



# PROSPECTS FOR AN INTEGRAL TAX REFORM WITH EQUITY: TOWARD A FISCAL COVENANT IN PERU

## EXECUTIVE SUMMARY

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*The purpose of this study is to contribute to the debate on fiscal policy and tax reform in Peru through an analysis of the reforms undertaken during the 1990s, whose focus was on improving tax administration for collection purposes. The study highlights the need to consider issues of governance and equity when assessing the performance of the Peruvian tax system and evaluating the prospects for pro-poor tax reform over the long-term and within a broader context of the reform of the state. It thus investigates the foundations of the Peruvian tax system beyond shorter-term adjustments.<sup>1</sup>*

Despite the economic growth of the past few years, recurrent taxation reforms have been insufficient to meet the needs of the population in terms of both the quality and the quantity of public services. These reforms have largely failed to enhance the equity of the tax system and broaden the tax base. As a highly unequal middle-income country, Peru requires a tax system that can offer sustainable, equitable and fair financing for public expenditures and social spending.

However, the challenge is not only to achieve higher levels of tax collection, but to ensure that the tax effort is also sustainable over time and grounded in a legitimising social contract between the state and society. The optimal tax policy will arise from the consensus generated by a process of broad-based dialogue and encouraged by tax authorities and policymakers. There is currently an urgent need to create spaces for open, transparent and inclusive dialogue between the state and society where different social forces come together to share opinions and influence state policy.

This study argues that integral tax reform with equity requires a coherent and far-reaching national dialogue on taxation, which will help forge the necessary fiscal covenant sustaining the fiscal pact between state and society.<sup>2</sup> Taxation, apart from generating resources to fund public expenses, also creates rights and obligations. It is necessary to overcome the inertia and political economy factors through greater public participation and oversight of tax reforms. Improving the legitimacy of the taxation system would help enhance the stability of fiscal policy and the predictability of public finances in the mid to long-term with a view to reducing poverty and inequality. This will also contribute to strengthen democratic governance and the institutionalisation of the state.

### I. THE PERUVIAN TAX SYSTEM

#### **Main structural weaknesses of the fiscal system question the ability of tributary policies to address issues of income distribution and fiscal equity**

When compared to the rest of Latin America, Peru has a moderate tax pressure. However, when compared to other regions, Peru's tax effort is relatively low, especially considering the country's economic and social development needs. This is due mostly to tax evasion, administrative shortfalls in tax collection and weak governance.

Additionally, Peru is heavily dependent on indirect taxes and has only a few instruments to collect tax on capital and income. This exposes the country to the vagaries of economic cycles and external shocks. Furthermore, the limited positive impact of social programs is not enough to offset the negative effect of tax collection on income distribution.<sup>3</sup> While public expenditure and social spending should, in theory, be the most effective instruments to redistribute income to the poorest and most vulnerable segments of the population, their poor performance in Peru requires exploring the extent to which taxation can also be used for equity purposes.

This situation is the result of three basic problems: (i) conflicting objectives, (ii) the gap between the legal and the effective tax system, and (iii) fiscal weakness. The first problem of goal-setting arises as a result of intertwined difficulties at different levels regarding the ultimate purpose of taxation, as, for example, between the basic functions of the state, technical considerations versus political goals and the possible clash between short-term and long-term goals. Furthermore, while the

<sup>1</sup> This study was commissioned by the United Kingdom Department for International Development (DFID Peru) and is the executive summary of a wider study. The original version of this executive summary is in Spanish and was translated into English by Alan La Rue. The ideas and opinions expressed herein are of the author and do not necessarily reflect either the point of view or the institutional policies of DFID.

<sup>2</sup> A fiscal covenant is the basic socio-political agreement or social contract that legitimises the role of the state and the realm and reach of the government in the economic and social spheres. The more fragile the fiscal pact, the greater the probability of reaching unsatisfactory results in terms of stability, predictability, distribution, allocation and growth. See ECLAC (1998) "The Fiscal Covenant: Strengths, Weaknesses and Challenges", Santiago, Chile.

<sup>3</sup> The Peruvian economy has grown an average of 4.5% over the past two years, demonstrating the highest rates in the last 5 years. However, economic growth has not been enough to reduce the number of poor or to meet the basic needs of the population, nor does it provide for and adequate fiscal management or foster competitiveness. In 2002, the standard of living as measured by GDP per capita was similar to 1972. Furthermore, 54.3% of the population were poor and 23.9% were extremely poor.

government exercises control over the laws that govern the tax system, it has little influence over the effective tax system itself.

The root problem faced by the taxation process is to be found in the weakness of the social contract between the state and society. Peru needs an agreement that reconciles the legitimate demands for public spending with the corresponding need for adequate public revenue.

