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CORPORATE TAX SYSTEMS AND POLICIES FOR ATTRACTING FDI IN LATIN AMERICA

GIORGIA MAFFINI AND ANNA MARENZI

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by

Giorgia Maffini and Anna Marenzi

University of Pavia and University of Warwick — Università dell'Insubria

Abstract

This paper is part of a wider research on "Tax Systems and Tax Reforms in Latin America", carried out 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. Reporting the experience of Latin American countries, the paper focuses on the effects of the corporation income tax (CIT) and fiscal incentives on foreign direct investment (FDI). The CIT affects both the marginal and inframarginal return to investment. Hence, it is an important factor in determining the cross-country distribution of FDI, together with tax incentives and other factors such as the stability of the institutional framework, the labor force abilities and good infrastructure. After the restrictive policies of the 1970s and the debt crisis of the 1980s, foreign direct investment in Latin America became a key element for fostering growth and development. Globalization in the form of increased trade and foreign investment has also encouraged countries to review their fiscal systems. In a world where an increasing number of countries compete to attract limited capital, tax authorities have to promote capital inflows by offering investment tax incentives while rationalizing the fiscal system. In this respect, countries in the region made extensive use of generous and broad-based tax incentives, mainly granted to firms located in tax-free zones. In the latter, investment is wholly or partly exempted from income and capital taxes. In a highly competitive environment where many developing countries can offer a generous treatment to low value-added FDIs, it is important for the development of Latin America to attract the "right" type of FDI. In other words, governments should stimulate foreign direct investment likely to generate spillover benefits in the host economy. The paper is organized as follows. After a general introduction, the first section depicts the evolution and the type of foreign direct investment in the region since the 1980s. Section two describes the policies used to promote capital inflows. Section three illustrates the corporation income tax systems and session four adds a description of the main rules adopted to tackle issues in international taxation.

Reference Authors: Giorgia Maffini G.C.Maffini@warwick.ac.uk

Anna Marenzi anna.marenzi@uninsubria.it;

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1. Introduction, contents and main conclusions

Reporting the experience of Latin American countries, the paper focuses on the effects of the corporation income tax (CIT) and fiscal incentives on foreign direct investment (FDI). The CIT affects both the marginal and inframarginal return to investment through the effective marginal and the effective average tax rate (Devereux and Griffith 1998 and 2003). Hence, together with tax incentives, it is an important factor in determining the cross-country distribution of FDI (Hines 1999 and De Mooij and Ederveen 2003). After the restrictive policies of the 1970s and the debt crisis of the 1980s, FDI in Latin America became a key factor for fostering growth and development. The liberalization of the economy and the deregulation and privatization of services have largely contributed to the FDI inflows in the region since the 1990s (Rios-Morales and O'Donovan 2006). Also before that, Latin American governments have widely used tax incentives to attract foreign capital. The use of many different fiscal incentives created a complex and opaque system imposing high compliance costs on taxpayers and a serious burden on the administration (see, among others, Zee *et al.* 2002).

Today, globalization in the form of increased trade and foreign investment has put fiscal systems even more under pressure. Developing countries all around the world have to attract investment in a more competitive environment and therefore, they still have to make use of fiscal incentives. At the same time, it is important to maintain an adequate stream of revenues for financing projects (e.g. education of the labor force, infrastructure) aimed at making the environment more attractive for FDIs. Since the mid-1990s, many countries in the region tried to re-organize their fiscal system more efficiently, mainly following the "low-rate broad-based" (LRBB) approach (Martner and Tromben 2004 and Tanzi 2000). As a result, nowadays Latin America has relatively low statutory corporate tax rates although there are still differentials in the tax rates and in the maturity of the CIT system. Nonetheless, the benefits from tax competition are not equally distributed among the countries of our selected sample (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay and Uruguay). For example, Chile has a modern corporate tax system which has assimilated most of the international standard rules, such as the taxation of worldwide income and the adoption of safeguards against tax arbitrage (e.g. transfer pricing rules, thin capitalization). On the contrary, Colombia and Paraguay still have a pre-global corporate tax system.

An efficient fiscal system should not support unproductive rent-seeking behaviors while trying to promote investment. Hence, it is important for fiscal incentives to be part of a coherent broad fiscal policy generating a transparent, efficient fiscal system. Generally, this doesn't happen in the countries of our sample as they still offer generous and broad-based tax incentives mainly to foreign and domestic firms located in free-tax free-trade zones. Companies located in those areas are granted full or partial exemption from income and capital taxes. (Agosin *et al.* 2005). These forms of generalized incentives did not guarantee inflows of high value-added investment in the region. Latin America countries have attracted mainly natural resources, market-seeking and efficiency-seeking FDIs. There is no substantial *technological assets-seeking* investment. The latter is more likely to induce positive spillovers into the domestic economy through technology and knowledge transfers.

It is nowadays increasingly important for Latin America to attract high value-added FDI. The latter are more likely to create positive externalities for the local economy and they are therefore crucial for growth and development. This type of investment is attracted not only by fiscal incentives but also by specific characteristics of the host country such as the education of the labor force and the availability of proper infrastructure. For building up a stock of non-fiscal capabilities able to attract foreign capital, countries in the region need to generate tax revenues as well. Latin American fiscal administrations started adopting measures to protect their tax base internationally. They endorsed transfer-pricing and thin capitalization rules and they developed a network of tax treaties against double taxation. This is a further step in the direction of a more efficient and more modern fiscal system. The reforms were not implemented by all countries of the region, though. Furthermore, complex rules such as those regulating transfer-pricing are sometimes not enforced as the administrations still lack the expertise to apply them.

The paper is organized as follows. The first section depicts the evolution and the type of foreign direct investment in the region since the 1980s. Section two describes the policies used to promote capital inflows. Section three illustrates the corporation income tax systems and section four adds a description of the main rules adopted in the selected countries to tackle issues in international taxation.

2. Foreign direct investments in Latina America: evolution and patterns

The increasing integration of the global economy has lead to the amplified importance of FDI around the world. Since the 1980s, global net flows of FDI increased by about 100 percent from about fifty-seven US$ billions in 1980 to six hundred sixty-five US$ billions in 2004 (see Figure 1). The sizeable growth in FDIs has been quite volatile: phases of stagnation (such as the first half of the 1980s and 1990s) were followed by periods of significant growth (second half of the 1980s and

1990s). FDI flows to Latin America followed a similar trend even though the region did not take advantage of the first FDI boom of the late 1980s: in the 1970s and 1980s, the countries of the region applied import-substitution industrialization policies hence building an environment of trade protection. Inflows of FDI into the region remained fairly stable from 1980 until 1993, increasing at an annual rate of less than 2 percent and lingering around one percent of GDP. The FDI boom in Latin America began in 1993.

