

# **Taxing Bank Transactions – The Experience in Latin America and Elsewhere**

## **Annex: Value-Added Taxes on Financial Institutions in Latin America**

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This paper reviews the use of ad valorem taxes on cash withdrawals and other debits—in some cases also credits—to accounts in banks and other financial institutions. Since this type of tax on financial transactions (FTT for short) became popular in late nineties, they have generated great interest among policy makers and tax analysts and resulted in a sizable body of literature, which is reviewed below.<sup>2</sup> Ten years of FTTs applied, albeit with discontinuities, over 15 countries, provide a vivid experience of the hard choices faced by tax policy authorities and the compromises at which they arrive.

### **The swell of FTTs in the last 10 years**

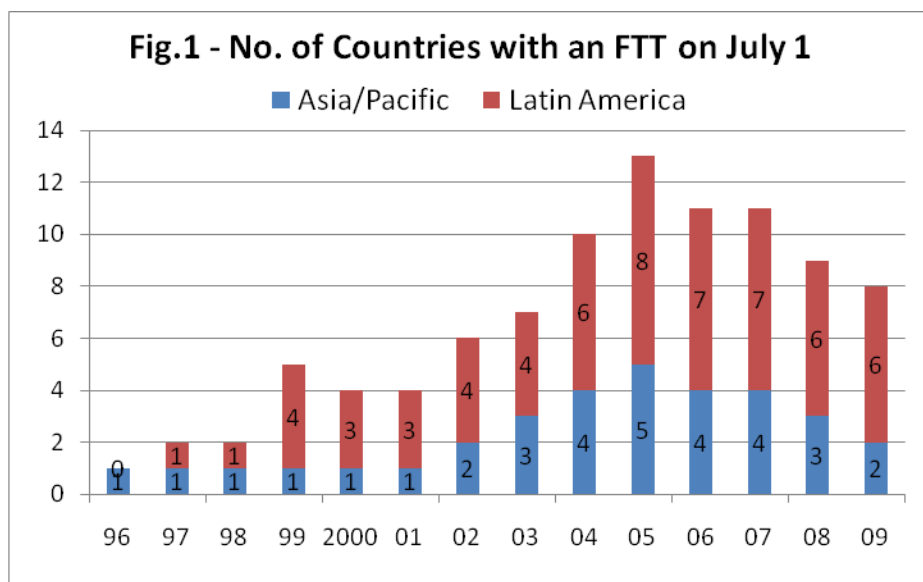
Although not recent, taxes on bank transactions have become more common over the last decade. As recently as 1996, only one country—Australia—had an FTT in force. The economic crisis that erupted in Asia in 1997 and led to the cessation of payments by Russia in 1998 had serious consequences for emerging economies in terms of access to capital markets and fiscal situation. With foreign financing drying up and tax bases shrinking, several South American countries, drawing on experience, early in the decade, with those taxes in Argentina and Brazil, resorted to FTTs as a temporary fiscal measure.

By mid 1999, FTTs were in place in Argentina, Brazil, Ecuador, and Venezuela. In mid 2005, FTTs could be found in 13 countries concentrated in South America (Argentina, Bolivia, Brasil, Colombia, Dominican Republic, Paraguay, Peru, and Venezuela) and the Asia and Pacific region (Australia, India, Pakistan, Papua New Guinea, and Sri Lanka) (Figure 1).

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<sup>1</sup> Consultant for the Inter-American Development Bank. Document prepared for the 3er. ITD Conference, Beijing, China. October, 2009

<sup>2</sup> There are other types taxes on financial transactions that are not covered in this article, notably the following three:  
(a) Taxes on foreign exchange transactions intended to raise money for development while dampening speculative international capital movements (Tobin taxes). See e.g. Tobin 1996;  
(b) Taxes on securities transactions aimed at raising domestic revenue while mitigating market volatility, discussed e.g. in Habermeier-Kirilenko 2003, Haberer 2004, and King 2004; and  
(c) Old-fashioned documentary stamp duties, typically levied at a fixed amount per document or deed.



Since then, some countries have been able to gradually replace the FTT with more conventional taxes, such that only eight countries (Argentina, Bolivia, Colombia, Dominican Republic, Mexico, Peru; and Pakistan and Sri Lanka) retained an FTT on July 1, 2009. The number would be even smaller if we excluded countries (Mexico and Pakistan) deploying FTTs only on cash flows as a device to somehow tax the gray sector of the economy. These developments notwithstanding, the FTT remain object of great interest, with proponents and opponents of the tax far from reaching a common ground. Before we introduce their arguments, let's review briefly the country experience.

### Brief review of the experience with FTTs

As early as 1957, *Sri Lanka* (then called *Ceylon*) introduced a 0.1 percent tax on debits in current accounts of commercial banks. The tax was repealed in 1965, only to be reintroduced in 1970/71, removed in 1979, and again reintroduced in 2002 to remain in place—at the original rate—until our days. In 1982, the commonwealth of *Australia* introduced a bank debits tax on checking accounts. The tax, which had a schedule of rates bounded by a dollar amount, was transferred to the states in 1990 and phased out between 2002 and 2005 as part of the package of reforms for introduction of the GST.

In Latin America, FTTs have had a bumpy start. In *Argentina*, a 0.1 percent tax on bank debits adopted in October 1976 lasted less than three months. Reintroduced in 1983 also at 0.1 percent (a rate later doubled), the tax lasts three years. Reintroduced in 2003 to last four years, its initial rate of 0.7 percent oscillates between 1.2 percent and 0.3 percent before the tax is eliminated six months short of its initial deadline. Finally, the tax base is broadened to include both debits and credits and reintroduced in March 2001 at the current standard rate of 0.6 percent (but being ushered in steps of 0.25 percent and 0.4 percent in the first four months). The tax has been extended year after year. In *Brazil*, an FTT was first introduced in August 2003 at the rate of 0.25 percent but suspended less than one month later by the judiciary, reinstated in the following January and lapsed at the end of 2004. The tax was reintroduced as a different levy and a 0.2

percent rate in January 1997 and lasted two years. After a legal and parliamentary disputes, the tax was again put in place in June 1999 at the rate of 0.38 percent (later reduced to 0.3 percent then reversed to 0.38 percent) and remained, through successive extensions, until the senate, in a bitter dispute with the government, refused its extension beyond December 2007.<sup>3</sup> *Ecuador's* experience with an FTT lasted only two years, 1999 (rate 1 percent) and 2000 (rate 0.8 percent). Introduced as an alternative to a harsh tax reform proposed—which included raising the standard VAT rate by 5 p.p.—the FTT replaced the income tax, but in the middle of a severe banking crisis in 1999 the income tax was reinstated with the FTT being treated as an advance payment of it.

The first time it was introduced in *Peru* in August 1989, the FTT was quite unstable in base, rate, and duration. The rate of the tax, initially set at 1 percent, was subsequently raised to 2 percent then reduced to 1 percent, 0.75 percent, and 0.4 percent before the tax was eliminated in March 2002, earlier than the expiry date set in its last extension. A new version of the tax, levied both on debits and credits, was put in place in March 2004 at the rate of 0.1 percent (following a startup rate of 0.15 percent applied during 26 days only) and its rate has been reduced gradually. The current rate is 0.06 percent, and it will be 0.05 percent beginning in January 2010—the tax has been made permanent. *Venezuela* has resorted to FTTs in four occasions: in May-December 2004, at the rate of 0.75 percent; in May 1999-May 2000, at the rate of 0.5 percent; in March 2002-March 2006, at rates ranging from 0.5 to 1 percent; and in November 2007-June 2008, at the rate of 1.5 percent on both debits and credits of accounts held by enterprises only. Currently, *Venezuela* has no FTT.

