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REFORM FINANCE AND A LATIN AMERICAN COMMON MARKET: SOME "HARMONIZATION" PROBLEMS IN TAX POLICY

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REFORM FINANCE AND A LATIN AMERICAN COMMON MARKET: SOME "HARMONIZATION" PROBLEMS IN TAX POLICY*

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Statesmen and economists in Latin America generally agree on the need for "coordinating and harmonizing" economic policy in order to facilitate economic integration.[1] Our knowledge, however, seems to

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1/Felipe Herrera, José Antonio Mayobre, Raoul Prebisch, and Carlos Sanz de Santamaría, "Proposal for the Creation of the Latin American Common Market," a reply to an invitation extended by President Eduardo Frei (Chile), April, 1965. For earlier example, see the "Joint Declaration of the Presidents of Brazil and Chile," issued at Santiago, April 24, 1963.

stop at the recognition that there is such a need. Which policies are to be coordinated? What, exactly, does "harmonizing" mean? How much of it is required, how soon, where, and why? What internal economic effects are likely to follow tax changes made in order to facilitate economic union with other countries? How can major domestic programs such as agrarian reform be tax-financed without impeding economic union? And conversely, how can governments controlled by traditional oligarchies be prevented from postponing tax and social reform on the pretext that increased costs would make it impossible to compete in the common market?

I. The Theory of Tax Union: Some Definitions

A. Harmonization

The term "harmonization" means the adoption by each member country, preferably following consultation with the rest, of tax policies that make it easier to attain the desired kind and degree of economic union.[2/] It does not require "tax equalization," in which tax bases and rates would be identical in all member nations. It may not even require "tax standardization," in which tax bases and structure are generally identical, but rates and major exemptions may differ.

This definition excludes many laudable policy changes from our analysis, such as the 1963 tax reforms in Chile and Colombia.[3/] There was no intent to make it easier to achieve regional economic integration

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[2/]These definitions, as well as the difference between tax reform and tax harmonization, were suggested by Carl S. Shoup in "The Theory of Harmonization of Fiscal Systems," General Report to the Congres de Luxembourg, Institut International de Finances Publiques, 1963 (Mimeographed).

[3/]Both countries raised rates under the income tax. Colombia prohibited the deduction from other incomes of alleged losses in beef raising. Chile simplified its schedular system (continued on next page)

in the drafting of these reforms. Rather, they were guided entirely by domestic considerations and by the "accepted wisdom" on tax policy for underdeveloped countries implicit in the Alliance for Progress program.[4/]

Although there is no reason to predict this in the Chilean and Colombian cases, some tax changes "good" in a national context may hamper economic integration. Reforms that widen existing tax differences may distort cost comparisons and make it much more difficult to predict the economic results of integration. By raising doubts about the ability to compete fairly, they make it harder for governments and citizens to accept economic union.

Harmonization measures, which tend to remove such fears and doubts, may involve one specific tax, a class of taxes, or an entire monetary and fiscal system. The necessary changes may be simultaneous, or countries in different situations (or degrees of underdevelopment) may move at different rates toward the desired goal. There might eventually be a "master plan," but isolated tax changes could be

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(continued from preceding page) of rates, and eliminated all personal deductions except the allowance for dependents, which was converted into credits against tax payable. This made Chile a pioneer in implementing a policy long urged in the U.S. See, for example, Joseph A. Pechman, "The Erosion of the Individual Income Tax," National Tax Journal, March, 1957.

[4/]The Charter of Punta del Este calls for a redistribution of income through more progressive taxation, with tighter enforcement and more realistic property tax assessments. Public enterprises are also to be operated more nearly at break-even prices. For a vision of the "accepted wisdom" and the degree of consensus among tax experts and policymakers in Latin America, see the proceedings of the Joint Tax Programs conferences. The conference on tax administration was held in Buenos Aires in 1961; the fiscal policy conference was held in Santiago in 1962. (Documentos y actas [Pan American Union, 1963 and 1964].)

undertaken meanwhile to remove obvious obstacles to integration; they would also be considered harmonization measures.

If the European pattern is repeated, Latin American scholars and policymakers are likely to begin with simple studies of specific taxes.5/ As integration proceeds, economic research and policy decisions should proceed to the analysis and required harmonization of the entire range of national economic policies. In Latin America it appears that agreement on the tax treatment of private investment, especially of capital coming from outside the area, will be the first aspect of taxation to be harmonized.6/

B. Geographic Principles

The "destination" principle refers to the taxing of sales or production by the country where the product or service is consumed; the "origin" principle means taxation in and by the country where the product or service is produced. In income and profits taxation, the "source" principle means taxation by the country in whose territory the income is generated or earned, while the "residence" principle means that income, wherever earned, is taxed by the country of legal domicile of the income recipient.

As an example, the United States relies on "source-plus-residence" as a principle, generally taxing U.S. citizens and residents on income from any source, and taxing the income of non-residents on income earned

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5/The Economic Council of the Central American Common Market recently ordered research on problems that might be caused by tax differences in member countries. Carlos M. Castillo, "Growth and Integration in Central America" (unpublished Ph.D. thesis, University of Wisconsin, 1965), p. 202.

6/Herrera *et al*. recommend this priority, *op. cit*., p. 25.

in the U.S.[7] Many Latin American governments and tax "experts" concur, with Argentina being perhaps the most conspicuous holdout. At least through 1964, Argentina taxed only income earned within the country, the source principle.

C. The Theory of Tax Unions

Tax changes made in order to facilitate economic union will themselves have economic consequences, just as do tax changes made at any other time. The analysis of the effects of changes required or inspired by customs union is called the theory of tax union, and it has opened a substantial new area for research.[8]

Unfortunately, we have little practical experience with which to predict the effects of tax union. The U.S. and similar "common markets" have an overlying federal tax and expenditure system that reduces the impact of local fiscal differences.[9] The present paper is largely concerned with speculation on the effects of existing tax differences among countries entering a customs union in Latin America. However,

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[7] Citizens and resident aliens may deduct from U.S. taxes payable, taxes paid to foreign governments on foreign-source income, up to the amount of U.S. tax liability caused by that same income.

[8] Shoup, op. cit. A substantial beginning on tax union theory has been made by members of Professor Shoup's workshop at Columbia University; one of the resulting studies is cited in note 10. A contribution by Marion H. Gillim directed specifically at LAFTA and the Central American Common Market is to be included in a forthcoming book, edited by Shoup, entitled "Fiscal Harmonization in Common Markets."