Some of the defining characteristics of the Peruvian taxation system include the fact that: (i) political factors often take precedence over technical considerations; (ii) taxation reforms have been largely shaped by short-term tax collection objectives; (iii) the tax system is asked to achieve multiple objectives simultaneously; (iv) mechanisms have been introduced to achieve equity and re-distributive objectives, but have tended to erode the system and generate effects opposite to the intended ones; (v) there is a split between the macro and the micro dimensions that has not permitted a consistency between economic growth and the reduction of poverty; (vi) while the design of the tax structure has adequately integrated the basic principles of a sound tax policy, the system has nevertheless deteriorated progressively over the last few years; (vii) although tax administration has made important advances over the last decade, the efficiency and effectiveness in tax collection needs to be further improved; (viii) taxpayers continue to perceive the tax system as being neither credible nor legitimate: on the taxation side, there is a perception of horizontal inequality and a lack of transparency in the mechanisms used; on the expenditure side, there is a perception that the general needs of the population are not being met, neither in terms of quality nor in quantity.

***Significant advances have been made, but the system has moved away from the principles that guided its reform at the beginning of the 1990s and it is too narrowly focused on short-term tax collection objectives***

In economic terms, the situation in Peru in the 1980s was no different than in the rest of Latin America. There were high levels of public sector fiscal deficits as a result of the effect of the debt crisis, which had dire consequences on public finances and economic policy management. This situation, together with an inflation rate that topped 7,000% in 1990, was exacerbated by an extremely complicated taxation system and a chaotic tax collection administration. This led to a sharp drop in tax revenue from 13.2% to 4.9% of GDP between 1985 and 1990. Toward the end of the decade, the GDP per capita fell to 1960 levels.

The low level of tax collection - which was a result of the large number of exonerations and exceptions - together with the lack of resources to manage and control the nearly 100 taxes in effect, caused the system to breakdown. Tax evasion became accepted behaviour and

corruption became significant. Barely 13.5% of the contributors that were required to do so actually paid the general sales tax (IGV).

In the beginning of the 1990s, with the first generation structural reforms, there was a consensus on the need to overhaul the tax system, reform tax policy and improve tax administration. The guiding reform principles were those of simplicity and tax collection. Between 1991 and 1992, an integral tax reform was initiated with the goal of rationalising and simplifying the tax system, modifying or eliminating taxes that distorted the economy and giving a greater level of autonomy to the tax authority, the National Superintendence of Tax Administration (SUNAT). Later, between 1993 and 1994, efforts were made to stabilise the tax system, simplify the legal framework and generalise the general sales tax (IGV), while guaranteeing the neutrality of resource allocation and simplifying administrative procedures. As a result of these reforms, tax revenues grew, although the base was not broadened and there were few inroads in formalising the economy.

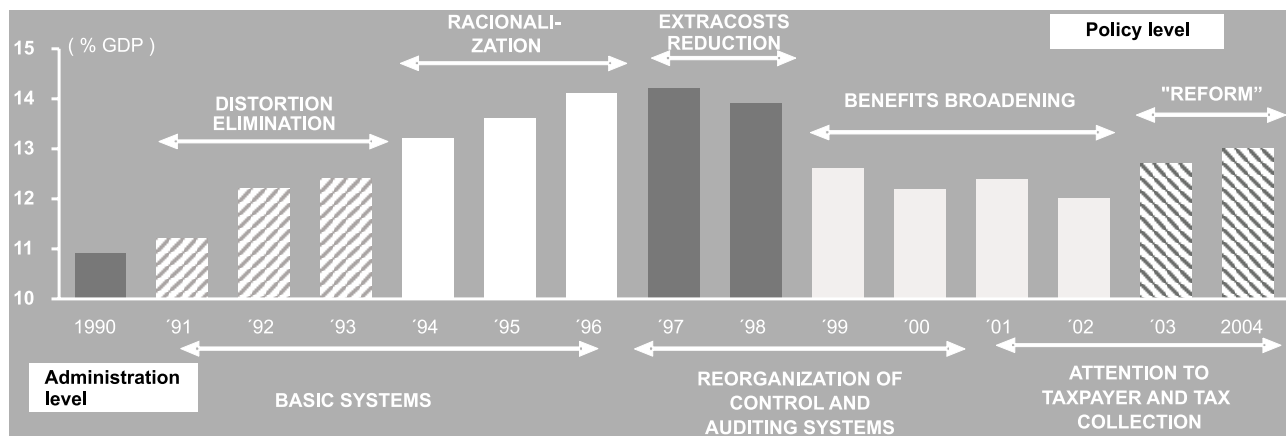
The years 1997 and 1998 were characterised by the elimination of special tax regimes in the jungle, the elimination of exceptions to the income tax and the reduction of additional costs faced by companies. Meanwhile, from 1998 to 2002, there was a proliferation of tax benefits, significantly increasing tax expenditure. Since the second semester of 2003, attempts are being made at raising tax collection in the framework of a new tax reform, which includes modifications to the tax code, simplification, "*bancaización*" (government legislation that forces enterprises to use banks for all large transactions) and a new tax on financial transactions (ITF). During this process, the role of the SUNAT has been prioritised, which has allowed it to partially recuperate its image through competitive recruitment of qualified personnel and a technological renewal in the areas of auditing and collection, as well as improved service to taxpayers.<sup>4</sup>