FIGURE 1 HERE

The view of Latin American governments changed radically in the 1990s: after the restrictive policies of the 1970s and the debt crisis of the 1980s FDI became a key element for fostering growth and development. FDI inflows prospered uninterruptedly until 1999. In terms of levels of net total FDI attracted, the leading countries are Brazil, Mexico, Argentina and Chile (see Figure 2). In terms of net total FDI as a percentage of GDP, the leading countries are Chile, Brazil, Costa Rica and Mexico (see Table 1). In this period, FDIs were attracted by deregulation and privatization of services and by policies opening up and liberalizing the economy (among others, Rios-Morales and O'Donovan 2006). Between 1990 and 1998, the countries in the region privatized assets for about US$ 154.2 billion and their high tariffs on imports and exports were reduced very quickly at about 10 percent -14 percent (Hosono and Nishijima 2001).

New regional integration schemes were also launched and/or revitalized through trade agreements signed by Latin American countries with both their neighbors and outside players (e.g. the Southern Common Market (MERCOSUR), the Group of Three, the North America free Trade Agreement (NAFTA) and the Free Trade Agreement of the Americas (FTAA)).

FIGURE 2 HERE

FIGURE 3 HERE

TABLE 1 HERE

More recently, after four years of deteriorating FDI inflows (from 2000 to 2003) as a consequence of the financial crisis, Latin America and the Caribbean underwent first a rebound and then an increase in FDI in 2004. In 2005, FDI inflows to the whole region increased by 12 percent and amounted to $67 billion ($104 billion including offshore financial centres) of which 40 percent came form the United States[1] (UNCTAD 2006). The reasons are to be found in the global and local strong economic growth and in the high commodity prices. However, Argentina was the worse hit by the debt crisis in 2001 and it has not yet got back to its previous levels of FDI (UNCTAD 2004). FDI flows to the region have increased substantially but other types of capital flows have remained sluggish. FDI is certainly still the central source of private external finance to Latin America in recent years. Using Dunning's well-known scheme (Dunning 1993), foreign direct investment can be classified according to the economic rational driving them: natural resource-seeking investments, market access-seeking, efficiency seeking and strategic/technological asset-seeking (see Table 2).

TABLE 2 HERE

In the last century, FDI in the region has been of the *natural-resource seeking* kind as it was primarily aimed at securing oil, gas and minerals. This type of investment rarely induces positive spillovers in the host economy, in particular when resources are exported as raw materials. The liberalization and privatization waves encouraged this type of investment also in the 1990s: transnational corporations (TNCs) could acquire state assets in the form of either privatized companies or gas, petroleum (Venezuela, Colombia and Argentina) and mineral rights (Chile, Peru and Argentina). But the reforms occurred in the last decade of the twentieth century also fostered *market-seeking* FDI,[2] especially in the services sector where newly privatized telecommunication and energy companies became good investment opportunity together with the sale of private sectors activities such as banks and other financial institutions (Mortimore 2000). A major example is Brazil: it is the biggest recipient of FDI in Latin America and in particular, between 1991 and 1998, 28 percent of FDI entered the country through the privatization program (Mortimore 2000) mainly in the telecommunication (e.g. Telebras and cellular phone concessions) and electricity sector. In general, between 1996 and 2002, 59 percent of the FDI inflows in Latin America targeted the services while 28 percent manufacturing and only 13 percent the primary sector (Rios-Morales and O'Donovan 2006). More specifically, the south cone received more *market-seeking* investments in services (financial services, telecommunications, electricity and gas distribution) and manufactures (agro-industry, chemicals and automotive) while Mexico and the Caribbean Basin traditionally collected mainly *efficiency-seeking* flows aimed at securing lower production costs and establishing

[1] The second biggest investor was the Netherlands (but caution should be used as many multinational groups locate their holding companies in the Netherlands because of fiscal privileges). Spain followed with 6 percent of total investment. Additional key players were other countries in the region as a result of the activity of some "Trans-Latin" corporations such as the Argentinean Technit, the Mexican America Movil and the Brazilian Camargo Correa.
[2] This type of investment was typically targeted at gaining access to local markets.

export platforms (ECLAC 2006). FDI from the automobile industry exemplifies this pattern[3] but it is important to remember that *efficiency-seeking* investments in the Caribbean also entered the electronics, apparel, and services sectors (e.g. electronics and the administrative services in Costa Rica). In Brazil and Argentina investments from foreign (mainly European) automobile companies aimed at either consolidating their position or at gaining access to local automotive markets. On the contrary, investment in Mexico, largely from US companies, was in search of lower production costs to better compete in the home country market.[4] The difference between the two sub-regions lies in institutional and geographical factors. First, the MERCOSUR countries lacked the geographic closeness with a major market and, at the same time, their large market attracted *market-seeking* investments almost by definition.[5] But their institutional environment was also very different from the Mexican one. The Mexican authorities implemented the *maquila*[6] program which allowed foreign export-oriented firms to operate tax-free. They also allowed the assembling of vehicles with a high percentage of imported parts, vehicles which were exported once assembled. The NAFTA was also a key element in boosting automotive FDI from the US: the agreement grants special provisions for the automobile sector. Its regional norms of origin establish that a good is considered to be produced within the NAFTA countries if 62.5 percent of its production costs are incurred in that area. This has favored investment of the US corporations in Mexico as goods (and their value-added) produced in the NAFTA region attract lower indirect taxes when exported back to the US. MERCOSUR countries have free-trade zones as well. Nonetheless, Mortimore (2000) highlights they are not as advantageous as the Mexican export-processing zone for assemblers. Countries in the South cone also kept barriers to import of motor vehicles and high levels of mandatory regional content.

Table 2 shows there are no substantial *technological assets-seeking* investments aimed at securing technology-intensive production assets. This type of FDI is more likely to induce positive spillovers into the domestic economy through technology and knowledge transfers. The literature argues that this is the main weakness of the Latin American FDI attraction model (Rios-Morales

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[3] Foreign direct investment in the automotive industry was a very important component of FDI in Latina America and the Caribbean during the 1990s. According to Mortimore (2000), in 1998 seven of the ten biggest companies in the region by consolidated sales belonged to that industry. They were General Motors, Volkswagen, Ford, and Chrysler in Mexico and Volkswagen, General Motors and Fiat in Brazil.

[4] Mortimore (2000) highlights that during the 1980s, European and particularly American corporations faced stiff competition from their Asian (in particular Japanese) counterparts in the automotive, apparel and electronics industries. By relocating part of the production (mainly the assembly process) in the Caribbean, American companies were able to fight back. They could assembly their final products at lower costs in the region and thus, export them back in their home market at lower prices.

