income have not evolved accordingly. Thus, given the relatively low burden of taxes on personal income, distributive effects of the tax system have been low, and the evidence shows that no redistribution changes have been produced as a result.

This poses a question regarding the ability of the tax system to capture an increasing percentage of revenues through taxes on personal income, selective taxes on luxury items, or equity taxes. In this respect, the orientation of changes in the Argentine tax system has not been favorable.

Taxes on personal income have not increased; in fact, they have decreased slightly, since taxable bases did not expand at the same time as tax rates dropped. Likewise, we have observed a growing participation of general consumer taxes (VAT), which have suffered a process of taxable base expansion as well as a sustained increase in the overall tax rate. Selective taxes have concentrated on items of low price flexibility (beverages, tobacco, etc.), whereas taxes on luxury items were eliminated. Lastly, taxation on equity has been low, as coverage of these taxes is reduced, in the case of fixed assets valuation does not match market price and collection coefficients are not adequate.

Table 2.16 shows the results of the 1997 tax distribution incidence, based on studies of the Argentine case. This demonstrates the existence of a regressive tax system, in contrast with the behavior of industrialized countries.

Table 2.16. Tax Burden in Income Deciles for the Entire Tributary System, Argentina 1997

Economic classification of taxes	Overall Average	Percentage of cases corresponding to each group		
		20% lower income	70% middle income	10% higher income
Income taxes	4.91	2.52	3.08	7.17
Social Security Contributions and withholdings	11.34	16.30	13.78	8.19
Wealth taxes	2.83	2.21	2.41	3.36
Goods and Services	19.59	25.93	20.81	17.76
Foreign Trade	1.66	2.30	1.76	1.51
Other Taxes	2.07	3.03	2.23	1.81
Total	**42.39**[1]	**52.29**	**44.06**	**39.80**

Source: Santiere. Gómez Sabaini y Rossignolo (2000).

[1]The Average Tax Burden of the System is 42.39%, a particularly high figure, as a result of several factors, among which we note- (i) the tax concept adopted encompasses more that is usual in other investigations; (ii) the GDP suffered a reduction in the recent National Accounts estimate; (iii) the definition of Family Available Net Income is notably more restricted that the one applied in previous investigations; (iv) in every case, Available Income is a figure that reflects values that are much lower than GDP and therefore, tax pressure in respect of GDP (conventional tax burden) has to be lower than the quotient between the same mass of taxes and Available Income.

The information gathered allows us to define a slightly regressive tax system, with a tendency towards proportionality. This definition is confirmed by estimates of the inequality index which, in the case of the Gini, increases its value when inequality grows. The proportionality condition is not positive from the point of view of equality, because we expect a developed tax system to comply with the requirement for vertical equality, according to which those with larger incomes should face a higher tax burden than those with lower incomes. In other words: we would expect the tax/income quotient to be lower on average in the lowest income groups and higher than average in the groups with higher economic capacity. This condition did not prove true in Argentina in 1997.

Lastly, we must indicate that investigations on the matter of tax distribution conducted in Argentina have, actually, been limited to the evaluation of several taxes (VAT, income, etc.), but the first overall effort dates back to 1965 and was part of the general analysis of taxation in the country. Then, the average tax burden (taxes / family income) was 19.5 percent and individualized by sectors showed a relative proportionality around the mean, with a small increase in the last section. The second study takes data centered on the year 1986 (Santiere 1989). The methodology of this study was to analyze the tax burden on different deciles of the population, as classified by their income levels. In 1999, Santiere and Gómez Sabaini recalculated the year 1986 to make it as compatible as possible with the methodology employed and allow dynamic comparison with the studies in 1993 and 1997. The analysis of this eleven-year period served to demonstrate the regressiveness of the Argentine tax system in regards to the selected well-being indicator, total family income. The trend is more marked in 1993 and 1997.

Towards the end of 1998, an investigation was published by Leonardo Gasparini who, after elaborating an extensive series of alternatives, presented a wholly regressive system in reference to per capita family income, which is slightly more progressive if the well-being pattern adopted is the family's or individual's global consumption.

