Volume 35 - Leveraging Peru's Economic Potential (2017)

Perspectives on Business and Economics

2017

Peruvian Tax Reform: Increasing Government Revenues and Social Equality

Kathyrn E. Bahner
Lehigh University

PERUVIAN TAX REFORM: INCREASING GOVERNMENT REVENUES AND SOCIAL EQUALITY

Kathryn E. Bahner

Introduction

Economic growth is necessary for any country to prosper. This growth stems from an economy becoming increasingly adept at producing goods and providing services, and it can be nominally measured through GDP. Over the past decade Peru has experienced a considerable increase in GDP, approximately 6 percent growth per year; however, the economy still has considerable room to grow (Ministry of Economy and Finance, 2016). The United Nations currently classifies countries into three categories based on a country's economic situation (United Nations Statistics Division). The categories are developing economies, economies in transition, and developed economies. Peru is currently considered a developing economy, which means that it is in the category of countries that are the least developed (United Nations Statistics Division). The Peruvian government needs to focus on increasing GDP growth to advance Peru from a developing economy to an economy in transition.

For the Peruvian economy to continue to grow, the government must raise more revenue for its underfunded sectors. In Peru, there are currently many sectors that are in direct need of additional funding: education, water and sanitation, healthcare, housing, and environmental protection. Providing additional funding to these sectors will improve the lives of the Peruvian people, allowing the country as a whole to become more productive. Because the government is not generating sufficient revenues to fund these sectors, not only is there a stunt in productivity growth but also gaps in social equality (defined as equal opportunities for all Peruvians, such as in education and healthcare) as well as in income and wealth equality.

There are three major ways in which the Peruvian government currently funds its operations: taxation, issuing public debt, and foreign direct investment. Generating higher revenues through taxation is more advantageous than issuing public debt because debt must eventually be paid off with additional interest. Furthermore, the funds used to pay off this debt will come from taxation revenues; therefore, a reformation of the tax system must come first.

In this article, I provide an overview of the current tax system in Peru. Then I analyze the effectiveness of the tax system and how the tax system affects social equality. Finally, I address the proposed legislation regarding tax reform and include my assessment of the proposal.

Overview of Government Revenues

The Peruvian government generates most of its revenues through taxation. In 2016 the projected overall government revenues for Peru were 124.2 billion soles (S/.) ($38.1 billion).[1] Taxation revenues make up 76 percent of government revenues. For 2016, the projected amount of taxation revenues was S/.94.6 billion ($29 billion). The Superintendencia Nacional de Administración Tributaria (SUNAT) is the government administrative body responsible for collecting national taxes. There are four taxes that make up 89 percent of the taxation revenues collected by SUNAT. These taxes are the income tax (both corporate and personal), the import tax, the value-added tax (VAT), and the excise tax. Figure 1 shows the projected distribution of taxation revenues for 2016.

As seen in Figure 1, the VAT generates the largest amount of taxation revenue, comprising 48 percent of total taxation revenues. The Peruvian government projected that in 2016 the VAT would generate S/.53.3 billion ($16.4 billion) of taxation revenue. The income tax, from both individuals and corporations, is projected to generate the second largest amount of taxation revenue (S/.37.6 billion [$11.5 billion]), which would be 34 percent of total taxation revenues. The import tax and the excise tax are projected to generate a smaller amount of revenues, with projected amounts of S/.1.68 billion ($520 million) and S/.5.97 billion ($1.83 million), respectively. These four taxes are imposed on Peruvians at the national level. There are also municipal taxes imposed on Peruvians based on an individual's or household's residence as well as a municipal property tax and a municipal vehicle tax (Ministry of Economy and Finance, 2013). This article focuses on taxes at the national level.

Non-tax revenues make up 24 percent of government revenues. Non-tax revenues are revenues the government receives that are not generated through taxation. Most of the non-tax revenues received by the Peruvian government come from social contributions, income from Peruvian government offices, and royalties from oil, gas, and mining. Social contributions are social security payments from employees and employers; they represent the largest amount of non-tax revenues, amounting to S/.12.7 billion ($3.9 billion) (Central Reserve Bank of Peru). Social security revenues are considered non-tax revenues because the money collected goes directly to a fund that is only used for social security purposes. That is, the government cannot access or use the funds for any other expenditure. Income from government offices consists of penalties and fines, licensing fees, and proceeds from the sale of government assets. From January to November of 2016, non-tax revenues totaled S/.22.9 billion ($7 billion).

