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# TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA: PARAGUAY

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# TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA: PARAGUAY

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**Abstract**
This paper aims to discuss the main features of Paraguay's current tax system and its evolution since the early 1990s. It is part of a wider research on "Tax Systems and Tax Reforms in Latin America", carried on at the Department of Public economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. Paraguay is a poor and unequal country, even compared to Latin American standards. Its current tax system is the result of the radical fiscal reform of 1991, which replaced the previous obsolete and inconsistent system. In the decade after the reform, a growing number of amendments, exemptions and special regimes have been introduced, producing significant changes to the original structure and a considerable reduction of tax revenues. Furthermore, this tax system, dominated by indirect taxes and characterised by high levels of tax evasion, is rather ineffective in addressing inequality. Finally, tax revenues are significantly below their potential, due to the extent of the informal economy, the widespread tax evasion and the diffuse corruption of tax officers. A new fiscal reform, recommended by the IMF under the Stand-By Agreement of December 2003, was approved in June 2004. The reform aims to address the critical issues described, to rationalise the existing tax system and to better tackle tax evasion and inequality. However, a major obstacle to this reform is the ability of the Paraguay government to fully implement it. Its application has been initially delayed to the year 2006 and its contents partially weakened. Finally, despite recent changes, the tax system remains fundamentally biased towards indirect taxation, which yields approximately 80% of tax revenues, while the newly introduced personal income tax appears to be more of a facelift than a real change, at least as long as major problems are not solved, such as tax evasion, informal economy, corruption.

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# 1. Introduction, contents and conclusions

Paraguay, is one of the smallest South American countries, both in terms of surface and population. This landlocked country covers an area of 406 million 752 sq. km. and has a population of 5.2 million, with an average growth rate of 2.6% between 1992 and 2004 (among the highest in Latin America, WB, 2006). The Republic of Paraguay political history, beginning with independence from Spain in 1811, has been shaped by three post-colonial dictatorships (from 1814 to 1870) followed by a period of high political instability, which ended in 1954, when General Alfredo Stroessner assumed the Presidency after a military coup. Mr Stroessner fierce and corrupted regime lasted until 1989. In June 1992 a new democratic Constitution was adopted, establishing Paraguay as a Presidential Republic, divided into 17 departments and 224 municipalities. Presidents of the Republic are in charge for a five-year term and may not be re-elected. Since 1989 all Presidents came from the Colorado Party, the country most powerful party, ruling uninterruptedly since 1947. In 2003 Nicanor Duarte Frutos, leader of the reformist faction within the Colorado Party, was elected President with an ambitious program of State reform. Among the actions taken, also upon encouragement by international organisations (primarily the IMF), a major tax reform was approved in 2004, but its implementation is almost entirely delayed to 2006.

Paraguay tax system is described in Section three, after a brief introduction to the country economy and public sector finances evolution, from the fall of the Stroessner regime up to present time, contained in the next Section. Section two also contextualises the Paraguayan tax system within the Latin American framework. The fourth Section evaluates the tax system in terms of the actual distribution of the tax burden, through the analysis of marginal effective tax rates on consumption, capital and labour. It also describes fiscal decentralisation in Paraguay, which is a highly centralised state. Finally, Section five analyses recent and planned tax reforms and closes with a critical evaluation of the initiatives taken and those still needed to solve the country’s deep social and economic problems.

# 2. A general overview of tax system and its development since the early 1990s

## 2.1 A first glance to economic, budget and expenditure features

From an economic perspective Paraguay lags behind the rest of Latin America under many respects: it is one of the poorest and most unequal countries, both in terms income and land distribution; it is also one of the least developed and least industrialised countries in the region. Furthermore, it stands out for the extent of the informal economy, of smuggling and money laundering, and for the endemic corruption.

Paraguay is a middle-income country, in 2004 GDP per head was 1.205 US dollars[1], approximately one fourth of that of Argentina and Brazil[2], and below the Latin American average. This average figure hides a highly unequal income distribution, one of the most unequal in the world. The Gini index for Paraguay is 0.58 (2002 data), the third highest value registered in Latin America, after Brazil and Guatemala[3], and 16.4% of the population lives in extreme poverty, with less than one US dollar a day (1990-2003 average) again one of the poorest performances in Latin America (UN, 2005), and the number of people living in poverty has increased from 32.1% in 1997 to 39.3% in 2004 (EIU, 2006). The population is mainly composed of poor farmers and underemployed town dwellers. About 30% of workforce is underemployed (IBFD, 2005), and in 2003 registered unemployment was 12.1%. Poverty and unemployment are coupled by poor human conditions: in 2003 Paraguay ranked 88th of 177 countries in the human development index compiled by the United Nations (UN, 2005).

In Paraguay inequality extends also to land ownership. Most of the land is owned by few large landowners: the traditional elite detaining significant economic power. In 2002, 62% of total agricultural production came from as little as 1% of total landholdings (EIU, 2006). The population is scarcely urbanised, less than 60% live in urban areas, of which one third live in and around the capital city, Asunción. Economic activity is also extremely unequally distributed on the national territory: it is almost totally centred around Asunción, despite recent developments in areas close to the Brazilian border,  while the Chaco region, occupying 60% of national territory, generates only 3% of GDP[4].

Unfortunately, official figures are biased by the existence of an extremely large informal sector, 24% of GDP according to recent estimates (IMF, 2000), which occupies approximately half of the urban labour force (Sohn, 2005), and includes trade in counterfeit goods, drugs, money laundering, smuggling, arms trafficking and also not registered legal activities. Therefore, the importance of trade is understated: it is estimated that as much as half of Paraguayan imports are illegally re-exported to Brazil and Argentina. Smuggling is consistent especially in the border city of Ciudad del Este, where Paraguay, Argentina and Brazil meet, although in recent years it has reduced due to tighter Brazilian border controls and to less favourable exchange rates. Paraguay is also a route for drug trafficking of Bolivian cocaine on route to the US and Europe. Contraband trade facilitates money laundering, a considerable phenomenon since the mid 1990s[5], thanks also to weak prosecution: an anti money laundering law introduced in 1997 is not rigorously enforced.

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[1] Statistical data are from National statistical sources: the Statistical Directorate (DGEEC – Dirección General Estadisticas, Encuestas y Censos) and the Central Bank (*Banco Central del Paraguay*); and from international sources: the UN Human Development Indicators, the World Development Indicators (World Bank), the Economist Intelligence Unit, the International Bureau of Fiscal Documentation (IBFD).

[2] The national currency is the Guaranì (PYG) since 1943, when it replaced the Gold Peso. From 1960 to 1982, the Guaranì was pegged to the United States Dollar at an exchange rate of 126 PYG = 1 US$. It was then under controlled fluctuation, with multiple exchange rates until February 1989, when Paraguay adopted a single free-floating exchange rate. In 2005 the average exchange rate with the US dollar was 6,178 PYG = 1 US$ (IMF, International Financial Statistics).

[3] Besides Brazil and Guatemala, only few African countries display a more unequal income distribution (UN, 2005).

[4] The Chaco, lying on the west and on the north of the country, is a flat region occupied by an infertile scrub forest and by a desert near the Bolivian border.

[5] EIU (2006) reports that in 1994 the foreign currency market registered the movement of over 66bn US$, 8.5 times larger than GDP for the same year.

This is not uncommon: laws are often weakly enforced or not applied at all[6]. In addition corruption is widespread: in 2005 Paraguay was ranked the fifth most corrupt country of 159 countries studied by Transparency International (TI, 2005). Corruption extends to all aspects of social, economic and especially political life. In public administration corruption is endemic and takes a multiplicity of shapes (Nickson, 2004b).

Within this framework, economic growth is strongly hindered. Over the last 15 years the Paraguayan economy has gone through few years of growth followed by years of stagnation and recession. Between 1990-2003 the average GDP growth was slightly negative (-0.6%), and negative or zero between 1998-2002. The export-led growth driven by agricultural produce is encountering serious difficulties, due to the over-exposition to weather effects on agricultural yields and to international prices' fluctuations. Exports contracted also as a consequence of the economic downturns of Paraguay main trading partners, Argentina and Brazil. In addition, since 1995 the economy has been plagued by repeated banking crises. Finally, political uncertainty has discouraged private investments. Since 2003 the economy has been slowly recovering, thanks also to improved macro-economic management. In 2004, GDP grew by 4.1% and per capita income by 2.8%, levels not touched since 1995. However, per capita income in 2004 is slightly lower than in 1991 and remains among the lowest in Latin America, poverty and extreme poverty are diffuse, income inequality is a plague.

The poor economic performance has been accompanied by no structural change. The economy still relies primarily on agriculture, its contribution to total GDP grew from 27% in 1990 to 31% in 2003. Agriculture employs 30% of total workforce and generates 80% of revenues from registered exports[7]. It is based on great estates and the main crops are soybean and cotton. In recent years considerable Brazilian investments were directed to soybean production in the Eastern region of the country, favoured by low land costs and land availability following substantial deforestation. In terms of contribution to GDP, agriculture is followed by the commercial services sector, but its share declined from 26% to 20%.

The industrial sector is underdeveloped, its contribution to total GDP is limited and declining (from 16% in 1991 to 14% in 2003), and it is mainly limited to agricultural products processing and to the production of basic consumer goods for the internal market. In addition, major companies remain in public sector ownership, despite repeated attempts to privatise State assets. Scarce industrialisation dates back to the Stroessner regime. Differently from other Latin American countries, the country did not promote import substituting industrialisation, nor protected infant national industries through a system of import tariffs, and stayed open to international trade. Other factors contributed to this underdevelopment, primarily the landlocked geographical position and the lack of significant mineral resources. The influence of two powerful neighbours, Argentina and Brazil, with an interest in Paraguay as a market for their industries and as a cheap energy supplier is often listed as an additional cause. In fact, the enormous energy resources made

[6] Examples abound, with reference to the public sector, the 1970 and 2001 civil service reform (law 200/70 and law 1626/01) were approved and then not implemented. The 2001 law compelling Government to propose balanced budget is generally ignored.

[7] The main exports are soybean, cotton, timber and meat products, which amount respectively to 36%, 7%, 5% and 10% of total exports in 2004 (Banco Central del Paraguay, 2006).

available by the two bi-national hydroelectric projects (Itaipù with Brazil and Yaciretà with Argentina) are not used to promote industrialisation, but are almost entirely exported to Brazil and Argentina.[8]

Despite Paraguay entered into the Mercado Comùn del Sur (Mercosur - the South Cone free trade agreement) in 1991, its export industries received no significant impulse.[9] However, in 2004 the trading bloc instituted a regional development fund which will benefit Paraguay as a less developed country within Mercosur. Furthermore, regional integration favoured an increase in trade relations among Mercosur countries: Brazil is Paraguay first trade partner, followed by Uruguay and Argentina[10]. As regards the external sector, since 2002 the current account of the balance of payments of Paraguay recorded a surplus, but the trade balance is constantly in deficit. Despite a significant increase in exports in the last couple of years, imports have increased at a faster rate. Exports include only a small range of goods, directed to a limited set of countries – hence the high vulnerability of Paraguay economy to sector or regional crises. More generally, since 2003 the overall balance of payments shows a surplus, and its yearly increase in 2004 was 16%, resulting in the accumulation of foreign exchange reserves.

Since 1989, economic policy has focused on monetary and fiscal stabilisation and on regional integration as preconditions for sustained economic growth. The high inflation rates of the late 1980s and early 1990s have been brought under control since 1995. The annual rate of inflation declined from 38% in 1990 to 6.8% in 2005. Balanced budgets have been pursued throughout the 1990s, but in the late 1990s fiscal deficit widened. Public finances are negatively affected by economic stagnation, by the significant extent of informal economy and illegal trade, and by the widespread corruption. Furthermore, tax collection is largely inefficient and tax evasion widespread (Villela et al, 2005). Finally, the low industrialisation limits the extent of the tax base.

