

## **ANALYSIS OF TAX REFORMS INTRODUCED DURING THE 1974-1983 DECADE \***

**Hernán Cheyre V. \*\***

The deficit tradition that has historically characterized the public budget in our country, led to a taxation system that gradually became structured on the basis of an approach emphasizing revenue collection, to the detriment of other considerations such as simplicity, efficiency and equity —fundamental attributes of tax systems that are widely accepted.

As a result of the above, the tax structure in force at the end of 1973 introduced a serious distortion into the process of resource allocation, while, from the equity standpoint, the wide range of exemptions and allowances hampered all efforts to establish a progressive tax system. The purpose of this paper is to analyze the significance of changes in tax policy during the past decade, compared with the structure prevailing in the period prior to the reforms and, at the same time, to point out the central characteristics of the system currently in force.

---

\* Paper presented at the Seminar “Temas Económicos de Hoy” held on August 9th 1984, organized by the Centro de Estudios Públicos. The Seminar was chaired by Mr. Antonio Recabarren.

\*\* Commercial Engineer, Catholic University of Chile; M.A. in Economics, University of Chicago. Professor, Department of Economics, University of Chile, Santiago.

## I Introduction

The economic reforms that started to be implemented in Chile in 1973 aimed to make the market responsible for resource allocation within the economy. In view of the situation prevailing at the time, it was necessary to advance in two directions. On the one hand, the State had to give up part of the resources it controlled, so that they could be managed by the private sector. On the other hand, there was the need to provide a framework such that the signs perceived by the market would be appropriate for inducing an efficient allocation of resources.

In view of the above, one of the first goals established by the government in the realm of economic policy was reform of the ruling tax system. This was because the burden on the private sector was inconsistent with the role it was being assigned in the economic system that was beginning to be implemented, and also because the tax structure gave rise to a distortion in the price system, emitting signals that operated against an efficient allocation of resources.

Regarding the origin of the tax legislation in force in 1973, it should be noted that although they go back a long time, the situation reached in the end was the outcome of successive modifications introduced over time, without any criterion to provide consistency. In this regard, the work by Ffrench-Davis on economic policies in Chile during the period 1952-1970<sup>1</sup> contains an important account of the evolution of the tax system since 1924, with special emphasis on recent decades. An interesting aspect arising from his study is that every Administration during the period under study showed a steadfast concern for modification of the tax system. However, the main concern was less related to the overall tax system under consideration, than to the incorporation of elements that would permit an increase in fiscal revenue: this, with a view to reducing the budget deficits that were occurring.

Despite the fact that during the period mentioned some reforms were carried out, in 1973 the ruling tax structure showed several deficiencies. From an economic perspective, there was a clear discrimination between sectors, which distorted the allocation of resources. As regards its potential as a tool for income redistribution, the tax system had been completely undermined, largely because of the wide range of exemptions, allowances and special privileges existing at the time.

---

<sup>1</sup> R. Ffrench-Davis: *Políticas económicas en Chile: 1952-1970*, Cap. VI.

Since 1974, substantial reforms have been made to the tax system. Although in general terms they all originated at the same moment in time, throughout the course of the decade there have been constant adjustments in the same direction.

The aim of this paper is to analyze the significance of the changes in tax policy during the past decade, making a comparison with the structure prevailing in the period prior to the reforms, and pointing out the main characteristics of the system currently in force.

## **II Situation Prior to the Reform**

### **a General Aspects**

One of the characteristic features of the Chilean economy over the years has been the traditional deficit in its fiscal budget. Although this had a significant impact on the course of the price level—which peaked 1973 when control of the situation was lost—, attempts to control public expenditure were never very successful, or perhaps it would make more sense to say that the problem was never addressed in a decisive manner. Attempts concentrated on raising the flow of revenue.

As a result of this, a tax system gradually began to take shape based on the criterion of fiscal revenues, to the detriment of aspects such as simplicity, efficiency and equity, widely accepted as fundamental attributes of tax systems. This phenomenon may be illustrated by considering two aspects. On the one hand, it can be seen that over the years there was a systematic increase in tax rates. On the other hand, it became increasingly common practice to look for “specific financing” for certain programs, forgetting that fiscal revenue constitutes a common pool to be shared out among alternative uses. Thus, when it was desired to increase public expenditure through some special program, a tax was created for this. Usually this operated by applying a tax surcharge on certain products.<sup>2</sup>

However, since taxation has a negative impact on affected sectors, under a discretionary system such as that operating in Chile, the existence of a number of exemptions and special privileges is not surprising. In this respect, it should be noted that the basic tax laws were not universally

---

<sup>2</sup> An extreme case would be the housing tax, which was imposed as a surcharge on the tax paid by companies, with the sole purpose of raising funds to build houses.

applied. The number of exemptions was such, that it is no exaggeration to say that both income tax law and sales tax law were just other exceptions.

As indicated by Lamarca,<sup>3</sup> in the case of income tax, the compendium of sectoral and territorial exemptions alone took up 164 pages. With respect to sales tax, the text of the relevant law contained 108 exemptions, and there were additional ones contained in 173 different pieces of legislation.

TABLE N° II.1 TAX STRUCTURE IN FORCE IN 1973

Taxes	Rate %
I. On incomes	
First Category	
General rate	17
Corporations	35
Banks and Insurance companies	40
Return to ownership	5.5
Second Category	
Wages and salaries	Graduated scale from 0 - 65
Self-employed professionals	7
Professional partnerships	12
Directors	30
Global Complementary Tax	Progressive scale from 0 - 60
Supplementary tax	40
Housing	7
Capital gains	20
II. On Property	
Real Estate	Multiple rates
Capital levy	Progressive scale
III. On Sales and Services	
General rate at producer level	17.5
General rate at retailer level	4
Tax surcharge on specific products	Variable from 8 - 50 (See Appendix N°1)
IV. Stamp duties	Wide variety

Table II.1 presents a brief outline of the tax rates included in the basic framework, in force in 1973.

<sup>3</sup> F. Lamarca: "Evolución y perspectivas del sistema tributario en Chile". In "Seminario Sistemas tributarios alternativos", *Documento Serie Investigación* N° 57, Depto. de Economía, Universidad de Chile.

As mentioned above, the tax structure shown in Table II.1 was not generally applied, so to analyze the real extent of the tax system in force in 1973 — both from the efficiency and from the equity viewpoint— further knowledge is needed on the type of exemptions and allowances built into the system. The most obvious conclusion that can be derived from an analysis of this information<sup>4</sup> is that no criterion for comparison existed —not even an implicit one— for determining special tax privileges, which varied widely between sectors and regions of the country.

Thus, the tax system introduced distortions that implied a loss of efficiency in the process of resource allocation. In the equity area, the wide range of exemptions and allowances hampered any attempt to establish a progressive framework.

An analysis of the main characteristics of the various direct and indirect taxation mechanisms is given below.

## b Direct Taxation

The biggest portion of direct taxation was income tax, based on Law N° 15,564, enacted in 1964.

The organization of the system itself created difficulties both in the area of resource allocation and in the equity sphere. In general terms, the problems can be classified into four main issues: first, the lack of an effective adjustment mechanism for dealing with the effects of inflation; second, the existence of heterogeneous tax bases for the same kind of income; thirdly, there were different rates for the same base; and, fourthly, the general rules were broken by the existence of a wide variety of alternative regimes and special tax privileges applicable to specific sectors.

## Inflation

One of the main problems of the legislation related to the way in which it dealt with the effects of inflation. The definition of the tax base, with respect to income from capital and from work, did not contain adequate mechanisms for expressing figures in terms of currency with the same purchasing power. Thus, the values to which the various rates were applied lacked economic sense, completely distorting the spirit of the law.

---

<sup>4</sup> See Appendices N° 1 and N° 2.

In the case of the First Category tax—a tax imposed on income from capital—, there was a provision allowing for the readjustment of fixed assets only, without taking into consideration other forms capital (such as current asset and inventories, for example).<sup>5</sup> As a result, tax was applied to a fictitious profits figure.<sup>6</sup>

This, in turn, induced businessmen to concentrate their investments in fixed assets, to the detriment of other alternatives which, although possibly more appropriate from a social point of view, were rejected simply because of this distortion built into the tax system.

Inflation also introduced a distortion into the system in the case of tax on labor incomes. As the tax scale was graduated, and income categories were not necessarily adjusted in line with inflation, nominal wage increases could result in a higher tax burden for the taxpayer, as he or she moved to a higher bracket in the tax scale.<sup>7</sup>

Despite the fact that the scenario mentioned above apparently tended to favor the Treasury from the point of view of tax receipts, the mechanism for paying taxes played against it. Except for the tax on labor incomes, which was paid on a monthly basis, both the Global Complementary tax and the First Category tax were paid on the following year, without readjustment. This problem, which was partly solved only in January 1973 with the introduction of provisional monthly payments, meant a relative disadvantage to wage-earners, who had to pay taxes at the time of receiving their income.

## Resource Allocation

With respect to the effects of the income tax structure on the allocation of resources between the various sectors of the economy, several points should be considered.