[9] The U.S. monetary system is also centrally-controlled for all practical purposes, despite its theoretical division into twelve regional central banks. In South America, different approaches to monetary policy pose problems for integration more serious than any tax differences, though Herrera et al. suggest that exchange rate policy can cope with most of these problems. Op. cit., p. 24.

even after union it will be difficult to isolate the consequences of "harmonizing" tax changes made to facilitate integration, because they will be combined with the effects of the integration itself.

The fascinating thing about tax union theory is that it is not at all simple, despite the apparent parallel with the now well-developed theory of customs unions. For one thing, tax union usually involves a change in principle (e.g., "destination" to "origin" in a sales tax), as well as changes in the tax base (e.g., turnover to value-added) and rates.[10/] Trade diversion and trade creation continue to be important concepts in tax union theory, but the rules for ascertaining which is dominant in specific cases are not necessarily the same as in customs union theory.[11/]

The revenue implications of internal tax changes necessary for tax harmonization may dwarf the revenue loss from the elimination of tariffs. As Shoup says of Europe:

> . . . the amounts involved, in view of the proportion of national income taken by current tax systems, are so large that the resulting gains or losses in economic welfare flowing from the adoption of one or another structure of fiscal harmonization may turn out to be even greater than are the welfare gains and losses anticipated through customs abolition and unification.[12/]

In addition to welfare changes, such tax changes will reinforce or may offset the stimulus to investment otherwise expected from the economic union.

[10/] D. Dosser, "Welfare Effects of Tax Unions," Review of Economic Studies, June, 1964, p. 179.

[11/] Shoup, op. cit.

[12/] Ibid.

II. Relevant Provisions of the Treaty of Montevideo

The Treaty of Montevideo committed signatories[13/] to work toward a free trade zone insofar as the bulk of their existing commodity trade is concerned,[14/] over a period of twelve years starting June 1, 1961. Goods not already traded will be included when and if the members agree to add them, or if trade in them takes place even without liberation.

As to factor movements, the Treaty says only that capital coming from any member country will be treated "not less favorably" than capital coming from any other country.[15/] There is no provision or even mention of tax or monetary union, nor of a common external tariff leading to a customs union at the end of the twelve years. Members do promise to work toward a common market, not just for themselves, but on a Latin American scale.[16/]

[13/] Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay are charter members (the Treaty was signed on February 18, 1960); Colombia and Ecuador joined a year later. Bolivia and Venezuela have been on the verge for several years, while the Central American Common Market countries and Panama are expected eventually to join as a unit. The island republics have been conspicuously left out of most of the discussions. At the August, 1961, meeting of the Inter-American Economic and Social Council, "Che" Guevara warned of dangers in economic integration, but added that Cuba wanted to join LAFTA anyhow. After considerable confusion, the members politely informed Cuba that her application would not be accepted because her economic system was incompatible with the Treaty of Montevideo (<u>Comercio Exterior</u>, September, 1962, p. 54). The possible role and advantages or drawbacks of memberships for Haiti, the Dominican Republic, Jamaica, and Trinidad and Tobago merit wider discussion and study. For that matter, so does the question of the compatibility of state enterprise in non-communist members, e.g., army-owned factories in Argentina.

[14/] The official definition is "<u>lo esencial</u>," which is unofficially agreed to mean around 80 to 90 per cent of existing intraregional trade.

[15/] Article 20.

[16/] Article 54. The report by Herrera <u>et al</u>. urges that this work begin at once. <u>Op. cit</u>., p. 6.

The Treaty does state that, to ensure fair competition and to facilitate integration and complementarity of their economies, especially in the industrial sector, members will do their best to harmonize their import and export regimens, as well as the treatment of capital, goods and services coming from outside LAFTA.[17/]

As to internal taxes, Article 21 requires that products of the zone "not be treated less favorably" than similar domestic products. If there is no significant local production, members pledge to try to avoid anulling through internal taxes the liberation granted through tariff reductions.[18/] A country hurt by such measures may appeal to the organs of LAFTA (the Committee and the Conference) for investigation and recommendations. However, the Treaty contains no binding arbitration or tribunal able to resolve disputes between member nations and, at least thus far, every member has a veto in all Conference decisions of consequence.[19/]

While subsidies are forbidden, exports may be exempted from internal taxes, and exporters may receive refunds (drawbacks) for import duties and internal taxes on the product or its components.[20/]

On the other hand, "adequate measures," presumably taxes, may be applied to agricultural products even if included in the list of liberalized imports, to level the price of imported products with those

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[17/]Article 15.

[18/]Article 22.

[19/]Voting rules are set forth in Articles 37 and 39. Herrera _et al_. consider it especially important that a mediation procedure and a veto-less committee be established. _Op. cit_., pp. 27, 29.

[20/]Article 52.

of the national product, and to hold imports to the quantity needed to cover shortfalls of domestic output, compared to domestic consumption.[21]

The Treaty is silent on monetary questions, following failure of Central Bank representatives to reach agreement on a payments system for the zone, in a meeting held in Montevideo in January, 1960. On the other hand, it does mention frequently an undefined concept of reciprocity which appears to equate any increase in exports to other member countries with a gain in welfare for the exporter. "Reciprocity" implies that this "gain" be matched by policies that increase member country imports from the area by similar amounts. Some hold that total trade should be balanced between members, or at least between each member and LAFTA as a whole; others understand that only the increase in exports and imports compared with pre-LAFTA trade should be balanced.[22]

The extent to which all increases in the value of exports to member countries are real gains is open to discussion; obviously, it depends largely on both short- and long-run costs. The operation of drawbacks and refunds of internal taxes could lead to absurd cross-hauling (see below). And in some cases, exports to members are increased by reducing exports to other continents, without any serious efficiency implications. Paraguay, for instance, increased exports to Argentina and Uruguay by U.S. $1 million in the first half of 1962, but at the expense of like sales to other markets.[23]

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[21] Article 28.

[22] In Herrera et al. it is clear that the net increase is what is relevant and that members need not compensate for imbalance in another member's trade caused by unreasonable exchange rates in that country. Op. cit., pp. 21-22.

[23] Comercio Exterior, Supplement, September, 1962, p. 43.

For the present discussion, we shall assume that over-all balance in payments with the world is more fundamental than balance with the zone, and is to be achieved through exchange rate policy and international finance. The discussion which follows is basically concerned with tax harmonization tending to promote the growth of LAFTA and each of its members. However, we should not lose sight of the impact of tax policy on trade with the rest of the world, nor on domestic production and consumption.