The above-mentioned endeavors and their results offer a rather coherent picture, leaving us with little doubt as to the regressiveness of the tax package in force in Argentina, always taking into account that the contrast variable is available income.

Finally, the latest investigations confirm renewed interest in the distribution and equality aspects of the taxation system, following a period in which this matter was largely ignored and attention was paid to the phenomena of automatic development of the economy, globalization, and other aspects related to economic policy.

Strengthening of the Tax Administration

The weakness of the tax administration has always been one of the main problems affecting the Argentine taxation system, and the response to this issue has been the least positive. This weakness is evident in the sphere of provincial tax administration (twenty-four jurisdictions) and even more so when one examines municipal tax administration (1500 municipalities).

To this end, the Argentine government set up the Federal Agency for Public Income (AFIP) in 1997 and took over unified control of national taxes (domestic resources, social security, and customs duties), following the guidelines viewed at the time as a solution for all Latin American tax administrations. The AFIP, which employs nearly 20,000 people, was granted administrative independence and its budget was financed by a predetermined percentage of the entity's total revenues.

A decade after its establishment, it is significant that one of AFIP's future objectives is to deepen the process of integration among its constitutive entities, since uniting the General Tax Bureau (DGI) and the General Customs Bureau/DGA) has still been more of a proposal than a fact.

Together with these administrative measures, the administration was supported by legal regulations that allowed for the honorable exit of a great mass of contributors who were not subject to any type of control by the entity, both regarding their statement and payment of income tax and compliance with social security obligations. With this in mind, legislation was passed on the 'Monotributista regime,' which consisted of a fixed-payment system that accorded different levels or categories under which contributors were enrolled. The payment system was a substitute for all other taxes (personal income tax, VAT, and social security contributions) and currently encompasses 1,200,000 cases, over which the AFIP wields minimum controls. This system, seemingly benign, is one of the most serious problems faced by the tax system, as it has permitted the incorporation of a mass of potential income tax and VAT contributors, which affects both the equality and the economic efficiency of the system.

In the past few years, it is noticeable that tax administrators, not only in Argentina, but in Latin America as a whole, have consistently placed the weight of tax administration on controlling VAT compliance. In this regard, we observe that countries have invested large amounts of money to improve tax compliance – and perhaps tax evasion is in decline – however, investigation of this phenomenon is limited. Tax non-compliance involves the performance of illegal actions, with the purpose of reducing tax payments, defined as evasion, and the temporary deferment of payments, known as arrears. Although arrears imply a delay in the availability of funds for the state, evasion results in the loss of state revenues and inequality in the distribution of the tax burden. This generates disloyal competition among evaders and those who are in compliance, as well as the inefficient distribution of economic resources. In order to estimate VAT compliance, the AFIP[20] calculated potential revenues, corresponding to VAT revenues that would have been collected if all those responsible had liquidated and paid their obligations in full and compared it to revenues actually collected. Through this methodology, potential revenues were determined by adding VAT contained in purchases that do not generate fiscal credit – that is, end consumer purchases and those of contributors who are tax-exempt or to whom this tax does not apply. During the period examined, non-compliance reached a maximum of 34.8 percent in 2002. Between 2003 and 2004, there was a marked drop in non-compliance, and last year, VAT non-compliance was 24 percent, the lowest in the series (Table 2.17).[21]