In the first place, it should be noted that although income tax did not have general coverage, its structure was distorting in itself. The fact that First Category tax had different rates that varied according to the way in which the company was constituted, acted only to artificially discourage the

---

<sup>5</sup> Article 35°, Law 15.564.

<sup>6</sup> Although there was a provision that allowed writing off up to 20% of profits, when the readjusted owner's equity was in excess of total immobilized assets, this was irrelevant in view of the inflation rates present at the time.

<sup>7</sup> Specifically, the tax scale was expressed in terms of "subsistence wages" which were not index-linked to price-level variation.

creation of companies under certain legal forms, and it openly discriminated against capital invested in banks and insurance companies.

The special case of corporations is more confused, for although corporate profits were subject to a higher first category rate than the general rate, at the level of individual income tax —global complementary tax—, shareholders did not pay tax on total profits, but only on dividends paid. Thus, by delaying payment of the Global Complementary tax corresponding to reinvested profits, the capitalization of companies organized as legal corporations was encouraged.

As for Second Category tax, its structure penalized professional partnerships, as they were subject to a higher rate than self-employed professionals.

Furthermore, in view of the alternative tax regimes —with different scales and tax bases for the various activities—, and the wide range of regional and sectoral allowances in force at the time, the overall panorama points to the fact that the entire structure was distorted. And although its ultimate effect on the allocation of resources between the various sectors is difficult to establish precisely, its structure alone makes it possible to see that the signals given pointed in the opposite direction to that required for a maximum utilization of productive resources.

Secondly, the system contained a further distorting element worth considering. The fact that tax rates and bases were different even as regards alternative ways of receiving income from the same source —such as in the case of returns from capital invested in a company or real estate— led to a composition of wealth in the country that was the outcome of artificial distortions, and which therefore could diverge from what would be most efficient from a social point of view.

In the third place, the tax structure distorted the process of intertemporal decision-making by economic agents, by discouraging savings and investment efforts. This problem can be seen quite clearly in the case of income tax, considering a horizon longer than one period. Since, under this taxation procedure, the total income earned in a given period is subject to tax —including the portion destined to savings and investment—, when the individual receives the return on his/her saving or investment in a future period, this also forms part of the tax base, and is again subject to tax. This “double taxation” on income from capital is what acts against saving and investment.

Although the foregoing provides a characterization of the central elements of the direct taxation system in force in 1973, it can be further illustrated by considering other taxes that formed part of the structure. In

this context, special mention should be made of the Housing Tax and the Capital Levy.

The first of these actually operated as a 7% surcharge on First Category tax, as the two taxes had a similar tax base. The exact purpose of this tax was to collect funds to finance the construction of dwellings for workers, through the housing corporation *Corvi*, saving and loan associations, or directly with constructors. Although the aim of the tax may have been commendable, the problem was that it operated by directly penalizing companies' profits, thus further discouraging the flow of funds towards the affected activities —already impaired by the First Category tax.

The capital levy —denominated as a tax on minimum presumed income— was meant to levy a tax on taxpayers' wealth. Despite being introduced as a temporary tax for the periods 1965 to 1967, it was extended continuously before becoming permanent in 1969. The tax base was "taxable net worth", and it was subject to progressive rates. Apart from the control and enforcement problems involved, from the resource allocation perspective this tax also implied a disincentive to capital formation.

## Equity

Although the system was theoretically structured on the basis of progressive rates, the wide range of existing alternative tax regimes and the variety of exemptions and allowances built into the general system conspired against a truly effective progressive tax system.

However, even within the framework of the basic legislation there were problems in this respect. Despite the fact that both labor income and income from capital were subject to progressive taxation, in the case of Second Category tax applied to earnings, the top marginal rate was higher than that of the Global Complementary tax. Thus, for the same income level, the amount to be paid in tax could vary according to the source of the income, to the detriment of the wage-earners.

Moreover, this problem was not only due to different marginal rates, for it would also have been present if the rates had been homogeneous. Indeed, in a taxation system divided into brackets subject to a progressive global tax which is not strictly complementary, the total amount to be paid in tax will in any case ultimately depend on the way in which total income is classified between income from labor and income from capital. Thus, for example, taking the case of two individuals with the same total income, one of whom obtains it from labor alone, whereas the other receives income



from capital and labor in equal proportions, the first individual pays higher taxes than the second. This problem is eliminated insofar as the global tax structure covers total income, by imposing a complementary tax on income subject to a different rate in the different category taxes.

However, as well as the mechanism described above, for the system really to be progressive would have required putting an end to the arbitrary system of exemptions and allowances, through which paying tax on some sources of income was avoided. An example of this is that labor income was not subject to any special treatment, whereas for income from capital there was a wide range of tax allowances, exemptions and alternative regimes.

### c Indirect Taxation

The central element of indirect taxation was the sales tax,<sup>8</sup> which operated without major alteration up to 1972, when the first significant amendments were made. Up to that time Sales Tax consisted of a general tax of 8% on the transaction of goods and services, applied at the various stages of the productive process, so the tax burden accumulated over the successive stages. As a complement to this general rate, there were several goods subject to special rates, and others which were exempt from the tax.

The main disadvantages of a sales tax like the one described above can be summarized as follows.

Firstly, it encourages the vertical integration of companies so as to avoid paying taxes on transfers needed for intermediate goods to move through the productive process. The implicit problem here is that the natural benefits of specialization are not taken advantage of, and this is associated with an unnecessary loss in efficiency.

Secondly, the cumulative nature of the tax translates into a “cascade effect” on product price, which results in a higher tax burden falling on those goods whose production has required a larger number of intermediate transactions. This problem is reflected, in a concrete way, in the fact that the structure of relative prices of goods subject to this tax is not determined by the actual cost incurred by the firm in producing additional units of each of the various goods in question, but rather by the combined effect of this plus the corresponding tax burden. Insofar as this burden is proportionally different between different goods, the signals being sent will be the wrong ones,

---

<sup>8</sup> Law 12,120, October 1956.

both to producers and consumers. The former will be discouraged from producing goods whose production requires a larger number of intermediate transactions —because of the taxes that must be paid—, and consumers will also try to avoid the tax by reducing their consumption of goods which, due to tax, have become relatively more expensive. As can be seen, the tax alone will cause a reeduction in the consumption of goods subject to proportionally higher taxation, and the efficiency loss lies precisely in not producing or consuming goods whose production cost for society is less than their valuation from the consumption standpoint.

A third problem in this kind of taxation consists of the fact that it is practically impossible to know the accumulated amount of tax paid by a given product. This information is crucial in the case of exports because, in order not to artificially reduce competitiveness in international markets —in other words, so as not to impose a “tax” on exports—, indirect taxes accumulated by a product have to be paid back to the exporter when the good is shipped abroad.<sup>9</sup>

Finally, a further problem must be added to those already mentioned, relating to the diversity of rates that were in force for different goods. Although 8% was the general rate, there was a large number of products subject to special tax surcharges,<sup>10</sup> an equal number of products which were exempt from tax, and there were specific activities which by law did not pay tax.<sup>11</sup> In spite of the fact that in a multiple rate system the final effect on resource allocation is uncertain, taking the four issues indicated as a whole it can be clearly seen that the system was being induced to operate in an inefficient manner.

This basic scheme operated until the end of 1972,<sup>12</sup> when significant changes were made. Specifically, a 17% tax rate was established for transactions taking place at producer level —of a non-cumulative nature—, along with a 4% tax on transactions at retailer level.<sup>13</sup> This was really an attempt to restructure the system, making it tend towards a tax on production. Nevertheless, the 8% rate was kept for transactions carried out between producers.

---

<sup>9</sup> In fact, rules arising from the GATT stipulate a drawback mechanism such as the one described above, and establish that exports can only be subject to indirect taxation in force at the country of destination.

<sup>10</sup> See Appendix N°1.

<sup>11</sup> See Appendices N° 2 and N°3.

<sup>12</sup> Law 17,828, November 1972.

<sup>13</sup> The provided that the latter rate should be abolished within 4 years, at a rate of one percentage point per year.

However, maintaining the 8% rate on transactions between producers did not eliminate the inducement to vertical integration between firms. It should be noted that an 8% tax rate, such as the one described, in fact allowed firms to manufacture different parts and spares at up to 8% higher cost than firms specializing in such manufactures. In other words, the system allowed an efficiency loss of 8% in the productive process, and this not only meant higher prices, but also reflected a real output loss.

As regards the other important component of indirect taxation, namely stamp duty, it should be noted that a large number of transactions were taxed under this category. Clearly, its direct impact was to raise the cost of transactions, which in many cases was a punishment strong enough to discourage transactions, and there was a tendency to evade the tax by making transactions outside the currently ruling legislation and, therefore, beyond the scope of institutions specifically designed to channel such transactions most efficiently. In addition, there was no clear rule for establishing the taxes to be paid, so they all followed completely arbitrary criteria.

#### d Provisions Prior to the Reform

The first measures to be put into effect from last quarter of 1973 onward were essentially aimed at repairing the system, rather than introducing more profound changes. The size of the fiscal deficit in that period not only required measures aimed at cutting expenditure, but significant efforts were also needed to raise fiscal revenue. In this respect, great emphasis was put on finding a solution to the abnormal situation many taxpayers found themselves in.