#### **FTT and crises go together**

In *Argentina*, the FTT appears in 1976 and is reintroduced in 1983, 1988, 1991, and 2001 following economic crises in 1975 (fiscal crunch), 1982 (debt default), 1988 (hyperinflation), 1991 (fiscal/debt crisis, convertibility), and 2001 (fiscal, payments) respectively (Vasini 2008). *Bolivia* enacts the FTT in 2004 following a failed attempt at taxing personal income and net wealth. In *Colombia*, the FTT turns up in 1998 amid an economic emergency and is extended in 1999 after a strong earthquake. In *Ecuador*, the FTT surges in 1999 when banks collapse in one of the worst crisis in the country's history. In *Venezuela*, the VTT is brought in 1994 amid a systemic banking crisis and in 1999, when oil prices drop sharply.

A total of eight countries eliminated their FTTs—four in South America and four in Asia and Pacific: *Brasil*, *Ecuador*, *Paraguay* (where a tax on certain bank debits was collected from 2005 to 2007), *Venezuela*, *Australia*, *India* (where a tax on cash withdrawals was collected from 2005 to 2008), *Papua New Guinea* (a bank debits tax in place from 2004 to 2007), and *Vanuatu* (a bank debits tax in 2003 and 2004). It is also eight the number of countries that retain an FTT at present. The patchy experience reflects the strong appeal of the bank accounts as a good tax handle in times of public finance distress as well as the controversial nature of the tax, which finds hard to hold when the strong need for additional tax revenue subsides.

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<sup>3</sup> Recently, the government sources indicated that a bill will be entered in September 2009 reintroducing the FTT with a 0.1 percent rate.

The tax has been more resilient in South America, where 6 countries retain it, and seems to be losing favor in Asia and Pacific, where can now be seen in only 2 countries. Interestingly enough, the fever of FTT is not to be found in other continents, and it is currently adopted in only two (Argentina and Mexico) of the countries forming the G-20 group. In the case of Mexico, however, the tax applies on *cash deposits* only, which makes it an animal quite different in purpose and economic consequences—as discussed below. Before that, however, let’s take a bird’s-eye view on the economic effects of FTTs—a type of tax hard to match in its ability to elicit solidly held views pro and against it.

### **FTT as a money-raising instrument**

FTT have typically been introduced to bridge public revenues during difficult times. Relying on a simple withholding operation by financial intermediaries, it requires little preparatory work and no taxpayer cooperation. Therefore it can be put in place in a relatively short time. Since bank debits are normally a multiple of GDP, a small tax rate is able to raise a sizable amount of revenue. This is an argument for using FTT as a money machine, especially if the rate is kept low and the tax does not stay in place for long periods, which could provide incentives for serious avoidance.

Even if not in the same league as the income tax and VAT, FTTs have contributed significantly to tax revenue in recent years. As indicated in Table 1, FTT revenue ranged from 2 to 7 percent of total tax revenue.

Table 1. FTT Revenue in Selected Countries

Country	Year	In Percent of	
		GDP	Tax Revenue
Argentina <sup>1</sup>	2008	1.89	7.15
Bolivia	2008	0.28	1.20
Brazil <sup>1</sup>	2007	1.40	5.75
Colombia	2008	0.67	5.01
Peru	2008	0.31	1.95
Venezuela	2008	0.91	6.74

<sup>1</sup>Central government.

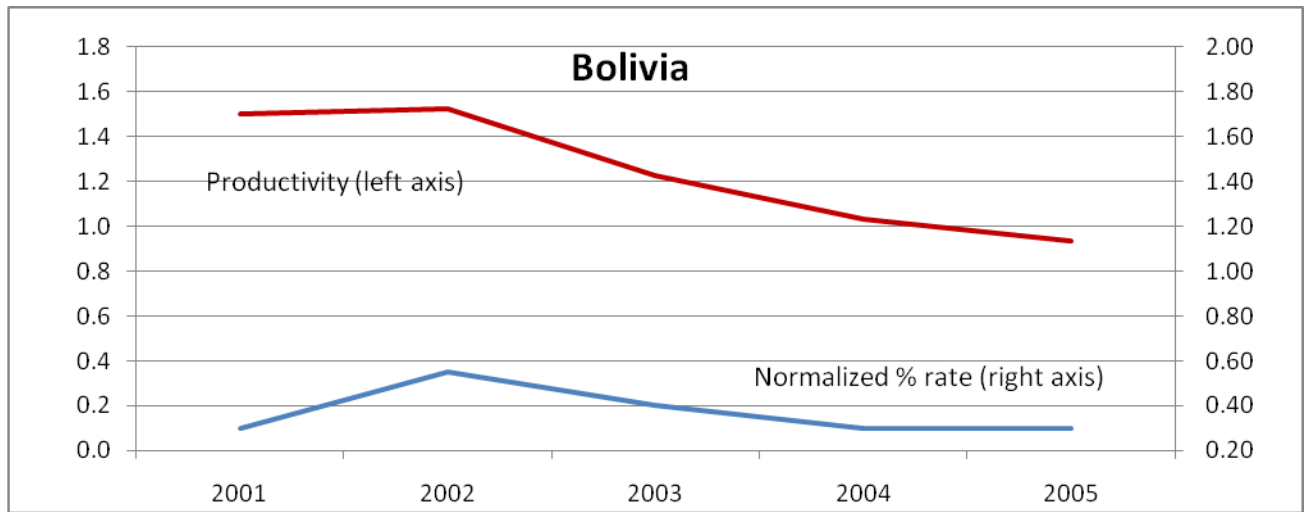
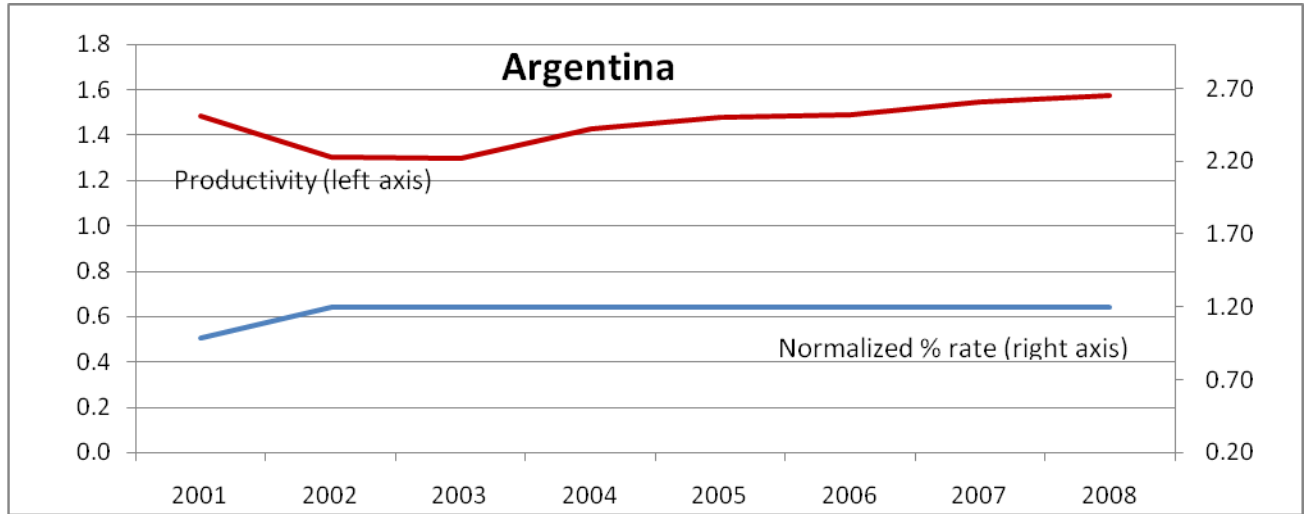
To look into the performance of the FTT over time, a measure of productivity is presented in Figure 2 for selected countries. Productivity is understood as tax revenue in percent of GDP per percentage point of the tax’s standard rate. The rate is normalized to take into account changes in its magnitude during the year, the fact that the tax may have been in force for only a fraction of the year, and the inclusion (as in the case of Argentina and Peru) of both bank debits and bank credits in the tax base.<sup>4</sup>