III. External Harmonization: The Need for a Customs Union

LAFTA is a free trade zone and not a customs union. Members are free to establish or maintain whatever tariffs they like with respect to imports from and exports to non-member countries, subject to the most-favored-nation clause in the Treaty of Montevideo.[24] At least three arguments for moving toward a common external tariff may be advanced: different external duties may produce certain distortions; measures taken to cope with this may in turn cause other undesirable consequences; and without a common tariff, other member countries may cut external duties, wiping out preferences relied upon by LAFTA producers.

A second question which deserves further study is the sharing of customs revenues following the creation of a common external policy, for third-country goods would then tend to enter the zone through a few ports and distribution centers.[25] Small countries would have little

[24] GATT members would also be subject to GATT norms.

[25] Better, in my opinion, would be to establish a unified customs service (and anti-contraband police) together with a customs union. Although grants could be made to member nations according to present revenues, the common market would gain revenue through suppressing contraband and growth in trade with the rest of the world.

or no customs revenue, because almost everything imported from third countries would be warehoused or transshipped in a larger member country.

A. The Diversion of Trade

When external tariffs affecting raw materials, semi-finished goods and capital equipment imported from other continents differ among members, trade may be diverted and production and investment may be misallocated into the country with the lowest external tariffs for the inputs of each industry. The diversion of trade, in a LAFTA context, would mean that if a given industrial input were on the common list of goods enjoying free movement within LAFTA, the requirements of all producers in the zone would tend to be imported through a port in the member country with the lowest external tariff on the item. The obvious limit here is the cost of transshipping, plus any additional transportation involved.

While it seems unlikely that a difference in external tariffs would be so great as to induce Mexico to import U.S. goods by way of Chile, it is conceivable that such diversion could take place between adjacent countries (Ecuador, Peru and Chile, for example). It is highly probable in that area which is destined to become a "southern megalopolis" in the next decades: a strip of cities and ports running from Rio de Janeiro through São Paulo, Montevideo, Buenos Aires and up the Rio Paraná to Rosario. Research on the cost of transshipping and of local transport in this area should indicate the extent to which pure trade diversion is likely to result from different external barriers to trade between LAFTA countries and the rest of the world.26/

26/ For a pioneering work, see Robert T. Brown, Transportation and the Economic Integration of Latin America, forthcoming publication of the Brookings Institution.

3. Origin Rules

If trade diversion does occur, the country of transshipment presumably gains a little income thereby, but the country to which the goods are ultimately destined loses both in customs revenues and through higher freight costs including the transshipment. A common proposal to solve the problem is a set of rules defining whether given goods "originate" in the zone, and hence are entitled to move freely in it.[27]

One such rule, often used by the European Free Trade Association, defines as regional goods those products for which 50 per cent of the price is value added within the region. Unfortunately, while this rule could eliminate pure trade diversion, in which goods move on without processing of any kind in the country of transshipment, it does little to prevent the misallocation of production and of investment. Existing factories in low-external-tariff countries have an advantage over rivals in high-external-tariff countries, with respect to imported raw materials, semi-manufactures, machinery and parts from outside the zone.[28] Investment in new plants is also likely to be decided in part by differences in external tariffs (or other barriers to trade with third countries), as investors seek to assure themselves of access to imported machinery, parts and raw materials which turn out to be unavailable within LAFTA, or unsatisfactory in quality or cost.

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[27] Another rule, vital if regional trade is not to be hampered by arbitrary seizures by inexperienced border personnel, is that goods challenged as to their origin must nonetheless be allowed to proceed to their destinations, subject to the posting of a bond.

[28] The Chilean Metalworking Industry Association (ASIMET) has opposed free trade in its products because "the present rules consider as products of the Zone goods that, with very little processing and using raw materials from outside the Zone, could enter other markets at prices that would not permit competition from similar goods really produced within the Zone" (El Mercurio, Santiago, April 10, 1964).

It must be noted that each country may have relatively low external tariffs on some items, and relatively high duties on others. They do not cancel each other out, except where a firm requires imported inputs in both categories. Normally distortion would arise from differences in specific external tariffs even if the average rates were about the same. Distortion arises because regional production and investment decisions are influenced by low tariffs or inputs imported from outside LAFTA, rather than following low non-tax production costs as they would under a uniform external tariff, transport costs aside.

By permitting the return of duty paid on inputs of exported goods (Article 52), the Treaty of Montevideo actually seems to promote distortion. The existence of different external tariffs could produce distortion upon the establishment of free trade in the finished product. If, in addition, LAFTA countries give "drawback" refunds, the external tariff becomes zero for goods sold in other LAFTA countries, but not for goods sold in the internal market. If transport costs are low, and neighboring LAFTA countries also give drawbacks, cross-shipment will result. A will supply B, B supply A, with identical goods based on components both import from Europe, say. Thanks to drawbacks, neither A nor B can compete with the other's producers in its own home market!

Even the 50 per cent rule, quite arbitrary in itself, could be gotten around by a manufacturer whose assembly, packaging or distributing operation really adds only about 25 per cent to the value of the product. He merely increases his profit margin until price is double the cost of the imported materials, and then allows his salesmen to give "special" discounts or below-cost credit as required to sell the product to each customer.[29]

To avoid this type of evasion, European theorists have evolved the "transformation" criteria, by which a product is considered to have originated in the free trade area if certain physical transformation processes are carried out in member nations.[30] This must again be defined on a product-by-product basis, and is still arbitrary. The complementarity agreements being signed between LAFTA members provide origin rules for the products involved.[31]

C. The Cost of Coping

In any case, the damage done by the diversion of trade and the misallocation of production and investment is compounded by the measures which must be taken to try to cope with the problem of external tariff differences. Member countries find themselves maintaining customs controls, inspections, red tape, etc., for the intra-zonal trade they sought to free.[32] Administrative costs continue, as do compliance costs for business firms. The only adequate solution is to move toward a common external tariff (customs union), or at least an external tariff

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[29] Bela Belassa, The Theory of Economic Integration (Homewood: Richard D. Irwin, Inc., 1961), p. 72.

[30] Ibid.

[31] The first such accord, for electronic tubes, also contained a pledge to unify external tariffs and exchange policy on tubes, parts and raw materials imported from third countries (Comercio Exterior, Supplement, September, 1962, p. 38).

[32] This implies that member nations are willing to sacrifice sovereignty over tariffs on goods from third countries in order to promote regional trade and growth. As Gillim suggests, if "sovereignty" takes precedence over integration goals, border controls will be maintained and tax harmonization is unnecessary.

such that differences do not cover the costs of transporting either inputs or products otherwise than by the routes they would follow in the absence of external tariff differences.