It is worth noting that after a great effort to simplify the tax structure in 1993, by mid-2003 more than 60 laws and legislative decrees had been introduced. The tax code had been modified 12 times, the income tax had changed 26 times, the general sales tax (IGV) and the selective consumption tax (ISC) had varied 23 times, and five new regulations dealing with receipts had been approved. While taxation systems need to be dynamic and flexible in order to adapt to changing times, frequent modifications create instability and complexity and undermine reliability and predictability, which works against the institutionalisation of the taxation system.

The fundamental challenges in achieving integral tax reform with equity are to broaden the tax base, formalise the economy and reform the state in order to be able to increase the level of tax effort to 14% in the short term and

<sup>4</sup> *The technical and organisational evolution of the SUNAT between 1991-1996 was characterised by the establishment of the initial organisational structure, the implementation of basic systems and the introduction of auditing mechanisms. Between 1997-2000, tax compliance improved and there was an application of new technologies, the development of a new auditing system, and the decentralisation of the attention given to the main contributors. Later, from 2001 onwards, more focus was given to improve services to the taxpayer and the defence of its rights. In mid-2002, the custom and tax administrations were merged, the General Direction of Customs being integrated into SUNAT, which led to new challenges arising from the integration of two administrations.*

**TAX EFFORT AND STAGES IN TAX POLICY AND TAX ADMINISTRATION**



Source: Elaborated using data of Central Reserve Bank of Peru and Ministry of Finances. Note: 2003 - 2004: forecast

16% in the medium term. It is imperative to modernise and to simplify, while making the system more progressive, broadening the tax base and reducing informality and evasion.

Peruvian tax policy lacks credibility. Clear and stable rules of the game are paramount to sustainable economic development. Gains in terms of recollection remain fragile as long as credibility is not restored. In fact, the reverse is true: increasing credibility would allow for more resources to be raised. Restoring the credibility of tax policy requires comprehensive, coherent and complimentary reforms on both the taxation and expenditure sides of the public finance equation.

In March 2004, the government presented its indicative programme for the period until 2006, the so-called "Hoja de Ruta" or "Roadmap." The programme articulates four main reform axes and commits government to a major overhaul of the system in the next five months.<sup>5</sup> These main axes are:

- Continuation of the favourable trend of increasing tax collection through a broadening of the tax base and the reduction of tax evasion and avoidance.
- There will be a progressive, concerted and sustained elimination of tax exemptions, which will follow a timetable based on the impact these measures will have on tax revenue.
- Congress will be asked to immediately approve the elimination of tax exonerations requested by regional governments such as San Martín and Amazonas.
- In the context of the Fiscal Decentralisation Law, the SUNAT will be instructed to enter into performance agreements with regional or local governments in order to increase tax collection – the extra resources raised will later be invested in local development projects.

These proposals are from the first stage of an integral tax reform, which should be carried out in conjunction with the other stages. These include increasing equity and

improving the ability to govern the tax system. This process shall conclude with the signing of a Fiscal Covenant that includes all of the actors involved in decisions related to growth, poverty reduction and public policy in Peru.

**Low tax effort and over-reliance on indirect taxes**

Peru has a tax effort notably inferior to those found in more developed countries, but it is on par with the other economies in the region. Tax pressure decreased sharply in the 1980s and tax collection reached its lowest levels falling from 15.8% in 1980 to 7.0% in 1989. As a result of the reform of the early 1990s, this curve was reversed and the tax effort grew until 1997, only to later drop again to 12% in 2002, a similar level to when the reform was initiated. This drop is explained by the combined effects of the economic slowdown, the use of tax stability agreements, and the proliferation of incentives, exonerations or special tax treatment.

The Peruvian system is one of the simplest in the region in terms of the types of taxes it manages. There are basically four: a general sales tax (IGV), income tax (IR), selective consumption tax (ISC), and duties on imports. However, and although the basic design is simple, frequent changes in the taxation rates applied have made the system increasingly complicated, burdensome and less transparent.