As regards tax modifications as such, Decree Law N°110 —dealing with income tax issues— was passed in October 1973, allowing firms to value their inventories at replacement cost.

In an earlier section, mention was made of the shortcomings in the legislation in incorporating the effects of inflation. As the inflation rate reached an all-time high in 1973, the distortions it caused in company accounts made it essential to take measures —albeit temporary ones— to solve this particular problem.

Subsequently, in January 1974, the capital levy was abolished due to its negative impact on the process of capital formation.

In relation to indirect taxation, the first changes to be carried out<sup>14</sup> consisted of a amendment to sales tax, raising it to 24% on transactions at

---

<sup>14</sup> D.L. N° 95 (October 1973) and D.L. N° 292 (January 1974).

producer level, and abolishing it at retailer level. However, the 8% tax on transactions between producers was maintained. In addition, the system was rationalized by eliminating discrimination between domestic and imported goods, unifying rates for the various legal entities, etc.

As regards other taxes, these were also subject to modifications, a summary of which can be found in a document written by the then Finance Minister, Jorge Cauas.<sup>15</sup>

However, all these changes were merely temporary, and made it possible to adjust to the circumstances of the time. The underlying objective was a complete reform of the tax system, aiming at greater simplicity, efficiency and equity.

### III Tax Reform

#### a Foundations and Aims of the Reform

Once the basic corrections had been made to put the system in order, studies began for its overall reform aimed at relocating tax policy within the context of the socio-economic development strategy that was beginning to be implemented. The precise objectives of the reform, as well as its foundations, are summarized in a document presented by the Finance Minister at the inauguration of a symposium for the analysis of the tax reform.<sup>16</sup>

As regards the objectives, the document mentioned argues that the tax system should be fair, simple and efficient. To quote: “fair, insofar as it should pursue the maximum possible equity; simple, in that it should not become an obstacle to productive and social initiatives; efficient, in that it should promote the maximum use of productive resources in the best possible way for the development and welfare of the population”.

In fact, what this meant was that the scope of tax policy goes beyond the amounts collected by the public sector to finance its expenditures. In terms of resource allocation, the tax structure may induce the expansion or contraction of certain activities, or it may have a neutral effect. In relation to equity, the system could be designed so that each taxpayer has to carry the same tax burden according to his/her contribution possibilities, or it might demand a greater proportional effort from sectors of higher capacity.

---

<sup>15</sup> J. Cauas: *El rol de la política tributaria en el desarrollo económico nacional*, November 1974.

<sup>16</sup> J. Cauas: op. cit.

As regards resource allocation, it is argued that the tax system should be neutral, in the sense of not interfering with decisions relating to consumption, production, employment, investment, etc., which economic agents take in accordance with the signals provided by the market. It is noted, however, that in cases where private valuations differ from social valuations, a non-neutral tax should be set so as to make them coincide.

In relation to the system's redistributive effects, it is argued that taxation should be seen as an essential tool for achieving greater justice in the distribution of income. Thus, taxation is conceived as "the basic mechanism to achieve effective equality before the law on economic issues, and to provide a country's inhabitants with the necessary equal opportunities".<sup>17</sup> On this question, emphasis is given to the principles of vertical and horizontal equity. The former implies that taxpayers who are able to pay higher contributions should carry a heavier tax burden, and the latter refers to the notion that all taxpayers who can pay equivalent contributions should bear the same tax burden.

## b Changes to Direct Taxation

The basic reforms introduced in the direct taxation mechanism are contained in Decree Law N° 824, published on 31st December 1974.

This legislation contains important amendments, in relation to taxes collected at the company level and at the individual level, as well as provisions affecting the system as a whole.

## Monetary Correction

One of the big innovations here—which in the opinion of many has been the most significant—was the introduction of a monetary correction mechanism. As its name suggests, the aim was to globally correct the distortions caused by inflation in determining the tax base and the amount payable in different periods.

In the case of corporate taxation, it has already been mentioned that the previous legislation only allowed the revaluation of fixed assets, which left serious potential distortions in the valuation of assets and liabilities. In

---

<sup>17</sup> J. Cauas: *op. cit.*, p. 7.

actual practice, this meant that the resulting tax base was fictitious, so tax was paid on an unreal profits figure. The new provision made it possible to readjust both shareholders' equity and current assets and liabilities. Thus, the aim was for companies to pay tax only on the real increase in equity during the period concerned.

As regards individual income tax, the monetary correction mechanism was oriented towards formalizing the system in terms of constant purchasing power units, so that both the tax base and the amounts actually paid would be expressed in real terms. In this sense, a fundamental measure was the creation of the "taxation unit" (*unidad tributaria*), which replaced the "subsistence wage" for this purpose and which, by law, is periodically updated according to the variation in the Consumer Price Index. This unit of account has begun to be used to define the tax brackets for establishing the credits to be imputed to taxes payable, etc.

The benefits of having introduced a adjustment mechanism such as the one described were threefold. In the first place, as some taxes are paid on an annual basis, the existence of inflation implied that the taxpayer paid in real terms a lower amount than what should have been paid according to the income received at a given moment in time. The new scheme implemented safeguards fiscal revenue in real terms. Secondly, in view of the simultaneous existence of taxes that are paid annually and others that are paid on a monthly basis, the absence of such a mechanism meant penalizing, in relative terms, taxpayers who had to comply with their tax obligations on a more regular basis, thereby impairing the progressive nature of the system. Finally, with a progressive tax scale where the brackets were not defined in terms of a unit of account, the effect of inflation alone could cause the taxpayers to move from one bracket to another, thus defeating the purpose of the scale.

### Corporate Taxation

Due to the wide variety of problems in corporate taxation, all sorts of modifications had to be made.

In the first place, an important landmark was the incorporation of a mechanism of monetary correction which, as indicated above, enabled companies to pay taxes on a real basis.

A second aspect relates to the system's coverage. According to the stipulations of the new legislation, the general system covered activities that, by virtue of various legal provisions, had been subject to special

taxation, or alternative regimes of income tax. This meant bringing into the general regime businesses such as airlines, insurance companies, banks, savings and loan associations, investment corporations, mutual funds, construction companies, news organizations, advertising agencies, radio broadcasting companies, telecommunications, etc. The new provisions sought to achieve a situation whereby capital invested in different sectors was subject to the same tax treatment, so funds could be allocated between the various sectors on the basis of objective financial return criteria rather than in response to artificial incentives that distort the process of resource allocation performed by the market.

It should be added that the above not only meant the abolition of alternative income tax regimes, but also that even within the general framework of the system the same rate applied to everyone. This covered corporations, banks and insurance companies, which under the previous legislation were subject to tax rates of 35% in the case of corporations, and 40% for the others. After the reform, the general rate —valid for all sectors— dropped from 17% to 15%,<sup>18</sup> and two years later it was lowered further to 10%.<sup>19</sup>

In the specific case of corporations, an additional remark should be made. In accordance with the legislation in force prior to the reform, shareholders paid the global complementary tax only on distributed profits, which led corporations towards higher capital formation by postponing the payment of tax. However, a system was opted for in which, at the level of personal income, tax would be paid on total accrued profits. For this purpose, a 40% surcharge on the first category was introduced, that could be set against the global complementary tax paid by individual shareholders. In this way, corporation tax was combined with individual tax, with a view to applying homogeneous taxation procedures to the various forms of company organization.

On the other hand, as well as bringing certain activities subject to special alternative regimes into the general framework, the new provisions also included those who benefited from special tax allowances or exemptions. At this point special mention should be made of state-owned companies which, under the previous legislation, were exempt from first category taxation. This was clearly incompatible with a system in which public capital was expected to yield the same return as the private sector, and also

---

<sup>18</sup> However, a temporary provision contained in the new legislation provided that for tax years 1976 and 1977, the tax rate would be equivalent to 20% and 18%, respectively.

<sup>19</sup> D.L. N° 1604, December 1976.

meant a clear disadvantage to private enterprises that had to coexist with public-sector companies in a competitive system.

Although relatively less important than the above, the case of small taxpayers deserves mention. Under the previous legislation, these were subject to a tax rate of 3.75%, applied on a base established at the sole discretion of the director of the Income Tax Service. In order to avoid the complexity and arbitrariness of such a system, the new legislation brought these taxpayers within a much simpler single tax system. Likewise, presumptive income was established for small mining ventures and for small-scale passenger transport entrepreneurs, while eliminating the exemptions given to agricultural properties.

As regards other issues, it should be noted that the mechanism allowing a tax credit of up to 20% of net income to cover the return to ownership was revoked, and the 20% tax levied on capital gains was abolished. In the latter case, this was due to the fact that it was a complex and low-yielding mechanism. Nevertheless, capital gains obtained from regular operations were included as taxable income in the general first category regime.

As regards the housing tax, this remained in force practically for the entire duration of the period covered by the present analysis —albeit at a lower rate of 5%— and was abolished only on January 1st 1983.

## Personal Income Tax

Changes in this area were mainly oriented towards concentrating personal income on a single base, irrespective of its source, so that the progressive tax scale could be applied to a uniform base for all taxpayers.