The Paraguayan public sector is characterised by extremely low levels of efficiency and effectiveness[11], high politicization and an endemic level of corruption (Nickson and Lambert, 2002), but its size is small compared to that of other Latin American countries. In 2003 General Government total revenues were 20.2% of GDP, entirely from current sources, while total expenditures were 20.4% of GDP, of which 16.5% current expenditures and 3.9% capital expenditures. The year closed with a deficit of 0.2% of GDP, lower than that registered in 2002 (2.8%), confirming a trend of excess spending that has characterised nearly all years since 1995. During 2003 a large fiscal imbalance led to weeks long arrears in salary payments to public sector

[8] Paraguay has the second world's highest per capita energy resource availability after Nepal. A viable economic development strategy would be to use this enormous energy endowment to become a regional hub for energy-intensive industries (Nickson, 2004a).

[9] Mercosur was established on 26 march 1991 by the Treaty of Asunción, signed by Argentina, Brazil, Paraguay and Uruguay. Under the agreement, a custom union has been developed and a full common market should follow: a common external tariff has been established and tariffs in goods originating in and traded among member countries have been gradually reduced and then eliminated in 1995 with some exceptions (textiles, steel, automobiles, petrochemicals).

[10] Until 1997 Paraguay second main trading partner were the Netherlands (soybean trade). In 2004 exports to Brazil, Uruguay and Argentina amounted to 54.2% of total exports, the share of each country being, respectively, 19.2%, 27.8% and 6.3% (EIU, 2006).

[11] Extremely low levels of efficiency and effectiveness are partially a legacy of the Stroessner years, when public administrators were rewarded by patronage and privileges rather than by performance monitoring (Nickson and Lambert, 2002).

workers and Paraguay was at the edge of external default when the first repayments on a 400 million US dollars loan from Taiwan became due. The IMF assisted the Government, and in December 2003 it approved a 73 million US dollars Stand By Agreement, giving the government access to loan disbursements from the World Bank and the Inter-American Development Bank, to be used to regularize external debt servicing. The Government has treated this arrangement as precautionary (the funds were added to international reserves, to be used only in the event of an economic crisis). The agreement was signed after a number of reforms where introduced both as regards fiscal policy and tax administration.

Due to the lack of disaggregated data, a detailed analysis of public sector finances is possible only with reference to Central Government[12]. This aggregate is however significant and in 2003 it amounted to approximately 83% of general government revenues and 85% of general government expenditures. Turning to Central government revenues (table 1), in 2003 they amounted to 16.8% of GDP, the main sources being tax revenues (10.2% of GDP), non tax revenues – primarily revenues from Itaipù (5.1% of GDP) and social security contributions (1% of GDP). Tax revenues increased with respect to 2002, but between 1990 and 2003 they fluctuated and their increase since 1990 is extremely limited (+0.6% of GDP). Revenues from Itaipù are a consistent and constant source of income, while social contributions are a minor revenue. In 2003 expenditures amounted to 17.2% of GDP, current expenditures were 13.8% of GDP, mainly consisting of personnel expenditures, which grew from 3.4% of GDP in 1990 to 7.5% of GDP in 2003[13]. Capital expenditures were 3.7% of GDP, while interests on public debt were 1.3% of GDP, mainly repayments to external sources.

With reference to tax revenues, a more detailed analysis reveals the predominance of indirect taxation, yielding 82% of total tax revenues (8.4% of GDP), and within this category, the primary role of VAT (4.3% of GDP) and custom duties (1.8% of GDP). Direct tax yield is significantly lower, 1.7% of GDP, almost entirely consisting of revenues from the corporate income tax.

## 2.2 Tax system and its structure since the 1990s and a comparison with other countries

Paraguay current tax system was established in 1991 (law 125/91, approved the 9th January 1992). The 1991 fiscal reform aimed to rationalise and modernise an obsolete tax system, based on about 150 specific taxes with widespread exemptions.

The new tax system is based on 9 main taxes and rests primarily on indirect taxation. Since its approval, numerous incentives, deductions and exemptions have been introduced, which eroded the tax base (Alarcón, 2004). Furthermore, this tax system lacks a net wealth tax and an inheritance and gift tax and, until recently, it was characterised by the absence of a personal income tax.

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[12] Detailed official statistics by the National Statistic Institute (DGEEC) and by the Treasury (*Ministero de Hacienda*) exist only for the Central Government, less detailed statistics are provided for General Government, no statistics for decentralised Governments.

[13] Public sector employment grew by 50% between 1989 and 2004 (Nickson, 2004b). This trend is the opposite of that registered in most Latin American countries, but it is due to the relatively limited number of public officials, especially in the health and education sectors, which were understaffed during the Stroessner years.

*Tab 1* The structure and development of Central Government fiscal revenues in Paraguay since 1990 as a percentage of GDP

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Total tax revenues* | *9.4* | *9.1* | *9.1* | *9.3* | *11.0* | *12.5* | *11.5* | *11.6* | *11.5* | *10.5* | *10.8* | *10.8* | *10.0* | *10.2* | *12.3* |
| *Direct taxes* | *1.5* | *1.5* | *1.8* | *1.6* | *2.3* | *2.6* | *2.5* | *2.2* | *2.2* | *2.4* | *2.0* | *1.8* | *2.0* | *1.7* | *2.2* |
| Tax on income | 1.2 | 1.2 | 1.5 | 1.6 | 2.3 | 2.5 | 2.4 | 2.2 | 2.2 | 2.4 | 2.0 | 1.7 | 2.0 | 1.7 | 2.2 |
| Individuals | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Corporations | 1.2 | 1.2 | 1.5 | 1.6 | 2.3 | 2.5 | 2.4 | 2.2 | 2.2 | 2.4 | 2.0 | 1.7 | 2.0 | 1.7 | 2.2 |
| *of which:* corporate income | | | | | | | | | *2.12* | *2.36* | *1.91* | *1.68* | *1.95* | *1.68* | *2.13* |
| Property | 0.3 | 0.3 | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| *Indirect taxes* | *7.9* | *7.6* | *7.3* | *7.6* | *8.8* | *9.9* | *9.1* | *9.3* | *9.3* | *8.1* | *8.8* | *9.0* | *8.0* | *8.4* | *10.1* |
| General sales (VAT) | 0.0 | 0.0 | 1.4 | 3.7 | 4.5 | 4.9 | 4.5 | 4.9 | 4.9 | 4.6 | 4.7 | 4.6 | 4.3 | 4.3 | 4.8 |
| Excises | 1.1 | 1.1 | 1.3 | 1.2 | 1.3 | 1.3 | 1.5 | 1.4 | 1.4 | 1.4 | 1.8 | 2.2 | 1.8 | 2.0 | 2.5 |
| *of which:* oil | | | | | | | | | *0.71* | *0.70* | *1.26* | *1.57* | *1.26* | *1.56* | *2.03* |
| Custom duties | 2.3 | 2.1 | 1.8 | 1.9 | 2.2 | 3.1 | 2.5 | 2.5 | 2.4 | 1.8 | 2.0 | 1.9 | 1.7 | 1.8 | 2.2 |
| Other | 4.6 | 4.4 | 2.7 | 0.8 | 0.7 | 0.6 | 0.5 | 0.5 | 0.5 | 0.4 | 0.4 | 0.4 | 0.2 | 0.3 | 0.5 |
| *Social contributions* | *0.5* | *0.6* | *0.8* | *0.9* | *1.0* | *1.1* | *1.2* | *1.2* | *1.1* | *1.3* | *1.2* | *1.2* | *1.2* | *1.0* | *1.1* |
| *Total fiscal revenues* | *9.9* | *9.8* | *9.9* | *10.2* | *12.0* | *13.6* | *12.7* | *12.7* | *12.6* | *11.8* | *12.0* | *12.0* | *11.2* | *11.2* | *13.3* |

* provisional

Source: CEPAL; corporate income and excise on oil data are from the Dirección de Planificación y Técnica Tributaria, S.E.T. – Ministero de Hacienda, Asunción, Paraguay

The Administrative Reform and Fiscal Adjustment Law approved in June 2004 (law 2421/04, the so-called "*Impuestazo*") introduced some amendments to this system with the potential to raise significant new revenues: it broadens the VAT tax base and the corporate income tax, it introduces a more effective tax regime to large producers, it eliminates some large exemptions, and, finally, it introduces a new personal income tax. However, after major protests, the application of most of the provisions of this law was initially postponed to the year 2006. The law had immediate effect only with regards to the abrogation of many of the exemptions to law 125/91.

While the structure of the tax system is not significantly different from that of other Latin American countries (except for the absence of a personal income tax, a feature that Paraguay shares only with Uruguay), data on fiscal pressure and tax revenues evidence a number of peculiarities. A comparison of Paraguay tax system with that of other Latin American countries is possible only with reference to Central Government. This however is a partial limit, as the only significant tax collected at the local level is property tax, with an extremely limited yield (see below, paragraph 4.2).

With reference to the Central Government, in 2003 fiscal pressure, as percentage of GDP, was 11.2%, the fourth lowest level in the Region after Haiti, Guatemala and Venezuela, well below the regional average of 15% (which is the mean of wide ranging values, from a minimum of 8.9% registered by Haiti to a maximum of 25% in Brazil) (table 2). If we exclude social security contributions and take into consideration tax revenues only (table 3), Paraguay remains the country with the fourth lowest level of revenues (10.2% of GDP), while the range of tax revenues in Latin American countries reduces significantly: from 8.9% of Haiti to 16.9% of Uruguay, for a regional average of 12.4%. This result is influenced by the different social security systems and the recent reforms undertaken by some countries (Jiménez and Cuadros, 2003).

Compared to the tax system of other Latin American countries (Martner and Tromben, 2004), that of Paraguay displays a number of similar features, but also some peculiar elements. First, similarly to other Latin American countries, Central Government tax revenues in Paraguay have increased since the early 1990s (+8.3% from 1990 to 2003). However, Paraguay performance was very weak in relative terms: its growth rate is significantly lower than the regional average of 35% and its ranking has worsened, from ninth to one of the lowest of 18 countries. In addition, Paraguay well reflects the regional trends as regards the contribution of different taxes to this increase: VAT revenues grew significantly (+16% from 1993 to 2003), and revenues from indirect taxes increased by 15% over the same period (table 1).

Second, similarly to other countries in the Region, revenues from income taxes display a very low collection level, 1.7% of GDP in 2003, but this value is the lowest registered, well below the regional average of 4.1% of GDP (table 4), while indirect tax revenues (8.4% of GDP) are slightly above the regional average of 8.3% (table 5). Again Paraguay displays a peculiar performance over the period 1990-2003: both direct and indirect tax revenues' growth has been well below the mean regional value. Indirect tax revenues grew by of 6% against an average of 22%, the growth in revenues from direct taxes has been negligible, 1% against an average of 52%.