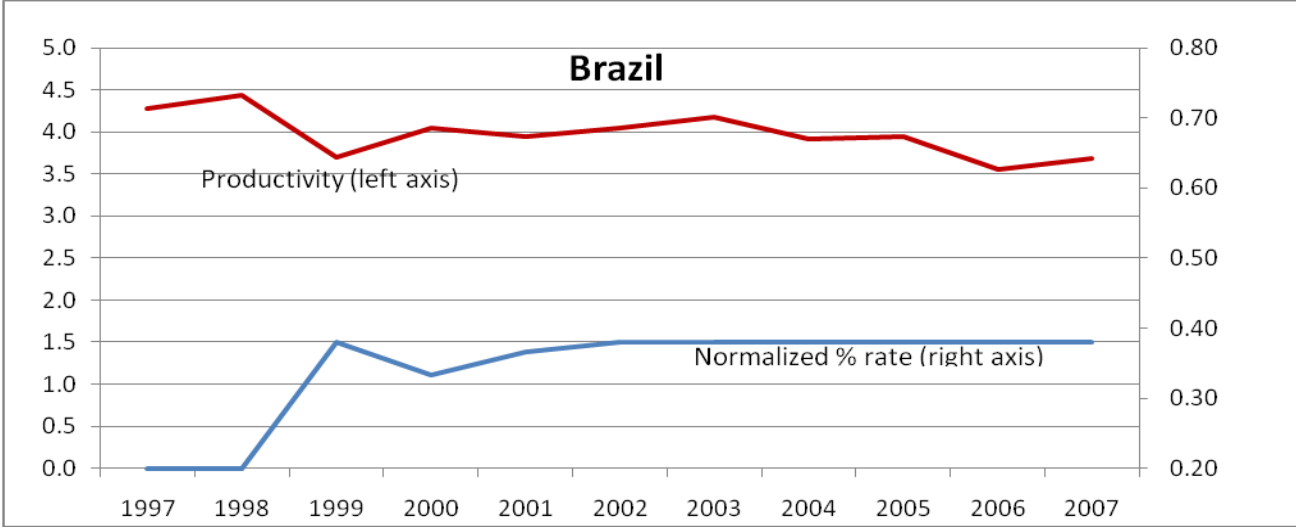
<sup>44</sup> In spite of these adjustments, the measure has its limitations, as the tax base and exemptions vary from country to country and some countries levy a lower tax rate on some preferential transactions. Yet, productivity is a useful

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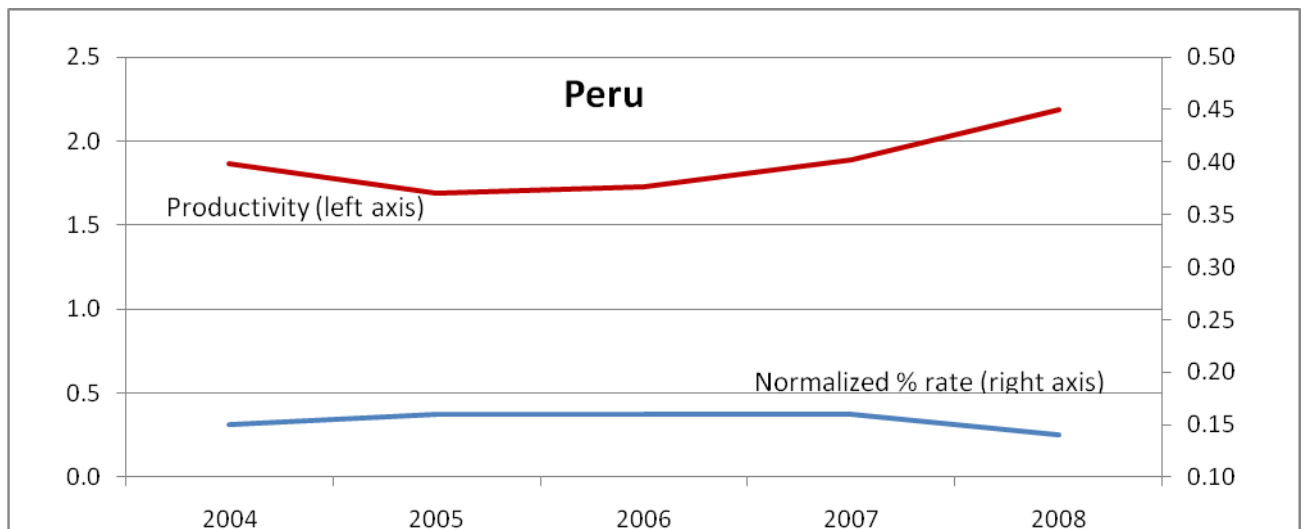
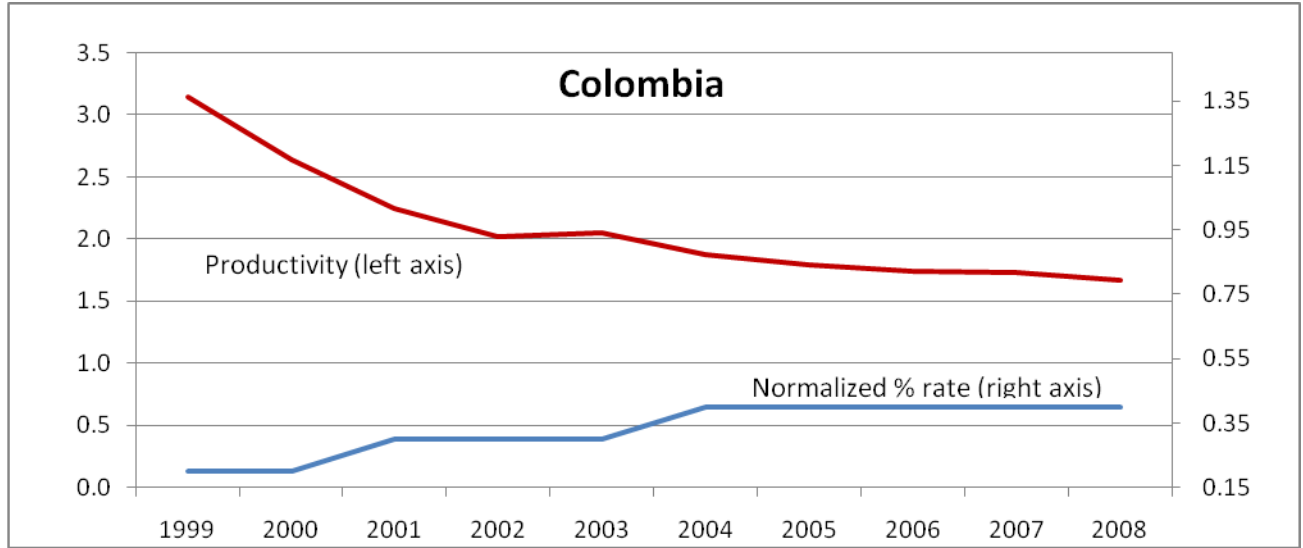
measure, if not to compare across countries, at least to analyze the performance of the tax in a given country over time.