At the same time, a new scale of tax rates was established, both for the tax charged on workers' wages —the single Second Category Tax— and for that covering all income received from different sources —global complementary tax. In both cases, the concept of the "tax unit" was used in order to eliminate the effects of inflation from the operation of the system. The objective of restructuring brackets and rates was to streamline the tax burden and level it off. In this way, the general progressivity of the system was made uniform.

## Second Category Tax

The tables below provide a summary of the evolution of the single second category tax, as a result of the changes made both to the rates and the tax brackets.



Table III.1 gives the tax scales in force before the reform, Column 1 showing the structure valid until March 1974. The main problem was that it did not coincide with the scale of the Global Complementary Tax. In fact, the top rate here was 60%, which led to the curious phenomenon that at the margin, those receiving income from labor alone were penalized more than those who obtained income from other sources. Furthermore, examination of the structure of tax brackets and rates reveals that the scale was progressive, but at decreasing rates. Column 2 shows the temporary changes introduced between March and December 1974. The objective here was to obtain higher fiscal revenue during that period, in order to reduce the fiscal deficit being experienced at the time, and for this purpose the rates in the higher income brackets were put up.

TABLE N° III.1 SINGLE TAX SCALE FOR WORKERS:  
SYSTEM IN FORCE PRIOR TO REFORM

Taxable amount (in subsistence wages) <sup>20</sup>	Rate	
	March 1974 % <sup>21</sup>	December 1974 % <sup>22</sup>
0 - 1	Exempt	Exempt
1 - 2	3.5	3.5
2 - 5	10	10
5 - 10	15	15
10 - 15	20	20
15 - 20	30	30
20 - 30	40	40
30 - 40	45	45
40 - 50	50	55
50 - 60	55	65
60 - 80	60	70
80 and higher	65	80

Table III.2 shows the new scale brought in after the reform undertaken at the end of 1974. The most important change from the previous structure was that the second category tax structure was made to coincide

<sup>20</sup> By way of reference the value of the subsistence wage for the first two months of 1974 was 10,170 escudos.

<sup>21</sup> This scale was valid until march 1974, when the rates were raised temporarily via D.L.N° 367 until December 1974.

<sup>22</sup> This column contains the transitory scale decreed by D.L.N° 367 mentioned above.

with the structure of the global complementary tax, thereby correcting the distortion mentioned above.

Finally, Table III.3 shows the scale operating in 1983. It is important to note that this differs radically from the scale in effect prior to the 1974 reform. In the first place, there is a significant decrease in the tax burden in this category. Secondly, the progressive structure is maintained, but unlike the previous structure, progressivity increases at an accelerating rate as income levels rise. This results in a more progressive income tax structure than previously.

TABLE III.2 SINGLE TAX SCALE FOR WORKERS<sup>23</sup>:  
SYSTEM IN FORCE AFTER THE REFORM

Taxable amount (in tax units) <sup>24</sup>	Rate %
0 - 1	Exempt
1 - 2	3,5
2 - 5	10
5 - 10	15
10 - 15	20
15 - 20	30
20 - 40	40
40 - 80	50
80 and higher	60

TABLE III.3 SINGLE TAX SCALE FOR WORKERS<sup>25</sup>:  
SYSTEM IN FORCE AFTER THE REFORM

Taxable amount (in tax units) <sup>26</sup>	Rate %
0 - 10	Exempt
10 - 25	8
25 - 40	13
40 - 55	18
55 - 70	28
70 - 85	38
85 - 100	48
100 and higher	58

<sup>23</sup> This is the scale that came into force as from January 1st 1975, via decree D.L.N° 824.

<sup>24</sup> At the time of the reform the Tax Unit had the same value as the subsistence wage. In December 1974 this stood at 37,000 escudos.

<sup>25</sup> This structure dates from 1981, when the scale that appears in the previous table was modified. It was modified only temporarily between March and December 1982 so as to increase tax revenue.

<sup>26</sup> By way of reference, the value of the Tax Unit in December 1981 stood at \$3,173 (pesos).

Figure 1 below summarizes the above, by considering the two structures simultaneously.

FIGURE 1

<< INSERT FIGURE 1 HERE >>

Another interesting indicator worth looking at is the average tax rate, in relation to taxable income. Table III.4 gives the evolution of average rates paid at various income levels, expressed in December 1983 prices.

As can be seen, there was a considerable drop in the average tax rate at all income levels. However, the fall was more pronounced at the lower income levels, with incomes up to \$ 25,000 at December 1983 prices being made exempt. The final column in Table III.4 illustrates quite clearly that the reduction was proportionately less at the higher income levels. In any case, the table shows that the overall reduction in second category tax rates has been substantial.

With respect to second category taxes paid by professional people, the rates for self-employed professionals and professional partnerships were consolidated, at a rate of 7%. Previously, the former paid the 7% rate, while the latter were subject to a rate of 12%. Clearly, the only effect of a discriminatory procedure like this was to discourage partnerships among professional people, thereby forgoing the advantages that such associations imply in terms of greater efficiency.

A final issue to be considered in relation to this tax is the modification in the treatment of company directors or consultants. Prior to the

reform, these paid taxes on income earned from such sources a 30% rate, which was lowered in the reform to 7%. The reason for this was to avoid discrimination at this level, concentrating the tax burden in the global complementary tax.

TABLE N° III.4 EVOLUTION OF AVERAGE RATES FOR SECOND CATEGORY TAXATION

Taxable income			Average tax rates %			
Dec. 83 \$	U. T. or S. V.	Feb. 74	Dec. 74	March 75	Dec. 83	Dec. 83 (Feb. 74)
7,000	2.21	5.5	5.5	0	0	- 100
10,000	3.15	6.8	6.8	2.7	0	100
15,000	4.72	7.9	7.9	5.1	0	- 100
25,000	7.87	10.6	10.6	8.9	0	- 100
40,000	12.60	13.3	13.3	12.2	0.9	- 93.2
60,000	18.90	17.6	17.6	16.9	3.2	- 81.8
90,000	28.36	24.7	24.7	24.2	5.4	- 78.1
130,000	40.97	30.8	30.8	29.3	7.9	- 74.3
160,000	50.42	34.5	35.5	33.2	9.8	- 71.6
200,000	63.03	38.8	41.7	36.5	12.7	- 67.3
240,000	75.63	42.3	46.4	38.8	16.0	- 62.2
280,000	88.24	45.3	50.7	41.3	19.5	- 57.0
350,000	110.30	49.3	56.6	45.1	26.1	- 47.1

### Global Complementary Tax

The most important modification to this tax related to the reorganization of tax brackets and rates, and the grouping of all income on a single base. In the late 1974 reform itself, however, no significant modifications were made as the emphasis was placed on achieving uniformity between the treatment of second category taxation and the global complementary tax. Changes were made subsequently, at the same time as changes to second category tax. Therefore, the fundamental differences between the structure in force at the time of the reform and the structure in 1983, are of the same type as in the case of the single secondary category tax. Accordingly, the structure of tax brackets and rates was reorganized, with an increasingly progressive scale as rates were raised proportionately more on higher levels of taxable income.

It is also important to make mention of the changes aimed at income received from different sources under one tax base. The wide range of pre-

existing special treatments did not permit a single strictly complementary global tax structure. Resolving this problem permitted the equal treatment of income received from different sources, entailing benefits from the standpoints of efficiency and equity.

Another modification, complementary to the new treatment of corporate income, consisted of granting a credit to the shareholders for dividends distributed, in view of the fact that these were subject to an additional rate of 40%, at the corporate level. As mentioned above, the additional rate mechanism was established so that shareholders would pay tax on total accrued profits rather than on distributed profits alone. A global complementary tax credit had to be set up, in order to avoid double taxation, equivalent to a fraction of the amount already paid via the additional rate.

At a different level, two issues should be mentioned. As regards the effect of inflation, for taxation purposes it was stipulated that monetary correction would be applicable both to income received each month of the year, as well as to the tax credits corresponding to taxes withheld. This was done so that all amounts involved in the process calculating taxes payable would be expressed in currency of constant purchasing power. Exemptions applicable to certain forms of interest income were revoked, for example bonds issued (or secured) by the State, and mortgage bonds. This was done so as to equalize the treatment applied to the various financial instruments, without artificially benefiting some at the expense of the others.

### c Changes in Indirect Taxation

The reform of the sales and services tax is one of the most significant advances on taxation issues. With the passing of Decree Law N° 825 in December 1974, Value Added Tax (VAT) was established at a rate of 20%, replacing the sales tax which charged 24% on all transactions at producer level and 8% on transactions between producers.

This new tax affected both producers and importers, and in commerce it covered both wholesalers and retailers. The great advantage over the previous system is that tax is paid only on the “value added” corresponding to each stage of the productive process, thereby avoiding the implicit cumulative effect of the sales tax which encouraged the vertical integration of firms. Similarly, as the total amount of tax paid by each good became independent of the number of stages it had to go through during the productive process, the relative prices of different goods are no longer artificially altered as a result of taxation.

From the supervision point of view, enforcement has been considerably simplified by the way the mechanism operates in practice. Indeed, given that the taxpayer has a debit with the Treasury arising from applying the tax rate to the total value of sales, and a credit for the taxes paid when purchasing the inputs, materials and capital goods required for the elaboration of the product, buyers and sellers have opposing interests which leads to an automatic control of tax evasion.