*Tab 2* Latin America: Central Government fiscal revenues 1990-2004 (%GDP)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Argentina | 12.1 | 13.3 | 14.3 | 13.9 | 13.6 | 12.9 | 12.3 | 12.7 | 12.9 | 12.9 | 13.1 | 13.2 | 12.8 | 15.1 | 17.0 |
| Bolivia | 8.2 | 8.5 | 10.2 | 10.6 | 11.1 | 11.8 | 13.1 | 14.4 | 14.8 | 14.0 | 14.0 | 13.8 | 14.2 | 14.8 | 16.9 |
| Brasil | 20.7 | 16.9 | 17.6 | 18.5 | 20.8 | 20.5 | 19.8 | 20.1 | 20.9 | 22.6 | 23.0 | 23.9 | 25.7 | 25.0 | 25.8 |
| Chile | 15.6 | 17.3 | 17.8 | 18.4 | 17.6 | 16.8 | 17.9 | 17.6 | 17.8 | 17.1 | 17.8 | 18.2 | 18.1 | 17.4 | 17.3 |
| Colombia | 8.7 | 10.7 | 11.3 | 11.8 | 12.8 | 13.4 | 14.2 | 15.2 | 14.4 | 14.2 | 14.1 | 16.0 | 15.9 | 16.1 | 17.2 |
| Costa Rica | 11.0 | 11.3 | 11.9 | 12.0 | 11.6 | 12.3 | 12.6 | 12.5 | 12.6 | 11.9 | 12.3 | 13.2 | 13.2 | 13.4 | 13.5 |
| Ecuador | 9.7 | 9.8 | 9.6 | 9.5 | 9.5 | 9.6 | 8.7 | 9.9 | 10.5 | 10.3 | 11.6 | 13.4 | 14.5 | 13.6 | 13.7 |
| El Salvador | 9.5 | 10.1 | 11.7 | 11.4 | 12.4 | 13.8 | 13.5 | 13.0 | 12.8 | 12.8 | 13.0 | 12.3 | 13.0 | 13.4 | 13.2 |
| Guatemala | 6.9 | 8.2 | 8.4 | 8.1 | 6.9 | 8.1 | 8.9 | 9.1 | 8.9 | 9.6 | 9.7 | 9.9 | 10.8 | 10.6 | 10.6 |
| Haiti | 7.3 | 7.5 | 4.4 | 4.7 | 2.5 | 5.5 | 6.9 | 8.7 | 8.3 | 8.8 | 7.9 | 7.4 | 8.2 | 8.9 | 8.9 |
| Honduras | 15.3 | 16.3 | 15.8 | 16.4 | 15.6 | 16.9 | 14.8 | 14.2 | 17.2 | 18.3 | 17.0 | 16.9 | 17.1 | 17.6 | 18.2 |
| México | 12.6 | 12.7 | 13.4 | 13.7 | 13.7 | 11.3 | 10.9 | 11.6 | 12.0 | 12.9 | 12.1 | 12.9 | 13.2 | 12.6 | 11.5 |
| Nicaragua | 9.0 | 12.4 | 13.6 | 13.0 | 13.7 | 14.2 | 14.2 | 15.7 | 17.2 | 17.1 | 17.4 | 16.9 | 16.8 | 18.4 | 18.9 |
| Panama | 14.7 | 15.3 | 15.0 | 16.1 | 16.2 | 17.4 | 17.1 | 16.8 | 16.2 | 16.6 | 16.0 | 15.0 | 14.8 | 14.7 | 14.9 |
| Paraguay | 9.9 | 9.8 | 9.9 | 10.2 | 12.0 | 13.6 | 12.7 | 12.7 | 12.6 | 11.8 | 12.0 | 12.0 | 11.2 | 11.2 | 13.3 |
| Peru | 11.6 | 13.1 | 14.1 | 14.3 | 14.9 | 15.4 | 15.8 | 16.0 | 15.6 | 14.4 | 14.0 | 14.2 | 13.8 | 14.7 | 14.9 |
| Dominican Republic | 10.5 | 11.9 | 13.9 | 14.9 | 14.1 | 13.9 | 13.2 | 14.8 | 15.1 | 15.6 | 15.0 | 15.9 | 15.9 | 14.8 | 15.1 |
| Uruguay | 22.4 | 23.1 | 24.6 | 23.8 | 23.3 | 23.1 | 23.1 | 23.6 | 24.1 | 24.1 | 23.6 | 23.6 | 22.8 | 23.0 | 23.1 |
| Venezuela | 4.4 | 4.8 | 5.9 | 7.1 | 9.4 | 8.9 | 8.2 | 10.1 | 11.6 | 11.6 | 9.4 | 9.6 | 10.3 | 10.4 | 11.0 |
| *Simple average* | *11.6* | *12.3* | *12.8* | *13.1* | *13.2* | *13.7* | *13.6* | *14.2* | *14.5* | *14.5* | *14.4* | *14.6* | *14.8* | *15.0* | *15.5* |

* Preliminary

Source: ILPES-CEPAL

*Tab 3* Latin America: Central Government tax revenues 1990-2004 (%GDP)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Argentina | 8.0 | 8.7 | 8.9 | 8.3 | 8.2 | 8.2 | 8.3 | 8.9 | 9.2 | 9.3 | 9.7 | 9.9 | 9.9 | 12.3 | 13.9 |
| Bolivia | 7.0 | 7.2 | 9.0 | 9.4 | 9.9 | 10.6 | 10.8 | 12.0 | 13.1 | 12.0 | 12.3 | 12.0 | 12.2 | 12.4 | 14.5 |
| Brazil | 11.4 | 8.8 | 9.3 | 9.5 | 10.7 | 10.6 | 9.8 | 9.6 | 10.6 | 11.2 | 10.5 | 10.9 | 12.0 | 11.3 | 11.1 |
| Chile | 14.0 | 15.9 | 16.3 | 16.9 | 16.2 | 15.6 | 16.7 | 16.3 | 16.4 | 15.7 | 16.3 | 16.7 | 16.7 | 16.0 | 15.9 |
| Colombia | 7.8 | 8.9 | 9.4 | 9.7 | 10.0 | 9.7 | 10.1 | 10.8 | 10.6 | 10.6 | 11.2 | 13.2 | 13.2 | 13.6 | 14.4 |
| Costa Rica | 10.8 | 11.1 | 11.6 | 11.6 | 11.2 | 11.9 | 12.0 | 12.0 | 12.1 | 11.5 | 11.9 | 12.8 | 12.8 | 13.0 | 13.1 |
| Ecuador | 7.5 | 7.2 | 6.9 | 7.0 | 7.1 | 7.1 | 6.6 | 8.0 | 8.6 | 8.9 | 10.2 | 11.3 | 11.3 | 10.3 | 10.5 |
| El Salvador | 7.9 | 8.7 | 10.1 | 9.8 | 10.6 | 12.0 | 11.6 | 11.1 | 10.8 | 10.9 | 10.8 | 10.5 | 11.1 | 11.6 | 11.5 |
| Guatemala | 6.9 | 8.2 | 8.4 | 8.1 | 6.9 | 7.9 | 8.7 | 8.9 | 8.7 | 9.3 | 9.5 | 9.7 | 10.6 | 10.3 | 10.3 |
| Haiti | 7.3 | 7.5 | 4.4 | 4.7 | 2.5 | 5.5 | 6.9 | 8.7 | 8.3 | 8.8 | 7.9 | 7.4 | 8.2 | 8.9 | 8.9 |
| Honduras | 14.7 | 15.5 | 15.2 | 15.6 | 14.8 | 16.3 | 14.2 | 13.6 | 16.7 | 17.8 | 16.5 | 16.2 | 15.9 | 16.3 | 17.1 |
| México | 10.7 | 10.7 | 11.3 | 11.4 | 11.3 | 9.3 | 9.0 | 9.8 | 10.5 | 11.4 | 10.6 | 11.3 | 11.6 | 11.1 | 10.1 |
| Nicaragua | 8.1 | 10.9 | 11.9 | 11.5 | 11.9 | 12.2 | 12.3 | 13.7 | 14.9 | 14.7 | 14.5 | 13.6 | 13.5 | 15.0 | 15.5 |
| Panama | 10.3 | 10.9 | 10.9 | 10.4 | 10.3 | 10.9 | 10.6 | 10.7 | 10.1 | 10.6 | 9.6 | 8.8 | 8.9 | 9.0 | 9.1 |
| Paraguay | 9.4 | 9.1 | 9.1 | 9.3 | 11.0 | 12.5 | 11.5 | 11.6 | 11.5 | 10.5 | 10.8 | 10.8 | 10.0 | 10.2 | 12.3 |
| Peru | 10.7 | 11.1 | 12.0 | 12.4 | 13.2 | 13.6 | 14.1 | 14.2 | 14.0 | 12.7 | 12.3 | 12.5 | 12.1 | 13.0 | 13.3 |
| Dominican Republic | 10.5 | 11.9 | 13.8 | 14.8 | 14.0 | 13.8 | 13.1 | 14.7 | 15.0 | 15.5 | 14.9 | 15.7 | 15.7 | 14.7 | 15.1 |
| Uruguay | 14.6 | 14.5 | 15.4 | 15.0 | 14.6 | 14.6 | 14.9 | 15.6 | 16.1 | 15.5 | 15.2 | 15.7 | 15.6 | 16.9 | 17.4 |
| Venezuela | 3.5 | 4.0 | 5.0 | 6.4 | 8.4 | 8.2 | 7.8 | 9.7 | 10.9 | 10.8 | 8.6 | 8.9 | 9.7 | 9.8 | 10.4 |
| *Simple average* | *9.5* | *10.0* | *10.5* | *10.6* | *10.7* | *11.1* | *11.0* | *11.6* | *12.0* | *12.0* | *11.8* | *12.0* | *12.2* | *12.4* | *12.9* |

* Preliminary

Source: ILPES-CEPAL

*Tab 4* Latin America: Central Government direct tax revenues 1990-2004 (%GDP)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Argentina | 1.5 | 2.0 | 1.6 | 1.4 | 1.7 | 1.8 | 2.1 | 2.1 | 2.4 | 2.5 | 2.9 | 3.9 | 3.6 | 4.4 | 5.1 |
| Bolivia | 1.6 | 2.0 | 2.2 | 2.6 | 2.6 | 3.2 | 3.6 | 3.7 | 4.2 | 4.2 | 4.4 | 4.3 | 4.2 | 4.1 | 5.1 |
| Brazil | 8.4 | 6.1 | 6.5 | 6.6 | 8.0 | 7.7 | 7.3 | 7.1 | 8.1 | 8.7 | 8.0 | 8.5 | 9.9 | 9.5 | 9.2 |
| Chile | 2.9 | 4.3 | 4.4 | 4.5 | 4.4 | 4.1 | 4.6 | 4.4 | 4.5 | 4.2 | 4.7 | 5.1 | 5.3 | 5.0 | 4.8 |
| Colombia | 3.2 | 4.2 | 4.4 | 4.5 | 4.2 | 4.0 | 3.8 | 4.4 | 4.3 | 4.8 | 4.9 | 6.1 | 6.5 | 6.6 | 7.2 |
| Costa Rica | 2.2 | 2.1 | 2.1 | 2.5 | 2.5 | 2.8 | 2.6 | 2.6 | 2.9 | 3.3 | 3.1 | 3.5 | 3.5 | 3.8 | 3.8 |
| Ecuador | 1.4 | 1.6 | 1.6 | 1.3 | 1.6 | 2.0 | 1.8 | 2.0 | 1.7 | 3.0 | 3.0 | 2.4 | 2.4 | 2.4 | 2.5 |
| El Salvador | 2.4 | 2.7 | 2.9 | 2.5 | 3.0 | 3.5 | 3.5 | 3.0 | 3.0 | 3.4 | 3.2 | 3.2 | 3.3 | 3.5 | 3.5 |
| Guatemala | 1.6 | 3.1 | 2.0 | 2.0 | 1.2 | 1.7 | 2.1 | 2.2 | 1.9 | 2.1 | 2.5 | 2.5 | 3.0 | 2.9 | 2.8 |
| Haiti | 1.1 | 1.2 | 0.7 | 0.7 | 0.5 | 0.6 | 1.2 | 1.3 | 1.1 | 1.3 | 1.6 | 1.5 | 1.7 | 1.7 | 2.0 |
| Honduras | 3.6 | 4.0 | 4.7 | 4.4 | 3.9 | 5.2 | 4.3 | 4.1 | 4.8 | 4.0 | 3.6 | 3.8 | 3.7 | 3.9 | 4.6 |
| México | 4.6 | 4.8 | 5.5 | 5.8 | 5.3 | 4.2 | 4.0 | 4.4 | 4.6 | 4.9 | 4.9 | 5.1 | 5.3 | 5.2 | 4.7 |
| Nicaragua | 2.3 | 2.1 | 2.1 | 1.6 | 1.3 | 1.7 | 1.8 | 2.1 | 2.2 | 2.2 | 2.3 | 2.4 | 2.8 | 3.9 | 4.4 |
| Panama | 4.5 | 5.1 | 5.0 | 4.6 | 4.6 | 5.1 | 4.8 | 5.1 | 4.2 | 5.0 | 4.7 | 4.4 | 4.5 | 4.3 | 4.4 |
| Paraguay | 1.5 | 1.5 | 1.8 | 1.6 | 2.3 | 2.6 | 2.5 | 2.2 | 2.2 | 2.4 | 2.0 | 1.8 | 2.0 | 1.7 | 2.2 |
| Peru | 1.6 | 1.6 | 2.1 | 2.4 | 2.6 | 2.9 | 3.6 | 3.6 | 3.5 | 2.9 | 2.8 | 3.0 | 3.0 | 3.8 | 3.9 |
| Dominican Republic | 3.0 | 2.8 | 2.8 | 2.9 | 2.9 | 3.2 | 2.9 | 3.3 | 3.4 | 3.5 | 3.5 | 4.4 | 4.2 | 4.3 | 3.4 |
| Uruguay | 2.3 | 2.2 | 2.9 | 3.1 | 3.0 | 3.1 | 3.5 | 3.8 | 4.0 | 3.9 | 3.8 | 3.6 | 3.9 | 4.0 | 4.3 |
| Venezuela | 1.4 | 1.3 | 1.6 | 2.3 | 3.6 | 2.3 | 1.9 | 2.1 | 2.3 | 3.0 | 2.2 | 2.1 | 3.5 | 3.5 | 2.4 |
| *Simple average* | *2.7* | *2.9* | *3.0* | *3.0* | *3.1* | *3.2* | *3.3* | *3.3* | *3.4* | *3.6* | *3.6* | *3.8* | *4.0* | *4.1* | *4.2* |

