A REVIEW OF PROPOSALS FOR TAX POLICIES AND ADMINISTRATION IN BOLIVIA

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December 11, 1993

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I. Introduction

The 1986 tax reform in Bolivia was comprehensive and highly successful. Since that time the economy has moved from a state of hyperinflation to one of economic stability and growth. As this process continues there will be a need for additional government revenues to develop social and physical infrastructure that Bolivia needs to achieve a high rate of economic growth.

The tax changes that have been put forth build on the 1986 tax reform. At the same time as modifications are made to the existing tax system, great care must be made to make sure that the changes add to the stability of the tax system and not introduce changes that will simply create political and business forces that over time will erode the ability of the system to generate revenues.

In this note we will analyze the following measures:

(1) Eliminate the present standard deduction of two minimum salaries for employees and one of the two minimum monthly salaries as a standard deduction for independent workers from the complementary VAT (RC-IVA).

(2) Either improve the existing Presumptive Income Tax on Businesses or replace it with an alternative form of business income tax.

(3) Improve the Structure of the Excise tax system.

(4) Implement a number of administrative reforms to enhance compliance and collections.

II. Improve the Complementary VAT (RC-IVA)

The complementary tax on wages and salaries of 13 percent was not designed to raise revenue but to encourage the issuing of VAT invoices by business through the creation of a demand for these invoices by the public. Individuals can reduce their payments of the complementary VAT by an amount equal to 13 per cent of the VAT receipts they cumulate or purchase over the period.

An active trade exists in official VAT invoices from individuals that have a surplus of official invoices to those that have a deficit. At the present time, however, there is large surplus of unutilized VAT invoices. This is reflected in the fact that such invoices are sold on the street at a price of 1.5% of the face value of the invoice, while their value to the buyer is 13% of the face value.

To reduce the number of unutilized invoices in the economy, it has been proposed that the standard deduction of 2 minimum wages be eliminated for both employees and independent workers, and a standard deduction of only one minimum wage be retained for the independent workers. The principal problem with this proposal is that it would require many small income earners to have to retain their VAT invoices and file to reduce their complementary VAT tax payments each payment period with their employers. This process inflicts huge compliance costs on business and low income individuals, for little or no revenue gain or reason for improved VAT compliance.

An alternative proposal that would eliminate the excess VAT receipts in the system, while at the same time generating a net income transfer to the poor, would be to simply reduce the value of the complementary VAT by an amount of only 5 per cent of the official VAT tax invoices rather than at the current rate of 13 per cent. In this way the higher income individuals that have income well over 2 minimum wages would have to submit invoices substantially in excess of their earnings. This would create a large demand for the excess invoices of others and would tend to raise price of these invoices to approximately 5% of their face value. Once the price of the traded invoices approached 5% of the face value of the invoices, the individuals subject to the complementary tax would be indifferent between buying invoices from the street and having the government deduct the taxes. At the same time the low income workers that were earning less then the standard deduction of 2 per minimum wages would earn approximately 5% percent of the value of their expenditures through the sale of their official VAT invoices. This would make the VAT more progressive than it is currently.

It is difficult to know what is the rate of credit for the submission of VAT invoices that would result in the total absorption of the quantity for sale on the market. One thing is for sure, the rate is substantially lower than the current 13 percent rate, because there is now exists a large excess supply. We would recommend that the rate of credit be dropped to about 5 per cent in the hope that almost everyone earning more than 2 minimum wages would pay some tax.

It is desirable that all of the higher income individuals pay some complementary VAT (RC-IVA), because this would reduce the incentive to avoid paying a business income tax (if one were introduced) through the payment of wages and salaries to the owners. In addition, it would raise the tax revenue yield on an aspect of the Bolivian tax system that is now creating huge compliance costs but little or no revenue.