As a first step, favoring both the use of LAFTA raw materials and the elimination of cross-shipping, the provision of Article 52 permitting exemptions and refunds of internal production taxes should be repealed. This will lead to pressure for further tax harmonization measures, discussed in the next section.

Specific research on actual transport costs, both for loading and unloading, and per ton-kilometer in various regions and with various forms of transportation, should help policymakers decide whether given differences in external tariffs are worth an effort to harmonize. If the conclusion is that differences will not have any significant effects, then LAFTA could proceed with neither a common tariff nor origin rules, <u>and</u> without maintaining other vestiges of control and barriers to intra-LAFTA trade under the pretense of preventing trade diversions.

D. <u>Minimum Preference</u>

If LAFTA enterprises are to invest on a scale sufficient to supply regional markets efficiently, many need some assurance of preference in those markets during at least a few years. Yet so long as each nation is free to change external tariffs at will, the preference created today by liberation of imports from LAFTA could be wiped out a year hence by eliminating duties on imports from the rest of the world.[33/] Likewise, a minimum external tariff even on raw

[33/] Lic. Plácido García Reyuoso has justly criticized LAFTA members whose government agencies, not affected by tariffs, continue to import supplies from other continents (<u>Comercio Exterior</u>, Supplement, September, 1962, p. 53). Domestic producers would exert pressure, but who will urge Peruvian officials to buy Mexican instead of U.S. supplies, even when price and quality are equal?

materials would favor the production of new materials and components within the region.[34]

E. Export Duties

Some LAFTA nations also attempt to tax exports of certain products. Presumably, these duties too should be removed on trade with member nations.[35] There could be some danger of diversion of these exports, tax-free, to nearby member nations not having export taxes, from which the goods will then be re-exported to the rest of the world. This will not affect those products (oil, copper) mined by large foreign companies, which are easily controlled and which in any case are usually taxed on profits rather than with specific or ad valorem duties on exports as such. The problem is also foreseen in the Treaty of Montevideo, which prohibits the re-export of a product imported from a member country, without permission of that country.[36]

IV. The Over-all Level of Taxation

Table I shows the ratio of taxes to product for some of the probable members of a Latin American Common Market:

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[34] Herrera et al. urge the creation of a system of reciprocal (minimum) preferences at once, pending agreement on a common external tariff. Op. cit., p. 12.

[35] In a survey of Mexican producers who had not taken advantage of tariff reduction by other LAFTA members on their products, a significant number stated that Mexican export duties made it impossible to compete in LAFTA despite the reduced import tariffs in other member countries (Comercio Exterior, December, 1964).

[36] Article 50.

TABLE 1

TAXES AND GROSS DOMESTIC PRODUCT IN LATIN AMERICA, 1960
(IN MILLIONS OF UNITS OF THE NATIONAL CURRENCIES)[a]

Countries	Gross Domestic Product at Market Prices	Central Govt. Tax Receipts	Percent
Argentina	790,000	102,700	13
Brazil (1959)	1,776,000	433,000	24
Chile	4,781	1,094	25
Colombia	26,418	2,813	11
Costa Rica	2,648	475	18
Ecuador	14,060	2,737	20
Guatemala	689	86*	13
Honduras	756	75	10
Jamaica	249	33	13
Mexico	134,400	12,600	9
Peru	43,610	5,260	12
Trinidad & Tobago (1959)	824	132	16
Venezuela	25,529	5,879	23

[a]Source: Economic Commission for Latin America, Boletín económico, suplemento estadístico, Vol. VII, No. 1 (October, 1962), except for figures marked * which are taken from the United Nations Statistical Yearbook, 1962, Table 181.

Note: Problems of definitions and comparability are here omitted; see sources.

Hypotheses abound as to the meaning of these differences.[37/] For example, they may reflect difference margins in per capita product over bare subsistence, different resource endowments exploited by easily-taxed foreign firms, or varying concepts of the proper role and size of the public sector. Different tax levels may also merely demonstrate relative efficiency in tax collection. High-tax countries can devalue,

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[37/]See Alison Martin and W. Arthur Lewis, "Patterns of Public Revenue and Expenditure," Manchester School, XXIV (September, 1956), reprinted in Richard Bird and Oliver Oldman (eds.), Readings on Taxation in Developing Countries (Baltimore: The Johns Hopkins Press, 1964).

or protect domestic markets with tariffs. If they do so, rather large differences in over-all tax levels may not harm producers in the high-tax countries enough to offset the advantages perceived by the voters (or the army officers, as the case may be) in high levels of public spending and investment.

Similarly, substantial increases in the level of taxation and spending (as might be required to finance programs of agrarian reform and development) may well appear justified by the expected gains -- social, economic and political. But are tax differences quite tolerable for isolated national economies as acceptable when these countries enter economic union?

In a LAFTA setting, the directly relevant producers are those making goods which are on the "common list" of goods that enjoy, or will enjoy with eight more years, irrevocable free trade within the region. Other things equal, such producers in low-tax countries would expect to enjoy a stronger competitive position than rivals in high-tax countries, when free trade begins.[38] While the producers in high-tax countries may always have lost sales in foreign markets, they will now risk loss of the domestic market as well.

This difficulty could presumably be prevented with an exchange rate adjustment each time duties were cut, but this annual disturbance would be unsettling for those countries accustomed to a "sound" currency and stable exchange rates. However, it is the high-tax countries that will have to make the adjustment, and many of them already

[38] Implicitly, we assume that public spending and investment is of no value to producers. In practice, they may cut costs (e.g., freight) or increase domestic markets (e.g., old-age pensions), offsetting tax differences in part.

suffer inflationary processes making periodic exchange rate adjustments necessary in any case.

On the philosophical level, will communities that formerly preferred a high level of taxation and public spending maintain that preference if told that it will mean the loss of employment and domestic markets in addition to the foreign markets already lost? This will be one more argument raised against new tax and spending programs, too, such as those required to finance massive public education or land reform and agricultural development.[39/]

Structural reforms are part of the Alliance for Progress, as is economic integration, but their return through increased production and lower costs, as well as wider markets, may be felt only some years after the basic investment. Social reform and competitive strength in economic integration may appear incompatible in the short run. Therefore, member governments should agree not to excuse any of their number from fulfilling Alliance for Progress reform commitments on grounds that competition in the common market prevents increasing the over-all level of taxation and spending.[40/]

[39/] The correct answer, of course, is to raise new revenue through taxes which have little impact on production costs.