**Figure 2. FTT Productivity in Selected Countries**





**Figure 2. FTT Productivity in Selected Countries (ctd.)**



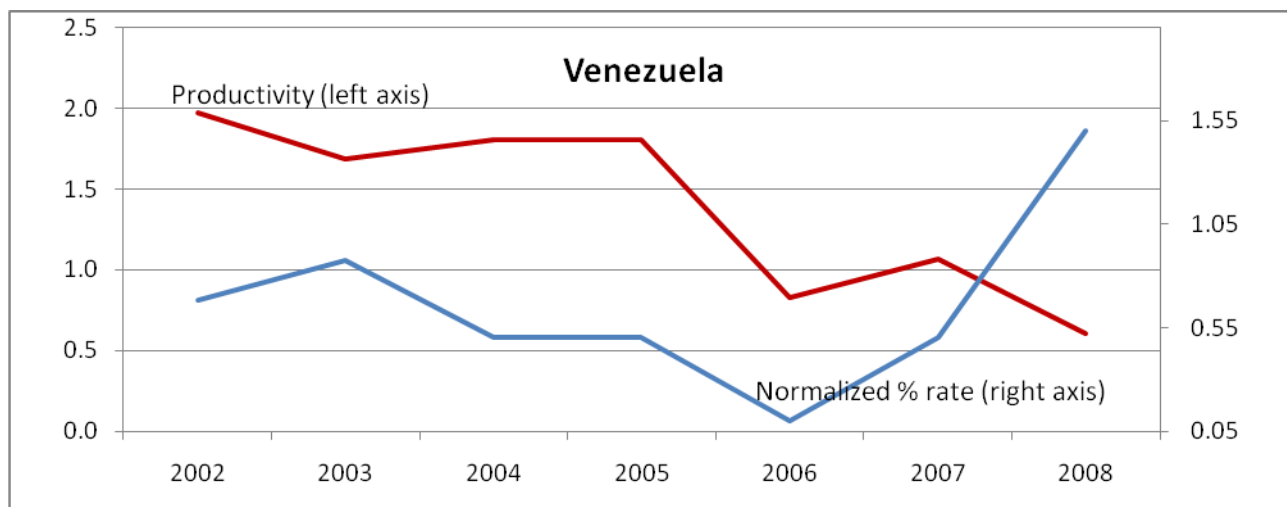


Figure 2 suggests that Argentina, Brazil, and Peru were able to keep productivity relatively stable over the period analyzed, while in Bolivia, Colombia, and Venezuela productivity deteriorates over time, indicating that the base of the tax has been receding.<sup>5</sup> The latter could indicate financial disintermediation or the development of mechanisms of tax avoidance. The figure also suggests that productivity tends to suffer with increases in the tax rate, a result derived by Baca-Mello-Kirilenko (2006); the authors find that FTTs do not provide a reliable source of revenue as its revenue decline over time for a given tax rate. It is also notable the low level of productivity in Argentina's FTT, at least in part consequence of the high rate (0.6 percent on both debits and credits).<sup>6</sup>

As pointed out by Albuquerque (2006), there are losses in tax revenue, from reliance on FTTs, which are not captured in the productivity index. To the extent that the tax is levied on debits corresponding to tax payments, it discourages compliance with taxes in general and penalizes the good taxpayers.

## Impact of FTTs on the economy

### *FTT and economic efficiency*

FTTs have a negative impact on economic efficiency through two channels: on the production side, it encourages vertical integration (intra-firm transactions economize on the tax), and in consumption, it increases the relative price of multi-stage goods (Arbeláez-Burman-Zuluaga 2005). The welfare cost (deadweight loss) of the tax was estimated, for Brasil, to be quite significant, at the equivalent of 13 percent of the tax's gross revenue, or 0.2 percent of GDP (Albuquerque 2006).

<sup>5</sup> In order to shore up financial intermediation, some countries have resorted to forced bankarization. For example, in Argentina cash withdrawals were limited in 2000 and 2001, and in 1997 wages payments were required to be made through bank credit. In several countries, payments in cash above a certain amount do not qualify as deduction for corporate income tax and VAT credit purposes.

<sup>6</sup> To the low performance also contributes the easy with which the Argentinean population can keep bank accounts in neighboring Uruguay (Gómez-Sabaini 2006).

A more benign conclusion is found by Suescún (2004). Based on a model with intermediate goods and a Leontief technology, the author concludes that an FTT is not particularly burdensome in terms of economic growth and efficiency costs. In fact, it is more efficient than any other tax barring a general consumption tax. Also of interest, the author finds that a two-step tax reform—that is, an FTT later replaced by a consumption tax—is superior to the introduction of a consumption tax from the beginning.

Suescún's result depends crucially on the assumption that all transactions take place through the banking system, with which financial disintermediation is assumed away. In the model, FTT plays the role of a general transactions tax, hardly distinguishable from a turnover tax. Seen from this optic, the results seem consistent with the standard theory of commodity taxation.

As noted by Albuquerque (2006), the FTT is a combination of a consumption tax, an income tax, an investment tax, a tax on tax payments, and a capital turnover tax—the trouble being with the last three elements. It can also be seen as a tax on liquidity and financial intermediation, the demand for which are considered very elastic. It is through these channels that the FTT reduces economic dynamism and punishes division of labor. In addition, the FTT impacts unevenly on the various activities and aggregates (notably capital, production, and wages), hitting heavily those activities intensive in intermediate goods and those requiring a higher turnover of financial resources.<sup>7</sup> To a large extent the FTT bases scarcely bear any relation with ability to pay.

### *FTT and financial (dis)intermediation*

The main indictment brought against the FTT focuses on the tax's effect of throwing sand in the wheels of financial intermediation. Means of payment, especially M1, reduce the cost of commercial transactions. The FTT, by exacting a charge on the use of those resources, operates in a direction opposite to the objective of settling transactions quickly and almost costlessly. Hitting at the heart of the financial machinery, it is no wonder that the FTT became anathema to banks and other financial institutions. In the words of a central bank governor, "the tax on cheques is destroying the financial system and blackening the economy".<sup>8</sup> For another, "The [FTT] represents a friction with a negative impact on liquidity."<sup>9</sup>

The FTT has been applied for a period long enough to allow analysis of its economic consequences. As discussed above, productivity of the tax tends to decline over time, indicating that economic agents gradually develop alternative payments mechanisms that economize on tax payments. A trivial such mechanism is to make payments in cash, rather than in cheques. If this inference is correct, we should observe an increase in the ratio of currency held by the public (M0) to demand deposits in the banking system (M1). The evidence suggests that such increase in M0/M1 has been associated with the introduction of an FTT or an increase in its rate.

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<sup>7</sup> This tax design starkly contrasts with the view that financial intermediation is kind of oil that lubricates the engine of economic activity, deserving to be spared of taxation. See Chia-Whalley (1999).

<sup>8</sup> Pedro Pou (Argentina), as reported in Clarín of August 27, 2003.

<sup>9</sup> Arminio Fraga (Brazil), as reported in O Estado de S.Paulo September 15, 2000.

*Colombia* is a country for which there are relatively more studies on the FTT, especially on the behavior of monetary aggregates. Arbeláez-Burman-Zuluaga (2005) used data for two periods, 1996-98 or prior to FTT introduction and 1999-2002 when the FTT was in force, and found that the ratio of cash holdings to the monetary base increased from 46 percent to 66 percent on average.<sup>10</sup> A similar comparison was made more recently by Valero-Sierra (2007) but relating M0 to M1; they find that the average ratio increased from 34 percent in 1993-98 to 46 percent in

1999-2004 (under the FTT). Lozano-Ramos (2000), using an autoregressive model, estimate that the demand for M0 increased 0.41 p.p. as a result of the FTT being introduced, although the increase was slowly reversed. In any case, they identify a decline in the value of transactions in bank accounts (demand deposits). Giraldo (2008) uses an econometric model, controlling for economic crises, to estimate the impact of the FTT on main deposit instruments. She finds no significant effect of the tax on real cash holdings (M0) and savings accounts. However, the study supports a significant negative effect on checking account balances, which, the author infers, was possibly accommodated by transfers to unreported accounts overseas.

#### **Productivity & disintermediation**

The standard measure of tax productivity, collection as percent of GDP per percentage point of tax rate, is  $p=(R/Y)*(1/t)$ , where R=tax revenue, Y=GDP, and t= tax rate. R and t are related by  $R=t*B$ , where B=tax base (in the case of FTT, taxable financial transactions). Therefore,  $p=B/Y$ , or, defining  $\hat{x} \equiv dx/x$  as proportional change,  $\hat{p} = \hat{B} - \hat{Y}$ , that is, for a given GDP, productivity changes in the same proportion as the tax base. Since B is easy to calculate, it is often used as a proxy for the set of financial transactions. Although this is acceptable as a first approximation, the reader must be aware that changes in B reflect not only disintermediation but also, inter alia, changes in tax exemptions and patterns of taxpayer compliance, as well as migration from taxable to non-taxable transactions.