The coverage of taxation has become increasingly more general with the elimination of exemptions provided by the previous legislation.<sup>27</sup>

However, apart from VAT, Decree Law N° 825 also included a special sales tax and a tax on services. Special sales taxes are of an eminently selective nature without the characteristics of VAT, i.e. they are sales taxes with no credits for any taxes paid in the purchase of inputs and materials required for manufacture. This category covers several goods classified as luxury articles, which are subject to an additional tax of 20%, the sale of second-hand motor vehicles, at a rate of 8%; as well as gasoline and other oil derivatives, at rates varying between 12% and 33.5%. Subsequently, other changes have been made, aimed at bringing the sale of fuels into the general VAT system, and eliminating the additional rates certain products were subject to.<sup>28</sup>

As regards the tax on services, this initially meant a 20% levy on a series of transactions stipulated in the text of D.L. N° 825, with other services subject to a rate of 8%. Although there were a number of tax-exempt operations, this was to avoid inconsistencies with respect to the rest of the tax system. Nevertheless, a series of enterprises and institutions remained free of tax.<sup>29</sup> As from January 1977, the tax on services was incorporated into the general VAT system.

In addition to the framework described above, it should be noted that the 1974 reform set up special taxes on liquor, entertainment shows and tobacco,<sup>30</sup> which were subsequently also gradually incorporated into the general VAT system.

Finally, the reform of indirect taxation has introduced a series of amendments to the law on stamp duties. Although the effect of any one measure may not have a significant impact on resource allocation, taking

---

<sup>27</sup> Initially, some products were exempt from VAT, but they were gradually incorporated into the general system. See Appendix N° 4.

<sup>28</sup> For more details on the evolution of both the sales and services taxes, see Appendix N° 4.

<sup>29</sup> See Appendix N° 4.

<sup>30</sup> D.L. N° 826 and D.L. N° 828, respectively.

the amendments as a whole one can discern a simplification of the different transactions, resulting in the end in greater efficiency.

#### d Development Laws

The reforms examined in the previous sections, on issues of both direct and indirect taxation, had twin objectives. On the one hand, an attempt was made to build a system that would be more efficient, simpler and more equitable than the one in force prior to the reform. In addition, alternative regimes were eliminated, along with many of the tax allowances, incorporating the various sectors and regions into the general system.

It has already been mentioned that apart from the deficiencies in the previous income tax and sales tax laws, the wide range of special treatments and exemptions turned the general structure into just another exception.<sup>31</sup> No doubt the reason for having alternative regimes and tax allowances was to foster development of certain activities and regions, but the tools used were far from being the most suitable for the goals pursued, and moreover they impaired the system's equity.

A paper by Méndez<sup>32</sup> examines the main development instruments used in Chile up to 1974. The author states that on direct taxation issues, tax allowances were basically aimed at favoring net capital returns, and this gave a relative advantage to the more capital-intensive activities. As regards indirect taxation, the consequence of the allowances was that different prices were paid for the same goods, depending on the type of consumer or producer, as well as on the geographical area of the country in which the transaction took place. With respect to tariff exemptions, Méndez emphasizes the wide range of special procedures in existence, and estimates that around 45% of total imports entering the country were not paying customs duties. Needless to say, this rendered the general tariff structure inconsistent. Finally, Méndez points out the inconsistency of having a series of measures, which he calls semi-tariff measures, which interfered with the development of certain sectors and regions. Thus, for example, he notes the implicit contradiction in providing fiscal incentives for regions whose principal product was on the list of banned exports.

---

<sup>31</sup> Appendix N° 3 contains a collection of territorial and sectoral exemptions.

<sup>32</sup> Juan Carlos Méndez: "Leyes de Fomento", in *Reforma Tributaria*, Ministerio de Hacienda, 1977, Section IV.

The 1974 reform made substantial changes in this respect. Although the general rule was that all sectors and regions were to be treated equally, so resources could be allocated on the basis of undistorted price signals issued by the market, certain fundamental principles were established relating to development laws and tax allowances. These are described in the paper by Cauas,<sup>33</sup> and basically state that whenever a certain region is to be given preference, development laws shall apply indiscriminately to every activity being carried on in that region. Similarly, it points out that any allowances made to a particular sector should be independent of the region of the country in which the activity takes place. One of the other notable principles referred to is that allowances should not be permanent.

In this context, the first measures adopted simply complemented D.L. N° 824 and D.L. N° 825, in that they brought the different sectors and regions within the general system, thereby abolishing all preferential treatment.

With regard to development laws themselves, mention should be made of the legislation granting tax allowances to the northernmost and southernmost regions of the country,<sup>34</sup> and the establishment of tax-free zones.<sup>35</sup> The former essentially involved a reduction in first category taxation, a tax rebate to enterprises in proportion to the taxable wages of their employees, and tax credits towards the cost of new investment.<sup>36</sup> The legislation concerning tax-free zones, on the other hand, established a tax exemption on sales and services to companies located within the tax-free zones or depots, applicable to transactions undertaken in these locations. They were also exempted from paying first category tax.

On a different issue, a tax credit was established for staff training expenditures incurred by companies, up to 1% of the taxable payroll.<sup>37</sup>

As regards economic activities in particular, the decree DFL 2 issued in 1959, remained in force. The objective of this Decree Law is to encourage the construction of low-cost housing developments by granting an exemption from first category tax to construction firms, and an exemption from global complementary tax on all income generated by this type of housing. Furthermore, such properties are exempt from municipal real estate taxes for a certain period of time.

---

<sup>33</sup> J. Cauas: *Op. cit.*, pp.30-31.

<sup>34</sup> D.L. N°889, published on 21 February 1975.

<sup>35</sup> D.L. N° 1055, published on 25 June 1975.

<sup>36</sup> The law stipulates that these allowances must decrease over time.

<sup>37</sup> D.L. N° 1446, published in 1976.



## IV Analysis of the Tax Structure in Force in 1983

### a General Aspects

The previous sections were given over to studying the tax structure in force in 1973, and to an analysis of the essential amendments arising from the passing of a series of decree laws in December 1974, in what has been called the “tax reform”. In both cases, emphasis was given to issues of efficiency and equity arising from a comparison of the respective schemes.

In summary, it can be stated that with respect to both direct and indirect taxation the objectives of the reform were twofold. On the one hand, a structure was designed that corrected various distortions implicit in the previous scheme, thereby inducing a more efficient allocation of resources. On the other hand, there was also a trend towards the gradual abolition of the various alternative tax regimes, with all sectors then being subject to the same general treatment.

Notwithstanding the scope of the reforms discussed above, which may be inferred from a comparison with the previous system, it is important to synthesize the real significance of the tax system in force in 1983, following a ten-year period in which successive amendments were gradually introduced.

In terms of simplicity, the progress achieved on taxation issues is undeniable; however, it will always be possible to conceive mechanisms with better attributes.

On the issue of equity, an attempt has been made to be consistent with horizontal and vertical equity; i.e. equal treatment for taxpayers with equal ability to pay, and different treatment for taxpayers with different contributory capacities. As regards horizontal equity, the search for this has not only involved the abolition of alternative regimes and tax allowances benefiting certain sectors in particular, but also the establishment of a tax base covering all income received by the taxpayer from different sources, and then the application of a progressive tax scale to that base. With respect to vertical equity, the scheme was modified to make it more progressive, in the sense that a decreasingly progressive scale was replaced by a scale which becomes increasingly progressive as it moves into higher income brackets.

As regards efficiency in resource allocation, a more “neutral” system has been sought, in the sense of avoiding decisions taken by producers and consumers being influenced by the existence of taxes.<sup>38</sup> And although there

---

<sup>38</sup> Except in cases where the tax has been imposed precisely to correct a distortion.

has been significant progress in this area, it has been centered on removing the obstacles that distort production and consumption decisions at a given moment in time.

In the case of indirect taxation, the emphasis has been on trying to avoid the relative prices of the various goods from being distorted by taxation, in the sense of inducing consumption and production decisions different from those that would have been taken in the absence of taxes. In the case of direct taxation, the legislation has been designed so that all the income received by an individual taxpayer is subject to the same rate, irrespective of the source. This had the aim of not inducing one type of work rather than another merely because of the taxation effect, and of not artificially fostering capital investment in certain activities to the detriment of others.

Nevertheless, the effect of the tax system on resource allocation over time —i.e. its impact on savings and investment— was not dealt with during the decade 1974-1983, but only occurred in January 1984, with the enactment of a law introducing substantial amendments to income tax legislation.<sup>39</sup>

#### b. Effects of the 1983 Tax System on Savings and Investment

The funds that taxpayers earmark for savings and investment depend on several factors, of which one is the expected return. The latter has an influence in the sense that the higher the net return obtained, the greater will be the incentive to save and invest, and the return to be received in the future must be sufficiently attractive to compensate for not consuming such resources in the present.

To the extent that the tax system is structured so that the net return received by savers and investors declines as a result of the taxes they have to bear, it can be said that the tax system discourages saving and investment.

In the Chilean situation, both first category taxation and global complementary tax penalize saving and investment.