[5] It is worth noting that as a consequence of the MERCOSUR, the market in the South cone is even bigger.

[6] A *maquiladora* is a Mexican corporation, wholly or predominantly owned by foreigners, that assembles products to export in other countries.

and O'Donovan 2006). Not only this is likely to be the reason why the literature does not find evidence of positive spillovers from foreign investment to the regional domestic economy (among others, Aitken *et al*. 1996) but it also makes the region vulnerable to the competition of Asian countries. Actually, Latin America continues to lose headway to destinations, such as China and other Asian nations even though FDI remains the biggest source of external private funding for the region. In the 1980s, the area received about 12 percent of global FDI. The percentage shrank to 10 percent in the following decade and to 8 percent since 2000 (ECLAC, 2006).[7] According to ECLAC (2006), while countries such as Singapore, Korea, China, Malaysia and Thailand implement more active and focused policies for attracting FDI, in Latin America strategies are still passive and not targeted at specific high-quality investments. Furthermore, whilst the more competitive European and Asian countries target their incentives to efficiency-seeking and strategic or technological-asset seeking FDIs, incentives in South America and the Caribbean are principally fiscal in nature and very general. Moreover, many countries of the region score quite low in various indexes measuring the quality of the business environment. Except for Costa Rica and Chile, the other countries appear in the bottom two quintile of the Index for Economic Freedom (Heritage Foundation),[8] Doing Business (International Finance Corporation),[9] the Corruption Perception Index (Transparency International)[10] and the A.T. Kearney Globalization Index.[11] This places the area far behind the developed nations and the Asia-Pacific region.

3. Investment promotion policies in Latin America

Before the FDI boom, most of the countries of our selected sample (e.g. Argentina, Mexico and Brazil) implemented batteries of diverse tax incentives aimed mainly at their less developed regions and at specific industries (Bird and Chen 2000). The incentives were not part of a broadly consistent industrialization and/or development policy. Therefore, they did not have much effect in terms of

[7] In 2005 South, East and South-East Asia attracted about $165 billion, with China alone accounting for about $72 billion. China was the third largest recipient of FDIs in 2005 totalling about 22 percent of total investment going to developing countries and about 7 percent of global investment (UNCTAD 2006).
[8] The index measures 10 broad economic factors: trade policy, tax burden, government intervention, monetary policy, foreign investment, banking, wages and prices, regulation, rights of ownership and degree of market informality.
[9] This index measures how easy it is to do business for a start-up company. It records he simplicity of company registration procedures, licensing agreement, and so on.
[10] This index measures the perceived and not the objective corruption in a country.
[11] This index measures four different aspects of globalization: economic integration (through trade and FDI inflows and outflows), technological connectivity (through number of internet users), and political engagement (number of country's memberships in international organizations and UN peacekeeping missions) and personal contact (through monitoring tourism and international travel).

promoting growth and development even if they might have had some positive effects on specific sectors (e.g. manufacturing and tourism in Mexico and Costa Rica). Being fragmented across sectors and regions and being implemented through particular laws, incentives were very likely to be abused, especially in federal systems such as Brazil and Argentina where local authorities are more exposed to lobbies' pressure (UNCTAD 2000).

The political economy literature attempts to pin down the mechanisms leading to some specific investment promotion policies (Jensen 2003) such as those mentioned above. Among others, Li and Resnick (2003) explain the level and type of investment incentives with the nature of the host country political institutions. The hypothesis is then tested in Li (2006). Using a cross-section of 52 developing countries, including the countries of our sample, the author finds evidence that the institutional characteristics of the host political system (*i.e.* democracy *versus* autocracy) affect the level of tax incentives granted to foreign investors. Generally, more democratic regimes offer effective property rights protection. Hence, strong tax incentives are not needed to compensate FDIs for the high risk of expropriation, seizure of assets, contract repudiation, and government corruption. Nonetheless, not all autocracies adopt the same incentives policy. Since tax incentives imply a transfer of benefits from domestic to foreign capital, the choice of which type of investment to promote is strictly bond to the economic *elites*' interests and their lobbying power. In Argentina, during the last military government, the incentives were implemented mainly for domestic political reasons either in response to domestic lobbies or to "compensate" some regions (e.g. Tierra del Fuego) for being far from the economic centre of the country (Byrne 2002). Borders security reasons also encouraged governments to promote a program of fiscal incentives for industries in some poor and under populated provinces such as the Manaus Free Zone in the Brazilian Amazon.

Since the 1990s, countries in the region tried to rationalize the investment incentives systems (Figari and Gandullia 2007) as the different and fragmented rules in place displayed many shortcomings. First, they were highly distorsive with respect to agents' economic decisions as they also encouraged corruption and unproductive rent-seeking activities. They made the fiscal systems more complicated and less transparent imposing high compliance costs on taxpayers and a serious burden on the administration. Another major drawback consisted in great revenue losses. This could potentially prevent the authorities to develop infrastructure, education and health programs. The latter features can make the countries attractive for FDI. While rationalizing the fiscal system, in a world where an increasing number of countries compete to attract limited investment capital, tax authorities have to encourage capital inflows by offering investment tax incentives (see, among others, Morisset and Pirnia 2001; Holland and Vann 1998; Rios-Morales and O'Donovan 2006). This practice can lead to a race to the bottom where all countries end up with a comparable amount of total investment and with serious revenue losses (Thomas 2000). In this respect, all the countries[12] in our sample relied upon free-trade zones which granted exemptions mainly from import duties and indirect taxes (e.g. VAT). Many of the free trade areas also exempt profits and their repatriation for a limited amount of years.[13] The aforementioned tax benefits were also extended to domestic firms (Agosin *et al.* 2005). Most of the fiscal advantages accruing in those areas have been phased out (e.g. Mexico) or will be eliminated as they are not compatible with many of the trade agreements signed by the countries in our sample (e.g. MERCOSUR and WTO).

As mentioned above, Latin America has attracted mainly natural resources, market-seeking and efficiency-seeking FDI with a "the-more-the-better" approach (Rios-Morales and O'Donovan 2006). In this environment, according to the UNCTAD FDI Indices,[14] between 2002 and 2004, Chile and Costa Rica have attracted a good amount of FDI with respect to their capability (see Table 3).