For *Brazil*, Koyama-Nakane (2001), using a cointegration model of Johansen extraction, find a modest impact of FTT on M1, which is dominated by inflation. However, they are able to determine that the FTT reduces the number of cheques issued in the economy and induces portfolio reallocation from term deposits to mutual funds. In addition, the FTT enlarges gross bank spreads while reducing net spread, thus reducing the profitability of all (private) parties involved.

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<sup>10</sup>The authors also point out two types of negative externalities associated with the FTT: (1) in certain regions of Colombia, carrying out of cash is dangerous, a fact that limits the choice between M0 and M1; and (2) to the extent that FTT encourages the use of cash, it makes more difficult the control of illegal activities.

For *Argentina*, an index was calculated showing that the usage of bank accounts declined by 76 percent between 2001—when the 1.2 percent FTT was introduced—and 2004.<sup>11</sup> In certain months of the period, bank deposits are estimated to have been reduced, by effect of the tax, by as much as 54 percent (Fenochietto, 2008). In *Peru*, bank deposits as percent of GDP declined from 24 percent in 2004 (when FTT was introduced) to 21 percent in 2004. In *Bolivia*, in the months preceding the tax in 2004 large cash withdrawals were observed, although deposits gradually recovered as people got used to it.

Kirilenko-Summers (2004), analyzing the impact of FTTs on financial markets in Latin America, find that for each dollar raised through a bank debit tax, an amount up to 28 cents in Venezuela, up to 41 cents in Colombia, and up to 47 cents in Ecuador, was lost to disintermediation. The authors analyze data for six countries of Latin America using a model of optimization and the standard measure of deadweight loss to calculate disintermediation (proxied by an erosion of the tax base). They estimate the deadweight loss caused by disintermediation at over 0.5 percent of GDP annually. This results from the very elastic characteristic of the demand for currency and other financial instruments. They also find that disintermediation effects cumulate as the taxes remain in place.

Financial disintermediation takes many forms. The most common is the substitution of cash for bank accounts, which, in a small or significant manner, typically results from the introduction of tax on bank transactions. Transferring bank accounts offshore is another possibility; as indicated by Galindo-Majnoni (2006), this practice was instrumental in the elimination of the FTT in Australia. Other possibilities are the resort to quasi-currencies, such as tax-exempt notes issued by provincial governments, as in Argentina (Baca-Mello-Kirilenko 2006). In *Colombia*, reportedly at some point business people used transferable notes among themselves instead of cash or checks (Arbeláez-Burman-Zuluaga 2005). In *Brazil* not only the banking system suffered with the FTT: of the decline in trade value observed in the stock exchange between 1997 to 2002, 19 percent can safely be attributed to the FTT (Narita-Novaes 2003), which eventually led to an exemption for those operations.<sup>12</sup>

Financial disintermediation (here perhaps more properly, financial distortion) may also take the form of portfolio reallocation, with resources being moved from types of investment subject to the FTT to other applications exempt or more lightly taxed. For example, in *Australia*, since the tax was levied on cheques, it could be avoided whenever payments were made through bank wire transfers, charge for utilities directly to the bank account, and the use of debit cards and ATMs instead of check writing. In *Bolivia*, demand deposits migrated to mutual funds and savings in national currency.<sup>13</sup> In *Brazil*, to avoid the FTT many holders of bank deposit certificates moved their resources to mutual funds (Koyama-Nakane 2001). In many countries that adopted the FTT, its heavy impact on short-term borrowing led to a migration toward instruments of longer

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<sup>11</sup> *Informe ABA*, December 2004. The usage index relates flows (debits and credits) to deposit balances.

<sup>12</sup> Narita and Novaes ascertained that not all stocks suffered evenly: the tax hit especially hard the stocks of the type investment/growth and those listed firms that pay dividends the least. Therefore, the tax had a bias towards dividend distribution.

<sup>13</sup> A secondary objective of the tax was to reduce the degree of dollarization in the economy. However, the tax, kept on foreign currency transactions, was not sufficient to induce a large desdollarization. See *Bolivia* (2004).

maturity. For example, in *Colombia*, to economize on the FTT, holders of bank deposit certificates were led to substitute for certificates or longer maturities (Lozano-Ramos 2000).

### ***FTT and interest rates***

A tax on financial flows imparts a shock that ends up having an effect on interest rates. This has been quantified and well documented for Brazil and Colombia, although the magnitude of the effect depends on other factors such as the level of interest rate—which in turns reflects current and expected inflation--and the term maturity of loans, which vary over time. For *Brazil*, Koyama-Nakane (2001) conclude that, as consequence of the FTT, the (gross) interest rate increases for the borrower, the (net) interest rate declines for the saver/depositor, and the spread (margin) for the financial institution declines in the long term. Allain (2003) estimates that Brazil's portfolio turnover was 2.42 times a year in 1998, when the relevant interest was about 25 percent; on basis of that data, he estimates that the 0.2 percent FTT then in force resulted in an increase in the Central Bank overnight lending (Selic) rate of 1.16 percentage points. Allain shows that the effect of the FTT is more obvious in the hot money market, where a 30 percent rate a.a., for repayment in 10 days, by virtue of the tax raises to 43 percent a.a.

Albuquerque (2001) estimates that if equilibrium real interest rate is 6 percent a year and a financial asset rotating 12 times a year, the FTT at a rate of 0.38 percent as in Brazil has the effect of raising the stationary rate of interest by 2.7 percentage points. The same author then derives the impact of higher interest on government debt, concluding that the working of the FTT through the bonds market makes the government lose through interest much of what it gets as FTT revenue. In a subsequent and more rigorous derivation, Albuquerque (2006) shows (Proposition 3) that the net budgetary effect (FTT revenue less increase in debt service) of an FTT is negative, although the primary deficit (misleadingly) decreases.

In *Colombia*, the introduction of an FTT had the effect of increasing the cost of loans, especially in the short term (Arbeláez-Burman-Zuluaga 2005). To some extent banks, by raising the spread, were able to pass the cost to business and consumers, but pretax bank profitability decreased. Galindo and Majnoni (2006) analyze the joint impact of the FTT and forced lending in Colombia.<sup>14</sup> They find a significant effect on interest rates, with the two factors accounting for a 3.5 p.p. increase in the spread between borrowing and lending rates. They argue that the FTT effect is dominating, responding for at least 2 p.p. in the spread expansion.

### ***FTT and competitiveness of exports***

It has been a tenet of modern tax policy that multistage taxes—by cascading on cost formation as goods pass through the chain of production and distribution—adversely affect the competitiveness of the country's sales to world markets. In fact, one of the most attractive features of the VAT is its ability to free exports, through zero rating, from the tax levied on intermediate goods. The FTT remains as a tax falling along the production chain without a mechanism of relief for exports, having therefore a negative influence on export competitiveness.

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<sup>14</sup> The latter refers to the requirement of applying a fraction of deposits to the purchase of bonds yielding below-market interest, to finance preferential rural activities and the housing mortgage market.

### *FTT's incidence on income distribution*

Taxing bank transactions poses equity issues, which have been discussed in Colombia and especially in Brazil. For *Colombia*, Arbeláez-Burman-Zuluaga (2005) ponder the progressive and regressive features of the tax, without arriving to an unambiguous result. They present, however, an interesting element of horizontal inequity: in less secure parts of the country, the holding of cash (to avoid the tax) is riskier, forcing people to rely more on bank transactions, thus suffering a tax burden higher than average. They also argue that goods sold in remote areas go through a longer chain of distribution, involving a higher tax burden through cascading. Clavijo (2005), after noting that the FTT “has impacted negatively the desired financial deepening so needed to expand credit and make it less costly” in Colombia, asserts that “about two thirds of the tax is paid by the users of the financial system and not, as wrongly believe various analysts and Congress members, the owners of financial capital.”

In *Brazil*, the distributional consequences of the FTT have received a great deal of attention. In one extreme, the tax is seen as being born basically by the wealthy: “...the tax punishes only the *rentiers*, whether they are *formal* or *informal*.”<sup>15</sup> Experts of Federal Revenue—enthusiasts of the tax—also make the case for progressivity based in that individuals with a bank account are a minority of population.<sup>16</sup> [A quantitative assessment by Paes-Bugarin (2006) found that the incidence of the CPMF is approximately proportional over the entire income distribution, making the tax neither progressive nor regressive.] Another study (Zockun, 2007), using household consumption data and the incidence of the FTT through the price system, found that it falls proportionately more on lower-income families, supporting the claim of regressivity.