* Preliminary

Source: ILPES-CEPAL

*Tab 5* Latin America: Central Government indirect tax revenues 1990-2004 (%GDP)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Argentina | 6.5 | 6.6 | 7.3 | 6.9 | 6.5 | 6.3 | 6.2 | 6.9 | 6.8 | 6.8 | 6.8 | 6.0 | 6.3 | 8.0 | 8.8 |
| Bolivia | 5.4 | 5.2 | 6.7 | 6.8 | 7.3 | 7.3 | 7.2 | 8.3 | 9.0 | 7.8 | 7.9 | 7.7 | 8.0 | 8.4 | 9.4 |
| Brazil | 3.0 | 2.7 | 2.8 | 2.9 | 2.7 | 2.9 | 2.6 | 2.5 | 2.5 | 2.5 | 2.5 | 2.4 | 2.1 | 1.8 | 1.8 |
| Chile | 11.0 | 11.5 | 11.9 | 12.4 | 11.8 | 11.5 | 12.1 | 11.9 | 11.9 | 11.5 | 11.7 | 11.6 | 11.3 | 11.0 | 11.1 |
| Colombia | 4.6 | 4.7 | 5.0 | 5.1 | 5.8 | 5.7 | 6.3 | 6.4 | 6.2 | 5.8 | 6.3 | 7.1 | 6.7 | 7.1 | 7.1 |
| Costa Rica | 8.6 | 9.0 | 9.6 | 9.1 | 8.6 | 9.1 | 9.5 | 9.4 | 9.2 | 8.3 | 8.8 | 9.3 | 9.3 | 9.2 | 9.3 |
| Ecuador | 6.1 | 5.6 | 5.4 | 5.7 | 5.4 | 5.1 | 4.8 | 6.0 | 6.9 | 5.9 | 7.2 | 8.9 | 8.9 | 7.9 | 7.9 |
| El Salvador | 5.6 | 6.0 | 7.2 | 7.3 | 7.5 | 8.5 | 8.2 | 8.1 | 7.8 | 7.5 | 7.6 | 7.3 | 7.9 | 8.2 | 8.0 |
| Guatemala | 5.3 | 5.1 | 6.4 | 6.2 | 5.7 | 6.3 | 6.6 | 6.7 | 6.8 | 7.2 | 7.0 | 7.1 | 7.6 | 7.4 | 7.6 |
| Haiti | 6.2 | 6.2 | 3.7 | 4.1 | 2.0 | 4.9 | 5.7 | 7.5 | 7.3 | 7.5 | 6.3 | 5.9 | 6.5 | 7.2 | 6.9 |
| Honduras | 11.1 | 11.6 | 10.5 | 11.2 | 10.9 | 11.1 | 9.8 | 9.5 | 11.9 | 13.8 | 12.9 | 12.4 | 12.2 | 12.4 | 12.5 |
| México | 6.1 | 5.9 | 5.8 | 5.6 | 5.9 | 5.1 | 4.9 | 5.4 | 5.9 | 6.5 | 5.7 | 6.2 | 6.3 | 5.9 | 5.4 |
| Nicaragua | 5.9 | 8.8 | 9.8 | 9.9 | 10.6 | 10.5 | 10.5 | 11.6 | 12.8 | 12.5 | 12.2 | 11.2 | 10.7 | 11.1 | 11.1 |
| Panama | 5.8 | 5.9 | 5.9 | 5.7 | 5.8 | 5.9 | 5.8 | 5.7 | 5.9 | 5.6 | 4.9 | 4.4 | 4.4 | 4.7 | 4.7 |
| Paraguay | 7.9 | 7.6 | 7.3 | 7.6 | 8.8 | 9.9 | 9.1 | 9.3 | 9.3 | 8.1 | 8.8 | 9.0 | 8.0 | 8.4 | 10.1 |
| Peru | 9.1 | 9.5 | 9.9 | 10.0 | 10.5 | 10.7 | 10.4 | 10.5 | 10.4 | 9.8 | 9.5 | 9.5 | 9.1 | 9.2 | 9.5 |
| Dominican Republic | 7.4 | 9.1 | 11.1 | 11.9 | 11.1 | 10.6 | 10.2 | 11.4 | 11.5 | 12.0 | 11.3 | 11.3 | 11.5 | 10.4 | 11.7 |
| Uruguay | 12.3 | 12.3 | 12.5 | 11.9 | 11.6 | 11.5 | 11.3 | 11.8 | 12.1 | 11.6 | 11.4 | 12.1 | 11.7 | 12.9 | 13.0 |
| Venezuela | 2.1 | 2.7 | 3.4 | 4.0 | 4.8 | 5.9 | 6.0 | 7.6 | 8.6 | 7.8 | 6.5 | 6.7 | 6.2 | 6.3 | 8.0 |
| *Simple average* | *6.8* | *7.2* | *7.5* | *7.6* | *7.5* | *7.8* | *7.7* | *8.2* | *8.6* | *8.3* | *8.2* | *8.2* | *8.2* | *8.3* | *8.6* |

* Preliminary

Source: ILPES-CEPAL

In conclusion, Paraguay has not managed, as most of other Latin American countries, to increase its tax revenues, in particular those from direct taxes. The extent of the informal and illegal economy, the inadequacy and inefficiency of tax administration, the diffuse corruption, may have contributed to this outcome. For example, in 1992 VAT compliance in Paraguay was the lowest in Latin America, a mere 23.2%, and remains one of the lowest in 2001 (Martner and Tromben, 2004). Second, 50% of Asunción businesses and retailers in 2004 were not even registered with the tax administration, according to a Ministry of Finance sample inspection (Nickson, 2004b).

## 3. Institutional characteristics of main taxes

Paraguay tax system partially reflects the three-tier government structure[14] (Central Government, Departments and Local Governments). The Central Government has the power to levy the main taxes and duties, such as: corporate income tax (*IRACIS – impuestos a la renta de actividades comerciales industriales o de seguros* and *Tributo Unico*), farming income tax (*IMAGRO – impuesto a la renta agropecuaria*), value added tax (*IVA – impuesto al valor agregado*), excise duties (*impuesto selectivo al consumo*), custom duties (*impuesto al comercio exterior*), registration and stamp duties (*impuesto a los actos y documentos*), and, from the year 2006, personal income tax (*impuesto a la renta personal*). Local Governments levy taxes on immovable property and other minor taxes, while Departments may charge fees for the licences, concessions and other services they offer (table 6).

*Tab 6* Paraguay: main taxes according to Law 125/91, as amended by law 2421/04

| *Type of tax* | *Name of tax* |
|---|---|
| Direct taxes – income taxes | Corporate income tax (*Impuestos a la renta de actividades comerciales industriales o de seguros*)<br>Farming income tax (*Impuesto a la renta agropecuaria*)<br>Single Tax (*Tributo Único*) / Small business income tax (*Impuesto a la renta del pequeño contribuyente*)<br>Personal Income tax (*Impuesto a la renta personal*) |
| Direct taxes – capital taxes | Property Tax (*Impuesto inmobiliario*) |
| Indirect taxes | Value Added tax (*Impuesto al valor agregado*)<br>Excise Taxes (*Impuesto selectivo al consumo*)<br>Custom Duties (*Impuesto al comercio exterior*)<br>Stamp duty (*Impuesto a los actos y documentos*) |

Source: adapted from Ministero de Hacienda, Asunciòn, Paraguay.

The power to introduce, abolish or change fiscal laws is exclusively attributed by the Constitution to the Central Government and Local Governments may only set local tax rates (except for the Municipality of Asunción, which may apply some surcharges). Taxpayers must fulfil some compulsory requirements, such

[14] Constitution, art. 156 on the political and administrative structure of the country.

as: register to the Single Registry of Taxpayers (*Registro Único de Contribuyentes – RUC*) introduced by law 1352/88; issue a receipt for all sales of goods and services; keep a register of receipts issued and of those received upon purchases; make an annual tax declaration using specific self-assessment forms and make payments according to tax-specific deadlines. Tax declarations and all related documents must be kept for 5 years.

The following paragraphs describe the institutional characteristics of main taxes, as they were in 2004, the most recent year for which statistical data are available. Each section ends with a brief description of innovations introduced by the 2004 reform, where applicable.

## 3.1 Direct taxes

Until 2004, direct taxes included a tax on farming income, a tax on corporate income and the Single Tax, a simplified tax that applied to a specific category of businesses, that of individual entrepreneurs, when their total revenues did not exceed a maximum limit defined each year[15], (otherwise they are subject to the corporate income tax). Law 2421/04, when fully into effect, will produce major changes to this system: besides the introduction of a personal income tax and of a small business income tax, it will produce significant changes also to other taxes, as detailed below (see also table 7). It is also expected to generate additional revenues from direct taxes, which were extremely limited until 2003. In 2003 the yield from direct taxes was only 1.7% of GDP, contributing a mere 16.7% to total tax revenues. Taxation of businesses generates 99.5% of total direct tax revenues, while the share of farming income tax is a negligible 0.5%.

*Tab 7* Direct taxes – evolution of tax rates 1993-2007

| *Tax* | *Tax rate* | | |
|---|---|---|---|
| | *1993* | *2006* | *2007* |
| Corporate income tax (*Impuestos a la renta de actividades comerciales industriales o de seguros*) | 30% | 20% | 10% |
| *Tributo Único* / Small business income tax (*Tributo Único / Impuesto a la renta del pequeño contribuyente*) | 4% | 10% | 10% |
| Farming income tax (*Impuesto a la renta agropecuaria*) | 25% | 10%-2.5% | 10%-2.5% |
| Personal Income tax (*Impuesto a la renta personal*) | n/a | 10% | 10%-8% |
| Property Tax (*Impuesto inmobiliario*) | 1%-0.5% | 1%-0.5% | 1%-0.5% |

[15] The 20,400,000 guaranis (approximately 15,394 US$) threshold, set by law 125/91, was to be adjusted every year according to the variation of the Consumers' Price Index published by the Paraguay Central Bank. In 2002 this threshold reached 52,389,833 guaranis (approximately 9,164 US$).