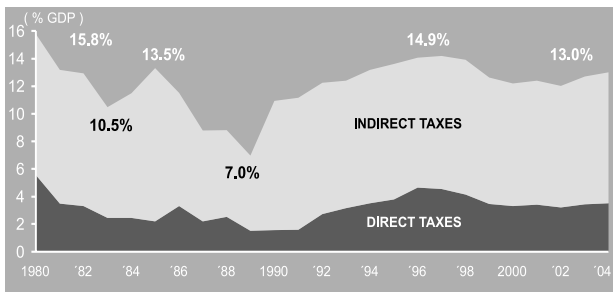
During the past decade, the income of local governments accounted for close to 13% of the total central government income. Transfers were the most important component for municipal governments (46% on average), followed by non-tax income (35%), which represented more than twice the amount of tax income. It is interesting to observe that in the second year of decentralization in Peru (2004), 77% of public finances remain centralized in the national government, meanwhile the regions register 22% and there is a further 8% at the local level. The income structure of local governments has not varied much more than what was observed during the past decade. In terms of tax

<sup>5</sup> See [www.pcm.gob.pe](http://www.pcm.gob.pe).

income - taking as proxy ordinary resources generated by each level of government - local governments only account for 0.04% of the national total. This situation shows the need to strengthen the ability of local governments to generate their own income, to promote greater local tax effort, and enhance transparency and accountability.

The principal source of tax income is the general sales tax (IGV), with income tax (IR) a distant second. While the amount of income tax has increased, it does not even account for half of the amount raised by the general sales tax. In terms of tax rates, the most significant variations are for personal income tax. In the past decade, the minimum rate has more than doubled (from 6% to 15%) and the maximum rate has fallen (from 37% to 30%) to match the rate applied to corporations, which had remained unchanged.

COMPOSITION OF TAX COLLECTION: 1980-2004\*



Source: Elaborated using data of Central Reserve Bank of Peru and Ministry of Finances. Note: 2003 - 2004: forecast

There is a clear argument that the tax effort in Peru is weakened by the large, informal economy. Henceforth, the level of tax collection is far below what it ought to be. Analysing the general sales tax collection (without discounting tax returns), the ratio of taxes paid to value of sales is less than 8%, which is much less than the general sales tax (IGV) rate of 19%.

## II. EFFICIENCY AND EQUITY - GOALS AND CHALLENGES

Equity is a key point in the national dialogue on tax reform. It should not be seen as an objective in or of itself, but as a natural consequence of simple, neutral and efficient procedures. Equity is necessary and its correct implementation is decisive. This in turn should lead to higher tax revenue and help create a more progressive system without causing major economic distortions.

However, if in becoming more progressive the tax system raises less revenue, any gain in redistribution on the revenue side will be outweighed by the lost opportunity of using expenditure instruments.<sup>6</sup>

In Peru, the efforts that have been undertaken to enhance the equity of the taxation system have led to an erosion of the system, complicating compliance, control and auditing and leading to lower levels of tax collection and equity, while at the same time resulting in greater tax evasion and economic informality. Some of the elements that affect the equity of the system stand out:

- In the area of income tax, changes have led to a higher maximum marginal rate and a lower level of exonerated income. High marginal rates promote evasion.
- In the area of general sales tax, laws have been passed to exonerate several products, and several regions, in addition to giving special fiscal credit without considering the impact that this will have on overall tax collection.

### Tax collection is highly concentrated

An important feature of the Peruvian tax system is the high level of concentration in the collection of taxes due to the low number of taxpayers. Since 1999, taxpayers classified as "Mega" and "Top" have accounted for an increasing proportion of total tax revenue, while the rest of the taxpayers contributed proportionally less. Hence, only slightly more than 1% of the taxpayers - known as "PRICOS" (principal taxpayers, by its initials in Spanish) - account for more than 85% of tax revenue. In fact, only 54 taxpayers account for more than 40% of tax collection in the country.

In geographic terms, there is strong centralisation in Lima where 60% of the taxpayers live. Tax effort is less than 1% in nine departments in the country; in 13 departments less than S/1.00 Nuevo Sol per capita of selective consumption tax is collected (less than US\$0.30); in Amazonas, the average yearly per-capita general sales tax (IGV) paid was only S/0.30 in the year 2000 (less than US\$0.09) and the average income tax collected per capita is currently S/4.00 (US\$1.15) in all areas except Lima and Arequipa.