The claim of regressivity is strengthened by the existence of channels for tax avoidance that are not evenly distributed: as detailed by Allain (2003), the FTT promotes the migration of savings abroad (for instance, ADR negotiated in New York) and the development of FTT-proof investment mechanisms such as exclusive funds—investment funds whose shares are all held by a single investor.<sup>17</sup> Such schemes are normally available only to large investors.

### **FTT in support of tax administration**

Much was made by the tax administrations of Brazil and Ecuador—and in a smaller scale, of Peru—on the ability of the FTT to elicit key information on taxpayer’s turnover in ways that would be otherwise inaccessible to the tax administration. The FTT, therefore, would be perhaps even more important for its information gathering ability than for the revenue it raised. It could be used to circumvent the rules of bank secrecy existing in many Latin American countries.

In 2008, Peru passed legislation strengthening the quality of bank information provided by the banks, regarding financial transactions liable to the FTT. The FTT of Ecuador was revoked at the

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<sup>15</sup> Tavares (1995). The study, in Portuguese, focuses only on the tax collected directly from individuals.

<sup>16</sup> Lemgruber-Viol et al. (2001).

<sup>17</sup> Partly in response to these practices, purchases of stocks were exempted from 2001, and an *investment account* was introduced in 2004 allowing tax-free portfolio reallocations within the same financial institution.

end of 2000. In 2001, Brazil passed legislation granting the tax administration access to information on bank transactions, independently of the FTT.

### **New forms of FTTs – In support of the formal economy**

While there is broad agreement that taxes on bank transactions have a negative impact on the use of banks (bankarization) and financial intermediation more generally, a new form of FTT developed in recent years with the purpose of promoting the use of cheques and bank transfers and discouraging cash transactions in significant amounts. These new taxes are levied only on amounts withdrawn (or deposited) in banks in cash, with the hope of coax people and businesses into greater reliance on formal transactions and away from the grey (cash) economy.

In July 2008, *Mexico* put in place a *tax on cash deposits*,<sup>18</sup> a measure intended to contain tax evasion by small business owners. The tax, at a rate of 2 percent, is withheld by the financial institution on the amount in excess of 25,000 pesos deposited in cash in a given month. Electronic transfers and cheque deposits are exempt. The amount withheld may be offset against income tax liabilities and other federal taxes. Mexican authorities have recently expressed the view that the tax has been useful in the containment of informality.

In 2005, both India and Pakistan introduced taxes on large cash withdrawals. In May 2005, *India* introduced a 0.1 percent tax on cash withdrawals exceeding 25,000 rupees in a day.<sup>19</sup> The concern, said Finance Minister Chidambaram in the occasion, were large withdrawals of cash: “These cash withdrawals leave no trail and presumably become part of the black economy.” Perhaps because of limited bankarization in India, the tax was not perceived as especially successful, and was discontinued in April 2009.<sup>20</sup>

In July 2005, *Pakistan* introduced a *tax on cash withdrawals from banks*.<sup>21</sup> The tax, intended to document the economy by inhibiting cash transactions, was withheld, at the rate of 0.1 percent, whenever cash withdrawals exceeded 25,000 rupees in a day. One year later, the rate was increased to 0.2 percent, and on July 1, 2008 again raised to the current rate of 0.3 percent. Consistent with its goal of generating information, the tax is treated as an advance payment against the income tax.

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<sup>18</sup> *Impuesto a los depósitos en efectivo (IDE)*. The tax was part of a fiscal report adopted in October 2007.

<sup>19</sup> *Banking Cash Transaction Tax (BCTT)* introduced by the Finance Act 2005. The exemption threshold was raised to 50,000 rupees by the Finance Act 2007.

<sup>20</sup> In proposing repeal of the tax, Minister Chidambaram explained that its main objective was to gather information for the Income Tax Department. Since other instruments had been developed in recent years with the same purpose, the tax was no longer necessary.

<sup>21</sup> Finance Act 2005.

These taxes on cash withdrawals (deposits, in case of Mexico) provide, in principle, an incentive to use modern means of payment, rather than relying on hand-to-hand cash transfers. If the rate is sufficiently high, this type of tax runs the risk, however, of setting back incipient bankarization, as certain economic agents (those who were making large cash withdrawals) may be led by the tax to eschew banks altogether. No evaluation of the experiences with a tax on cash withdrawals or deposits, in terms of economic consequences, seems to be available. Perhaps these taxes can help to make a dent in the difficult problem of economic informality. If so, it would also be helpful to inquire whether withdrawals (of monies about to enter informality) or deposits (of monies originated wherefrom) are a better tax base in the combat to the grey economy.

### **Learning to live with an FTT**

Financial transaction taxes, of the type reviewed in this paper, are not seen—at least not yet—as a permanent component of tax systems. Rather, they are considered as a tool in the arsenal of tax choices, to be wielded in difficult times when other, presumably better, instruments are not available. However, the current generation of FTTs is better designed than the earlier versions, and incorporates, through a learn-by-doing process, characteristics that attenuate the most flagrant distortions of the tax, and make it more palatable.

The existing FTTs apply to all usage of bank deposits, not only cheques as was the case in Australia. With this, most easy forms of avoiding the tax, such as using debit cards or withdrawing money from ATMs, are not available.<sup>22</sup> Countries have also smarted up to the fact that checks may circulate through multiple endorsements before they are deposited and become taxable; at present, legislations either limit the number of endorsements or make each endorsement taxable, the multiple tax being due upon deposit and payable by the depositor.

#### **Fancying a single tax**

The recurring idea of a single tax has resurfaced with the spread of FTTs. Their base is so broad that it was thought that a small rate could generate as much revenue as the existing taxes combined. A debit tax of 0.33% has been advocated ([www.debittax.com](http://www.debittax.com)) to replace all taxes of Australia, where tax revenue exceeds 30% of GDP. (A 0.38 % FTT in Brazil, where this type of tax has performed best, could not raise more than 1.5% of GDP). Recently, in a long shot, Cintra (2009) presents the Brazilian experience as a pathway to a single tax.

No country sporting an FTT includes in its base transactions between financial institutions, including the central bank. The disruption caused by Colombia's FTT to the interbank market, before it was made exempt from the tax, has taught a lesson to everybody.<sup>23</sup> In order to mitigate

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<sup>22</sup> In Latin America, a saver cannot write a cheque directly against a mutual fund. Withdrawals from those funds are channeled through checking accounts, where they may be subject to an FTT.

<sup>23</sup> On grounds of equity, in March 1999 Colombia's supreme court extended the 0.2 percent FTT to interbank transactions. As a result, interbank credit in national currency declined from 218 billion in the last week of February to 21 billion in the first week of May, when the market came to a virtual halt. Interbank credit in USD declined from 166.6 million in the last week of February to 18 million in the first week of April. To deal with the situation, in August the central bank practically replaced the interbank market and provided liquidity with repos and reverse repo operations. The scheme, however, involved significant transaction costs for the banks. Eventually, an exemption from the FTT was granted to interbank transactions. See Lozano-Ramos (2000) and Coelho-Ebrill-Summers (2001).

the lock-in effect of the tax, countries usually exempt from FTT transfer of resources between accounts held by the same person in the same or different institutions.<sup>24</sup>

If an investor must pay a tax to reallocate her portfolio, the tax causes a significant lock-in effect that impedes efficient investment allocation. This problem is the more serious the more developed are capital markets in the country. To deal with this issue, in October 2004 Brazil introduced a scheme called *investment account*, consisting of a bridge account through held at a financial institution where monies from redemptions and sales of securities can be parked, tax free, until they are invested in other financial assets—also free of tax. Therefore, the resources are exempt from taxation while kept inside the investment ring, and become taxable only when they transit through the checking account.<sup>25</sup> Other countries have adopted characteristics of the investment account system, especially in connection with stock exchange operations, either through statutory law or by tolerated practice.