### 3.1.1. Corporate income tax

IRACIS, the corporate income tax, is charged under the Fiscal Reform Law (law 125/91). It is an annual tax on income of resident[16] legal bodies[17] levied by the central government. Individual entrepreneurs are chargeable when their total income exceeds the maximum exemption limit.

Taxation is based on the source principle, the taxable income is made of all incomes of Paraguayan source, among which the following heads: revenues from trade, industry and services, profits and gains, capital gains from sales of immovable property by commercial companies or by any taxpayer selling more than two properties in the tax year. However, exemption is granted to a number of heads: dividends and profits distributions received by residents subject to IRACIS; interests from state or local government securities; interests on investments with domestic financial institutions; interests on saving accounts with financial institutions; interests on publicly traded securities issued by open joint-stock corporations; capital gains from the placement or sale of securities issued by open joint-stock corporations.

The basis of taxation is given by total gross revenue net of some deductions:

- Depreciation allowances;
- Overheads for rent, electricity, telephone, advertisements, stationery, machines installation and maintenance;
- Donations to central or local governments, to religious organisations and other charities – up to 1% of the donator net revenue;
- Commissions are deductible provided that the associated social security contributions have been paid;
- Salaries and other labour expenses. Benefits are totally deductible when imposed by law. Otherwise they are partially deductible, up to a maximum of 10% of profits before taxation;
- Service charges. Professional charges that are not subject to IRACIS are deductible up to a maximum amount equal to 1% of the taxpayer total yearly revenue, or up to 2.5% when professional charges include the value added tax.

A flat tax rate of 30%[18] is applied to total yearly gross revenues, net of allowed deductions, and the tax is assessed and paid during the following financial year (running from 1st January to 31st December).[19]

Tax exemption is granted to a selected group of legal bodies:

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[16] An individual has the status of 'resident' if s/he stayed in Paraguay for a minimum of 180 days during the previous 12 months. A company is 'resident' if it was established in Paraguay according to Paraguayan law (excluding its branches or agencies abroad) or if it is a branch, agency or plant owned by non residents but established in Paraguay and therefore compulsorily registered in the Single Registry of Taxpayers. Paraguayan-source income of non-residents is taxed at the following rates: 5% for dividends and other profit distributions; a surtax of 5% on after tax profits of branches, agencies or establishments; 35% for other income.

[17] Legal bodies include companies, associations, cooperatives, foundations, private bodies, public companies, public agencies, non resident bodies and their branches, agencies and plants on Paraguayan territory.

[18] This tax rate, set in 1991, has not changed until the 2004 reform.

[19] The fiscal year ends on 31st December for all activities except sugar mills and cooperative societies processing agricultural products (the fiscal year ends on the 30th April); insurance and reinsurance companies, breweries and producers of soft drink (the fiscal year ends on the 30th of June).

- Central government, local governments, government agencies, mixed-economy companies and binational bodies with respect to donations received (which are deductible for the donor);
- religious institutions, with regard to income from religious and cult services and from donations destined to such purposes;
- qualified not for profit organisations;
- The Housing National Board (CONAVI);
- Universities;
- Legally recognised cooperative societies, established after the 1st January 1992, during their first five years of operation;
- The Paraguayan Central Bank.

Exemption is also granted to free zone activities located in the international free zone of Ciudad del Este harbour[20]. Free zone activities include trade (introduction of goods from abroad or from national custom areas), industry (manufacturing and processing of goods for export) and services.

Tax payment is based on self-assessment. The tax is prepaid, in four instalments, in the months of May, July, September and November. Each instalment is equal to 25% of the IRACIS due for the previous year. Prepayments are credited against the final liability, eventually paid when filing tax returns.

The Fiscal Adjustment Law (law 2421/04) approved in June 2004 introduces some significant changes to this tax both as regards the tax rate and the tax base. First, it lowers the tax rate from 30% to 20% during its first year of application (2005) and to 10% from the second year onwards (2006). Dividends and profits distributions received by residents are taxed at the reduced rate of 5% (instead of being exempted, as before). Secondly, the law extends the tax base and abolishes special regimes. It eliminates many exemptions, most importantly the five-year tax holiday on first-time investment and the exemption of interests from bonds, and it limits the exemption for non profit organisations to those not permanently involved in revenue-generating activities. However, the law safeguards exemptions on education, savings corporations, cooperatives, and interests and capital gains on shares and public bonds. Thirdly, the definition of taxable income is extended, and interests from capital investments abroad are included as revenues of Paraguayan origin.

### 3.1.2. Single tax / Small Business Tax

The Single Tax was introduced by law 125/91 and it is charged on individual entrepreneurs, residents in Paraguay, whose revenues are below the IRACIS threshold. Those chargeable are exempted from the value added tax and from the corporate income tax. The tax base are the revenues from commercial, industrial or service activities. The tax is levied at a rate of 4%, and the taxable income is the highest between the declared and an imputed gross income, the latter is calculated by adding the annual value of the following indicators of expenses (as detailed in table 8):

- Salaries and wages (including the owner's salary, by convention equal to the minimum wage);

[20] Law 523/95.

- Rent for properties needed for the activity;
- Utility bills (electricity, water and telecommunication);
- Purchases of goods, raw materials, including fuel, as well as other purchases and expenses, excluding financial expenditures and fixed assets (the amount of this item is increased by a 30% profit mark-up, according to the concept of presumed utility – "*utilidad presunta*" ).

*Tab 8* Imputed income and the Single Tax (*Tributo Unico*)

| *Items* | |
|---|---|
| a) Salaries and wages | + |
| b) Rent for properties needed for the activity | + |
| c) Utility bills | + |
| d) Purchases | + |
| e) Presumed utility (30% of point d) | = |
| Imputed Income | x |
| Tax rate (4%) | = |
| Tax | |

Source: Ministero de Hacienda, Asunciòn, Paraguay.

A tax credit of 50% of documented VAT paid during the fiscal year is allowed up to the taxpayers' Single Tax liability.

The 2004 reform (law 2421/04) abolishes this tax and substitutes it with a small business tax (*impuesto a la renta del pequeño contribuyente*), that differs under three main respects: the tax rate, the definition of the tax base and the threshold for its application. The small business tax is charged at a rate of 10%, the same as that of the Corporate income tax. The taxable base is net income, calculated as the difference between revenues and expenses, or an imputed income equal to 30% of gross revenues. Compared to the Single Tax, this tax is charged upon a wider range of businesses: the threshold for its application is elevated to 100 million guaranis (approximately 16,738 US$ in 2004). Furthermore, the tax credit for VAT paid does not apply anymore. The small business tax has the potential to reduce the distortions favoured by the previous regime, primarily the incentives for tax evasion by large companies due to the existence of two different tax rates for smaller and bigger businesses.

### 3.1.3. Farming income tax

IMAGRO, the farming income tax, is charged under the Fiscal Reform Law (law 125/91). It is an annual tax on income from farming activity carried out in the national territory and it is levied by the Central Government. Farming activities include all activities carried out in order to obtain primary products by using the factor land, such as: livestock conduction, production of wool or leather; fruit and vegetables production; milk production. It includes also the possession of rural buildings (regardless of the activity they are used for). Every legal body or person undertaking farming activity is chargeable to the farming income tax at the flat rate of 25%. The taxable income is given by the imputed gross rent from the land[21], equal to 12% of the fiscal value of the land defined by the National Land Register Service (*Servicio Nacional del Catastro*). The tax is paid within four months after the end of the fiscal year and the following heads are exempted:

- Real estates of less than 20 hectares. Furthermore, 20 hectares are excluded from calculation of gross rent for real estates of less than 100 hectares;
- Parts of real estates occupied by forests and permanent lagoons.

The basis for taxation is the gross rent after deducting the following heads:

- Expenses incurred in relation to the farming activity –calculated in presumptive form and equal to 40% of gross rent or 45% when the taxpayer is a tenant;
- VAT paid on goods and services purchased for the farming activity – up to a maximum of 30% of gross rent. If VAT paid exceeds this limit, the excess can be taken forward as tax credit in the following years;
- Losses due to natural causes – the amount to be deducted, as a percentage of gross rent, is fixed by law when natural accidents occur.

The 2004 reform (law 2421/04) overhauls this tax by introducing a distinction between large and medium-sized landholders[22] both as regards the taxable income and the tax rate. While large landholders are taxed on their net income (total revenues net of expenditures linked to the activity), as happened before the reform, medium-sized ones are taxed on presumptive income, calculated on the basis of productivity coefficients defined in the law. The IMF (2005) considers that, due to the low values of the productivity coefficients, the tax on medium-size landholdings will not generate significant revenues and that the majority of the revenues from this tax will come from the richest landholders. Similarly to the previous regime, small landholders are exempted[23]. The reform reduces the tax rate, from 25% to 10% for large landholders and to 2.5% for medium-sized landholders.

### 3.1.4. Personal income tax

The Fiscal Adjustment Law (law 2421/04) introduces a new personal income tax (*impuesto a la renta personal*), scheduled to take in effect from the year 2006. The tax, levied by the central government, will be initially charged only on individuals and on individual entrepreneurs whose income exceeds ten minimum monthly wages[24], at a tax rate of 10%. Gradually the tax will extend to all individuals with an income above three minimum monthly wages[25], and a tax rate of 8% will apply to taxpayers with an income below ten minimum monthly wages, while higher incomes will be taxed at 10%. The tax structure is therefore

[21] The imputed gross rent is attributed to the land owner, unless the land is used by third parties (as formally stated in a written contract).
[22] Large landholders are those with a property larger than 300 hectares in the Eastern Region and larger than 1.500 hectares in the Western Region. Medium- sized ones are those between 20 and 300 hectares in the former region and between 100 and 1500 hectares in the latter one.
[23] Small landholders are those whose property is smaller than 20 hectares in the Eastern Region and smaller than 100 hectares in the Western Region.
[24] In 2004 the minimum wage amounted to 972,413 guaranis (165 US$).
[25] The initial thresholds of ten minimum monthly wages will be reduced each year of one minimum wage, to reach, after seven years, the final threshold of three minimum monthly wages.

progressive through increasing bracket tax rates. The taxable base is gross income from Paraguayan sources, defined as: employment income; 50% of dividends and profits distributions received as shareholders of companies subject to IRACIS; capital gains from the transfer of properties (buildings or land); interests. The basis of taxation is the gross income net of deductions: social security contributions, donations to the state or other bodies, expenditures and investments related to the contributor's job or profession, personal and family expenses supported by VAT receipts. This latter provision aims to reduce the high levels of tax evasion. However this will likely increase the costs of administering the tax (IMF, 2005).

## 3.2 Indirect taxes

Indirect taxes are the backbone of Paraguay tax system: in 2003 they yielded 82.4% of total tax revenues (84% of GDP). VAT alone generates 51.2% of total indirect tax revenues (equal to 4.3% of GDP), while excise taxes and custom duties yield respectively 23.8% and 21.4% of total indirect tax revenues (equal to 2% and 1.8% of GDP, respectively). A critical issue for public finances is the reduction of revenues from trade tariffs, caused by the increased regional integration (-19% from 1990 to 2003). Other minor indirect taxes, among which stamp duties, amount only to 3.6% of revenues (0.3% of GDP).

### 3.2.1. Value Added Tax

In 1993 Paraguay was one of the last Latin American countries to introduce a value added tax[26]. Its introduction represented one of the main innovations of the 1991 fiscal reform (law 125/91), and the VAT is now the pillar of the country fiscal systems, generating more than 40% of total tax revenues. The tax is of the consumption type and it applies the destination principle.