[40/] Those countries whose tax levels are already high may need to devalue. In many cases, too, they should finance structural reforms by reducing other costs instead of raising taxes further, e.g., the premature retirement of public employees in Chile or the overstaffing of railroads and armed forces in Argentina. No country should be excused from social development measures so long as such obvious economic waste persists, no matter how high the level of present taxation. The problem may be to mobilize political pressure of potential reform beneficiaries against the vested interests.

V. Direct Taxes on Income, Profits and Property

So long as income and wealth are quite unevenly distributed, "one man-one vote" democracy is likely to lead to a rather high level of spending and taxes, with or without economic union. Whatever the majority's preferences, however, they are hardly likely to be shared by investors and managers. A minority of the population, these people form a large part of the high-income group most affected by high taxes -- if the taxes are effectively progressive, as tax reform under the Alliance for Progress seeks to make them. Among countries with substantially the same over-all level of taxation, there may be great differences in the share assigned these individuals and their companies. Will such differences affect growth after economic union?

A. The Managers

Managers presumably seek to maximize the after-tax return on the owners' capital, although a more practical aim may rather be to justify higher remunerations for themselves. Large corporations, with professional management, may well be relatively more important after economic union than in pre-integration "watertight compartment" economies. Research in managerial motivations and decision making, therefore, would help greatly in shaping policies for economic union.[41/]

To be sure, taxes may appear unimportant in total costs, and relatively high taxes are often found in countries with relatively good roads and high personal incomes, or other cost and local market

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[41/] See, for instance, Alfred Lauterbach, "Government and Development: Managerial Attitudes in Latin America," Journal of Inter-American Studies, April, 1965, pp. 201-225.

advantages that compensate for the tax differences. Apparently, then, tax differences should not actually lead to any reallocation of investment and production among countries entering economic union. However, policymakers should not ignore an emotional attitude toward taxes felt by many businessmen, both in and out of Latin America. As a hypothesis, I suggest that an investor or a manager will tend to react more strongly to a 5 per cent difference in direct profits tax rates, or a 2 per cent difference in turnover taxes, than to a differential in labor productivity or material costs which amounts to the same in the year-end balance sheet.[42/]

Such an attitude would not be entirely irrational. Comparative tax information is easier to obtain than data on labor productivity in various countries.[43/] Too, in many LAFTA countries businessmen have considerable influence with the legislative and executive branches of government. Their complaints about alleged tax differences may lead to lower tax rates, while many cost differences are less amenable to political pressures.

B. Multi-plant Companies

Several companies now do business from plants located in various countries of Latin America. After economic union, a few may attempt to supply all of their customers from just one plant, but transportation costs are likely to lead many others to open new branch plants as they

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[42/] Bruce Herrick suggests that this bias, if it exists, is probably inversely correlated with the size of the firm. If so, it would be more important at first than after integration has increased the average size of firms.

[43/] For instance, in Price, Waterhouse's excellent series on "Doing Business in (Country)."

expand to region-wide business. One probable result of this is a loss of fiscal revenue in the countries with relatively high profits taxes. Other things being equal, multi-plant firms will naturally allocate production (or will at least assign accounting costs and receipts) among plants so as to produce most of their profits in the member country with the lowest tax rates.[44]

To prevent juggling in which the profits do not appear in the tax declaration presented to any of the countries, national revenue services should now set up private exchanges of information from declarations of companies operating in more than one country. Better yet, LAFTA might offer a centralized auditing service which would check returns of multi-plant firms on behalf of all tax services involved, sparing the company the nuisance of separate audits by each country, while reducing opportunities for evasion.

Needless to say, company tax compliance and record-keeping costs would be greatly reduced if member nations would agree on uniform profits tax bases and allocation forumlas. Such differences among state taxes are a constant source of irritation for multi-plant taxpayers in the United States.

C. Attracting and Orienting Investment

A uniform tax code and set of rules and fees for the installation of new plants would help attract investment to the region. It would

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[44] Further problems are posed by companies that seek to escape taxes on intangibles, capital and dividends, through bearer shares and incorporation in "tax havens" such as the Bahamas or Lichtenstein. See International Fiscal Association, Cahiers de Droit Fiscal International, Vol. XLIXb, Hamburg, 1964. Again taxation by the common market itself might be simpler than deciding which member nation is entitled to tax these corporations.

be equally advantageous for local capitalists considering operations on a regional scale to know that in any member country tax bases and record-keeping requirements would be the same as at home.[45/]

Likewise, all countries sincerely interested in new investment and employment, should study and simplify the red tape involved. In effect, the employment now given a few individuals who specialize in knowing how to overcome these hurdles could well be sacrificed in favor of quicker installation of new enterprises employing hundreds of thousands of workers.[46/]

The LAFTA Advisory Committee on Industrial Development recommended concrete measures in 1964 to lead investors to choose the locations indicated in the hypothetical regional plan for allocation of new industry. Member governments are asked to deny tax incentives, credit, and import privileges for materials and machinery, for new industries which the plan has assigned to other countries. At the same time, each country is supposed to offer tax, credit and other stimuli for investors interested in launching the activity assigned that country in the plan.[47/] The need for such planning might be less if LAFTA had revenue sources of its own, permitting redistribution and compensation to the relatively less-developed nations, but there is no sign of such a revenue source.[48/]

[45/]The tax treatment of foreign and domestic capital in LAFTA countries is described in considerable detail in Comercio Exterior, Supplement, June, 1964, pp. 23-34.

[46/]For example, Bolivia in 1961 assigned Ministry of Economy employees to help investors through establishment red tape, and to keep local government employees from demanding "tips" to complete routine licensing procedures.

[47/]Comercio Exterior, Supplement, June, 1964, pp. 57-59.

[48/]Keith B. Griffin, "The Potential Benefits of Latin American Integration," Inter-American Economic Affairs, XVII, No. 4 (Spring, 1964), pp. 18-19.

A year later, the report submitted to the Presidents of the Latin American Republics by Herrera et al. urged fiscal, technical, and financial aid and incentives for firms undertaking desired investments in the desired locations.[49] However, the planners would now limit themselves to basic or key industries, such as steel, chemicals and autos.

To the extent that differences in profits and other business taxes do affect the allocation of production and investment, these differences should be part of the deliberate plan at the regional level to orient and encourage a desired location of new industrial activity. Other tax differences, however, should probably be narrowed to a point where they do not seem important to businessmen. This will reduce the pressure on all governments to lower business taxes in order to improve competitiveness within the region. Otherwise, such pressure could lead to a "Gresham's Law of Taxation," in which business taxes tend toward the lowest level in the region, to the detriment of public services or of budget balance, and forcing the postponement of agrarian reform or any other major new public programs.[50]

Naturally, significant differences in tax bases are as important as rate differences. If some, but not all, member countries permit loss carry-forward and accelerated depreciation, or give investment allowances (e.g., Argentina), this may offset or amplify the effects of rate differences for growth industries and new plants.