Also, to make the tax more palatable from an equity point of view, some countries have introduced exemptions for bank deposits/withdrawals corresponding to wages and salaries, pensions, and social assistance benefits. Accounts of government offices and agencies are typically exempt from the tax, as well as the representatives of foreign governments, international institutions. Some countries exempt schools and universities, and in others the withdrawals for the payment of tax liabilities are exempt from the FTT. There are many other exemptions of a narrower scope.

Of course, the more the FTT is adjusted to take into account equity concerns and sector-specific characteristics, the greater becomes its complexity; the most costly is its compliance, and the lower its revenue productivity.

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<sup>24</sup> Treatment of joint accounts varies between full taxation to exemption if the account denomination (set of account owners) is the same in both banks.

<sup>25</sup> It was possible to transfer resources, exempt from tax, between investment accounts held by the same investor in different banks. For a description of the investment account system, see Galindo-Majnoni (2006).

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## Value-Added Taxes on Financial Institutions in Latin America

Value-added taxes were introduced in Latin America relatively early<sup>26</sup> and reflected an evolution from old turnover taxes on commodities. As a result, the extension of VAT to services took place only gradually and the more so in relation to financial services. In relation to the latter, the preferred approach has generally been to treat financial institutions as final consumers, by exempting from the VAT the services these institutions provide.<sup>27</sup> Nevertheless, there are still striking variations in the tax treatment of financial transactions in Latin America, a review of which is provided below.

### I. Argentina

Although the standard VAT rate is 21 percent in Argentina, a reduced rate of 10.5 percent applies on accrued interest and commissions if the borrower is a registered VAT taxpayer or a business taxable under the small-business special regimen. The reduced rate also applies to loans from abroad if the lending institution is subjected to the Basel banking standards. Interest and commissions on other loans are liable to the standard rate. There are, however, exemptions covering a number of financial transactions, including those taking place in bond, equity, and currency exchanges; financial instruments placed through public offering; lending among financial institutions; derivatives; interest on bank deposits; mortgage loans; lending by a firm to its employees; loans to the public sector; microcredit lending; interest on negotiable bonds issue in public offering; trust funds; mutual funds; individual retirement accounts; and savings & loans associations.

Insurance premia are also liable to VAT, with the exception of life insurance (in its various forms), retirement plans, and work-related risks. Reinsurance of those risks is also tax exempt.

### II. Brazil

A quasi-VAT, the *Tax on Circulation of Commodities-ICM*, was introduced at state level in Brazil in 1967. With the constitutional reform of 1988, it became the *Tax on Transactions involving Circulation of Commodities and Rendering of Services of Interstate and Intermunicipal Transportation and of Communication-ICMS*.<sup>28</sup> All other services were left outside the ICMS and made taxable—if included in a positive list—under the *Tax on Services-ISS*, which is a one-stage levy belonging to the municipalities. In addition, credit for input VAT is only granted

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<sup>26</sup> By 1979, twelve countries of the region already had a VAT in place. See Ch. 1 and Fig. 1.1 of Ebrill-Keen-Bodin-Summers (2001).

<sup>27</sup> In an *ordinary* VAT exemption, the supplier of goods or services charges no VAT on sales but bears (as running expense) the VAT paid in the purchase of the corresponding goods and services used as input. In a *complete* VAT exemption, the supplier not only enjoys a VAT exemption on sales but can also claim a tax credit for the VAT paid on the corresponding inputs—the credit being realized either as deduction from VAT due on other, taxable sales or, that proving insufficient, as a cash refund by the tax administration. The complete exemption is conventionally dubbed *zero rating*. On account of the complexities involved in administering a zero rating mechanism, fiscal systems in Latin America tend to limit its use to export sales.

<sup>28</sup> Most states adopt 17 percent as standard ICMS rate, while in a few of them the standard rate is 18 percent. Since the rate applies to the tax-inclusive price, a 17 percent rate becomes, effectively, 20.48 percent.

under the ICMS for those inputs directly incorporated in the taxable supplies—the so-called *principle of physical credit*. Thus, Brazil’s VAT is still mired in the old taxes on commodities. Most services, and especially financial services, were left out of the ICMS net. A notable exception, however, is found in financial leasing, whose consideration is subject to the tax.<sup>29</sup>

### **III. Other South American Countries**

Bolivia, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela have in common that the financial sector is lightly taxed under the VAT. However, the tax treatment of the sector, in those countries, presents significant differences.

#### ***Bolivia***

Bolivia’s VAT generally exempts transactions involving stocks and debentures, credit instruments, and securities. In particular, the transfer of financial assets for securitization, the transfer of portfolios between financial intermediaries, and transactions involving the public offering of securities are free from VAT. However, fees and commissions for the provision of banking and other services are taxable at single 13 percent rate. Interest is not included in the base of the VAT but is subjected to the *Complementary Regimen to the VAT*, a withholding tax with a rate also of 13 percent.<sup>30</sup>

Financial leasing is VAT taxable unless it is used to finance real estate purchases. Life insurance premia are nontaxable, while other types of insurance are in the VAT base.

#### ***Chile***

Under the Chilean system, no VAT is levied on interest generated by, and transactions involving financial and debt instruments of any kind, including collateral provided by financial institutions. However, fees and commissions charged for the provision of financial services are taxable at the standard 19 percent rate. The 19 percent rate also applies to financial leasing and insurance premia not included in the categories maritime, international transportation and aircraft (for air clubs only).

#### ***Colombia***

Financial institutions in Colombia are generally subjected to VAT, at the 16 percent standard rate, on fees and commissions for the provision of banking and other financial services, including charges for foreign exchange transactions. Exempt from the VAT are interest on credit operations, fees charged for administering mutual funds and social security funds, commissions

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<sup>29</sup> Beyond the scope of the VAT, Brazil has *Tax on Transactions on Credit, Exchange, and Insurance, and on Bonds and Securities*-IOF, applied at various ad valorem rates on the time-adjusted value of selected transactions, and on insurance premia.

<sup>30</sup> The two main components of the RC-IVA are interest and wages and salaries. It corresponds roughly to an individual income tax fully withheld at source.

on sales of life insurance and capitalization plans, commissions received by investment management firms, and insurance brokerage fees.

Leasing contracts are taxable if based on movable property. The insurance activity is in the VAT base, except individual insurance (life individual or group, accidents, health catastrophe, education). Reinsurance, on the contrary, is exempt for all branches.

### *Ecuador*

Ecuador is the only country in the group to apply zero rating to bank and stock exchange services; the treatment extends to the administration of investment trusts and funds, and insurance and reinsurance in the branches personal (life individual and group, bodily injury, medical assistance, savings and retirement) and land transit accident. Charges for ancillary bank services, such as the rental of safety boxes and the safekeeping of securities are taxable at the standard 12 percent rate. The standard rate also applies to financial leasing and non-personal types of insurance and reinsurance. The transfer of stocks, partnership shares, and other securities are not subjected to VAT.

### *Paraguay*

Paraguay's VAT is levied—at the standard rate of 10 percent—on fees and commissions charged by financial institutions. It emphasizes, however, the taxation of services provided by banks established in foreign jurisdictions. In this case, the tax applies to commissions on the trade of securities; commissions of agent constituted for the payment of dividends, amortizations, and interest; issuance of credit cards; fees and commissions charged in connection with other financial transactions; administration of portfolios and similar services; and collection of payments for technical and administrative assistance. The list is exhaustive, so in principle all activities of foreign banks, not listed, are exempt from VAT.

An explicit exemption VAT is available for transactions involving company shares, private and publicly-issued securities, bank deposits and loans, loans granted by savings and loans cooperatives and other selected institutions, and transfer of credits. Financial leasing is taxable, as are all forms of insurance and reinsurance.