TABLE 3 HERE

Chile has performed well in attracting foreign capital as it is politically and economically stable. In addition, it has a low corporate tax rate (17 percent) coupled with the a full integration system in which the CIT paid is creditable against income taxes imposed on resident (Global Complementary Tax) and foreigners individuals (Additional Tax). Moreover, in order to boost financial markets, the government allowed full/partial exemption of capital gains on the disposal of certain assets. In 2002, a new and favorable tax regime for platform companies[15] was launched with the aim of encouraging multinational corporations to set up their regional headquarters in Chile. For tax purposes, platform companies are considered as non-resident or domiciled taxpayers so that only income generated in the country is taxed and dividends and profits that they may receive from subsidiaries abroad would be exempted. Chile has also signed a great number of tax treaties with other Latin American countries (e.g. Argentina, Brazil, Mexico, Paraguay), developed (e.g. Canada, France, Spain, Sweden and the UK) and developing countries (e.g. Malaysia) allowing a reduction in withholding taxes.

Costa Rica profits from a stable economic and political climate and from a well-educated labor force. The country has greatly used incentives to attract capital flows, in particular in the

[12] Argentina is the only exception.
[13] For an analysis of the costs and benefits of tax holidays, see OECD (2001).
[14] See www.unctad.org.
[15] Law 19,840 enacted in November 2002 enables foreign investors to set up a platform company in Chile for channelling and managing investments in third countries. Companies set up as a Business Platform must be incorporated in accordance with Chilean law and can either be open stock corporations or closed stock corporations, subject to the same regulations and governmental supervision as listed stock corporations.

manufacturing sector (e.g. electronics with the Intel semiconductor assembly and testing plant) which has prospered under the tax-free zone system.

Finally, both Chile and Costa Rica have specific institutions assisting and guiding foreign companies to set up their operations in the two countries.

In the actual highly competitive setting where many developing countries can offer generous treatment to attract low value-added FDI (D'Amuri and Marenzi 2006), it is important for the development of Latin America to attract the "right" type of FDI. In other words, governments should stimulate foreign direct investment likely to generate spillover benefits in the host economy (e.g. transfer of knowledge). Positive externalities of FDI are normally ignored by private investors and they are not incorporated in their decision making process so that the level of investment could be sub-optimal. In this direction, Brazil and Mexico granted incentives for qualified investments to encourage technological qualification of enterprises: a tax credit (15 and 30 percent, respectively) is available for R&D expenses incurred in the tax years and different forms of accelerated depreciation incentive are allowed for investment on new fixed assets and for new equipment used in R&D activities (Figari and Gandullia 2007).

4. Corporate taxation and investment in Latin American countries

The CIT affects both the marginal and inframarginal return to investment through the effective marginal and the effective average tax rate (Devereux and Griffith 1998 and 2003). Hence, together with tax incentives, it is an important factor in determining the cross-country distribution of FDI (Hines 1999 and De Mooij and Ederveen 2003). Specifically, tax burden on FDI depends on three elements: domestic corporate taxation of home country and host country, international taxation of cross border income flows (dividend, interest, etc.) and interaction of tax systems between home and host countries.

4.1 The systems of corporate taxation

The current corporate tax systems of the selected countries are the result of several fiscal reforms mainly started in the beginning of the 1990s and, for certain countries, still underway. Generally, most countries have realized a consistent reduction in the statutory tax rate in the last decades. At the same time, they have adopted base-broadening measures, such as, taxation of worldwide income, adoption of safeguards against tax arbitrage and reduction of tax exemptions and incentives (see, among others, Tanzi 2000; Martner and Tromben 2004; Agosin *et al* 2005). Wibbels and Arce (2003) suggest that, as trade and financial liberalization consolidate, CIT revenues get less relevant for Latin American countries. In fact, the share of corporate income tax as a percentage of GDP declined from an average of 5 percent in 1975-78 to 3.9 percent in 1997-2002.

Each country has developed its own tax system in a different social, economic and political framework; this has conditioned the evolution of the national tax systems. As a result, the countries show different level of maturity in their corporate tax systems. In this respect, it is possible to identify three groups of countries[16]. Chile and Mexico display a corporate tax structure that assimilates most of the international standard rules, such as transfer pricing guidelines. A second group of countries (Argentina, Brazil and Colombia) exhibit a system where the current CIT reflects a protracted process of gradual changes, principally responding to macroeconomic fluctuations and shocks rather than to a well defined tax design project. Among these countries, Colombia has a pre-global system, primarily focusing on collecting revenues from internal transactions and local trade rather than favoring capital flows and foreign investments. The transition towards a modern tax system is the main aim of the new wave of tax reforms undertaken by the countries of the third group at the middle of the 2000 (Costa Rica, Uruguay and Paraguay). For different reasons, their full implementation has been delayed but these reforms could potentially modernize the tax systems. In particular, the proposed tax reforms in Costa Rica and Uruguay include several elements of international taxation: a transition towards the worldwide income taxation model and the introduction of a set of traditional instruments, such as transfer pricing rule, definition of permanent establishment and tax haven regulations. Finally, the reform underway in Paraguay broadens the CIT tax base and reduces the tax rate. It should reposition Paraguay system from a primitive to a one that is more appealing for capital and trade.

The main features of the corporate tax system in our sample of Latin America countries are summarized in Table 4.

TABLE 4 HERE

A domestic company is liable to be taxed on its worldwide income in Argentina, Brazil, Chile, Colombia, Mexico and it is granted tax credits for taxes paid abroad. A foreign company is normally taxed only on its host-source income. Costa Rica, Uruguay and Paraguay adopt the

[16] In considering the proposed classification, it should be noted that, the income tax systems of Brazil, Colombia, Costa Rica and Uruguay have a general income tax levied on both individual and business enterprises. The lack of a separate corporate tax law is a relevant element in evaluating the degree of maturity of a tax system.

territorial system,[17] although the proposal of moving to a worldwide system is actually under discussion for the first two countries[18]. Hence, in Costa Rica, Uruguay and Paraguay income arising from foreign sources and received by resident companies is not taxed at all, and foreign taxes are not deductible or creditable. Both Costa Rican and Uruguayan tax systems provide relief to non-residents with respect to source income. Under certain circumstances, Costa Rica may exempt or reduce income tax when there is evidence that the residence country does not grant any credit or deduction for the Costa Rican income tax. In Uruguay dividends and technical assistance are exempted from corporate taxation. Generally, subsidiaries of multinationals are taxed using the same basis of local entities. A different tax rate is applied in certain countries (Chile, Colombia, Costa Rica and Paraguay) to branches of foreign enterprises.

As noted by Martner and Tromben (2004) and Tanzi (2000), in the 1990s most countries began to reduce and unify their national corporate tax rate in order to be more in line with international standards. As a result, today Latin American countries have relatively low statutory corporate tax rates although the tax rate differentials across countries can still be significant. The Latin America average CIT rate was 28.3 percent in 2006: the highest values are those of Argentina and Colombia (35 percent), the lowest one is that of Paraguay (10 percent). All countries apply a standard flat corporate tax rate (see Table 4). However, most of the countries in the region display multiple regimes where together with the standard corporate tax rate, there also exist presumptive, preferential and simplified treatments (see also, Figari and Gandullia 2007).

