Heavy Metal

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"**Ain't nothin' like it, her shiny machine".** So sang Van Halen, one of America's most successful heavy metal bands in the 1980s, in the song entitled "Panama". It's certainly so now and between 2005 to 2010 that country's economy grew by over 8% a year; it was the fastest rate in the Americas which is not surprising when one sees the amount of heavy metal machinery, rather than music, in the streets of the capital as new construction springs up like mushrooms across the city. Panama is set to overtake Costa Rica and Venezuela in Gross Domestic Product (GDP) per head and as for Foreign Direct Investment (FDI), it has received an amount that comes close to 9% of GDP – the largest share on the continent.

Significantly, after signing a Double Tax Treaty with France and therefore reaching the required number (12) of such treaties, the country was elevated in July to the Organisation for Economic Co-operation and Development's (OECD) white list which comprises countries willing to work against tax evasion. Ironically, France had previously told its country's banks to exit the country due to Panama's former stand on taxes.

Regional income tax co-operation, however, is also needed (I mentioned a return to this topic in Issue 218, Come Together). At the same time income inequality (a distinctly developing country problem) has to be addressed. Unfortunately, the popularity of indirect, over personal, taxes which are easier to collect, fall hardest on the poor. The contrarian view, shared by many economists in developed countries which have less income extremes, believes that taxes should be switched more from income and investment to consumption taxes; these countries, of course, also have established tax systems in place – not that the picture is an ideal one.

Take the United States of America where in California the top 1% of payers by income accounted for 43% of income tax revenues in 2008. You might be interested to know also that in the US as a whole, the last figures I have show that the top 1% paid 38% of federal income taxes and the top 5% paid 58%. And if the Latins do have confusing tax systems (more to follow), consider this: America's tax code has grown from 2.4 million words in 2001 to 3.8 million last year. Lost for words takes on a new meaning.

It is estimated that developing countries receive just 15% of global Foreign Direct Investment – despite having 80% of the world's population – and as this percentage is surely going to steadily increase, Latin America must ensure that investors are faced with a less complex tax system. (Chile is considered the most attractive place to invest, followed in descending order by Mexico, Brazil, Perú and Colombia).

How can the system be made more welcoming? This is the challenge. Within the OECD, active foreign trade business is sometimes subject to special rules for passive income and the territorial tax system, already found in Panamá, is applied. What might evolve in Latin America is not clear, but I fear we are light years away from a Latin American solution.

Although Latin American countries are signing international tax treaties, co-operation is not the sole motive: they want to promote FDI – and therefore growth – in their respective countries. To the surprise of many, including myself, Panamá, the region's banking centre, has signed a Tax Information Exchange Agreement with the US, supposedly on the strength of perhaps securing a profitable trade agreement with Washington (see The Tortoise and The Hummingbird, Issue 217). Encouragingly, with countries in Latin America beginning to trade more with each other, we are seeing regional tax agreements being signed as well, such as the one between Argentina and Ecuador which covers all taxes in both countries and will apply to taxes modified or added in the future. Such co-operation is a very positive step in achieving regional tax integration.

Up to now the most popular model which has been used to negotiate treaties has not been the OECD template, which is associated with International Financial Centres especially, but the one offered by the United Nations Tax Model Convention. Latin America is included on the Committee of Experts on International Co-operation of Taxation Matters formed by the UN and currently the representatives are Uruguay, Perú, Chile and Mexico. If this approach has caused bristling in Brussels the fact remains that the OECD assumed a symmetry in the commercial exchange among nations whereas more FDI from developed countries into developing countries puts the tax authorities in the latter case at a disadvantage. What the UN model achieves is a fairer balance between the respective revenue interests, granting greater relevance to taxation at source.

Consequently, a criticism is that the measures adopted in tax treaties are mostly in favour of developed countries with their greater negotiating power, a revelation none of us will be shocked by. Assuming Panamá gets its free trade agreement with the US, it is clear that free trade agreements come at a price and the implementation of tariff reductions results in a corresponding decrease in fiscal revenues. The Inter-American Development Bank says, for instance, that participants in the Central American Free Trade Agreement (CAFTA)(Costa Rica, El Salvador, Guatemala, Honduras, Dominican Republic and Nicaragua) with the US will lose between 3 per cent and 6 per cent of their fiscal revenues because of it. This loss of revenue has to be compensated for with other taxes and a value-added tax is the common route. In Chile and Venezuela it represents almost one-half of total fiscal revenues obtained from taxes and in Argentina, Brazil and Mexico the amount is one-third. But remember, the burden falls on the shoulders of those least able to pay it.

If most Latin American tax systems remain, in varying degrees, a quagmire open to manipulation and often suffering from under-staffed and under-financed tax authorities, what might be the way forward for improving Latin America's international tax policy? In order to encourage FDI and at the same time collect fiscal revenues from it without discouraging investment in the first place, the region's countries need to work towards greater tax co-ordination and integration despite disparities in their tax systems.

A first step would be a uniform Latin American Income Tax Treaty in conjunction with an effort to reach more agreement over tariffs so that the CAFTA experience of losing up to 6% of fiscal revenues can be avoided. Panamá did not join in CAFTA and let's hope that by holding off the separate free trade agreement it expects from the US will not turn out to be worse.

But a general Latin American Income Tax Treaty faces the almost insurmountable task of achieving compatibility, co-ordination, co-operation and convergence; some degree of this has been achieved by Brazil, Colombia, Uruguay, Paraguay, Chile and Mexico through exemption or tax credit systems and a "deep integration" pact between the fast-growing and market-led economies of Chile, Perú, Colombia, and perhaps Mexico, is promising. The members of the pact represent a combined gross domestic product of USD1,600 billion and provide a counterweight to Brazil's prominence. If, however, the whole region is to have a uniform Tax Treaty, a Latin American body must be formed to oversee the process. That said, one institute already in place in Panamá, the Inter-American Centre of Tax Administrations, is recognised for its regional tax expertise so this might be the answer.

As to solutions, one president in the Americas described his tax system as "complicated, unfair, cluttered with gobbledygook and loopholes designed for those with the power and influence to hire high-priced legal and tax advisers". Any country in the region fits the bill except that in this case the country was the US and the president was Ronald Reagan making a televised speech in 1985.

Many agree that the world's tax systems, in general, are a headache, but if you can navigate the shoals, and get a good adviser, the adventurous will find the hidden treasure that Latin America has always promised to the bold. Just be sure to have some aspirin handy.

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