Overview of Taxation Revenues

Income Tax

Both individuals and corporations are required to pay income tax in Peru. There are six categories of income subject to personal income tax. These categories are earned income (income earned from working for an employer); income from self-employment; trade or business partnership income; dividends; interest; and rental income ("Peru - Income Tax"). The personal income tax is based on "tax units" created each year by SUNAT. The tax units are restructured each year by SUNAT to account for certain factors, such as inflation. For example, in 2011, one tax unit was equivalent to S/.3,600 ($1,098), whereas in 2015 one tax unit was equivalent to S/.3,850 ($1,174) ("Peru: Thinking beyond Borders"). The personal income tax is a progressive tax.

The number of tax units assigned to each household or individual is determined by the

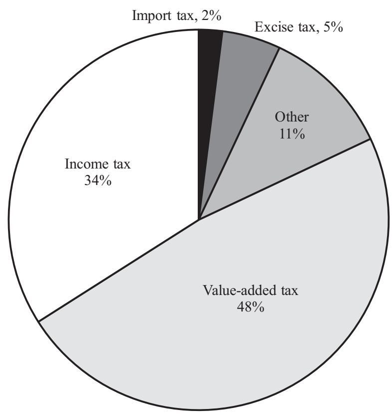
[1]Assuming an exchange rate of S/.1 = $0.31.

Table 1
Distribution of Peruvian Tax Brackets

Taxable Income	Applicable Tax Units	Applicable Tax Rate (%)	Marginal Increase in Tax Rate (%)
<$6,459	1–5	8	N/A
$6,459–$25,838	5–20	14	6
$25,838–$45,218	20–35	17	3
$45,218–$58,138	35–45	20	3
>$58,138	>45	30	10

Source: "Peru: Thinking beyond Borders."

Figure 1
Projected Sources of Taxation Revenues in Peru in 2016



Source: Ministry of Economy and Finance, 2013.

taxable income earned by the household or individual. There are currently five tax brackets that Peruvian citizens are subject to based on their number of tax units; the applicable tax rates range from 8 percent to 30 percent. Non-Peruvian residents who earn income in Peru are subject to a flat 30 percent tax rate on taxable income. Table 1 shows the current distribution of Peruvian tax brackets created by SUNAT along with the applicable income tax rates.

In addition to individuals and households, an income tax is imposed on corporations. The corporate income tax is structured as a flat tax, which means that the tax rate is the same for all corporations. Corporations can deduct all expenses that are related to the generation of the corporation's earnings. Gross income less these deductions is subject to a corporate income tax of 28 percent (De La Vega).

Investment Income and Capital Gains Tax

Investment income includes dividend income, interest income, and rental income. Investment income and capital gains are subject to different tax rates than earned income. The tax rate applied to dividend income is a flat rate based on whether the dividends were earned from a Peruvian source or a foreign source. Dividends earned from a Peruvian source are subject to a 4.1 percent tax rate, whereas dividends earned from a foreign source are subject to a 30 percent tax rate ("Peru - Income Tax"). Interest earned by corporations is subject to a 4.99 percent tax rate, whereas interest earned by individuals and small to medium-sized businesses is tax exempt ("Tax Guide: Peru 2014," p. 12). Owners of rental property are subject to a tax imposed on rental income. The tax rate on rental income ranges from 6.00 percent to 6.25 percent based on the value of the property and the amount of rental income that is received. Capital gains that are less than or equal to the equivalent of five tax units are exempt from taxation. Any capital gains that are over the equivalent of five tax units are subject to regular income tax ("Peru - Income Tax").

Import Tax and Excise Tax

Both the import tax and the excise tax are indirect taxes. An indirect tax is a tax that is collected by an individual or organization other than the Peruvian government; the individual or organization then transfers the collected tax to the Peruvian government. There is currently a tax on all imports, which ranges from 0 percent to 15 percent based on the type of goods being imported. Imports are also subject to the VAT (De La Vega).

The excise tax is applied to specific goods with the intention to limit or lower their consumption. This indirect tax applies to such items as fuel, alcohol, cigarettes, and soft drinks. It is applied to either the import or the sale of these goods. Moreover, in contrast to the personal income tax, this type of tax typically is considered regressive because people with different income levels pay the same tax rate. The amount of excise tax imposed is based on an amount specific to the good, or on an ad valorem basis[2] ("2016 Asia Pacific Indirect Tax Country Guide"). Regarding taxation, an ad valorem basis is the levying of a tax on an item at a flat rate; thus, the applicable amount of tax is proportional to the value of the good.