4.2 Preferential and special regimes

The use of a presumptive taxation system is a common feature of several Latin American countries (Tanzi 2000 and Gonzalez 2006), such as Argentina, Brazil and Colombia. Generally, these systems estimate taxpayer's income using some specific base such as assets, gross receipts/turnover, or external indicators of income or wealth. For example, the Argentinean presumptive minimum income tax works as an assets tax. In Brazil annual turnover is the tax base for the regime of presumed profit. In Colombia, the minimum presumptive income is equal to 6 percent of the corporation's net worth, minus a fixed abatement.

[17] In the past, Latin American countries, as most of the developing countries, used to rely on territorial taxation system for two reasons. Firstly, having a net external liability position, countries in the region had to gain more from taxing income of foreign investors than exempt residents' foreign income. Second, it was difficult for the tax administration to find out how much foreign income accrued to residents (see, Zee *et al*, 2002).

[18] In particular, according to the Base Report presented in August 2005 by the Tax Reform Commission, the Uruguayan tax system should move from residential approach to the territorial one, after a transitory period (see Barreix and Roca 2007).

Moreover, in most countries the current CIT regimes allow preferential treatments for enterprises operating in specific sectors. Mining companies in Chile are taxed under a progressive scheme with tax rates ranging from 0 to 5 percent. Small enterprises in Uruguay are exempt from CIT and pay a monthly lump-sum tax. In Brazil micro-companies and small enterprises have the option to be taxed under a simplified regime[19] with a progressive rates ranging from 3 to 5 percent for micro-companies and from 5.4 to 8.8 percent for the small enterprises.[20] Medium and large-sized Mexican companies engaged in transport and agriculture activities pay little or no CIT under the simplified regime. In Costa Rica the simplified regime replaces either the CIT or the VAT for qualified taxpayers[21] that adopt it. Simplifying regimes are normally introduced for reducing compliance costs for certain "weaker" entities. Nonetheless, it is widely recognized that, some so-called simplified regime may be actually very complicated (Chen and Martinez-Vazquez 2003).

4.3 Dividends, capital gains taxation and other taxes

In all countries of the sample, excluding Paraguay, inter-company dividends are partially or fully exempt from corporate income tax for resident companies. In Argentina an equalization tax applies where distributions are in excess of taxable profits. Capital gains accruing to corporations are usually treated as ordinary income for tax purposes. Latin American countries tend to impose high rates of withholding taxes (see Table 4). Net worth taxes are levied in Argentina, Colombia, Mexico and Uruguay with different characteristics across countries (Tanzi 2000; Sadka and Tanzi 1993). As already mentioned, a presumptive minimum income tax is levied on firms incorporated in Argentina: the tax is levied at a rate of 1 percent on the value of all assets held at the end of each fiscal year. In Mexico the net worth tax operates as a minimum tax (1.8 percent) for enterprises reporting no income tax liability in their annual tax return. Finally, in Colombia and Uruguay the tax is imposed on the net worth (which depends on the relevant taxpayer and on the type of assets involved) of resident and non-resident companies. The tax rate is fixed at 1.2 percent in Colombia and at 1.5 percent in Uruguay.

Finally, depending on the interaction across the different features of the corporate tax system, effective tax rates may differ substantially from statutory rates. Generous deductions and exemptions or large multifaceted incentives contribute to lowering effective tax rates. At the same

[19] Among other legal entities, subsidiaries, branches and permanent establishments of foreign companies do not qualify for the simplified tax regime.
[20] The tax rate covers mainly, corporate taxation, social contributions on profit, and federal social security tax and excise tax.
[21] The simplified regime is targeted to corporate and individual taxpayers with an annual purchases not greater than a certain amount and with no more than three employees, provided their business activity is one of the eleven included in this regime (china and porcelain production, furniture production, handmade shoes manufacturing, etc.).

time, taxes other than the corporation income tax, such as turnover taxes, gross or net taxes, and property taxes, may increase significantly the effective tax burden on capital investment. A recent comparative measure of total real tax burden affecting foreign capital in some countries of our sample has been produced by Chen and Martinez-Vazquez (2003). The authors calculate the marginal effective tax rates (METRs) on FDI of US multinationals in manufacturing and services sectors for Argentina, Brazil, Chile, Mexico and Peru. The all inclusive effective corporate tax rates are reported in Table 5.

TABLE 5 HERE

The results indicate that Mexico and Chile provide the most tax advantageous environment to US investors. Mexico has a relatively generous CIT regime in term of depreciation allowance (5 per cent for buildings, 25 per cent for vehicles, 30 per cent for computer, and 5-2 per cent for machinery[22]) and the lowest property tax among the four countries. Chile has the lowest legal tax rate.

4.4 Aspects of international taxation in Latin America

The competition for attracting FDI imposes two main constraints on tax administrations. First, they should avoid any double taxation on non-residents' income. Second, they should preserve the tax base so to finance projects (e.g. infrastructure building, education programs) to appeal more to high value-added FDI. Countries have established a series of treaties to avoid double taxation (DTTs) and the erosion of the tax base, specifying when the source country is allowed to levy a tax, whereas the country of residence is required to concede the right to credit. Tax treaties contribute to create a stable and transparent environment for trade development and FDI promotion through clear and steady rules. Furthermore, tax treaties contain specific limitations on the withholding tax rates on dividends, interest, and royalties imposed by the source country, as prescribed in the OECD Model Convention. Alternatively, the withholding tax rate levels are left to bilateral negotiations, as in the UN Model Convention for developing countries. DTTs should also include rules for the exchange of information between countries to facilitate the protection of the tax base. Unfortunately, this is rarely the case for developing countries and hence, withholding taxes are levied at higher rates.

[22] Among the four countries, the less generous regime of depreciation allowance is that in Argentina with the following percentages: 2 percent for buildings, 20 percent for vehicles, 33 percent for computer, and 10 percent for machinery.