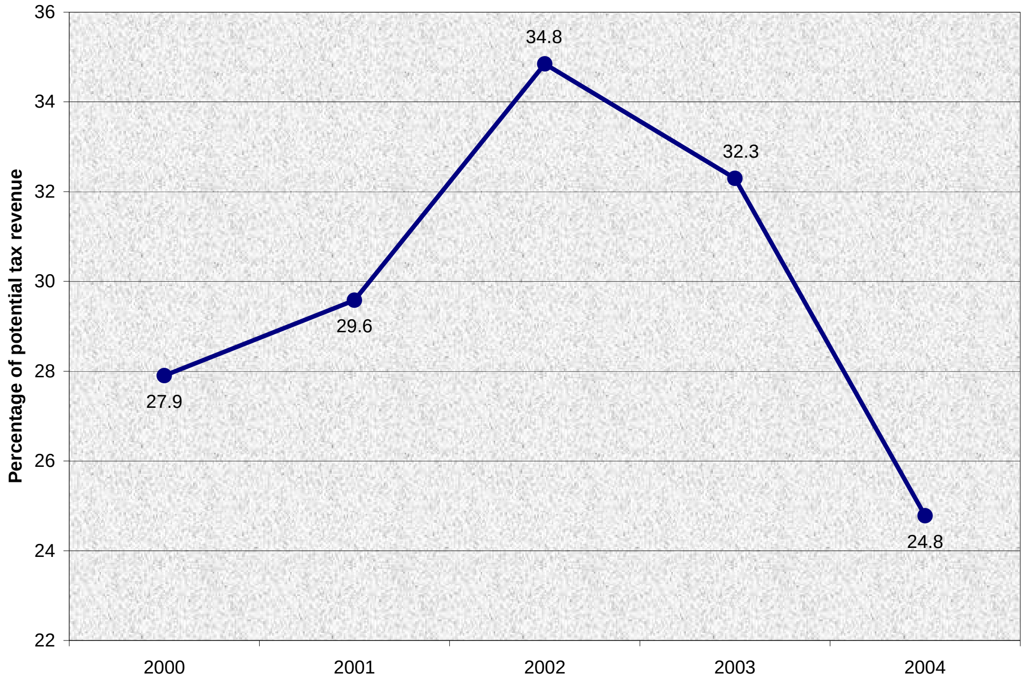
Table 2.17. Estimation of VAT Evasion[1]. Potential and Effective revenues.
(In thousands of Pesos)

	2000	**2001**	**2002**	**2003**	**2004**
Potential Revenues (A)	24,281,104	22,651,886	24,305,698	31,821,691	38,542,803
Adjusted Effective Revenues (B)	17,507,175	15,951,530	15,836,045	21,545,103	28,992,953
Evasion (C=A-B)	6,773,929	6,700,356	8,469.653	10,276,588	9,549,850
Evasion in percentage (D)=(C)/(A)*100	27.9	29.6	34.8	32.3	24.8

Source: AFIP (2005). "Estimación del incumplimiento en el IVA, Años 2000 a 2004."
[1]Including tax arrears.

The improvement in tax compliance is mainly the result of two factors: the procyclicity of tax collection and the increased efficiency of the tax administration. Increase in tax revenues tends to follow closely intensified economic activity, if all other variables conditioning this activity hold stable (tax rates, taxable base scope, etc.) The second factor is the group of new measures implemented by the tax administration to reduce non-compliance.

Graph 2.13. VAT Evasion



Final remarks

There are several imbalances that affect the Argentine taxation system. First, the public sector's financial situation has become highly unstable due to erratic revenues and its dependence on the economic cycle. Second, a structure which leans too heavily on direct taxation and which is extremely 'allergic' to taxing personal income and equity, affects the equality vital to any tax system.

Additionally, the disorderly process of decentralizing expenses towards sub-national jurisdictions with significant productive development differences has resulted in an accentuated lack of correspondence between expenses and income at the federal level. This has been resolved by a significant dependence of asset transfer systems between jurisdictions that are not sufficiently transparent. Likewise, we see a predominance of exception mechanisms which, under the relatively light burden of income tax, have been granted to VAT and thus lead to severe inefficiency in the assignment of resources.

Lastly, the great significance of the informal economy, added to the weakness of the administration both at the state and provincial tax levels, not only involves the loss of resources, but also aggravates existing differences in equality and domestic competitiveness.

Specifically, throughout this work, eight main features of the present situation and six main challenges facing Argentina's tax system have been identified. In summary, the main characteristics or stylized factors quoted are:

a. sustained growth of consumers taxes;
b. gradual loss of resources from import duties;
c. intermittent but significant presence of export taxes;
d. poor performance of income taxation;
e. irrelevance of wealth taxes;
f. importance of payroll taxes;
g. the use of emergency or extraordinary taxes; and
h. the importance of tax expenditures.