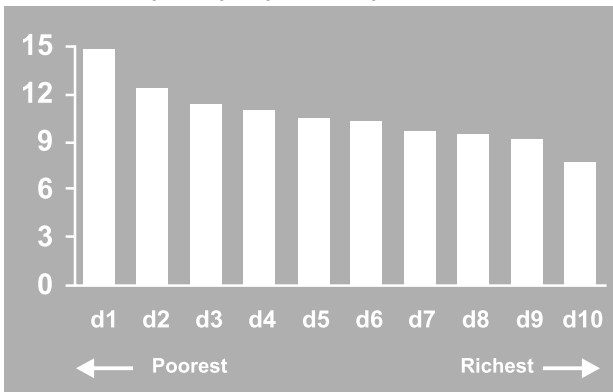
### Regressive Incidence of indirect taxation

The general sales tax (IGV) has a clearly regressive impact on the redistribution of income. In spite of the fact that 10% of the population with the highest income have an average family income 21 times greater than the poorest families (39 times higher when considering individuals), the tax pressure on the poor is twice the proportion that it is on the rich. These figures show the inequity of this kind of taxation.<sup>7</sup> For its part, the selective consumption tax (ISC) has an incidence that affects the

<sup>6</sup> On the expenditure side, there has not been a good record in meeting equity-related goals in Peru. Beyond the fact that there have been insufficient resources in order to give adequate services to the public, the management of current resources has not had the re-distributive effect needed to compensate for the inequities and distortions of the tax system. There are many reasons for this, the most notable of which are: the poor focus of social programs; a too-rigid budget that allows for little room to manoeuvre; the inequitable geographic distribution of public expenditure and the poor quality of state-provided services, etc.

<sup>7</sup> On the base of national family surveys (ENAH0 2002-IV) values for tenth-percentiles. This is a first approximation, and, as such, the information available does not permit making a precise estimation of tax incidence because of the significant under-declaration of income by those with the highest incomes. The reported incomes corrects the values declared by the surveyed population, nevertheless, it is necessary to cross-match data from the national accounts. For example, if one takes the average family income, assuming that all work that generates earnings was of the fifth category ("quinta categoría" is a classification applied to contributors under the Peruvian system), only the richest 10% would could pay the income tax of "natural" (non-corporate) individuals at a rate of 15%.

**INCIDENCE OF GENERAL SALES TAX (IGV) 2002**  
% of income per capita per tenth-percentile of income



Source: Elaborated using data of National Statistics Institute (INEI-ENAH0 2002 - IV)

poorest group the most, the richest group less than the poor, and the middle-income group least of all. The tax pressure on the poorest 10% of the population is 1.5 times higher than on the richest group.<sup>8</sup>

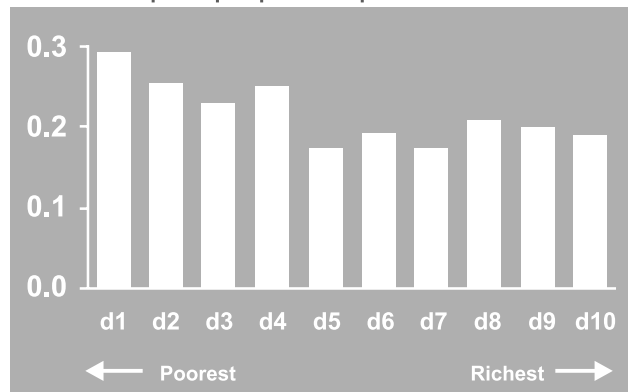
It is important to comment on the argument that contends that people who earn less also engage in a higher level of self-generated consumption, which in turn reduces the negative impact of indirect taxes. While it is true that 30% of the population's consumption is untaxed (be it for sales-tax exoneration, self-generated consumption, transfers and others) and while this is progressive in the sense that it is inversely proportional to the level of earnings, there is no significant difference between the bottom-fifth on the poverty scale (32.7%) and those with the highest earnings (26.7%). Therefore, in the case of Peru, this would be a transversal argument that affects the whole population and would not be applicable only to the group with the least earnings.

Income tax (IR) is by nature progressive and could counteract the regressive effect of indirect taxes. However, indirect taxes hold much more weight within the tax structure and the positive effect of direct taxes are significantly reduced by cost of collection and by tax evasion and tax avoidance. Furthermore, since 53% of the population live in poverty, the majority of taxpayers are exempt from income-tax. Furthermore, little tax is collected at the other end of the spectrum since the highest earners also have access to a number of alternatives to avoid paying taxes.

***The proliferation of tax expenditures has eroded the system and generated inequity***

One of the main reasons behind the deterioration of tax collection in Peru is the proliferation of legal changes that have eroded the tax base and have created too many special regimens and exemptions. These frequent changes and exceptional treatments have increased the complexity and inequality of the system and have negatively affected its ability to become self-sufficient and sustainable. The most logical path in order to return to adequate levels of tax

**INCIDENCE OF SELECTIVE CONSUMPTION TAX (ISC) 2002**  
% of income per capita per tenth-percentile of income



Source: Elaborated using data of National Statistics Institute (INEI-ENAH0 2002 - IV)

collection and tax effort is to broaden the tax base, rather than raising tax rates, while fighting tax evasion and reversing the proliferation of special regimes and exceptions.