In general, when compared with the tax treaty network of more developed countries, Latin America's one is rather limited (see Table 4). Nonetheless, it is rapidly expanding, especially for countries such as Argentina, Brazil, Chile and Mexico. Chile is very active in terms of DTTs negotiation: it signed twenty-one[23] treaties since the end of the 1990s. In general, Chilean treaties are based on the OECD model,[24] which contains reduced withholding tax rates for different kinds of income and grants tax credits for taxes paid in the host countries.[25] Argentina signed eighteen tax treaties with, among others, Austria, Belgium, Denmark, Finland, France, Germany, Italy, Norway, Spain, Sweden, Switzerland, the Netherlands and the UK. Most of the treaties are based on the OECD model. Brazil also has an extensive network including treaties with Belgium, Canada, France, Italy, Japan, Luxembourg, the Netherlands, Portugal, Spain, Argentina, Chile and Ecuador. It has recently concluded negotiations with Mexico, Israel, Belgium and South Africa starting a trend of reducing withholding taxes on royalty payments (from 10 per cent to 15 per cent) within the framework of the OECD model convention. By contrast, Colombia tax treaty network is underdeveloped. Until now, Colombia has one bilateral tax treaty signed with a traditional capital exporting country (*i.e*. Spain recently ratified on 1 July 2006). Another major treaty signed with the Andean Community created significant tax restrictions for the movement of services.[26] Since Costa Rica, Uruguay and Paraguay enforce the territorial model, there is no need to grant double taxation relief for their residents with respect to foreign-source income. All countries, in different ways, provide relief to non-residents with respect to source income. The transition towards a worldwide taxation system recently proposed in Costa Rica and Uruguay will require a revision of the current rules, though.

A number of anti-avoidance and anti-deferral measures such as transfer pricing regulations, thin capitalization rules and controlled foreign company (CFC) legislation have been adopted in the last ten years for protecting the national tax base (Table 4). With the exception of Paraguay and Costa Rica, all countries of our sample have implemented transfer pricing rules incorporating at least generally the arm's length principle contained in the 1995 OECD Transfer Pricing Guidelines. The process started in 1995[27] in Mexico, the only OECD member of region.[28] Other countries

[23] Countries which have in force a Double Tax Treaties with Chile are Argentina, Poland, Spain, Peru, Ecuador, Korea, Brazil, Mexico, Canada, Norway, UK, Denmark, Croatia, Sweden and New Zealand, Malaysia, France, Ireland, Paraguay, Russia, Portugal. The following countries are negotiating a treaty with Chile: Finland, Cuba, Hungary, the Netherlands, Colombia, Switzerland, US, Venezuela, Italy, Czech Republic, China, Thailand, South Africa, Australia, Belgium, Kuwait, India.

[24] Chile is not a member of the OECD but only an observer.

[25] Following the United Nations model, the treaty signed with Argentina in 1986 represents an exception as it grants the right to taxation almost entirely to the country of source.

[26] In order to avoid double taxation with regard to air and maritime transportation Colombia has signed some international tax agreements with Chile, Germany, US, Venezuela, France and Brazil.

[27] In 1995 the transfer-pricing legislation was enacted for *maquiladoras* and in 1997 for all taxpayers.

[28] Mexico joined the OECD in 1994.

followed suit: Argentina[29] (1998 and 1999), Chile (1997), Colombia (2004), Peru (2001), Venezuela (1999 and 2001) and Uruguay (2007) enacted transfer-pricing rules based on the OECD principles even if the individual legislation has differentiated aspects in each country. Brazil does not follow the international arm's length principle established by the OECD. Actually, the Brazilian legislation ratified in 1997 departs from international norms. It settled on a maximum amount for both deductible expenses on inter-company import transactions and for taxable revenues on inter-company export transactions. It also imposes some specific methods and fixed margins for determining the correct transfer pricing for Brazilian tax purposes. The introduction of transfer-pricing rules is an important step towards a modern fiscal system able to protect the national tax base. Enforcement activities are becoming more and more frequent in Argentina, Brazil, Chile, and Mexico. Nonetheless, the tax administration's lack of experience in dealing with complex rules has created a situation of arbitrariness chiefly in Brazil and Argentina (Villela and Barreix 2002). OECD arm's length principles have been nominally adopted in many countries of the region. The administrations which have applied transfer pricing rules in practice (e.g. Mexico and Argentina) departed from the OECD model, though. In fact, many Latin American tax administrations have employed more protective principles for calculating the tax base (Velayos *et al.* 2007).

Transfer-pricing rules become ineffective if companies in tax havens receive great part of the profits generated in another developing country. Legislation defensive against low-tax jurisdictions is already in place in Argentina, Brazil, and Mexico and will be effective in Uruguay as from 1st July 2007. CFC legislation prescribes that income from a controlled foreign entity situated in an offshore location will be attributed to the domestic taxpayer and subject to tax in her/his country of residence. There can be very different ways to apply this rule. In Latin America, the existing and more widely used model is to adopt a blacklist of low tax jurisdictions. Mexico adopted this approach in 1996,[30] Brazil (1996) and Argentina (1999) followed suit.[31]

The international aspects of taxation and tax incentives are crucial elements for Latin American countries willing to compete in today's world. The aforementioned implementation of anti-avoidance and anti-deferral measures is not enough: regional integration has to be encouraged even further through the free flow of information between governments and between governments and investors (Bird 2007).

[29] Argentina is an observer at the OECD.
[30] In 2006, Mexico has changed its system form the "black-list approach" to a more complex system in which the tax administration assesses whether a specific structure is in fact a low-tax structure.
[31] Colombia has also adopted CFC rules but it has not defined its "blacklist" yet.