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[49] Comercio Exterior, Supplement, June, 1964, pp. 15-16.

[50] The "Gresham's Law of Taxation" appears in John F. Due, "Studies of State-Local Tax Influences on Location of Industry," National Tax Journal, June, 1961.

D. Individual Investors and Entrepreneurs

Once economic union is achieved, economists may well expect a rough equivalence of the after-tax return on marginal capital investments among the member nations. Proposed regional markets for common stocks and commercial paper aim at increasing the flow of investment capital, but some equalization of return may eventually follow (with due allowance for risks, including political ones).[51]

When the wealthy discover differences in personal taxes on their profits, rents, interest and dividend incomes, their options depend on the geographic principles used by the governments involved. An Argentine, for example, could take advantage of the source principle used there in order to invest or lend in other member countries with lower tax rates, and bring home the resulting income tax-free. As a manufacturer, he could produce in a low-tax country goods needed for the entire region. He would import into Argentina (duty-free) the quantity needed for local customers, but pay profits taxes only on the income from distribution activities inside Argentina. Other things being equal, tax differences would lead to a "flight" of capital, production, and new investment, but the investor would remain in Argentina and might even bring back profits, which would become favorable items in the Argentine balance of payments.

A Chilean, on the other hand, would be subjected to the source-plus-residence principle: he would be taxed on profits earned anywhere, subject probably to a credit for taxes paid on that portion of profits

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[51] For a report on agreements and meetings of Latin stock market officials, looking toward integration, see the article by Bercht and Velasco in CEMLA, Coordinación monetaria regional, México, 1963.

earned and taxed in another member nation. In this case, eseape requires that he change his domicile as well as move the production to a low-tax country. The result of great tax differences, then, could be a flight of production, investment, capital and even investors.

Economic union, between countries with tax differences great enough to annoy investors, may thus reduce the industrial sector of the high-tax countries in favor of growth in the low-tax countries.[52] Naturally, the dislocation would tend to be greater for new plants--not yet located anywhere--than for existing firms with substantial sunk costs. Likewise, young entrepreneurs might be more mobile than their elders.

Personal income tax rates, at least in schedular taxes on capital earnings, might well be "harmonized," in the sense of reducing extreme differences, simultaneously with the adoption of treaties to avoid double taxation within the zone.[53] Pending a multilateral agreement on double taxation, tax credits for taxes paid to other member countries would reduce revenue less than full exemption of income earned abroad (the source principle).[54]

[52] Obviously, the effects also depend on tax shifting and incidence. For a tentative exploration of the problem in Latin America, see the papers by Richard Musgrave and Federico Hershel, presented at the Conference on Tax Administration held in Buenos Aires in 1961 (Documentos y actas [Pan American Union, 1963]).

[53] The case for treaties with countries outside LAFTA is not so clear--why should Chile encourage Chileans to buy stocks in the United States by eliminating double taxation of the dividends?

[54] If personal taxes were proportional rather than progressive, and if rates and bases were perfectly equalized, the investor would be indifferent as to which country taxes his income. Under progression, however, the exemption of income taxed elsewhere would lower the marginal rate applied to income from domestic sources, making investments in tax treaty countries more attractive than domestic investments of equal risk and pretax yield. This distortion in investment can be reduced by taxing all income and giving tax credits for taxes paid elsewhere, up to the rate applied to the foreign-source income by the investor's own country.

E. Property Taxes

Countries in need of higher tax revenue to replace lost customs revenues following integration may run into problems should they attempt to increase direct taxes on business income or profits above regional averages. For Latin America, the most promising source of replacement revenue, as well as for the financing of social reforms without unduly hampering competitiveness in economic union, is the real estate tax.

Naturally, a general tax on net wealth would be more neutral among forms in which wealth is held. Such a tax exists in Colombia and is being considered seriously in Chile. However, unless a multilateral agreement can be obtained to levy such a tax in all member countries, economic union will make it difficult for any nation to tax capital without inducing some flight. This may be one area where the lesser-developed nations might be favored. The more prosperous six or seven nations in Latin America might agree to establish a uniform capital tax, allowing Bolivia, Ecuador, Paraguay, Central America and the Caribbean Islands to woo investors by not having such a tax--which they probably couldn't administer anyway.

Pending such an agreement, individual nations could well rely on the real estate tax for increased revenues. Most assessments are far below market levels, and many countries in Latin America have no tax at all or have only nominal rates, at least on rural property. While heavy urban realty taxation could depress the construction industry, possible reactions are much slower than to other tax increases in a situation of economic union. In addition, heavier land taxes would reduce the market value of land required for agrarian reform, and for urban low-income public housing, thus reducing total revenue needs. (In countries where the principle of compensation at tax valuations is established, however, land reform enthusiasts may well prefer to live with the old, low-assessed values until the government has expropriated the land it wishes to redistribute--and then raise taxes.)

There is thus little need to harmonize property taxes, except that member nations of an economic union should sign a treaty similar to that of the Central American Common Market, limiting the amount and duration of tax concessions, including property tax exemptions, given new plant investment.[55] If governments believe that investment responds to tax incentives, and if investment in LAFTA tends to concentrate in fewer centers than are politically acceptable, the less-developed member nations might be allowed to woo investment with larger tax incentives than those permitted most countries under such a treaty.

V. Taxes on Production, Turnover and Consumption

It has been fairly well established that turnover taxation, applied to each transaction on the total value of the transaction, is "bad" taxation even for a country in isolation.[56] It produces uneconomic vertical integration, and distorts prices (and hence consumption) by adding more to the cost of producing and selling those goods that must pass through more transactions than other goods. When the number of transactions is equal, it adds more to the cost of materials-intensive production, whose value-added tends to be concentrated nearer

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[55] Convenio Centroamericano de Incentivos Fiscales al Desarrollo Industrial, signed at San José, July 31, 1962.

[56] See almost any public finance textbook. A detailed discussion appears in John F. Due, Sales Taxation (Urbana: University of Illinois Press, 1957).

the beginning of the process, than to labor-intensive production, as a result of the "pyramiding" of early-stage taxes at each subsequent transaction.

If turnover taxation is undesirable for a country in isolation, is it not more undesirable in a free trade zone? Vertically-integrated industries will be even more encouraged, especially in high-rate countries. Yet, a tax structure that favors vertical integration hardly seems consistent with specialization and the division of labor in a wider market.