The complementary VAT (RC-IVA) inflicts huge compliance costs on both employees and employers with very little tax revenues being generated. Each period each employee has to fill out a long and complicated form, plus cumulate or purchase a large array of VAT invoices. In turn, all employers must calculate a new amount of withholding on a monthly basis for each employee. This is a very heavy compliance burden, which at the present time is yielding insignificant revenues and very little benefits in terms of increased VAT compliance because their is an excess supply of VAT invoices for sale on the street at about 10 per cent of their tax value. Over time as the administration of the VAT is strengthened through auditing and enforced collections, the complementary VAT (RC_IVA) should be eliminated in favor of turning it into a general low rate income tax that would yield substantial revenues. This could be done by simply eliminating the possibility of reducing the amount of tax being withheld by submitting the VAT invoices.

III. Improve the Presumptive Income Tax on Business Income by Introducing a Simplified Business Income Tax System

Law 843 of 1986 established a "Presumed" Income Tax on corporations, which is based not on income but on total net assets. This radical concept was introduced as a means to reduce evasion, and simplify tax administration. The theory is that assets are difficult to hide, and therefore corporations would find it much more difficult to escape taxation.

The presumed tax has produced some revenue, but the results have not been dramatic. These disappointing results probably are due to the fact that the tax is based on net, rather than gross, assets. Businesses are able to reduce their tax burden simply by increasing their debt burden. This can be done either artificially or bona fide. For this reason, a tax based on gross assets (but at a much lower rate than the current rate on net assets) would be preferable. It should be noted, however, that both the net and gross assets calculations have serious defects. First. any tax that is based on assets could discourage physical capital investment as compared to intangible assets. Second, the tax does not vary in accordance with a business's fortunes: such a tax is too light in a good year, but could potentially drive a business into bankruptcy in a bad year. Third, an assets tax encourages businesses to distort their financial statements (to lower the value of their assets), which is unhealthy for the economy in general. Fourth, an assets tax is not creditable in home country of many foreign investors. This discourages foreign investment because an uncreditable tax increases an investor's total tax burden while a tax that is creditable normally does not.

A corporate tax based on cash-flow has been proposed as a substitute for the current tax. This proposal is quite interesting, but also suffers from various defects. As with the assets tax, a cash-flow tax would not be creditable in the home country for many foreign investors. Hence, from the point of view of foreign investors it is not an improvement over the gross or net asset tax.

A cash-flow tax also favors large businesses over new businesses. A business that has been operating for several years will be able to use all of its current expenses, including new fixed investments, against its established income stream. A new company, however, may have to wait a number of years before its income stream is sufficient to make use of all its deductions for current expenditures. Again, the difference between the present value of the deductions in each case is significant.

Perhaps more important, the immediate deductibility of expenses would have drastic negative consequences on revenue. Under a cash-flow tax the present value of the tax on any new investment is approximately zero because the full amount of the investment is deductible in the year it is made. Hence, the revenue from a cash-flow tax would mainly arise from the taxation of cash flow of existing assets. Over time we would expect the revenue obtained from a cash flow tax to fall as new assets become a larger proportion of the capital stock generating the cash flow.

For these reasons, no country that has considered this tax has implemented it.

We agree with the proposal to reestablish a corporate income tax based on net income. Such a tax is creditable for foreign investors, varies according to a business's actual performance, should produce increased revenue, does not discourage physical capital investment relative to intangibles, and treats all businesses more or less equally according to their economic performance. We note that the corporate income tax was abandoned in 1986 because it was not working. There are several means to ensure that this does not happen again.

Most importantly, we encourage a simple tax with few deductions, no special incentives, and a low rate. Simplicity provides a taxpayer with fewer means to evade tax, and facilitates the tax agent's auditing task. Two categories of deductions, interest and depreciation, are unavoidable. Nevertheless, relatively new methods for controlling these deductions have been developed that are fair to the taxpayer, easy to administer, but protect the government's revenue.