[2]*Ad valorem* is Latin for "according to value."

Value-added Tax

The last major tax imposed on Peruvians is the VAT. Like the import and excise taxes, the VAT is an indirect tax. The VAT is imposed on specific goods and services each time value is added throughout the supply chain. Therefore, a single product has the potential to be taxed multiple times. The VAT in Peru is currently 16 percent; however, the VAT is always accompanied by a 2 percent municipal promotion tax. Thus, these two taxes, applied together, are levied at a total rate of 18 percent ("2016 Asia Pacific Indirect Tax Country Guide"). The VAT is imposed on five types of transactions: the sale of goods within Peruvian territory; services performed or used in Peru; construction contracts executed in Peru; real property sales made by the contractors; and the importation of goods ("Tax Guide: Peru 2014"). The VAT is considered a regressive tax. It is not applied to the export of goods.

Mining Royalties and the Special Mining Tax

In addition to the taxes discussed previously, mining companies are required to pay both mining royalties and a "special mining tax" to the Peruvian government. In 2011, President Ollanta Humala revised the method formerly used to determine mining royalties and created the special mining tax. These reforms resulted in an increase in government revenues of nearly $1.1 billion per year. The amount of the special mining tax levied against a mining corporation is computed on a quarterly basis based on a corporation's operating gross margin. The special mining tax is deductible for corporate income tax purposes and is levied at a range between 2 percent and 8.4 percent of operating income ("Tax Guide: Peru 2014").

Royalty payments are payments made by a licensee to a licensor while the licensee is using the licensor's asset or assets. The Peruvian government receives mining royalties when the government leases land to companies who perform mining operations on that land (Otto et al.). Prior to the 2011 revision, mining royalties were levied on sales at a rate ranging from 1 percent to 3 percent. After President

Humala's reform, mining companies now pay royalties based on their operating profits rather than sales and at a rate that ranges from 1 percent to 12 percent (Pantigoso et al.).

Effects of Tax Evasion

Income Tax Evasion

A major problem with the current tax system in Peru is tax evasion. This is due primarily to the large informal sector in Peru. The informal sector is defined as the percentage of Peruvians who are not registered with the government for employment purposes. Approximately 75 percent of all people living in Peru are part of the informal sector and do not pay income tax. The Peruvian government estimates that more than 50 percent of income tax that should be reported is evaded (Ministry of Economy and Finance, 2013, p. 18). In 2016, the government was projected to collect S/.37.6 billion ($11.53 billion) in income tax. If all Peruvians were included in the formal sector and no income taxes were evaded, the government, in theory, could collect approximately S/.75.2 billion ($23 billion) more in income tax. Although eliminating the informal sector could increase taxation revenues by billions of soles, there is no quick solution to overcoming the problem of not registering for employment. The government is currently making efforts to decrease the size of the informal sector and is considering implementing repercussions for non-compliance.

On December 31, 2014, the Peruvian Congress passed a law revising the tax bracket criteria for the personal income tax. The new income tax structure retained the five brackets but changed the tax rate for the lowest bracket from 15 percent to 8 percent ("Peru: Thinking beyond Borders"). Congress made this revision as an attempt to decrease the size of the informal sector. The thinking behind this revision was that decreasing the tax rate of the lowest tax bracket from 15 percent to 8 percent would entice Peruvians in the informal sector to join the formal sector and start paying income tax. However, this effort to reduce the size of the informal sector was not successful. One reason for this is that Peruvians in the informal sector currently do not pay income tax at all; so even though their applicable tax rate was lowered, they still did not have the motivation to begin paying income taxes. Thus, the issue of non-compliance with employment registration persists.

Value-added Tax Evasion

VAT evasion has been an ongoing issue in Peru. There is no designated registry for businesses to register for the VAT; rather, businesses have an obligation to register with SUNAT in order to receive their taxpayer identification number ("2016 Asia Pacific Indirect Tax Country Guide"). The two primary ways that businesses evade the VAT are by failing to register with SUNAT or by failing to report and pay the proper amount of VAT after registering with SUNAT. Approximately 35 percent of VAT is evaded. While SUNAT encourages businesses to register to pay the VAT, there is no registry designated specifically for the administration of the VAT ("Peru: Thinking beyond Borders"). The Ministry of Economy and Finance anticipates that legislation will be enacted to further clarify the application of the VAT, which will then aid in the proper application and collection of the tax (Ministry of Economy and Finance, 2013).