The official estimate of tax expenditures in Peru for 2003 is 1.91% of the GDP and represents 15.6% of the total tax income that the government intended to collect. Nearly 70% of total tax expenditures comes from the general sales tax (IGV) exemptions and corporate income tax (IR) exemptions. If we take into account that tax incentives and exonerations are accumulated and combined in such a way that some agents can achieve different benefits from a range of tax structures (for example: the type of tax, the activity, or the region in question), we can conclude that the panorama of incentives and tax exonerations in Peru is vast and complex, which promotes opportunities for evasion and avoidance to the detriment of not only the public treasury, but to the population at large. Additionally, this panorama also affects the tax administration and, as a result, makes auditing more complex and difficult as it creates more opportunity for tax avoidance and evasion.

An evaluation of the effects achieved in the zones and sectors where the incentives and exonerations have been applied show that the tax exemptions have not had the positive effect that was hoped for either the economy of the region or the country. They have not stimulated the creation or expansion of local industry in the zones in question but have in fact provided incentives for the creation of commercial enterprises that are detrimental to local production. These commercial investments were not made using traditional profit criteria, but rather to take advantage of specific tax benefits. In the same way, the cost of living of the population living in the favoured zone has not experienced significant changes.

***Tax stability agreements and special regimes accentuate horizontal inequity***

The Contracts of Judicial and Tax Stability are another example of tax expenditure in Peru. By the end of 2002,

<sup>8</sup> Does not include automobiles

there were more than 250 such contracts signed with foreign investors and other receptors of foreign investment. These contracts "freeze" the tax regime of these companies and offer benefits such as untaxed remittances, preferential exchange rates, etc., for 10 years in most cases.

It was expected that privatisation would usher in greater economic activity and result in higher levels of tax collection. Nevertheless, the signing of contracts of judicial and fiscal stability with the operators have given many of them the opportunity to pay less tax, further aggravating the regressive nature of the Peruvian tax system.

An analogy can be drawn between special tax regimes and tax exemptions, since both provide the opportunity for particular contributors to become exempt from particular taxes. A first negative effect is that the greater the attempt to combat informality, the more informality is encouraged, since no one in these systems will want to surpass the limits permitted by the special regime and leave a lower tax bracket. A second negative effect is that the special regimes do not permit the gathering of information necessary to conduct adequate control and auditing, which creates an environment with low levels of transparency. These special systems produce pockets of evasion that do not integrate well with the overall taxation system and generate greater inequity.

In order to promote the activities of small and medium contributors, it is preferable to adopt a general system that is universally applicable, concentrating on simplifying the system for all and not only for some (large contributors also require a system that is easy to comply with and which has a minimum of bureaucracy). Systems of direct assistance can be provided to the smallest contributors. In this area, Peru has one of the most developed networks of assistance to taxpayers that exists in Latin America, with a capacity to attend and assist a large number of contributors with state-of-the-art technology.

### **Weaknesses in tax collection**

Tax evasion and avoidance are phenomena that not only erode state revenue, but also deteriorate the social and economic structure of the country. They harm the legitimacy of political institutions, public finances and governments and reflect the fragility of the underlying fiscal covenant and the inequality of the system. Among the principal non-economic factors that contribute to this is that there is a notable lack of tax conscience, a non-transparent tax system, an inflexible administration and a low detection risk.

Peru is home to some of the highest levels of general sales tax evasion in the region, in spite of the fact that the level had fallen from 68% in 1993 to 56% by the end of the 1990s and to nearly 50% in 2001. There is no doubt that the fight against evasion is not easy. Not only does it require strong political will, but it is a challenge for the entire society as it requires changes in entrenched attitudes and behaviours in a generally permissive society.

Contraband and informality are partly the result of high transaction costs or artificial barriers created by the state. As a result, Peru has one of the most informal economies in the region: 58% of GDP, ranking after Bolivia and Panama (64% on average) and far behind Chile (18%) and Costa Rica (23%). *The Economist* magazine estimates that in the most developed countries, the informal economy fluctuates around 15% of GDP, while in developing countries it averages more than 33%.

## **III. GOVERNANCE - GOALS AND CHALLENGES**

### ***Fragility of the implicit fiscal covenant that funds public finances***

There is currently a lack of political and parliamentary consensus regarding the level, the composition and the trend of public expenditure, and of the tax revenue that is needed to support it. This fragility undermines the predictability and reliability of public finances and is reflected in the insufficient level of resources raised to finance public spending or to improve the efficiency of tax administration, thus minimizing the costs of tax collection. The tendency is thus to use fiscal policy instruments that involve the least political cost possible because of the difficulty inherent in either raising taxes or of reducing public spending. Furthermore, there is a general lack of transparency in the decision-making process involving tax policy decisions.