The value-added tax is often proposed as a replacement for turnover taxes. Each producer pays the tax on the value of goods or services sold by him, less the amount he paid for goods or services already taxed. This leads to the same tax cost for integrated industries as for goods produced by a series of specialists (except for interest on the taxes paid earlier, in the latter case). But it requires a higher percentage rate of tax--e.g., 12 per cent instead of 5 per cent--which psychologically may increase taxpayer reaction for the same total revenue.

What happens when some countries have value-added taxation and others turnover taxes (pre-integration yield being equal)? In the countries with value-added taxation, integration will favor specialized industries and those that add a large portion of value in the first stages of manufacture, over their rivals in turnover-tax countries. In the member countries with turnover taxes, integration will tend to favor vertically-integrated firms and the processes that add most value in the last stages. In both cases, tax revenues will fall as previous production is reallocated among the member countries following the freeing of trade, but it does not appear possible to predict which country will suffer the greatest revenue loss.[57]

At present, no LAFTA country has a value-added tax. Most have turnover taxes (e.g., Chile, 6 per cent), and Argentina has a gross receipts tax at the provincial level.

In any case, following the logic of the single-nation case and recognizing the added distortions in specific industries that might be produced by the coexistence of both systems, research is needed on the cost and benefits to be obtained if all LAFTA countries changed from turnover taxation to single-stage or value-added taxation of production, as may soon be done in the European Common Market.

We have so far said nothing of the rival principles of taxation according to "origin" or "destination" of the merchandise. Briefly, the origin principle calls for taxation of production where it takes place, while the destination principle means that production is taxed at the point of consumption. Under the destination principle, exporters receive a refund of taxes presumably paid during the process of manufacture. The destination principle also permits importing nations to levy a compensatory tax, supposedly equivalent to the production (turnover or value-added) taxes paid by domestic producers.[58]

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[57] Of course, to the extent that regional free trade stimulates additional production and the substitution of imports from third countries, production tax revenues will rise.

[58] If no compensating tax is levied, and if transport costs are inferior to the production taxes on a product, neighboring countries would each supply the other with goods produced efficiently in both countries. That is, no producer, paying taxes, could compete in his own domestic market with his rivals in LAFTA, who receive tax refunds. On the other hand, he could himself export, collect a tax refund, and successfully sell in the domestic market of his rivals. As with export drawbacks, much unneeded shipping across frontiers would take place, purely for tax reasons, yet net tax revenues would fall.

The destination principle has a double disadvantage, from the viewpoint of regional economic integration. It maintains intact the customs administration, controls and red tape for intra-zonal trade, and it permits hidden protection for domestic industries in member countries. The calculation of the appropriate turnover tax refund for exports is arbitrary, if not impossible. Taxes have been paid not only on raw materials, but also on the manufacture (or importation) of every piece of machinery, office supplies, etc., used in production of the goods exported. If a nation wishes to give a hidden export subsidy, then it need merely over-estimate the export refund. Likewise, if a nation wishes to limit imports from the zone to protect its own industry, it merely need err on the high side in calculating the compensating tax.

The value-added tax is simple to calculate for refunds and a compensating import duty--for both, the invoice price is used (fob and cif respectively). However, there is no need to maintain the destination principle at all under value-added taxation--so long as rates are reasonably similar, imports and domestic products bear the same taxes and the border controls and tax refund apparatus can be removed. Of course, a country determined to "cheat" on free trade may still adopt labeling, sanitary, or other protective devices to prevent competition from other producers.[59]

In theory, then, the ideal system would be value-added taxation of production, and the application of the origin principle in order

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[59] Mexico recently warned other LAFTA members that agricultural products on the common list will not be admitted to Mexico if there is any disease, insect., etc., about which Mexico is concerned, in the exporting country. Acto, December 7, 1964, p. 7 (Comercio Exterior, Supplement, December 7, 1964, p. 7). While apparently reasonable, such rules have sometimes been used by states in the U.S. as a pretext for barring fruit imports that would compete with home-grown fruit.

definitively to abolish intra-zonal frontiers and customs administration. However, research is needed to see whether these advantages would justify the cost of changing existing tax systems.60/ There is no need to have uniform rates for value-added taxation, though large rate differences might have psychological effects on production and investment decisions similar to those in the case of business profits tax differences.

Consumption taxation by definition satisfies both the origin and destination principles so long as the consumer buys the good (and pays the tax) in his own country. U.S. experience with state sales taxes shows that some consumers will travel or order by mail to take advantage of tax differences, but high transport costs in LAFTA should make this evasion relatively insignificant except perhaps for frontier areas; sales tax rates might be "shaded" toward the level of adjacent nations in such border areas.

Likewise, special excise taxes on liquor, tobacco, and the like need not be uniform, but large tax differences will bring some evasion through purchase in lower-tax countries. On the other hand, this problem already exists in virtually every LAFTA nation, with contraband articles that pay no tax at all. The existence of differing tax rates in neighboring countries is unlikely to matter, compared to the contraband of third-country products. A Latin American Common Market might well eliminate free port sale of consumer goods, and tax-free sales

60/The preceding does not pretend to exhaust the problems of harmonizing sales tax systems, much less a burgeoning literature centered on the European markets. One readily-available reference is Clara K. Sullivan, "The Search for Tax Principles in the European Economic Community," published in 1963 by the International Program in Taxation, Harvard Law School.

aboard ships and airplanes traveling to and around Latin America. This would increase member-nation revenues by eliminating a common, easy, and legal source of tax evasion on luxuries such as liquor, tobacco, and perfume.[61]

VI. Employer Contributions to Social Security

One of the basic concerns of those who would "harmonize" taxes and social legislation, to protect the industry of countries whose legislation is considered "advanced," is the cost of social security and labor legislation. We shall here consider that cost which is borne, at least in the first instance, by the employer. (Differences in over-all tax-spending levels were discussed in III above.)

The type of cost difference which here concerns us is the difference in rates of payroll taxes paid by employers in member countries, plus those labor and social laws which add directly to labor costs per unit of product. Examples of the latter include different numbers of paid holidays among member countries and different norms on paid vacations, overtime pay, severance pay, minimum wage laws, and equal pay for women.

The commonly-accepted theory in dealing with these differences is that they may safely be ignored under most circumstances.[62] What does matter is total unit labor cost; if this differs among member countries,

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[61] The payments balance vis-a-vis the rest of the world would also be improved. As to sales on ships and planes, the market should be able to enforce a rule that travel between Latin American ports or airports is not "international," and therefore the tax of one country or the other must be collected. This is done with respect to state sales taxes on interstate flights and trains in the United States. Better yet, such sales could be made subject to a substitute tax, at a rate near the market average, which would become a revenue source for the common market itself, to finance its administration.