In the case of saving, the return obtained by the taxpayer is included in the tax base of the global complementary tax, which in practical terms means that income from that source is subject to the individual taxpayer's marginal tax rate.

---

<sup>39</sup> Law N° 18,293, D.O. of 31st January 1984.

In the case of investment, consideration must be given to the joint impact caused by the first category tax and the global complementary tax. An illustrative example of this would be the case of a taxpayer who owns shares in a company, and who, according to the gross profits earned by the company during a given period, would be entitled to \$100 in dividends. What will his/her net return be after the corresponding taxes? Assuming the investor is in the highest bracket of the global complementary scale (58%), the situation would be the following:

Gross income	100	(1)
First Category Tax (10% of (1))	- 10	(2)
	<b>90</b>	(3)
Additional corporate tax (40% of (3))	- 36	(4)
Dividends distributed	<b>54</b>	(5)
Global complementary tax, marginal rate (58% of (5))	- 31.3	(6)
+Tax Credit (40% of (5))	+ 21.6	(7)
Net tax	<b>44.3</b>	(8)
Effective Tax Rate	55.7%	

As can be seen, corporate taxation has been designed in such a way that the actual rate paid by an investor on the income generated by his/her participation in the company, tends to coincide with the marginal rate of the global complementary tax corresponding to that individual.<sup>40</sup>

In brief, both savings and investment are being penalized within the framework of the taxation system in force in 1983. The actual impact of this on capital formation will eventually depend on the degree of sensitivity shown by savings and investment to variations in net returns, and on how such variations may also affect the other determinants of these variables.

Therefore, while it is not possible to claim that the elimination of these distortions will solve the problem of the dearth of saving and investment currently seen in Chile, it would at least be a significant step towards doing away with the disincentives that currently hold back the development of such activities.

<sup>40</sup> This equivalence between the rates arises from the process whereby corporate and personal income tax were integrated, and due to the way it is calculated, it has greater validity for the higher brackets of the global complementary tax. For example, a taxpayer whose corresponding marginal rate is 20%, pays an effective rate of 35.2%.

## **V Foundations and Characteristics of the 1984 Tax Reform**

### **a General Considerations**

As already mentioned in the previous section, the Chilean tax system has been structured in such a way that income intended for savings and investment has been discriminated against. In the economics literature, this problem is known as “double taxation”, and can be summarized in the following terms: when the taxpayer receives a certain income, what is left after paying the corresponding income tax may either be used for consumption during the period concerned, or may be saved (invested). Depending on the decision taken, such income may or may not be subject to additional taxes. If the person chooses to save or invest, the yields generated thereby and received in a future period will be included in the taxpayer’s tax base, thus implying payment of additional taxes, and thereby diminishing the net return obtained. This is the meaning of the statement that taxation based on total income implies a “double taxation” of savings and investment: taxes are paid on the basis of income that has already been taxed at the moment of receiving it, i.e. before whether to use it for consumption or saving (investment). It should be noted that if the taxpayer were to decide to use the total amount of the income received for consumption purposes, it would not be subject to “double taxation”.

It is clear that the extent to which this affects capital formation in the economy will depend on how sensitive saving and investment are to variations in expected net return. However, in contrast to circumstances where the responsibility for such activities falls on the State, there are two requirements for the system as such to be consistent with a market-based framework: firstly, the private sector must have resources to work with, which means that the tax burden must not become a hindrance to its development; and, secondly, the tax collection mechanism chosen must not discourage capital formation.

The main reason for introducing changes in tax legislation was precisely to correct the situation described above.

### **b. Main Changes Introduced in the Tax Reform**

The changes made to tax legislation in Law N° 18,293 can be divided, for analytical purposes, into two categories: reductions in tax rates and modification of the tax base.

As regards the former, the new legislation includes cuts in personal taxes. With respect to income from work —second category— the legislation contemplates a reduction in the single tax rates, and abolishes the special rate paid by self-employed professionals.<sup>41</sup> As for the global complementary tax, the Law provides for an adjustment of the tax brackets and rates making up the scale, similar to that stipulated for the single tax on labor income. In both cases, the changes come into effect gradually over time, and the system that will be come into force as from 1986 is summarized in the following table:

TABLE N° V.1 SCALE FOR SINGLE TAX ON LABOR INCOME AND GLOBAL COMPLEMENTARY TAX CONTEMPLATED IN LAW N° 18,293

Taxable amount (in monthly tax units)	Rate %
0 - 10	Exempt
10 - 30	3.5
30 - 50	10
50 - 70	15
70 - 90	20
90 - 120	30
120 - 150	40
150 and higher	50

For the tax-years 1984 and 1985 there will be a reduction of one percentage point per year in each tax bracket in the scale ruling in 1983.

As regards the tax base for corporations, the concept of revenue received or accrued is kept on, and is subject to first category tax. However, this tax can be deducted from the global complementary or additional taxation declared by the company's owners, partners or shareholders, in relation to declared income.

As regards the tax base for individuals, the global complementary tax incorporates an important element relating to income from company ownership: total income (received or accrued) no longer constitutes the base, which becomes withdrawals alone in the case of partnerships, and profit distribution in the case of corporations.

<sup>41</sup> In the case of self-employed professionals, Law N° 18,293 stipulates a graduated reduction: income received in 1984 shall be subject to a rate of 3.5%, and as from 1985 it will be equal to zero. Until 1983, the rate was 7%.

In relation to deductions from the tax base, a clause was included authorizing taxpayers to make an annual deduction from their individual tax base to a value of 20% of the amounts invested in shares, deposits and other securities expiring in a period of at least one year, and the total amount of additional contributions to a Private Pension Fund (AFP). The law sets upper limits for these amounts.

In accordance with the above, the additional 40% tax on profits received or accrued by corporations was abolished, as this was effectively operating as an advance payment of the global complementary tax which shareholders were subject to. With taxation focused on the individual person, and the tax base consisting only of distributed profits, this provision loses meaning. In any case, the reduction is to be graduated: a rate of 30% was set for 1984, 15% in 1985, falling to zero as of 1986.

### c Scope of the Reform

The provisions contained in the new income tax legislation affect both the tax burden and the structure of the system.

Regarding the tax burden, the fact that consideration was given to a reduction in personal tax rates reflects the Treasury's intention to continue the process of freeing up resources for private sector administration.

With respect to the amendments to the structure of the system, these imply a change in incentives at the both company and individual level.

At the company level, the fact that owners pay global complementary tax only on distributed profits has a direct effect on firms' financial structure: as their owners' tax base is only their withdrawals, there is an incentive to finance expansion projects with shareholders' equity instead of borrowing, for postponing tax payments gives access to a lower-cost source of financing. This is an extremely important point, as it directly attacks one of the most serious problems that have affected firms over the course of the past decade; namely, their low capitalization level. As there were not enough incentives to reverse the situation, economic expansion had to be financed to a large extent through borrowing.

As can be appreciated, the change in the tax base basically aims to give incentives for companies, for any given amount they want to invest, to finance the operation with their own capital rather than by borrowing. As to whether additionally it induces further investment or not, it should be noted that this modification does not eliminate the main problem implicit in income tax, which relates to the "double taxation" affecting income from

savings and investment. In fact, postponing tax payment does not mean that the tax liability is eliminated. However, although this procedure does not eliminate the bias against investment inherent in the tax system, there is an indirect incentive favoring it. Indeed, the incentive to firms' capitalization arises precisely because the company has access to a cheaper source of funds. And this does not only imply modifying the financial structure of the company, for the lower cost of funds allows financing a series of projects that would not be profitable if they were to be funded through borrowing, and which by virtue of the modification may give a positive return. Consequently, via this indirect effect it is possible to speak of an incentive to investment.

In a system where a tax on income from savings and investment exists —such as that contemplated by the new income tax law—, direct incentives to saving and investment only occurs when taxpayers are able to deduct from their tax base the portion of income allotted to these activities. In this sense, the changes made at the level of personal taxation, as regards being able to deduct from the tax base a certain percentage of the amounts invested in specific instruments, undoubtedly constitutes a step in the right direction. However, one cannot expect to achieve much in this way, given the upper limit and the restrictions imposed on the use of the provision. What should be clearly understood is that the problem of “double taxation” mentioned in earlier paragraphs will be attenuated only insofar as such mechanisms are more widely used. Therefore, any innovation introduced in future to solve this problem in direct taxation, should contemplate an improvement of the mechanism regulating the deductions permitted from the tax base.

## **VI Summary and Conclusions**

The changes made to the country's tax legislation from 1974 onward have constituted significant progress in the attempt to consolidate an economic system based on actions undertaken by the private sector.

The tax structure operating in 1974 had serious problems in the areas of efficiency and equity. As regards the former, the tax structure distorted the price system, providing signals that operated against an efficient allocation of resources. With respect to equity, the wide range of exemptions and allowances hampered any effort to establish a progressive tax structure.

Against this background, the reforms encompassed both areas, and related to both direct and indirect taxation.