The value added tax is levied by the Central Government on the sale of goods and services and on the import of goods. The tax is charged on individuals selling personal services with an annual gross income above a fixed threshold[27]; on resident individual entrepreneurs with an income above the IRACIS threshold, and on all other legal bodies and importers, regardless of their income. Exports are not liable to VAT and exporters can recover the VAT paid on inputs through a system of fiscal credits against any kind of tax.

The VAT rate is 10% and the seller of goods or the provider of services needs to include the tax in the price and to state its value in the invoices.

Originally a tax characterised by a wide basis, the VAT actual tax base (and therefore tax revenues) has been eroded by the introduction of a wide array of privileged regimes and exceptions for some types of transactions (e.g. tourism, transports) and of various exemptions, among which:

- fuels from mineral oil and imports of crude oil;

[26] Uruguay introduced VAT in the 1960s, and in the following two decades it was introduced in all other Latin American countries, except Paraguay and Venezuela.

[27] The threshold of 9,600,000 guaranis (approximately 7,244 US$) fixed by law 125/91 was to be adjusted every year in accordance with the variation of the Consumers' Price Index. In 2001 it reached 18,266,216 guaranis (approximately 4,449 US$).

- raw farm products, foreign currency, shares, securities, immovable property;
- inheritances;
- tangible fixed assets not produced in Paraguay and imported by first time investors, as defined by the law 60/91 the so-called "investments incentive law");
- leasing of immovable properties, interests on securities, certain financial brokerage activities, loans to and deposit with financial institutions, loans made by certain financial institutions.

In addition, exemptions apply also to political parties, social welfare organisations, officially recognised educational and training bodies, not for profit organisations (so long as they do not distribute profits to their members).

Exceptions apply to tourism and to public transport (national and international):

- tourism: the tax rate of 10% is applied to a reduced tax base, equal to 15% of the value of imports (as a consequence, the actual tax rate is reduced to 1.5%);
- passengers public transport services: the tax base relevant for the application of the tax is 7.5% of the actual tax base, therefore the actual tax rate is only 0.75%;
- international transport services: the tax base is reduced according to the nature of the service:
    - transport of goods: the tax base is 25% of the freight value. When the freight value cannot be identified, it is estimated to be equal to 10% of the total value of the goods transported, and the tax base is 25% of this amount;
    - passengers' transport: the tax base is 25% of the price of tickets sold in the country;
    - transit: the tax base is 15% of total freight value. When the freight value cannot be identified, the tax base is 25% of one tenth of the total value of transported goods.

VAT is paid monthly on the previous month transactions, on the basis of self assessment.

The 2004 tax reform (law 2421/04) broadens the VAT base and partially revises the tax rate from 1st January 2005. First, the reform eliminates exemptions under special regimes and introduces the tax on services, rentals, transports and on previously exempted goods (such as basic foods and oil products). Second, some goods and services are granted a lower rate. Basic goods such as rice, noodles, oil for cooking, flour, iodide salt, milk, eggs, raw meat and mate tea, are subject to a maximum tax rate of 5%. Pharmaceuticals and financial services are charged at 5% for a transition period of two years, afterwards the tax rate will be increased each year of one percentage point, up to 10%. A tax rate of 5% is levied on the transfer of rights to use goods and immovable properties.

### 3.2.2. Excise taxes

Law 125/91 introduced a single stage excise tax (*Impuesto Selectivo al Consumo*) on selected goods: beverages, alcohol, oil and tobacco, either produced in Paraguay or imported. This indirect monophase tax is levied by the central government. For domestic goods, the duty is payable by the manufacturer at the first stage of the distribution process. For foreign goods, payment is due when they are imported. The duty is levied on an *ad valorem* basis, and the taxable value is the selling price, net of VAT and other taxes, for national goods; it is the custom value for imported goods. Tax rates vary depending on the type of good charged, and have increased in recent years due to the deterioration of the national fiscal scenario and the consequent need to easily and quickly increase fiscal revenues. The following tax rates apply in 2004:

- Pure alcohol: 5%;
- Spirits, liquors, grape-made wines, cider and absolute or fuel alcohol: 10%;
- Mineral water, beer, soft drinks and drinks with a maximum of 2% of alcohol: 8%;
- Fruit juices with a maximum of 2% of alcohol: 8%
- Sparkling wines and rectified alcohol: 10%
- Tobacco: 7% (cigars and loose tobacco) or 8% (perfumed and Virginia-type cigarettes);
- Petroleum by-products: 34% (motogasoline, alcohol gasoline, supergasoline), 38% (unleaded gasoline), 20% (aircraft gasoline), 10% (kerosene, fuel oil and liquefied oil), 14.1% (gas oil) and 1% (turbo fuel).

The tax is paid monthly with regards to sales and imports of the previous month upon self assessment.

The 2004 reform (law 2421/04) sets new maximum rates, in some cases higher, in other lower, than the existing ones. The maximum rate is fixed at 12%. It also introduced a rate of 5% on luxury goods (perfumes, natural pearls, precious stones and metals, watches, leather, weapons) and of 10% on other items (air conditioners, dishwashers, printers, televisions, mobile telephones, toys and musical instruments).

### 3.2.3. Custom Duties

Custom Duties are collected by the General Custom Service, renamed National Custom Service and established as an autonomous State agency by the recently approved Custom Code (law 2422/04). The Custom Code (*Codigo Aduanero*) and the MERCOSUR Common External Tariffs (in effect since 1st January 2005) specify the items subject to the tax and the tax rates. According to MERCOSUR agreements, the import duty for goods originating from MERCOSUR countries is 0%, with few exceptions[28]. Furthermore, common external tariffs are applied to imports originating from outside the area. The *ad valorem* custom duty is levied on the value of goods, which is determined according to the WTO Valuation Agreement.

Exemptions apply to specific cases: reciprocity rules stated by International Treaties and Agreements; personal goods of people in transit; personal goods of immigrants and of Paraguayan citizens returning in the country after a minimum period of two years abroad; tools imported by not for profit organisations for cultural, educational, research or social services purposes; samples of no commercial value; tools used by disabled people; inherited goods; capital goods for selected types of investments, as listed by the law 60/90.

Depending on the type of dispatch, the tax is levied according to four different systems: general system (the general rules apply); tourism (the tax is calculated on a reduced value of goods); minor imports (applied by

[28] Cars and spare parts (from 0% to 13%); sugar (30%).

taxpayer, only up to a maximum amount and with immediate payment); limited value goods (applied to the introduction of personal goods, up to a maximum amount and with immediate payment); franchises.

### 3.2.4. Registration and Stamp duty

The registration and stamp duty is charged under law 125/91. It is an ad valorem tax, levied by the central government and applied to transactions and contracts completed or fulfilled through the production of written documents, such as:

- Financial intermediation activities: loans and credits (and their extension) by banks and financial institutions as listed by the law 861/96; fees collected on bills of exchange, banker's drafts, cheques drawn on other city than Asunción, payment orders, letters of credit and any transactions implying a transfer of funds, domestically or abroad;
- Export of farming and livestock natural products.

Many exemptions apply, in particular transactions subject to the value added tax are exempted from the stamp duty. Tax rates differ widely. As regards financial intermediation activities, loans and credits are charged at a rate of 1.74%, domestic transfers at a rate of 1% and international transfer at 1.5%. With regard to the exports of agricultural products, the maximum applicable tax rate is fixed at 12%, and different tax rates may be imposed, provided they are below this threshold (for example a tax rate of 4% applies to soybean exports). Taxes are collected through withholdings by banks or financial institutions and are paid on a monthly basis.

## 3.3 Local taxes

The main tax levied by municipal governments is the property tax, on which there are two surcharges: on unbuilt sites and on unkept urban buildings. No data are available on revenues from this source, which are seriously constrained by limited tax administration competencies and efficiency, obsolete and incomplete cadastral data, and are estimated to be extremely low (Martner and Tromben, 2004).

### 3.3.1. Property tax

Law 125/91 introduced a property tax levied by Local Governments. The tax is charged upon the owner or tenant of the property as of the start of the fiscal year. The tax base is the value of buildings within the national territory, according to the National Land Registry (*Servicio Nacional de Catastro*).[29] The tax rate of 1% is reduced to 0.5% for rural estates of less than 5 hectares used for farming activities.

A number of total, partial and temporal exemptions apply. Total exemptions apply to:

[29] The National Land Register fiscal values were revised by decree n. 1267/03, in effect from the 2004.

- buildings owned by the State or local governments, and buildings conferred to these bodies in the form of free tenancy. Exemptions do not apply to public bodies pursuing commercial, industrial, farming, financial or service activities;
- buildings owned by recognised religious organisations and used for public service;
- national historic monuments;
- buildings owned by recognised organisations offering public services (hospitals, hospices, orphanages, etc.);
- buildings used by foreign governments for diplomatic delegations or consulates;
- buildings used as head office by political parties, unions, charities and educational, cultural, social, sport institutions.

In case of natural calamities, partial exemptions up to 50% of the tax amount may be allowed. Temporal exemptions apply to tenants of lots or pieces of ground managed by the Rural Welfare Institute (Instituto de Bienestar Rural – IBR) for the first five years of tenancy. Assessment and collection are autonomously regulated by each municipality, which retains 70% of total revenues and transfers the rest, on a 50-50 basis, to their Departments and to less resourced Local Goverments.

## 3.4 Social contributions

According to the Paraguay Constitution, national laws should regulate a compulsory social security system to cover all hired workers and their families. Currently there is a general social security system that covers all employees that are not covered by special schemes. The general system provides assistance not of contributive nature also to the veterans of the Chaco war. Its contribution to total fiscal revenues is extremely limited, an average of 1% of GDP between 1991-2003.

Social security is regulated by decree 1860 of 1950, approved by the law 375/56 and overhauled by the laws 537/58, 1085/65, 427/73, 1286/87 and 98/92. The general social security system is administered by the Social Security Institute (*Instituto de Previsión Social* – IPS), established by the decree 17071/43. This decree established the compulsory nature of social security coverage of risks of illnesses, maternity, disability and industrial accidents for all minors of 60 years whose only mean of subsistence is the salary or wage.

In addition to the Social Security Institute, the following six institutes provide social security to employees of selected bodies: the Loan Fund of the Treasury, for pension of Central Administration, Departments and some decentralised units (*Caja Fiscal – Ministerio de Hacienda*), the Retirement Fund of Municipal employees (*Caja de Jubilaciones del Personal Municipal*), the Retirement Fund for Railway employees (*Caja de Jubilaciones de Empleados Ferroviarios*), the Retirement and Pension Fund for employees of the National Electricity Administration (*Caja de Jubilación y Pensiones de la ANDE*), the Retirement Fund for employees of ITAIPU (*Caja de Jubilaciones del Personal de ITAIPU*) and the Fund for Retired from the Legislative (*Caja de Jubilados del Poder Legislativo*).

The social security is financed by the employers, the employees and the State. Employees' monthly contributions range between 2.5% and 9% of net monthly salary or wage – excluding family allowances and thirteenth month's payment (table 9). Employers' monthly social contribution range between 2.5% and 16.5% of gross salary or wage paid. Decree 1860/50 (modified by law 427/73) establishes that contributions cannot be lower than minimum wages, even for apprentices.