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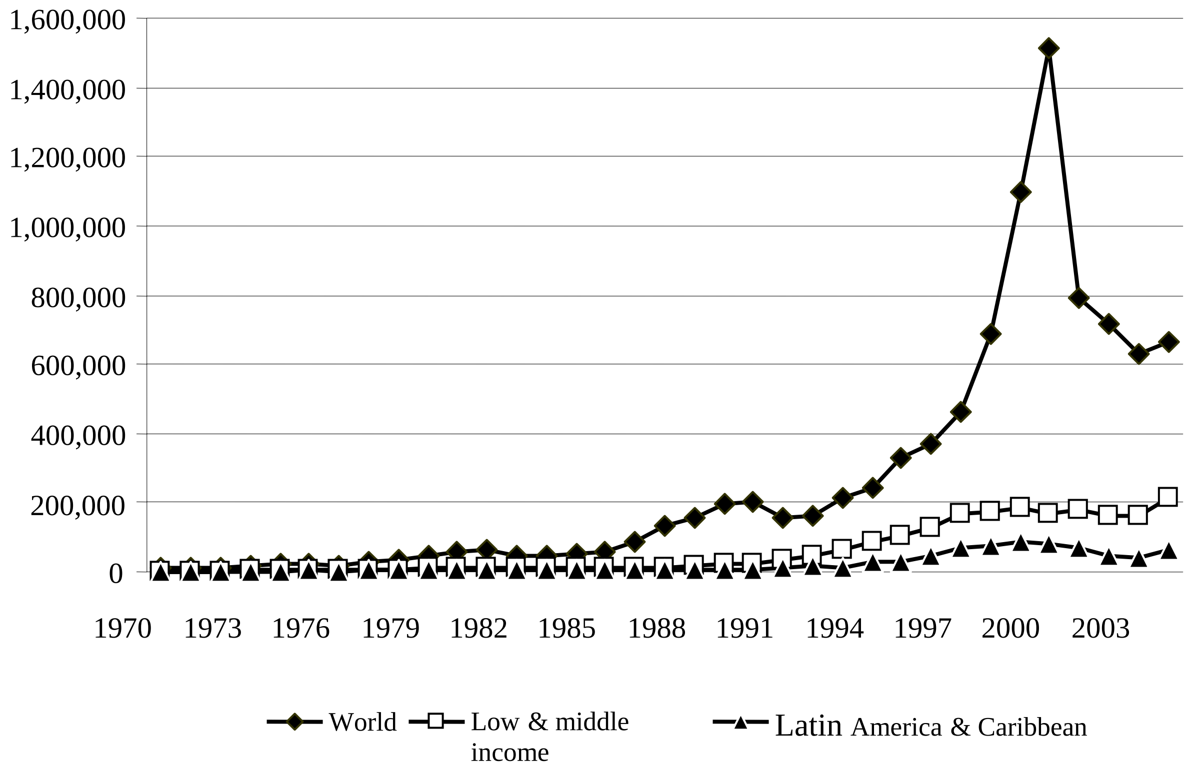
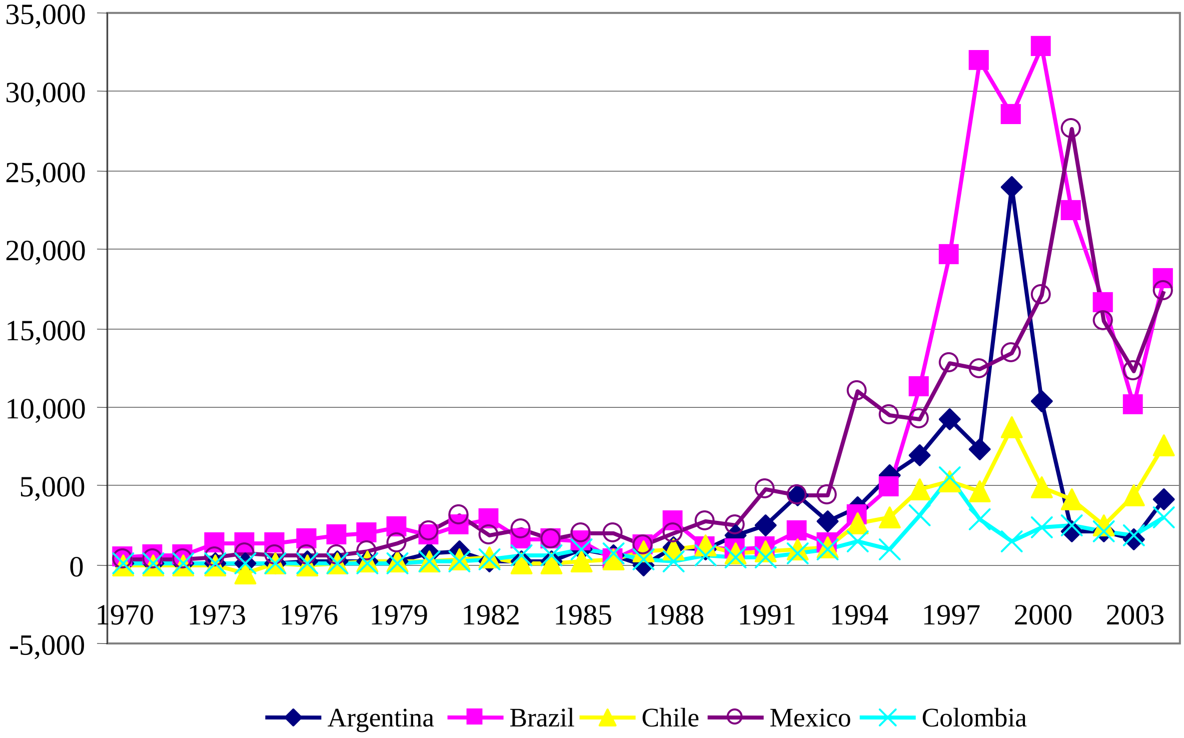
Figure 1 World FDI net inflows (current US$, millions)



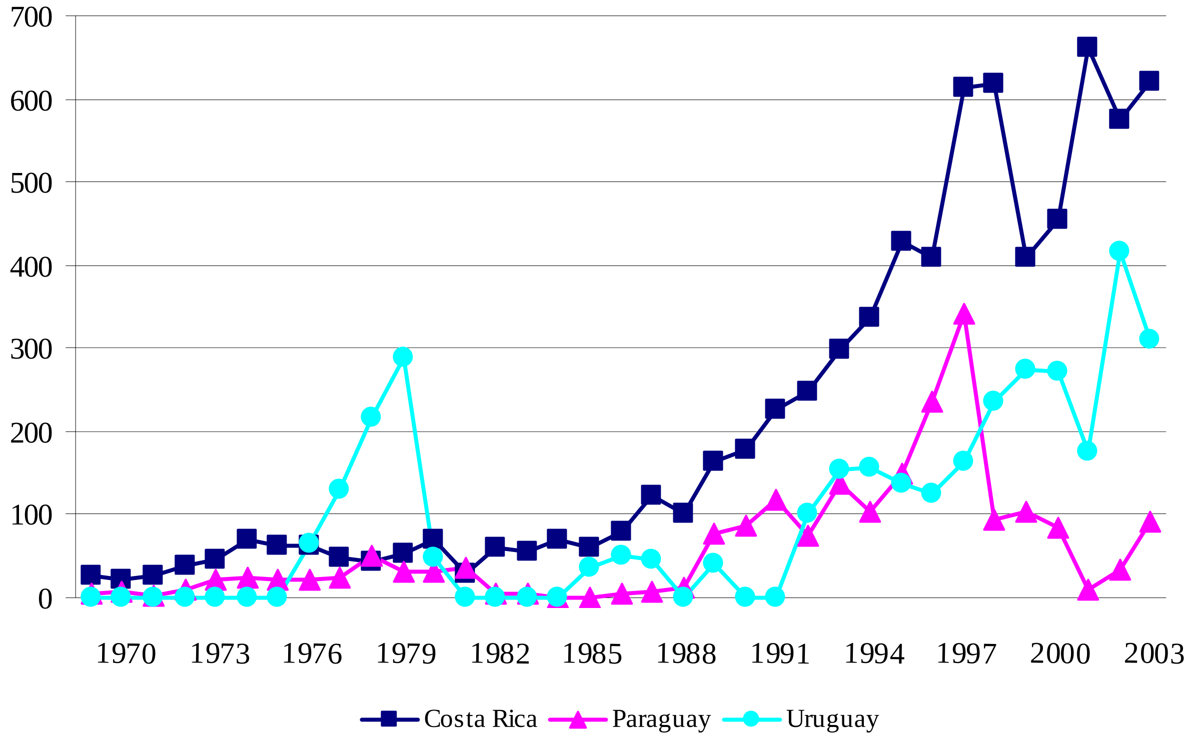
Source: World Development Indicators, World Bank. September 2006