In direct taxation, one of the major innovations was the incorporation of a mechanism of monetary correction, so that the determination of the tax base and the amount payable by the taxpayers —individuals and firms— would be expressed in currency of constant purchasing power. In the particular case of corporate taxation, the following additional changes were made: (i) various activities were brought inside the general system —activities which, by virtue of different legal provisions, were subject to a preferential tax treatment instead of income tax; (ii) within the framework of the general system all sectors were subject to the same rate; and (iii) the general regulations incorporated activities benefiting from special tax allowances or tax exemption, such as state-owned enterprises. In the case of personal taxation, the amendments were aimed at concentrating all income on one base, irrespective of its source, so that a progressive tax scale would be applied on a uniform base for all taxpayers. Simultaneously, a new rate scale was established which included reductions compatible with the lower tax burden desired for the private sector, and which at the same time were targeted on the sectors with lowest relative income.

On matters of indirect taxation, the most significant reform was the introduction of Value Added Tax (VAT). This mechanism eliminated the distortions generated by the cumulative effect implicit in the sales tax system, which encouraged the vertical integration of companies and artificially distorted the price relations between the different goods.

As regards development laws, although according to the general principles all sectors and regions were to be treated equally, it was established that whenever a given region was to be given special preference, the corresponding legislation should apply to every activity undertaken in that region, without discrimination. Likewise, any allowance granted to a particular sector had to be independent of the region of the country in which the activity takes place. In this respect, it is worth noting the issuing of a decree granting allowances to the northernmost and southernmost regions in the country and the establishment of free zones.

In synthesis, the changes made in the 1974 tax reform can be divided in two parts. On the one hand, the structure designed corrected various distortions implicit in the previous scheme, thereby leading to a more efficient allocation of resources. On the other hand, there was a trend towards the gradual abolition of the various alternative regimes, with all sectors then being subject to the same general treatment. Notwithstanding the significant progress that this represented in the search for a more “neutral” system, it is important to point out that the problem of the tax system’s impact on saving and investment was not addressed during the decade 1974 -1983. This only



happened in January 1984, in a law introducing substantial amendments to income tax legislation.

Thus, the problem of “double taxation” of income from savings and investment was present throughout the period under study, and although the changes introduced in this respect are aimed in the right direction, they only represent a first step in the search for a non-discriminatory system in this respect. Innovations to be introduced in future in the area of direct taxation, which seek to solve this problem, must contemplate improving the mechanism that regulates the deductions allowed from the tax base.

### **Appendix N°1** **Sales Tax Surcharge**

Fancy goods	50%
Air conditioners	50%
Imported fabrics, cloth and yarns	50%
Imported clothing	50%
Jewelry, precious or artificial stones	50%
Imported mechanical toys	50%
Photograph and movie cameras	50%
Quality furs and yachts	50%
Binoculars and projectors	50%
Imported tapestries and carpets	50%
Fancy folding screens	50%
Collectors' stamps and coins	50%
Lace, brocade and tulle	50%
Gold, silver, platinum and ivory goods	50%
Playing cards	50%
Bars, pubs and canteens (consumption tax)	50%
Boites, cabarets and discotheques	50%
Sensitized film and plates	50%
Imported refrigerators	50%
 Stereo systems and others	 40%
 Chocolates, sweets, candy, etc.	 30%
Washings machines, dryers, blenders	30%
Refrigerators - of domestic manufacture	30%
Vacuum cleaners and polishers	30%
Electric shavers and radios	30%
Record players, cassette players and cassettes	30%
Amplifiers and recorded cassettes	30%
Restaurants and social clubs (consumption tax )	30%
Hotels and boarding houses	30%
Toiletries	30%
 Ice cream	 25%
Tapestries and carpets - of domestic manufacture	25%
Semi-precious stone goods	25%
Lighters, powder cases and cigarette cases	25%

Mechanical toys - of domestic manufacture	25%
Quality furniture	25%
Outboard motors	25%
Quality tableware and cutlery	25%
Albums for collections	25%
Glass, except flat and/or smooth surface glass	25%
Touring bicycles	25%
Watches	25%
Lawn mowers	25%
Outdoor furniture	25%
Domestic heating equipment	25%
Wallpaper	25%
Roofs for cars and terraces	25%
Car accessories and decorations	25%
Musical instruments	25%
Skiing gear	25%
Camping tents	25%
Fire arms	25%
Luminous advertisements	25%
Typewriters and calculators	25%
Acrylic and German silver goods	25%
Postcards and posters	25%
Houseplants	25%
Decorative barometers and thermometers	25%
Lace, brocade and tulle - domestic manufacture	25%
Embroidered fabrics, felts and velvet	25%
Phonograph discs	22%
Tyres - of domestic manufacture	21%
Shampoo, toothpaste and deodorants	15%
Paint	14%
Instant coffee	13.5%
Tinned meat and fish	13.5%
Matches	12%

Cement	10.33%
Consumption in pubs and restaurants	10%
Consumption in tea- or coffee-houses	10%
Consumption in boarding houses	10%
Art books	10%
Works of art by foreign artists	8%
Domestic wines	26%
Beer	46%
Non-alcoholic beverages and mineral water	35%
Pisco	39%
Liqueurs	45%
Bottled gas (sales tax surcharge to consumers)	27%
Television sets	23%
Second-hand motor vehicles	10%

## Appendix N° 2

### Exemptions from Sales Tax

Law N° 12,120<sup>42</sup>

- Nitrate, iodine, salt and drinking water
- Fresh or frozen meat, including whale meat, cattle, poultry, ham, cured meats, sausages, bran, firewood, wheat, maize , oats, beans, lentils, chick peas, peas, rice, potatoes, beet, sacharine, «chuchoca» (toasted and pounded corn), maté, onions, garlic, charcoal, cereal and legume flour.
- Fish, shortening, lard, cornflour, potato starch, meat pies and sugar, when these products are used for human consumption; vegetable salad or cooking oil and oleaginous seeds used in their production.
- Eggs, pasta, semolina, bread, milk— either natural, dehydrated, condensed, evaporated or powder— and products for feeding infants, butter, cheese and cottage cheese.
- Shellfish and edible sea algae, in their natural state, with the exception of lobster, sea urchin, oysters and king-crab

---

<sup>42</sup> Heading II, Clause 22°.

- Fresh and dehydrated fruit, fresh green-leafed vegetables
- Candles, soap and similar products for washing clothes, brooms and scrubbing brushes used for this purpose.
- Medicinal drugs, and antibiotics, cotton wool, gauze and surgical adhesive tape, for medicinal purposes: thermometers, bandages, syringes and needles for injections.
- Export products and any sale or purchase of copper carried out by the copper industry for the export of manufactured copper.
- School exercise and texts; books, newspapers and magazines for reading, and the sale of water-marked writing paper.
- Cigars, cigarettes and processed tobacco, which only pay tax on sales to consumers.
- Radio and television appliances, spare parts and equipment purchased by the licensees solely for their broadcasting stations.
- Every sort of transaction of foodstuffs taking place in open air markets including food provided to staff at their places of work (industry or commerce) during the working day, and in any place within the premises.
- Transactions taking place in fetes and events carried out by charity organizations.
- Sales made by the the Social Security Service to its affiliates, as well as sales by welfare organizations to workers who receive family allowances through such institutions.
- Sales to distributors by manufacturers with assembly plants in the country, of goods assembled in such plants.
- The first transfer of wine made by producers south of Ñuble, provided such wine has not been produced with grapes or wines purchased from third parties.

**Other Exemptions not Included in  
the text of Law N° 12,120<sup>43</sup>**

- Purchases and sales by commercial airlines, when disposing of or repairing physical assets
- Sale of physical assest between enterprises that make use of industrial complementation allowances.

---

<sup>43</sup> Extract of the document «*Reforma Tributaria*», Ministry of Finance, 1977, Section IV.

- Sales and purchases of minerals by the National Mining Company, and sales of gold by this company to the Chilean Central Bank.
- Small-scale industry in the provinces of Aysen, Chiloé and Magallanes, the departments of Pisagua and Iquique, and the locality of Pomaire.
- Activities related to the fishing industry (extraction, fishing, hunting, freezing, etc., of organisms for which water is the natural habitat; construction and maintenance of fishing boats/ships, etc.,)
- Purchase of gasoline by the nitrate industry, for purposes of transporting saltpeter, iodine and subproducts.
- Activities related to the small- and medium-scale mining industry.
- Rural hostels.
- Purchase of physical assets by Savings and Loan Associations for their own use and consumption.
- Sales made by the Central Bank of Chile and by the *Banco del Estado de Chile*.
- Purchases of works of art by commercial banks, for the decoration of their premises or for purposes of exhibiting them in State museums.
- Sales by: Corporación Andina de Fomento, Corporación de Construcciones Deportivas, Corporación de Desarrollo de Atacama y Coquimbo, Corporación de Desarrollo de Valparaíso y Aconcagua, Corporación Financiera Internacional, Corporación de Televisión de la Universidad de Chile, Dirección de Aeronáutica, Dirección General de Aguas, Dirección General de Deportes y Recreación, Dirección General del Metro, Dirección General de Obras Públicas, Empresa Marítima del Estado, Empresa Nacional de Riego, Empresa Portuaria de Chile, Famae, Junta de Adelanto de Arica, Junta Nacional de Jardines Infantiles, Línea Aérea Nacional, Universidad de Chile, Universidad Técnica del Estado, Instituto de Desarrollo Agropecuario, Servicio de Aduanas.
- Purchases by: Corporación de Magallanes, Ferrocarriles del Estado, Instituto Corfo de Aysén, Chiloé and Magallanes, Instituto de Desarrollo Indígena, Junta de Desarrollo Industrial del Bio-bío, Malleco and Cautín, Junta Nacional de Auxilio Escolar y Becas, Municipalidades, Obras Voto Nacional O'Higgins, Cuerpo de Bomberos.
- Purchases and sales by: Caja Central de Ahorro y Préstamos, Corporación Vecinal de Alcantarillado de Punta Arenas, Fundación de Viviendas y Asistencia Social, Ministerio de la Vivienda, Ropero del Pueblo, Servicio de Agua Potable de «El Canelo».