The employer's obligations include: registration to the Social Security Institute when starting activities; communications to the Social Security Institute when workers are hired or when they leave the company; and monthly payments of employers' and employees' contributions. Payments' deadlines depend on the amount: payments below 1,000,000 guaranis are due by the 10th of the following month, between 1,000,000 and 10,000,000 by the 15th and payments above 10,000,000 guaranis by the 25th.[30]

## 4. Tax policy issues

In Paraguay, as in most Latin American countries (Martner and Tormben, 2004), revenues from income taxes display a very low collection level, 1.7% of GDP in 2003. However this value is well below the regional average. As in neighbouring countries, since the early 1990s, Paraguayan tax reforms have attempted to increase tax revenues by favouring duties easier to collect and with larger tax bases (e.g. the introduction of VAT in 1993), by reducing the corporate income tax rate (from 30% to 10% according to the 2004 reform), and by addressing the internal aspects of tax administration. As a result, the current tax system is imbalanced towards indirect taxation, as detailed in the following section, through the use of implicit tax rates to analyse the actual distribution of taxation charge over consumption, labour and capital (Martner and Tormben, 2004). Furthermore, the tax system remains strongly centralised and the contribution of different levels of government to total fiscal pressure is discussed in paragraph 4.2.

[30] Exceptions apply to companies located in the inner areas of the country (except *Departimento Central*): their deadlines are extended to the end of the month.

*Tab 9* Synopsis of social contributions to the IPS under the general social security system and of related benefits

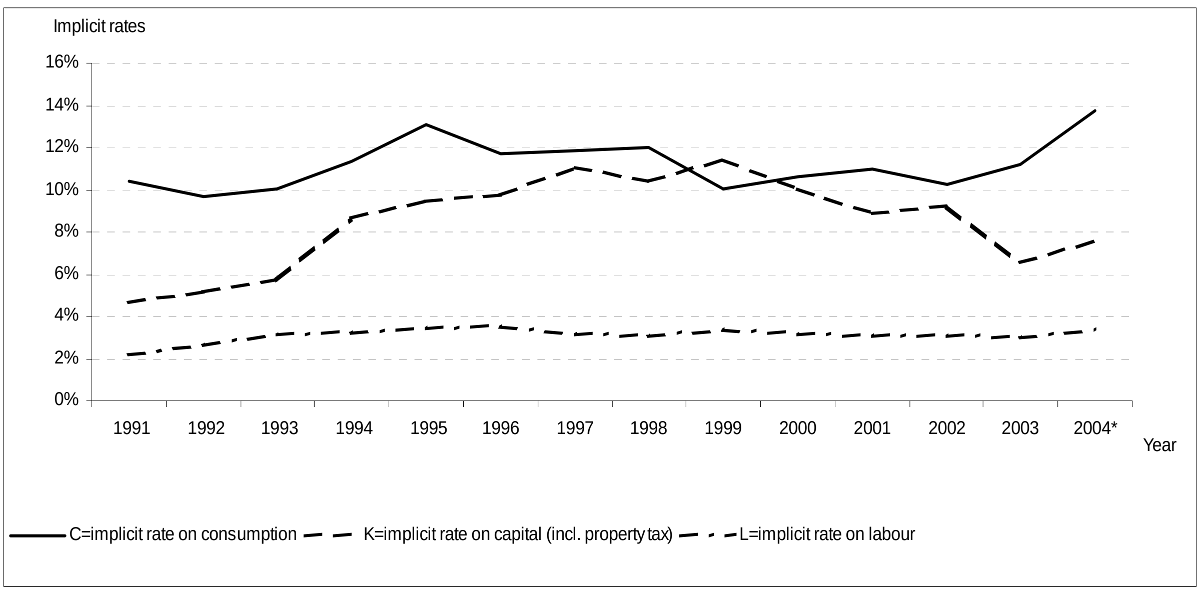
| | *Contributions from* | | *Retirement scheme* | *Health scheme coverage* | *Not covered medical services* | *Coverage for* | | |
|---|---|---|---|---|---|---|---|---|
| | *Worker* | *Employer* | | | | *Children* | *Spouse* | *Parents* |
| *Direct contributor (male)* | 9.0% | 16.5% | Yes | Total | - | Yes | Yes | Yes |
| *Direct contributor (female)* | 9.0% | 16.5% | Yes | Total | - | Yes | Temporarily (in case of unemployment) | Yes |
| *Man servant (male)* | 2.5% | 5.5% | No | Total | - | Yes | Pregnancy, birth; puerperium | No |
| *Man servant (female)* | 2.5% | 5.5% | No | Total | - | Yes | Temporarily (in case of unemployment) | No |
| *Education administrative employees (private sector)* | 9.0% | 16.5% | Yes | Total | - | Yes | Yes | Yes |
| *Teachers - public and private sector (female)* | 5.5% | 2.5% | No | Total | Prothesis | Yes | Temporarily (in case of unemployment) | No |
| *Teachers - public and private sector (male)* | 5.5% | 2.5% | No | Total | Prothesis | Yes | Pregnancy, birth; puerperium | No |
| *ANDE employees* | 6% | 12% | Only old age pension | Total | - | Yes | Yes | Yes |
| *Retired* | 6% | Exempted | - | Total | Certain protheses | Yes | Yes | No |
| *Retired teachers* | 5.5% | Exempted | - | Total | Certain protheses | No | No | No |
| *Chaco war veterans* | Exempted | Exempted | No | Total | Certain protheses | Yes | Yes | No |

*Source*: Instituto de Previsión Social, Asunciòn, Paraguay

## 4.1 The distribution of taxation charge

Between 1991-2004 Paraguay tax revenues increased but the distribution of the fiscal burden didn't display significant changes. The fiscal burden evolution over time may be analysed by using the implicit tax rates as defined by Martner and Tromben (2004) with reference to three main headings: consumption, capital and labour (figure 1).[31] The analysis shows the fiscal burden on consumption being higher than those on capital and labour. As regards the evolution over time, there is no significant change in the relative weight of the three indicators. In addition, they all show an oscillating trend in the years 1991-2004: implicit tax rates on consumption fluctuated between a minimum of 9% and a maximum of 14.5%. Implicit tax rates on labour show a slight increase, from around 2% to slightly above 3%, while those on capital have increased each year from 1991 to 1999, except in 1998, to decline from the year 2000 onwards, a trend that reflects the erosion of the tax base of the corporate income, but also the economic downturns of the late 1990s and early 2000s.

*Figure 1* Implicit tax rates 1991-2004




* preliminar
Source: CEPAL and *Banco Central del Paraguay*

These results confirm the prevalence of indirect taxation and the preference for easier to levy duties (such as custom duties and VAT) to face the high levels of tax evasion and the highly inefficient tax administration. It also highlights the regressive nature of the fiscal system, unbalanced towards indirect taxes, which, together with social contributions, are generally regarded as regressive if passed on to prices. The newly introduced

[31] The implicit rate on capital, is defined as:
(corporate income tax revenues+property tax revenues)/net operating surplus of the overall economy
No data are available on property tax revenues after 1993, therefore by assumption, property tax revenues as a percentage of total GDP in each of the years 1994-2004 has been set equal to their average value between 1991-1993 as recorded in the IMF – Government Finance Statistic Yearbook 2001.

personal income tax may produce some changes to this picture, expecially because higher incomes are subject to this tax.
The analysis confirms also the high levels of tax evasion, due also to informal and unregistered activities. For example, Beresteanu and Dahan (2002) calculated that the effective tax rate on labour should have been 25% in the mid 1996. A value significantly higher than the implicit rate calculated in our analysis.

## 4.2 Taxation by levels of government and fiscal federalism

Decentralisation is among the main policy advices promoted by the literature on state reform, due to its alleged impact in terms of improved governance, economic development and macroeconomic stability (Tanzi, 1995). Paraguay was a unitary and administratively centralised state until 1992 when article 1 of the National Constitution defined Paraguay a "decentralised unitary State", articulated into three tiers of government: the national level, the 17 Departments and the 224 Municipalities. The new Constitution attributes political, administrative and normative autonomy to the decentralised governments, and in some cases autarchy in the collection and use of financial resources. Departments are no more mere decentralised representatives of the central government, with supervision powers over the police, but are governed by an elected council. Municipalities already enjoyed some degrees of autonomy (Municipal Organic Law 1294/1987) and are headed by an elected major since 1991.
The adoption of a politically decentralised system in 1992 was surprising for a traditionally highly centralised state (Nickson, 1995) for at least three main reasons: the lack of any social or economic movement in support of it; the aversion to decentralisation by the leaders of the major political parties, who normally command high loyalty and obedience; and the absence of this issue from the political debate prior to the Constitutional Convention (Turner, 1997). Decentralisation emerged due to a transversal alliance of members of all political parties interested in gaining access to power independently from the national government. It was seen also as a way to gain political legitimation by local leaders. Therefore the process was driven by very different purposes from those listed by the literature on state reform and was a top-down, rather than a bottom-up process (Bird, 1993).
The lack of statistical data does not allow any analysis of decentralised government finances. However, decentralised governments current revenues are a fraction of the difference between General Government and Central Government ones, an extremely limited amount, on average equal to 3% of GDP in 1990-2003. It has been estimated that municipal revenues and expenditures are less than 10% of general government ones (Rezk, 2002).
As regards decentralised governments revenue sources, a double system applies: municipalities rely almost entirely on own sources and receive almost no transfers, while departments rely on transfers from other levels of government, the main ones are: 15% of property tax from municipalities in their jurisdiction, 30% of revenues from the national tax on gambling, royalties from the hydroelectric companies Itaipù and

Yaciretà[32]. Municipalities have more resources, but generally insufficient. Their main tax revenue is from the property tax, amounting to 30-40% of the biggest municipalities' total revenues. Other major municipal taxes are: the surtaxes on property tax, a business and professional licence tax, a motor vehicle licence tax, a building licence tax, a building splitting tax, a tax on transfers of immovable property, a tax on public transport passengers, a tax on public shows and entertainment, a tax on gambling, a tax on raffles and draws, a tax on credit transactions and a tax on advertising. Tax revenues are often constrained by the limited local fiscal capacity due to the extreme poverty of many local communities, by the absolute inefficiency of municipal tax administrations, and by the inadequacy of cadastral administration (Rezk, 2002). Rezk (2002) adds a further factor: the lack of "tax payment culture" among the population. Municipal non-tax revenues include charges for services provided and special contributions due when public works increase private properties' values. Finally, municipalities receive few and limited transfers: comparticipation to property tax, to tax on gambling and to royalties from Itaipù and Yaciretà. Municipal governments' autonomy to manipulate tax rates and to determine service charges is extremely limited. The former may only vary between limits set by national laws, the latter are linked to service costs.

In conclusion, municipalities' financial autonomy is high, but the degree of decentralisation of tax revenue sources is extremely limited. Departments rely primarily on few transfers, often of an unusual bottom-up nature (e.g.: property tax revenues transferred from municipalities to their Departments). Therefore, despite the formal decentralisation, decentralised governments have no significant tools to engage in fiscal competition, and the public sector remains one of the most centralized in Latin America (Nickson and Lambert, 2002).

## 5. Tax reform

Tax reform, as well as fiscal discipline and a redirection of public expenditures towards basic services and infrastructures, is among the essential policy reforms listed by the so-called "Washington consensus"[33]. According to this perspective, tax reform should pursue the primary goals of ensuring sufficient revenues, promoting economic efficiency and equity, by broadening the tax base and by diminishing marginal rates (Williamson, 1990). During the 1970s and 1980s most Latin American countries engaged in radical fiscal

[32] According to a law approved in 1998, departments and municipalities were to receive 10% of total royalties in 2000, an amount that would have increased annually by 5%, to reach a total of 50% in 2008. By contrast, already in 2000 actual transfers were less than planned ones.