Presidential Tax Reform

On April 10, 2016, Pedro Pablo Kuczynski was elected President of Peru as a representative of the Peruvians for Change party. As his party's name suggests, Kuczynski has proposed numerous changes, among them revisions to the taxation system. Kuczynski's reforms include lowering the VAT from 18 percent to 17 percent and raising the corporate income tax rate from 28 percent to 30 percent. These changes are based on the premise that, in general, corporations pay their corporate income tax. Given minimal tax evasion in the corporate sector, a 2-percentage-point increase in the corporate tax rate will directly increase revenue. Because there is significantly more evasion with the VAT, Kuczynski believes that lowering the VAT could encourage more people to register and pay this tax (Post).

Comparison of Peruvian Tax System with that of Chile

Peru's neighbor, Chile, implemented a successful tax reform in the 1990s that strengthened both socioeconomic equality and government revenues. The overarching goal of Chile's tax reform was to increase government revenues by $580 million per year for the years 1991 through 1993 (Boylan). The Chilean tax reform was successful for two main reasons: the reform was extremely moderate in nature, and the changes were fully disclosed to the public (Boylan). Chile's President, Patricio Aylwin, and the Chilean Congress enacted four tax reform laws in 1990. The reforms consisted of the following: an increase in the corporate income tax; a restructuring of tax brackets; a shift from the system of taxing estimated profits to actual profits for the highest contributors in the agriculture, transportation, and mining sectors; and, lastly, an increase in the VAT (Boylan).

There are both ideological similarities and differences between the Chilean tax reform in the 1990s and Peruvian President Kuczynski's proposed tax reform. Both countries determined that changes needed to be made in the VAT and the corporate income tax. However, Peru and Chile have taken different approaches to tax reform. Kuczynski proposes to lower the VAT from 18 percent to 17 percent, whereas the Chilean government increased the VAT from 16 percent to 18 percent (Boylan). Furthermore, the Chilean increase in the corporate income tax was more aggressive, with an increase from 10 percent to 15 percent, whereas Kuczyinski proposed a slight increase from 28 percent to 30 percent. Overall, Chile was more aggressive in demanding more taxes from corporations.

Socioeconomic Structure of Peru

The structure of a taxation system is a major determinant of the wealth gap within a country. Each year, the Ministry of Economy and Finance breaks down the socioeconomic structure of Peru and separates households into five socioeconomic classes. The classes range from class A to class E. Table 2 shows the distribution of the socioeconomic classes of Peru, how the distribution has changed from 2004 to 2014, and what analysts project it to be in 2021.

Class A is the highest, or upper, class; the middle class is a combination of class B, the consolidated middle class, and class C, the emerging middle class; class D is the emerging lower class; and class E is the lower-class poor. In 2004 class E consisted of 27 percent of households, and the middle class, classes B and C, consisted of 29 percent of households. In 2014, the size of class E decreased to include 18 percent of households, and classes B and C increased to include 44 percent of households (Ministry of Economic and Finance, 2016). The middle classes are increasing, while the lowest class is decreasing; therefore, the wealth gap is shrinking. I believe that the government must take further action to assist the movement of households from the lower classes to the middle classes. The government has the ability to do so by focusing on personal income tax reform.

Tax System Structural Ideologies and Their Effect on Social Equality

Tax systems may be structured in a liberal, moderate, or conservative manner. Liberal tax systems generally impose higher taxes. Furthermore, liberal tax systems impose proportionally higher tax rates on the wealthy while imposing lower tax rates on the less wealthy. More liberally structured tax systems not only increase government revenues but also increase social equality. The wealth gap slightly decreases when wealthier households are taxed at a higher rate than poorer households. This leads to greater social justice. A more liberal tax system is needed not only to raise taxation revenues but also to close the wealth gap and to attempt to provide equal opportunity for all citizens, especially those who are less fortunate. This is particularly true for a developing nation.