### Appendix N° 3

#### Sectoral Tax Exemptions and Allowances Contained in the Previous Legislation<sup>44</sup>

##### Totally Exempt from Tax

- Publicly-owned agricultural institutions
- Agrarian Reform Corporation (Cora)
- National Mining Company (Enami)
- National Petroleum Company (Enap)
- Housing construction corporation (Corvi)
- Publicly-owned housing construction institutions
- State Public Transport Company
- State Railroad Company (Ferrocarriles del Estado)
- Publicly-owned shipping companies
- National Airline
- Central Bank of Chile
- National Bank (*Banco del Estado de Chile*)
- Savings and Loan Association
- National Association for School Assistance and Scholarships (Junta Nacional de Auxilio Escolar y Becas)

##### First Category Tax Exemption

- Man-made plantations
- Natural forests
- Tree plantations for industries
- Natural and juridical persons working in fishing activities
- Mining companies associated with the «Corporación de Ventas de Salitre y Yodo»
- Small-scale mining companies
- Coal mining companies planning to implement improvements
- Chilean companies manufacturing iron and steel.

---

<sup>44</sup> Extract from the document «*Recopilación de Estatutos Especiales y Legislación Tributaria de Fomento*», Volumes I and II, 1974, edited by the Internal Revenue Service. This Appendix contains only a brief summary for illustrative purposes. Tariff exemptions have not been included.

- Low-cost housing construction companies
- Low-cost dwellings
- Chilean investment corporations
- Development Bank (Banco de Fomento)
- Primary instruction corporations
- Sporting activities

#### First Category Tax Reduction

- Fishing industry processing marine products purchased from third parties
- Manufacturing industries in general<sup>45</sup>

#### Global Complementary Tax Exemption

- Man-made plantations
- Natural forests
- Tree plantations for industries
- Small-scale mining enterprises
- Low-cost dwellings

#### Property Tax Exemption and/or Reduction

- Man-made plantations
- Natural forests
- Tree plantations for industries
- Juridical persons working in fishing activities
- Agriculture in general
- Agricultural colonization
- Chilean companies manufacturing iron and steel
- Low-cost dwellings
- Primary instruction corporations
- Fire Brigade

---

<sup>45</sup> First category tax reduction was proportional to the increase in initial physical volume of production in firms with uninterrupted activities over the past five years. This allowance could only be claimed until the 1970 tax year. As can be seen, this regulation imposed a relative penalty on activities in which there was a decrease in demand.



## Death Duties and Gift Tax Exemptions

- Man-made plantations
- Natural forests
- Tree plantations for industries
- Corporations whose company object is the plantation of forests
- Agricultural colonization
- Low-cost housing construction companies
- Low-cost dwellings
- Operations undertaken by the Agrarian Reform Corporation (Cora)

## Appendix N°4

### Evolution of the Tax on Sales and Services from the 1974 Reform onward

#### 1. VAT Exemptions Contained in D.L.N° 825

##### *A Sales and other operations involving:*

- 1 Primary sector products derived from agriculture, animal husbandry, logging, hunting, fishing and mining, unprocessed.
- 2 Bread, milk, milk substitutes, drinking water, fruit, fresh green-leaved vegetables, potatoes, onions, garlic, wheat, maize, beans, lentils, chick peas, peas, rice, eggs, livestock, salt, broad beans, flour, meat, fish, seaweed, seafood, shellfish for human consumption (except oysters lobster, and king-crab), school exercise books and textbooks, books, newspapers, magazines for reading
- 3 Used motor vehicles; bottled gas obtained as a subproduct of oil and with the purpose of being mixed and distributed to consumers; gasoline, kerosene, diesel oil, fuel oil, oils and natural, mineral or synthetic grease.
- 4 Electric power and fuel gas
- 5 Goods subject to taxes stipulated by Law N° 11,741 on cigars, cigarettes and processed tobacco.

##### *B Goods imported for National Defense, and by the ECA (primary products)*

## 2. Special Taxes on Sales Conatined in D.L.N° 825

### A 20% Tax Surcharge on:

- Jewels and precious stones, gold, silver, platinum and ivory goods.
- Quality furs
- Works of art by foreign artists, produced abroad
- Air conditioning equipment not for industrial use.
- Photographic cameras, movie cameras and projectors
- Automatic washing machines, refrigerators with capacity over 9 cubic feet.
- Video and/or sound equipment, with a value exceeding 10 UTM
- Yachts
- Perfumes, cosmetics
- Spares for the above
- Non-alcoholic beverages
- Mineral waters to which flavouring and sweeteners are added.

### C Gasoline and other petroleum derivatives:

— Gasoline for cars, trucks and other vehicles	35.5%
— Kerosene	12%
— Diesel oil	21%
— Fuel petrol	14%
— Mineral oils and grease	22%
— Special fuels	24%

### D Irrespective of the above, a fixed rate tax on every litre of common or special gasoline

## 3. Tax on Services Contained in D.L. N° 825

### A 20% tax on income from:

- 1 Storage and custody of physical goods, except for goods intended for sale.

- 2 Leasing of personal property, furnished real estate, real estate with fittings, commercial establishments
- 3 Leasing of registered trade marks, patents, etc.
- 4 Construction of physical goods and real estate
- 5 Real estate brokerage and management, stock brokers.
- 6 Automobile parking lots
- 7 Services provided by advertising, tourist and employment agencies.
- 8 Banking services
- 9 Photographic services and photographic work in general
- 10 Services rendered by commission merchants, auctioneers and agents in general
- 11 Direct insurance
- 12 Telephone and cable services
- 13 Provision of electric power and fuel gas to consumers
- 14 In general, interest, premiums or other forms of remuneration received for providing services or business consultancies of a similar nature

*B A tax rate of 8% charged on:*

- 1 Repairing of physical goods.
- 2 Commercial laundries, beauty salons, tailor shops, swimming pools
- 3 Transport by: air, sea, river, lake and overland
- 4 Services associated with those mentioned above
- 5 Air transport services rendered by Chilean commercial air transport companies
- 6 All kinds of advertisement and propaganda
- 7 Fumigation services
- 8 Services inherent to the hospital business rendered in institutions that are not under the authority of the State nor belonging to State universities (nor recognized by the State).

*C The following services are exempt from this tax:*

- 1 Income from tickets for shows and paid entertainment events that are subject to other taxes.
- 2 Inward or outward freight
- 3 International travel tickets
- 4 Certain kinds of insurance premiums

- 5 Commissions earned by banks on loans granted
- 6 Inflows which constitute income according to clause 17°
- 7 Inserts or advertisements published in conformity with the right to challenge
- 8 Interest from financial operations and instruments
- 9 Real estate leasings
- 10 Services rendered by self-employed individuals working alone
- 11 Services rendered to sales people subject to VAT, related to the selection, analysis, transformation, elaboration, finishing and preparation of their products
- 12 Services rendered together with the sale of material goods, and which form part of the VAT tax base.
- 13 Earnings mentioned in articles 42 and 48 of the Income Tax Law

*D Enterprises and institutions exempt from service tax:*

- 1 Radio broadcasting stations and TV channel licensees, on income from their business
- 2 Press corporations (newspaper printing) and news agencies (sale of information services)
- 3 Home delivery of milk and bread
- 4 Urban, inter-urban and rural public transport companies, with respect to income from passenger transport
- 5 Education establishments (income from teaching)
- 6 Hospitals under the authority of the State or State-recognized universities
- 7 The following institutions, for services rendered to third parties: SSS, SNS, Sermena, FF.CC., Empremar, Casa de Moneda, Correos y Telégrafos (except for telex services), Telégrafo Comercial (except for telex services), Polla Chilena, Lotería de Concepción

#### **4. Principal Modifications Introduced in the Sales and Services Tax Legislation**

- 1975 Abolition of VAT exemption for primary sector products.
- 1976 Abolition of VAT exemption for bread, milk, drinking water
- 1977 Tax on services incorporated into the VAT system
- 1978 Fuels, electricity, telephone and cigarettes become subject to VAT

- 1979 Abolition of additional tax on photographic cameras, stereo systems, movie cameras, record players, and other equipment for the amplification, reproduction or recording of sound or images.  
Alcoholic Beverages Law becomes subject to the general tax law on sales and services
- 1980 Public entertainment events become subject to VAT. The tax on the transfer of used personal automobiles is reduced to 0.5%. □