[33] The phrase 'Washington Consensus' was introduced by John Williamson in 1990 "to refer to the lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries as of 1989" (Williamson, 2002). The advised policy reforms were: fiscal discipline; a redirection of public expenditure priorities toward fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education, and infrastructure; tax reform (to lower marginal rates and broaden the tax base); interest rate liberalization; a competitive exchange rate; trade liberalization; liberalization of inflows of foreign direct investment; privatization; deregulation (to abolish barriers to entry and exit); secure property rights (Williamson, 1990).

reforms which combined and supported the incoming processes of financial sector and external trade liberalisation. These reforms were characterised by five main structural changes (Villela et al., 2005):

1) the simplification of the tax system through the reduction of the number of taxes;
2) the revision of fragmented tax legislation and its rearrangement in tax codes;
3) the introduction of a value added tax;
4) the modernisation of tax administration;
5) the introduction of a global and progressive personal income tax and the suppression of taxation of personal income through multiple taxes for each type of income.

Paraguay is generally regarded as a country that lags behind other Latin American countries in terms of modernisation of the public sector and of the economy in general. As noted by Sohn (2005), referring to the situation in 2001 “as we enter the 21st century, Paraguay, a country of 5.2m people, is only ‘reluctantly’ and at ‘glacial speed’ making tentative moves to put in place the necessary ingredients to promote sustained growth and developments” (Sohn, 2005). This comment is true also as regards tax reform: compared to other Latin American countries, Paraguay was a late mover and introduced reforms only after the fall of the Stroessner Regime, the main ones being those contained in law 125/1992 and law 2421/2004.

Coherently with the first three structural changes listed above, which characterised earlier reforms in other countries of the region, the 1992 Paraguayan reform pursued the simplification of the tax system by reducing the number of taxes, rearranging tax legislation, introducing a value added tax. However, it failed to tackle the problem of tax administration efficiency and effectiveness and disregarded the introduction of a personal income tax, limiting income taxation to legal entities. After this first reform was approved, numerous tax deductions, fiscal exemptions and incentives were introduced, eroding the tax base and reducing the system equity, furthermore the tax administration remained highly inefficient. In 2003, the new government faced a fiscal crisis and responded with an ambitious reform programme, which included tax reform (law 2421/2004). Improvements include the broadening of the VAT tax base and the corporate income tax, a more effective tax regime to large companies, the elimination of some large exemptions, and the introduction of a personal income tax.

## 5.1 Economic and budget outlook

With reference to economic performance, 2004 was an exceptional year: GDP grew by 4.1%, the highest increase since 1995. Economic growth was driven by the expansion in the agricultural sector (repeating the 2003 performance), which grew by 3.3%, due to favourable weather conditions and international prices, but resulted also from the upturn in non-agricultural activities, such as meat production and commerce, which grew by 7.5% and 5.3% respectively. The GDP growth was reflected in the growth of aggregate demand at a rate of 4.7%. Exports contributed to this growth by 1.8%. Private consumption grew by 4.5% and public consumption by 6%. The economic growth was accompanied by a reduced inflation rate, which dropped to 2.8%, the lowest value since the early 1990s. Unemployment stood at 10.2%, compared to 12.1% in 2003.

Notwithstanding this performance, the economy remains structurally imbalanced and exposed to exogenous factors, such as international prices and weather conditions, due to the heavy reliance on agriculture. In turn, public sector finances are negatively influenced by the volatility of economic performance, but suffer also other problems. With reference to the non financial public sector, its finances have been under pressure between 1999 and 2002, due to economic downturns and maladministration. Since 2003 they have recovered and reached a surplus of 2.4% of GDP in 2004.

The central government's current budget has been in surplus every year since 1990 except in 2000, while the overall balance, in GDP terms, changed from a surplus of 3.2% in 1990 to a deficit in every year between 1991-2003, except in 1993 and 1994. Until 1998 the overall central government deficit was less than 1.5% of GDP, it then widened between 1998 and 2002, and was again brought under control from 2003 (0.4%). In 2004 central government finances recovered and reached a surplus of 1.6%. The deterioration of central government finances resulted from the concomitant fluctuating performance of total revenues and the constantly increasing expenditures up to 2002. Expenditures were then brought under control and revenues recovered in 2004.

In the years 1990-2004, the tax-GDP ratio for Central Government fluctuated between 9.3% and 12.5%, achieving the second highest result in 2004, with a ratio of 12.3%, due to an increase in both direct and indirect taxation (+30% and +20%, respectively). Tax revenues grew between 1991 and 1995. In 1996 a special division was established within the Ministry of Finance to deal with the largest 1,500 contributors in the Greater Asunción area, with the purpose of increasing revenues from corporate income tax. Between 1998 and 2002 tax revenues deteriorated, mainly due to depressed economic activity, to the decline in re-export trade and the limited growth of overall trade. Other factors with a negative impact on tax revenues were increased maladministration and amendments to the fiscal law that reduced the tax base (Alarcón, 2004). Therefore, in order to increase revenues, since 2003 new initiatives have been taken to address corruption, maladministration, and tax collection inefficiencies (Duarte Frutos, 2004 and 2005).

Central Government finances suffered also from the rapid growth of current expenditures, from 9% to 16% of GDP between 1990-2002. Salaries are the main head (approximately 55% of total current expenditure) and they grew every year between 1990 and 2002, due to increased personnel in education and health services (Nickson, 2004a). Given the high level of current expenditure, in order to maintain fiscal balance, governments cut back on public investment projects from 1993 onwards, thus undermining economic growth. As a result, Paraguay lags significantly in public infrastructure (EIU, 2006).

Paraguay debt stock is one of the lowest among Latin American countries, but this is mainly due to its low credit rating and to the very limited access to international capital markets (Sohn, 2005). In 1992 Paraguay restructured its foreign debt and cleared arrears. Since then public debt has risen, to reach 69.3% of GDP in 2002, when Paraguay began to experience debt-servicing difficulties. In 2003, in order to prevent public default, the new government restructured the majority of its external debt, with IMF support. Public debt is slowly reducing, to 46.8% of GDP in 2003 and 41.4% in 2004 (of which 37.4% is external debt).

## 5.2 Recent and planned tax reforms

In 2003 the new government led by Nicanor Duarte Frutos initiated an ambitious program of State reform addressing the long term weaknesses of Paraguay public sector and private economy, and aiming to place the country on a path of sustainable growth. This program included a chapter on modernising Public Administration and another on establishing a favourable economic environment for investors.[34] Within these chapters a number of initiatives in fiscal policy were taken to address the problems highlighted above. In 2003 arrears on public debt were cleared, the custom code and the social security system were reformed, new public procurement procedures were introduced and a reform of tax administration began, with the purpose of improving tax collection. In 2004 a Stand by Agreement with the IMF was signed and the tax reform was approved (Duarte Frutos, 2004 and 2005).

The tax reform was strongly supported by the IMF, and required as a condition for the Stand By Agreement, in order to strengthen public finances and provide the necessary additional revenues to fund long due policy initiatives, such as social programs targeting poverty, health and education, in a country that ranks extremely low in nearly all social and human development indicators and that is characterised by exceptionally high levels of social and economic inequality. Furthermore, the reformed taxes themselves have the potential to reduce the regressive nature of the tax system, previously extremely skewed towards indirect taxation.

The approved law differs from the first proposal, which reflected the advices of the IMF: the corporate income tax is lowered to 20% in the first year, rather than to 10%; the VAT is not charged on agriculture and education; the vehicles tax (*patente fiscal*) is to be levied only for two years and only on luxury vehicles, the personal income tax is delayed.[35] The IMF estimates that the differences introduced will reduce the eventual maximum yield of the law from over 2.5% of GDP to less than 1.5% of GDP. However, the law retains many of its main improvements, including a substantial broadening of the VAT and corporate income taxes, the introduction of a new personal income tax for high earners, a more effective tax regime to large farmers.

These measures have the potential to increase tax revenues and to reduce income inequality. In a country were laws are often not implemented and tax administration is weak and corrupted, the most important defy appears now to be not a further improvement of the tax reform, rather the full and effective implementation of the approved one. Furthermore, total revenues are significantly below their potential (Villela et al., 2005) due to the widespread corruption, tax evasion and the informal economy. Therefore, if fiscal policy has to be effective, these "corollary" problems have to be tackled with determination, with additional initiatives, some already implemented by the government.

Under the new custom code, customs are independent from the Ministry of Finance and custom controls are reformed. Customs had been regarded as one of the most corrupt branches of the public sector (Nickson,

[34] The other axes of the reform program are: sustainable economic growth; reform of the education system to improve human capital; health policy; public works and housing construction; energy for development; environment protection; opening to the exterior and international relations; new spaces: State and Society; human rights; fight against poverty and social exclusion; fight against corruption; modernisation of security forces (Duarte Frutos, 2003).

[35] These differences are largely due to the opposition of powerful elites, wishing to protect their privileges. In 2004 they successfully used their access to the media to present the reform as socially regressive and mobilise the masses against the reform. (http://www.abc.com.py)

2004b), it was common practice for custom officers to under invoice legal imports and to allow prohibited goods, such as counterfeit products, to enter the country, in exchange for illicit revenues. This resulted in significant fiscal revenue losses. In addition, to prevent corruption within the Ministry of Finance, primarily the collusion between tax inspectors and taxpayers, the rotation of officers is introduced and the special unit for the investigation of largest taxpayers companies is abolished. Furthermore, to increase tax compliance, especially among smaller firms liable for VAT, 400 inspector were sent out for checks in Asunción. Finally, collusion between lawyers in the legal department of the finance ministry and taxpayer companies was fought by extending the number of lawyers responsible for court actions and by rewarding them with a performance pay (10% of tax debts collected through court actions).

Overall, these measures have gone a long way to reduce public sector expenditures[36], to increase fiscal revenues and to improve tax administration. They already impacted on the 2004 public sector budget: tax revenues increased by 20% with a GDP growth of 4.1%, but the main issue is now the full implementation of the approved reform, which requires additional improvements of tax administration, to make it more ethical and efficient. A long due civil service reform would favour this improvement, but seems far from happening, especially after the failure to implement the civil service reform approved in 2001. This is a worrying sign of persistent and diffuse interests for patronage in public administration and for a 'privatized', clientelist and highly politicized public sector, which for long years has been an opportunity of employment for activists of the Colorado party and a source for party funding (Nickson and Lambert, 2002; Nickson, 2004b).

## 5.3 Final recommendations

Paraguay, a country of 5.2 million, lags in Latin America for its scarce industrialisation, diffuse poverty, high unemployment and underemployment, extreme income and land distribution inequality, as well as for its delay in implementing needed policy reforms. The weight of the Paraguayan public sector has been traditionally limited, and public finances insufficient to tackle the social and economic problems of the country. Taxation relies extensively on indirect taxes, which are easier to collect, but are regressive. Recent tax reforms have the potential to increase available resources and make the tax system more progressive. They are surely liable of improvements, but in a country where too often approved laws are not implemented, the actual defy is not that of designing a better tax reform, rather that of fully implementing the approved one. In addition, only if Paraguay is able to reduce the extensive tax evasion and erosion of the tax base, then the approved tax reform will fully produce its effects, as regards both the increase of tax revenues and the reduction of income inequality. In order to fight tax evasion, the endemic corruption that affects Paraguay economy and society, as well as its public sector, has to be tackled and reduced. Furthermore, tax officers competencies and commitment have to be strengthened, through a long due civil service reform.

[36] In addition, in order to reduce expenditures, the social security reform establishes a new contribution rate for workers and reduces the number of beneficiaries and the new public procurement procedures are designed to prevent the common practice of over invoicing supplier contracts to public sector units.

Under the Presidency of Nicanor Duarte Frutos, since 2003 a number of initiatives have been approved and more are planned that should help Paraguay to move in the direction traced above. It is not an easy task, also because the problems of the country are not limited to the tax system and the civil service adequacy, nor to corruption, and public policy is required to address a wide array of social and economic issues. In addition a main obstacle to any reform is the strong and powerful opposition of the privileged and the scarce mobilisation of the mass of impoverished and underemployed citizens, while till now pressures for reform have come nearly exclusively from external sources.

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