With regard to depreciation, we propose that companies be required to place all depreciable assets (other than real estate) in a single "pool." A deduction is allowed for a fixed percentage of the pool's account balance, and there is no asset "life." Rather, the balance of the pool is decreased by the amount of the deduction allowed, and increased by the value of assets acquired, and adjusted for inflation. This system also solves the problem of capital gains and losses: the account balance is simply reduced by the sale price of the assets sold.

The foregoing explanation of the pool system is overly-simplified. However, the system is much simpler than traditional depreciation systems (not to mention the capital gain/loss problem it solves) and has been successfully implemented in several countries, including Canada.

The interest deduction has long been used as a means to reduce corporate income tax. The determination of whether a financing expense is deductible has become a complex area in tax administration. Many countries, including the United States, have resorted to limiting interest deductions as a means to control revenue loss from the deduction of certain interest expense. We propose a system that would limit the maximum interest deduction to an amount equal to interest income, plus a fixed percentage (about 30%) of a company's net income (calculated without respect to interest income and interest expense). Interest expense that cannot be used in the current year can be carried forward and used in future years.

We note one common abuse of the current system, that many employers pay less than one-third of their employees' salaries officially, in order to evade social security and other taxes. Under the current system, there is no disadvantage to the employer. Under a real income tax, salaries are deductible, so businesses will be anxious to declare all wages. You can expect to see a rapid increase in the reported salary levels of Bolivians.

Finally, we note that even a simplified corporate tax can be abused. For this reason, an improved tax administration is essential to the success of the new tax. This cannot be overemphasized. In this regard, we note that limiting deductions, as explained above, is only half the battle. The business's gross income must also be controlled. The VAT is critical in this half of the equation. A well administered VAT makes it much more difficult to underdeclare gross receipts as that is also the base for calculating the amount of VAT owed, before deduction of tax credits.

Even so, we recognize that the current weakness of Bolivia's tax administration could undermine the success of the tax. For this reason, Bolivia may wish to retain a gross assets tax as an alternative minimum tax. Mexico has implemented this approach, and they believe it prevents companies from evading the corporate income tax. However, two things should be noted: the alternative minimum tax must be carefully designed or the entire corporate tax would be rendered non-creditable for foreign companies; and having this alternative minimum tax will require the tax administration to administer not one but two corporate taxes. therefore, this issue must be considered carefully, and perhaps implemented as a temporary measure.

IV. Improve the Structure of the Excise Tax System

The proposal to reduce the excise tax rate on beer to 40% but to levy this tax on the retail price is an excellent one. The tax should still be collected at the point of manufacture or import, but the government should set the price of beer that is to be used as the tax base for tax calculation at the retail level, and adjusted every three months. These retail check prices can be estimated through a supplementary question to the regular survey carried out by the central bank (or the national statistical agency) to calculate the consumer price index for the period. Once this system is tested for the excise tax on beer, it might be extended to other commodities on which excise tax is levied.

It is also an excellent idea to eliminate the inheritance tax and to transform the tax on residents traveling abroad into a tax on airline tickets.

It is likely to be a good idea to eliminate the taxes under the Regimenes Simplificado, Integrado Y Unificado, but at the same time a system should be instituted to create a threshold to eliminate the very small VAT taxpayers out of the system. These small taxpayers yield little or no revenue, yet often absorb a large share of the scarce administrative resources.

V. Improvement of Tax Administration

To improve the administration of the tax system we would recommend the following measures be undertaken:

1. Taxpayers should declare to the tax department which bank, and which of its branches, will be the one through which they will always be paying their taxes, unless they notify the tax department of a change in their "tax bank".

2. A legal, information and management system be set up to implement a process of enforced collections, within the tax department. Hiring private debt collectors without the corresponding legal authorization of enforcement, will likely just yield political embarrassments for the government.
3. If private auditors are to be hired, a heavy set of penalties should be imposed on them if they are caught being engaged in any irregular practices. A small monitoring unit should be set up to check on the work of the private auditors.
4. An information system should be instituted to link information on imports, by taxpayer number, to the VAT administration system.