Finally, the main challenges ahead that have been identified in relation to the Argentine tax system are:

a. financing of the social security system and its effects at the different levels of government;
b. replacement of emergency taxes on corporate assets and taxes on financial operations;
c. the substitution of export taxes;
d. the reduction of tax expenditures;
e. the need to strengthen the fairness of the system; and
f. the strengthening of the tax administration.

Notes

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[2] Oscar.cetrangolo@cepal.org.

[3] gsabaini@ciudad.com.ar.

[4] For a review of the macroeconomic aspects in this period, see Heymann, D. (forthcoming) 'Buscando la tendencia' Work Study by ECLAC, Buenos Aires.

[5] These aspects are fully reviewed in Carciofi (1990) and Cetrángolo et al (1997).

[6] It is common to see analyses of Argentina's situation in which the provinces' governments are ascribed the highest responsibility when the aggregate fiscal problem is explained.

[7] These aspects are discussed by Cetrángolo and Jiménez (2003).

[8] Between 1991 and 1995 cumulative revenues from privatizations accounted for 2.7 percent of GDP.

[9] Additionally, if we consider the consolidated result (including that of provinces' governments) the surplus amounts to 3.5 percent for 2004.

[10] This relation in Brazil is 7.2 (between Federal District and the State of Maranhão), and in Mexico 6.2 times (between Federal District and Chiapas). This same relation in the case of Canada is only 1.7 times.

[11] The graph shows the provinces ranked by GDP per capita and by education evaluation results, from high to low, and infant mortality rate, from low to high. For a further

analysis of these matter see Gatto, F. and Cetrángolo, O. (2003), 'Dinámica productiva provincial a fines de los noventa,' Serie estudios y perspectivas N° 14, CEPAL, Buenos Aires.

[12] There are no series of tax resources from governments of municipalities. Between 1993 and 2000 tax collection from municipalities was 0.07 percent of GDP.

[13] During the first three years of the convertibility regime, consolidated tax revenue grew fast and reached 22 percent of GDP in 1993, as a consequence of the plan of stabilization and its impact on revenues due to collection lags ('Tanzi effect').

[14] There are no series of tax revenues from provinces before 1950.

[15] An in-dept analysis of this problem is found in Cetrángolo & Grushka (2005).

[16] Outside the region, Australia also implemented in 1983 a tax on debit banking, which subsequently reached a provincial level and which currently is under study for its abolishment.

[17] Coelho, L., Ebrill, L., and Summers, (2001), page 24.

[18] De Ferranti, D., Perry, G., Ferreira, F., y Walton, M., (eds.), (2004), chapter 9.

[19] Gómez Sabaini and others (2002) and Santiere and others (2000).

[20] AFIP (2005).

[21] Information utilized came primarily from the National Accounts System. They used the supply-product matrix for 1997, updating it with value indexes for the years of the series being analyzed. In order to determine potential revenues, first, the theoretical tax base was calculated according to taxable household consumption (household consumption less consumption that is exempt or non-taxable) to which they added intermediate consumption and taxable investment for production of exempt goods and services, and

the consumption of public sector taxable goods and services and investments, since their VAT content cannot be deducted at later stages. Following that, they estimated potential revenues by applying the most appropriate VAT rates to each item. Thus, a general 21 percent taxable base rate is applied to household consumption, and, in specific cases, this rate drops to 10.5 percent for some products and services (some agricultural products, passenger transport and health care services, among others). For intermediate taxable consumption for the production of exempt or non-taxable goods, VAT is 10.5 percent for capital goods and services such as soil preparation and rotation, 27 percent applies to some public services, and 21 percent to the remaining goods and services acquired during the production process. In the case of taxable investment for the production of tax-exempt and non-taxable items, the overall rate is 21 percent, except for purchases of capital goods, where the rate is10.5 percent. The same 10.5 percent rate is also applied to new constructions and household improvements. Finally, in regards to the state taxable base, made up of goods and services expenses and taxable investments, the VAT rates applied are the same used for aforementioned goods and services.

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