Figure 2 FDI net inflows in Argentina, Brazil, Chile, Mexico, Colombia (current US$, millions)



Source: World Development Indicators, World Bank. September 2006

Figure 3 FDI net inflows in Costa Rica, Paraguay, Uruguay (current US$, millions)



Source: World Development Indicators, World Bank. September 2006

Table 1 FDI net inflows (% of GDP – average values per period)

	1970-1979	1980-1989	1990-1999	2000-2004
Chile	-0.19	2.03	4.99	6.06
Brazil	1.13	0.66	1.58	3.70
Costa Rica	2.26	1.78	3.13	3.18
Mexico	0.80	1.16	2.24	2.85
Colombia	0.36	1.30	2.14	2.79
Argentina	0.26	0.65	2.59	2.10
Uruguay	0.73	0.52	0.61	2.06
Paraguay	1.09	0.28	1.79	0.91
Latin America & Caribbean	0.73	0.80	2.21	3.20
Low & middle income countries	0.48	0.54	1.98	2.63
World	0.47	0.63	1.42	2.62

Source: World Development Indicators, World Bank, September 2006

Table 2 Type of FDI in Latina America

Sector	***Natural resource seeking***	***Market-seeking***	***Efficiency-seeking***
Goods	*Petroleum & gas* Bolivia, Colombia, Ecuador, Peru, Venezuela, Argentina, Trinidad and Tobago. *Mining* Chile, Argentina, Bolivia, Colombia, Ecuador, Peru, Venezuela.	*Automotive* Argentina, Brazil, Paraguay, Uruguay *Chemicals* Brazil *Food* Argentina, Brazil, Mexico *Beverages* Argentina, Brazil, Mexico. *Tobacco* Argentina, Brazil, Mexico.	*Automotive* Mexico *Electronics* Mexico Caribbean Basin. *Apparel* Mexico Caribbean Basin.
Services	*Turism* Mexico Caribbean Basin.	*Finance* Mexico, Chile, Argentina, Venezuela, Colombia, Peru, Brazil *Telecommunications* Brazil, Argentina, Chile, Peru, Venezuela *Retail trade* Brazil, Argentina, Mexico *Electricity* Colombia, Brazil, Chile, Argentina, Central America. *Gas distribution* Argentina, Chile, Colombia, Bolivia	*Administrative services* Costa Rica

Source: ECLAC (2005, Table 1.6)

Table 3 Matrix of inward FDI performance and potential, 1988-1990 and 2002-2004

1988-1990	*High FDI performance*	*Low FDI performance*
High FDI potential	Chile, Colombia, Costa Rica, Mexico	Brazil, Uruguay
Low FDI potential	Argentina, Paraguay	
2002-2004	*High FDI performance*	*Low FDI performance*
High FDI potential	Chile	Argentina, Brazil, Mexico
Low FDI potential	Costa Rica	Colombia, Paraguay, Uruguay

Source: UNCTAD, FDI Indices

Table 4 The main features of the corporate income tax systems

	Argentina	**Brazil**	**Chile**	**Colombia**	**Costa Rica**	**Mexico**
Territorial scope	worldwide	worldwide	worldwide	worldwide	source	worldwide
Standard CIT rate (%)	35[a]	15 + 9 (SC)	17	35	30	28
- Surtax rate		10		10 (2002-6)		
- Branch profit tax			35	7	15	
Inter-company dividends	fully/partially excluded	fully excluded	fully excluded	fully excluded	fully excluded	fully excluded
Capital gains	CIT rate	CIT rate	CIT rate	CIT rate	generally not taxed	CIT rate
Rule against thin capitalization	yes	yes	yes	none	yes	yes
Net worth or Assets tax (%)	1 on assets	none	none	0.4 on net worth	none	1.25 on assets
Tax treaties	18	+25	13	4		+30
Revenue protection	TP/TC/CFC	TP/CFC	TP	TP	none	TP/CFC
Withholding taxes (%):						
- dividends	0[b]	0	0-40[c]	7	15	0
- interest	15.05-35	15	35	39.55	15	4.9-10.0-28
- royalties	17.05-28-31.5	15	30	39.55	25	28

	Paraguay	**Uruguay**[e]
Territorial Scope	source	source
Standard CIT rate(%)	10	25
- Surtax rate		
- Branch profit tax	15	
Inter-company dividends	fully/partially excluded	fully excluded
Capital gains	CIT rate	CIT rate
Rule against thin capitalization	none	none[f]
Net worth or Assets tax (%)	1 on assets	1.5-3.5 on net worth
Tax treaties	5	2
Revenue protection	none	TP/CFC
Withholding taxes (%):		
- dividends	15	7
- interest	15 (i.e. 50% of 30%)	12
- royalties	15 (i.e. 50% of 30%)	12

Source: UNCTAD (2000), Byrne (2002) , KPMG (2003) and others.
Notes:
[a] A regional turnover taxes averaging 1-3.5% is in force.
[b] Distributions that exceed taxable profits are subject to the 35% equalization tax.
[c] Dividends distributed to individuals resident or domiciled are subject to Global Complementary Tax (GCT) of 0-40%. CIT is creditable against GCT.
[e] The information reported in the table refer to the tax reform approved by the Uruguayan Parliament in 2006.
[f] The new measures will be effective 1 July 2007.
Legend: SC= rate of social contribution on net profits; TP=transfer-pricing; TC=thin-capitalization; CFC= controlled foreign company legislation.

Table 5 Effective Corporate Tax rate on Foreign Capital Investment

	Argentina	Brazil	Chile	Mexico[a]
Services	44.2	41.6	31.0	24.0
Manufactoring	31.6	34.5	22.3	19.3

Source: Chen and Martinez-Vezquez (2003)
Notes: the simulation of METRs is based on 2001 tax legislation. Statutory CIT rate were: 35% in Argentina and Mexico, 34% in Brazil and 15% in Chile.
[a]The METRs incorporate the 2002 post-reform tax system.