An integral tax reform with equity thus demands an agreement or a covenant that fits into the political-institutional framework and which satisfies the criteria of good governance (transparency, responsiveness, responsibility and predictability) and fosters economic growth.<sup>9</sup> A tax system that builds upon the cooperative efforts of civil society and political institutions has an important role to play to meet these development objectives, based on the lessons learned from accepted theory and practical experience in tax policy and management.

Furthermore, this fiscal pact or social contract will be unviable unless decisions on taxation policy are related to the expenditure required to meet social demands. Any discussion on taxation must be linked to the debates on the quantity and quality of public spending. Tax policy decisions are political decisions reflecting the preferences of each country to reach specific public policy objectives. They relate to the prevailing consensus on the adequate level of re-distribution of income and wealth, as well as on the desired level of economic growth. In that regard, it needs to be underscored that Peru does not yet possess a vision for the future, nor a long-term development strategy. The closest approximations to a state strategy for development are the National Agreement, multi-annual sectoral strategic plans and the Law of Prudence and Fiscal Transparency.

<sup>9</sup> Fiscal governance is the capacity of the government to implement sustainable fiscal policy that is credible and fair, with minimum management costs.

Important initiatives have nevertheless been attempted in order to reach an agreement about the basic functions of state, such as the Covenant of Governability and the National Initiative against Corruption. There has been no lack of initiatives or good intentions to steer Peruvian society toward a path of dialogue so it can collaboratively deal with its economic, political and social problems, but the challenge remains to provide continuity in these efforts in order to reach a political compromise that will turn words into tangible results.

***The legitimacy of the tax system relies on state reform and an effective process of decentralization***

To be integral and binding, tax reform must be accompanied by a modernisation and a reform of the state. The legitimacy of the tax system grows out of an efficient state apparatus that provides goods and public services of quality, and which contributes to general well being by caring for the needs of the population and encouraging the development of a competitive and productive economy. This means a state that is capable of acting as a partner with the taxpayers who are responsible for generating tax revenue.

There have been a number of efforts to reform the Peruvian state, but these have not enjoyed the sufficient impulse and have only been partly implemented, or have not been implemented at all. This track record of failure affects the expectations Peruvians have of newly proposed reform initiatives. Consecutive governments have tended to focus on short-term measures to handle immediate interests, instead of focusing on longer-term strategies. This reflects the fragility of the institutionalisation of the Peruvian state itself.

The situation in Peru is complex, as the country is in a process of "double transition." On the one hand, Peru has initiated a delicate process of decentralisation, which is being carried out within the framework of another larger and more complex process: the consolidation to democracy after a decade of autocratic rule. The decentralisation model chosen by Peru is based on the decentralization of public distribution, whereas the principal actor - the State - sheds itself of fiscal resources by transferring them to the newly created regional governments and municipalities in order to improve the distribution of wealth and income. One of the greatest challenges is not only to learn how to finance regional and local governments, but also ensure that they deliver more and better services.

In order to evaluate the current levels of governability in the regions, it is necessary to consider the high expectations created for, and the scarce resources available to the regional governments, as well as the limited transfer of competencies to these governments. Furthermore, the vast majority of the regional presidents were elected with fewer than a third of total votes and half of regional governments belong to opposition parties.

One of the most important challenges is to increase tax revenue and to ensure that a decentralised government can be more efficient and equitable than one that is centralised. These laudable objectives ought to be

entirely possible considering that the costs of tax collection should fall, and that regional governments should be able to increase their revenue base and decrease levels of evasion due to their proximity to the local population.

Taxation reform and fiscally neutral decentralisation are key factors in securing the sustainability of public finances; nevertheless, the current political-institutional context puts both of these at risk. The Law of Fiscal Decentralisation attempts to: (i) refine the structure of the taxation system, recognising that it should be rational, efficient, simple and most of all, universal; (ii) regulate the allocation of resources to regional governments and eliminate vertical imbalances; (iii) provide incentives to regional governments to promote higher tax collection, as well as the efficient use of these resources; and (iv) establish rules of fiscal responsibility.

***Taxation is the visible portion of the fiscal covenant that sustains the State***

Tax policy decisions are not based solely on economic criteria, but take into account a complex mix of social and political interactions between distinct groups in society in a historical context. They also need to adequately consider the existing administrative capacity of the state.

A clear example is the process of tax reform undertaken since mid-2003. The original stated goal was to raise tax revenue. The initial reform proposal contained a mix of naturally progressive measures (focused on cellular telephone and cable consumption, among others areas), which met with strong opposition from diverse public and private groups. Once implementation failed, the government applied an alternative measure: it raised the general sales tax (IGV) by one percent, a tax which is regressive by nature but which encountered significantly less resistance.