[62] See Belassa, op. cit., p. 211.

then production and investment will (and should) move where unit costs are lowest, up to the limit imposed by marketing and transportation cost differences. Total unit labor costs are obtained by adding all wage costs, direct and indirect, and dividing by physical production. In this calculation, it does not matter whether labor costs are all direct wages, or whether a large portion consists of legally-required vacations, bonuses, and employer contributions to social security. For that matter, it does not matter whether these "fringe" or non-wage costs are legally imposed, won by labor unions, or voluntarily conceded by employers for practical or even for altruistic reasons. In the European Common Market, there is some evidence that non-wage costs assumed voluntarily by employers are negatively correlated with non-wage costs imposed by law.[63] It would be interesting to test the hypothesis that the same is true in LAFTA.[64]

A further argument in favor of ignoring non-wage labor cost differentials is that these may well have been shifted largely to the workers, so that any attempt to "harmonize" them will, in fact, in the short run <u>produce</u> rather than <u>correct</u> distortions. Again, we have some evidence for Europe, where Belassa reports that wages plus the employer's costs of social laws are far more nearly equal among members of the Common Market than are wages alone.[65] Is this the case in Latin America?

Under perfect price and wage flexibility, with elastic labor supply, social costs would, of course, be shifted entirely to workers to the

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[63] <u>Ibid</u>., p. 217.

[64] One reference is "Gradual Extension of Social Insurance Schemes in Latin America," <u>International Labour Review</u>, September, 1958.

[65] Belassa, <u>op. cit</u>., p. 218.

extent they consider the benefits worth the cost, and hence perfect substitutes for wages. Harmonization would then do no harm--wages would just adjust upward or downward as each country "harmonized" social laws toward the average. However, it would require serious research to assert--contrary to popular belief among Latin American economists--that prices, wages or the labor supply are highly elastic. Moreover, there are some social benefits that have little to do directly with the amount of labor employed. For example, employers as a group usually pay the total cost of family allowances, entirely or shared with the workers, but individual employers pay a standard rate on the amount of their payrolls, while the state redistributes the proceeds among workers according to family size.

To hear them talk, some businessmen resent relatively high social security taxes, paid vacations, severance pay, and other legally-imposed labor costs.[66/] As with direct taxes, some reduction in these differences may be in order, to avoid misallocation of production and investment to low-tax countries, and to avoid pressures to reduce all social benefits to the lowest level in the region.

Complete equalization might be unwise, just as for taxes in general, because family allowances and other social legislation may quite likely reflect genuine differences in social preferences among nations. Yet equalization, or at least "standardization" of the general benefit structure, would simplify life for multi-plant employers and could favor future labor mobility.

66/Besides the direct cost, managers may resent the cost and nuisance of the extra record-keeping. In a few cases, owners and managers in countries with great social differences may even resent extension to workers of pleasures heretofore privileges of the rich, or of the rich plus white-collar workers, e.g., paid vacations.

Given the checkered career of democracy in this area, the economist may even have to judge whether existing differences in taxes or social legislation are justified by the social preferences of those whom *he* considers to be "the community." The unemployed want jobs, not longer paid vacations for those now employed, and therefore politically influential, through their union. Many workers might prefer more wages instead of employer contributions to social security systems the workers consider almost useless. Yet in many cases, these groups may have no effective way to make their wants felt. The supply of labor, at least at low skill levels, often appears inelastic at present wage levels. Present wage levels may be legal minima, politically imposed to raise wages for a substantial part of the population (the employed) in preference to still lower wages and the possibility that even complete wage freedom would not lead to full employment of the unskilled.

If economic development is spurred by regional free trade, perhaps fuller employment will raise wages above legal minima, and workers will acquire more bargaining power. In such cases, the governments with high-cost social laws and programs might do well to cut back toward average levels for the region, to avoid the unfavorable "climate" among investors created by relatively high-cost social legislation and to permit the new labor market forces to express themselves in higher direct wages. If workers really prefer non-wage benefits, they then would presumably obtain them through collective bargaining, as substitutes for cash wages.

In conclusion, the case for "harmonization" of minimum wages and employer contributions to social security programs and the like is by no means clear. Reduction now of relatively high-cost programs would be resisted by currently-employed workers in LAFTA countries, however much it might in time lead to more employment and more bargaining power for labor. The increasing of costs in present low-cost nations might cause them serious balance-of-payments problems especially if employer contributions are increased without lowering minimum real wages or if real wages are rigid downward, preventing prompt shifting of higher costs.

Trade of these countries with LAFTA and the rest of the world will fall as exports are less able to compete and import demand drops with falling incomes and unemployment. Devaluation may help, if real wages are flexible, but it is not clear that the unification of social legislation has merits sufficient to justify the economic and social costs of devaluation. Far better, probably, would be for governments with relatively high or low non-wage labor costs to eliminate some of the extremes, especially those far above the average for the zone.

At the same time, high-cost social security programs should be examined carefully for waste, such as premature retirement of public employees. To the extent that high- or low-cost programs do not reflect the popular will, or contain out-and-out waste, economic integration and increased competition may provide more ammunition to those who want reform. Governments and voters will become more conscious of what the neighbors are doing, and that may tend toward voluntary "harmonization" or reduction of the extremes.

VIII. Summary of Recommended Tax Policies

The term "harmonization" refers to economic policy changes intended to facilitate regional economic integration by reducing differences in national policies. We have recommended, with varying degrees of confidence, the following harmonization policies for a Latin American Common Market:

1. A common external tariff, with at most differences smaller than the added cost of transshipment through the nearest alternative port.

2. General use of the origin principle in production taxes, in preference to tax refunds to exporters and compensating duties on imports from member countries.

3. Flat prohibition of "drawback" and the refund of internal taxes for goods exported to other member countries.

4. Reduced differences in personal and business income taxes.

5. Treaty regulation of incentives extended to woo investment.

6. Standardization of the bases for profits taxes, and of the rules for the establishment of new firms and branches.

7. Value-added or single-stage taxes to replace turnover levies.

8. Reduced differences in employer social security tax rates.

9. Increased reliance on real property taxes to make up revenue lost through tariff reduction and to finance new programs, including education and land reform.

10. Adoption of a low-rate tax on capital and net wealth by the relatively more developed countries in the area.

11. Enactment of taxes to support the common market institutions, and region-wide profits tax auditing and other enforcement activities under common market auspices.