### *Peru*

In Peru, a vast array of financial transactions are exempt from the VAT: credit services of bank and financial companies; capital gains; trade in bonds, securities, and commercial papers; interest and commissions received by financial institutions authorized to operate; interest generated by securities issued by companies; factoring; creation of securitization trusts; services provided by administrators of private pension funds; and interest and gains generated by central bank-issued bills. Financial leasing is exempt from the VAT if the parts involved are registered income tax payers. However, the standard 17 percent VAT rate applies to insurance premia with the exception of the branches life and credit to small enterprises.

### *Uruguay*

Uruguay has broad VAT exemptions on financial activities. The VAT (standard rate 23 percent) is not levied on commissions on the brokerage of securities; transactions with bonds and securities, public and private; credit transfers; interest on bank deposits and public and private securities; bank transactions; bank acceptances; and investment financing enterprises. Interest generated by the discounting of documents to an individual is taxable if this is not registered taxpayer under one of the business income taxes (IRIC-urban or IRA/IMEBA-rural). Financial leasing is VAT exempt, provided several conditions are met: the option purchase is irrevocable; the option exercising price does not exceed  $\frac{3}{4}$  of face value; total maturity exceeds 3 years; financing is not for real estate; and lessee is a registered taxpayer under IRIC or IRA/IMEBA.

### ***Venezuela***

Venezuela exempts all transactions and services performed by banks, credit institutions, and other financial institutions, including: savings institutions and funds; pension funds; social security funds; savings cooperatives; stock exchanges; savings and loans entities; and agricultural exchanges.

Financial leasing is subject to the VAT (standard rate 16 percent). The insurance activity is largely free of tax, with the exemption comprising transactions performed by insurance and reinsurance companies; insurance agents; insurance brokers; brokerage companies; and adjusters and other insurance cooperating agents.

## **IV. Mexico**

Mexico has accumulated considerable experience with the taxation, under the VAT, of financial services. Currently, the most significant VAT financial services subject to VAT are personal consumer loans (includes financing through credit cards, excludes housing financing), financial leasing, and insurance premia. On consumer loans, the standard VAT rate (15 percent) applies to the real component of interest, obtained by deflating the nominal interest rate by the percentage variation in nominal value of the *investment unit* calculated by Banco de Mexico (the country's central bank). In the case of foreign currency-denominated debt, the taxable base is adjusted for the exchange variation in the period.

The VAT also reaches most fees and commissions charged by financial institutions. On the other hand, the VAT law provides ample exemption for bonds, securities, derivatives, and debt instruments issued, in line with regulations, by the public or private sectors.

In the insurance activity, VAT exemptions benefit the areas of death and for-life pensions, as well as the associated commissions of agents; credit and mortgage insurance; and farming and housing financing risks. The reinsurance activity is zero rated under the VAT.

There has been certain difficulty in firming up a generally acceptable criterion for the apportionment, between taxable and exempt supplies, of the input VAT paid by financial institutions.<sup>31</sup>

## **V. Central America**

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<sup>31</sup> In any case, Mexico has been the country, in Latin America, who made the most efforts in designing a balanced mechanism for the apportionment of input VAT in the financial sector.

This section reviews the status of the VAT on the financial activity in the Central America region. The definition of Central America employed here is, however, a broad one, to include, besides the five core countries Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua, also the Dominican Republic and Panama. This group of seven, sometimes referred to as DR-CAFTA, corresponds to the countries that engaged, in a coordinated manner, in a trade arrangement with the United States, and are working toward the completion of a Central American Common Market. .

### ***Costa Rica***

Costa Rica's General Sales Tax (standard rate 13 percent) is a quasi-VAT in the sense that it still lacks two of VAT's key features. For one, the Costa Rican system allows credit for the VAT paid on purchases only when the inputs are physically absorbed in the manufacturing process—a method called *physical deduction*.<sup>32</sup> Two, instead of extending the VAT net over all marketable services then identifying the exemptions (as all modern legislations do—a *negative* list), Costa Rica's VAT law lists those services that *are* taxable (a *positive* list). In that list, financial services, including banking and such ancillary services as brokerage, are nowhere to be seen. Leasing with an option to buy has been, however, included in the VAT base, as well as insurance premia except on personal risks, harvests, and social housing.

### ***Dominican Republic***

The Dominican Republic has extended a broad exemption from the VAT (standard rate 16 percent) to the financial activity, provided, however, that it applies only to institutions and agents authorized to operate by the Central Bank or the Banking Supervisory Agency. The scope for VAT taxation on financial activities is limited to leasing, fees for the provision of security boxes, and insurance with the only exception of mandatory insurance against unemployment and work accidents.

### ***El Salvador***

The VAT law grants exemption for banks, nonbank financial intermediaries, and any other institution registered with the Central Bank or the Financial System Supervisory Agency. However, exemption covers strictly interest, although apparently collection of tax on other forms of value added in financial intermediation has not been enforced. All reinsurance, and the premium on personal insurance, is exempt, while all other types of insurance are taxable. Leasing is also taxable at the standard 13 percent rate.

### ***Guatemala***

A broad exemption from the VAT (standard rate 12 percent) applies to services provided by institutions reporting to the Banking Supervisory Agency; stock exchange and dealers authorized

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<sup>32</sup> The standard usage in the invoice-credit method is called, for contrast, *financial deduction*. For a description of the methods for determining the VAT liability, see Ebrill-Keen-Bodin-Summers (2001). For a discussion of Costa Rica's VAT, see Cornick-Thompson-Torrealba (2008).

to operate; credit cooperatives; and savings and loan institutions. In addition, a VAT exemption benefits transactions involving credit instruments issued by enterprises, listed in exchange, and generally, the issue, sale, and transfer of credit instruments, securities, and shares of joint-stock companies.

All leasing and insurance transactions are taxable, while reinsurance is VAT exempt.

### *Honduras*

In Honduras, a blanket VAT exemption applies to all banking and financial services.

The insurance activity is taxable, except personal insurance which is exempt together with all reinsurance. Leasing operations are taxable at the standard 12 percent rate.

### *Nicaragua*

A broad VAT exemption benefits all types of securities (*participaciones sociales y demás títulos valores*).

Also exempt are mandatory car insurance, insurance against farming risks, and most forms of personal insurance (death, pensions and for-life benefits, accidents and other events covered by a life insurance policy). Other forms of insurance, as well as leasing, are subject to the 15 percent VAT.

### *Panama*

The Panamanian VAT law expressly exempts from tax the transfer of negotiable instruments and securities in general; payments or receipts of interest generated by financial services; interest on pension funds and unemployment funds; mutual funds and other savings instruments; and the activities of stock and farm exchanges, and of cooperatives.

Also listed are exemptions for financial services provided by institution legally established, financial intermediation services. Finally, the insurance activity is also free from the tax, as an exemption is available for services provided by persons and institutions operating under authorization of the Supervisory Agency for Insurance and Reinsurance.

Financial leasing, however, is taxable at the standard 5 percent VAT rate.

In summary, all seven Central American countries have a VAT, although they are at different stages of evolution toward a truly general sales tax of value-added shape and consumption based. The starting point of that evolution consisted of turnover taxes on commodities. Therefore, only gradually services in general--and financial services in particular--attract the attention of policy makers.

### *In summary*

As a practical matter, VAT taxation of the financial sector in Latin America is limited to financial leasing and certain branches of insurance, typically property, plus a limited array of fees and commissions charged by banks. Countries in the region have generally been parsimonious in applying VAT to a broader array of financial services (besides leasing and

insurance) because of the still modest development of capital markets in the region, the risk of off-shoring, the complexity inherent to applying the VAT more broadly to financial activities, and custom.

It is worth mentioning that except for Ecuador on a limited basis, no country in Latin America applies a zero VAT rate to its financial sector. With that, banks and other financial institutions are largely treated as final consumers and suffer the burden of the VAT on their taxable purchases.<sup>33</sup> Non-crediting of input VAT associated with extensive exemptions for taxable supplies, may be providing an acceptable compromise.

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<sup>33</sup> Although the VAT paid on inputs purchased to produce exempt output cannot be recovered through the VAT credit mechanism, it is still the case that such expenses can, typically, be deducted as business expense for purpose of the corporate income tax.