Later, Congress delegated legislative powers to the executive to implement a tax reform whose central focus is that nearly 80% of new tax increases would come from the application of a new tax on financial transactions (ITF), which entered into force recently and which is being challenged on constitutional grounds by opponents. Meanwhile, the same Executive that designed the ITF has already proposed an amendment to the law that is designed to reduce the tax rate and limit the length of time this tax will be applied. Furthermore, it has been announced that a "real" tax reform will be revealed in the coming months.

Under these conditions, the success of tax reform depends on the way the different political groups perceive the reform and how they will react to this perception; tax reform is an exercise of political legitimisation and ideas, interests and institutions play a key role in its design. Nevertheless, the political economy of its implementation is not totally considered. Political pressures are exposed when tax reform initiatives often result in a clash between those who benefit from, and those who are prejudiced by, the measure. This reduces significantly the number of tax instruments available to the government.

#### IV. PROPOSALS

- The path toward tax reform can be divided into three stages. The first stage requires: (i) a gradual "cleansing" of the tax system, (ii) the initiation of an open and well informed process of dialogue that involves all the actors (public sector, private sector and civil society) who - without debating specific proposals or trying to reach specific agreements on them - concentrate on discussing the foundations of taxation, such as the questions of efficiency, simplicity, equity and informality, etc., in order to generate sufficient political consensus on the social contract sustaining the fiscal covenant.
- Simultaneously, some of the main tax policy decision that should be considered in the short term include: weighting the sequence of priorities of the tax system in accordance to the political and socio-economic conditions; tax more efficiently the levels of personal profit as a tool toward achieving a more progressive system; adjusting and widening the base of the general sales tax (IGV); applying taxes to specific consumption items to achieve a more progressive system; protecting the natural environment and increasing fiscal productivity; improving control, auditing and client-services for the taxpayer and including the revision of the incentives that encourage contributors to comply.
- In the second stage - and within the process aimed toward consolidating a fiscal covenant in Peru - it is necessary to reach consensus on the medium and long-term development objectives that would give taxation the required senses of purpose and enhance the consistency and legitimacy of public finances. The underlying idea is to create a framework and elaborate long term goals that orient and give each successive government a vision beyond the short term, but which also has the flexibility necessary to give the government enough room to manoeuvre.
- Finally, in the third stage, it is necessary to ground the governance foundations of the taxation system by implementing an integral tax reform based on a fiscal covenant that is composed of a group of mechanisms that guarantee effective compliance.
- In this strategic framework, it would be necessary to undertake rigorous technical studies that nourish the process of debate, adequately assess options, and minimise political interference and improvisation. These studies should include: (i) an exhaustive diagnosis of the Peruvian tax system, (ii) comparative experiences and international best practices in tax reform (examples of success and of failure in tax policy and administration) and (iii) a tool to evaluate the cost-benefits of the proposals and identify the "winners" and the "losers" under distinct scenarios of tax reform.
- The great challenge in analysing the fiscal architecture is to identify the needs of the country and its ability to generate resources in order to determine how best to implement institutional reform. The question of the "how" is one of the key factors that make a fiscal covenant work and concretise good intentions. It is necessary to determine how, at what pace and with which priorities, goals and agreements can be reached. The key here is to have clear definitions and lines of action that consider and balance conjectural political realities with the longer time frames of taxation and economic activity.
- Achieving and consolidating a fiscal covenant requires that the different sectors and interest groups - public and private, economic, social and political - comply with key requirements and stick to their commitments. There is the need to: secure a collective medium-term and long-term vision of the country's future and development aspirations; construct and promote a stronger civic and citizenship culture; encourage the participation of interest groups in the articulation of reform alternatives; neutralise opposition, compensate "losers" and secure property rights (the benefits will be realised in the medium-term or long-term when another generation of public authorities and politicians inherit them); assure the sustainability of information systems; improve systems of coordination and communication; and strengthen the local governments (regional, departmental and municipal).
- There needs to be a process of sensitisation in order to ground and embed the need to reach a fiscal covenant within society at large. There is a need for real and sustained political will and commitment, as structural and institutional taxation reform is a long-term process. There must be an effort to align the political interests of the executive, the legislature and international cooperation. There is a further need to institutionalise the fiscal covenant by developing technical capacity for setting performance benchmarks and monitoring compliance; define a system of indicators and responsibilities; maintain the integral nature of the fiscal covenant; maintain a clear distinction between structural and more immediate necessities; and develop a genuine understanding in government that transparent fiscal laws and clear budget rules will have a positive impact on its legitimacy and efficiency.