Proponents of a conservative tax system believe the government should receive lower revenues in general and that wealthier households should not be taxed at a rate that is significantly higher than the rate for the lower classes. There are cases in developed economies where a more conservative tax system can be effective. However, in a developing economy, such as Peru, a more liberal tax system can spur prosperity.

Table 2
Socioeconomic Structure of Peru (Percentage of Households)

	2004	2014	2021
Higher class (A)	<1	2	3
Consolidated middle class (B)	4	13	16
Emerging middle class (C)	25	31	36
Emerging lower class (D)	44	36	31
Lower-class poor (E)	27	18	14

Source: Ministry of Economy and Finance, 2016.

The Need for a Liberal Tax Structure in a Developing Economy: Chilean Tax Reform

The Chilean tax reform of the 1990s, discussed previously, is a prime example of how a liberal tax reform may be necessary for a developing economy. Of the $580 million increase in taxation revenues, $50 million was derived from the restructuring of income tax brackets (Boylan). It is important to note that this reform did not increase the applicable tax rate of any tax bracket; rather, it classified more households in the upper-income bracket that were previously in a lower bracket. Therefore, this part of the reform was considered liberal because the additional revenue was derived from those in the upper-income sector. The increase in the VAT was a reform that generated $200 million of additional tax revenue. This was neither a liberal nor a conservative reform, as the VAT is applied at a flat rate on all taxpayers. This was the most politically moderate adjustment to the Chilean tax system.

All in all, the Chilean reform represented a shift to a more liberal tax system, as the largest amount of new revenues was derived from corporations and a considerable portion of new revenues was derived from the upper-income sector. It may be more effective to tax corporations as opposed to individuals because corporations generally earn higher incomes. Furthermore, this type of liberal reform can lead to greater social equality.

Overall, the Chilean tax regime in the 1990s was socially liberal and helped decrease the wealth gap. Corporations and wealthy households paid approximately two-thirds of the new tax revenues generated by the reform (Boylan). Peru might consider implementing a similar type of liberal tax reform to both increase taxation revenues and social equality. For Peru to progress to a transition economy, the government needs to generate higher tax revenues and then use those funds to increase social spending. Increasing social spending will also allow the lower classes greater access to resources and technology and the opportunity to achieve higher levels of education. These will in turn increase social equality and decrease the wealth gap.

Peruvian Tax Reform

My suggestion for tax reform in Peru is to implement a more liberal taxation system that not only will increase government revenues but also be moderate in nature. A moderate reform is necessary because making extreme changes to Peruvian tax law in a short period of time could create unnecessary social tension.

Tax evasion in Peru occurs as a result of the size and existence of the informal sector. However, targeting tax evasion is not the most efficient way to increase government revenues. While I believe efforts to decrease tax evasion are still necessary, they should play only a minimal role in increasing government revenues. For the most part, wealthier individuals in Peru are not evading taxes; rather, they work for corporations, which require their employees to file tax returns. On the other hand, most of the informal sector is made up of the poorest people in Peru. Fighting tax evasion will effectively raise taxes on those with lower incomes, which, in turn, will decrease social equality.

I support President Kuczynski's proposal to increase the corporate income tax from 28 percent to 30 percent. The 2-percentage-point increase is reasonable, because it will effectively increase the country's corporate income tax revenue at a rate that is not overly aggressive. Also, I believe it is wise to accompany the increase in the corporate income tax with a decrease in the VAT. Although Kuczynski gives as the reason for this reduction encouraging more people to register and pay this tax (Post), in my opinion the reduction is beneficial because this type of tax also disproportionately impacts classes D and E, the classes most in need of assistance. Not only is this tax reform more moderate by increasing one tax while decreasing another but also it increases social equality by minimizing the societal impact of a regressive form of taxation.

In addition to Kuczynski's tax adjustments, I would recommend that the Peruvian government create an additional tax bracket solely for the top 2 percent of households. The top 2 percent of Peruvians are the wealthiest households in Peru, and these citizens clearly have the means to pay additional income tax. I suggest that the applicable rate be 39 percent for this additional tax bracket. This 9-percentage-point increase in the tax rate would greatly increase government tax revenues as well as increase social equality. These additional revenues could then be reinvested in social spending, which would decrease the wealth gap even more.

In conclusion, tax reform in Peru can play an instrumental role in increasing government revenues and, in turn, stimulating the social sector. When Peruvians in the lower classes are provided funds for greater opportunities in such areas as education and healthcare, the Peruvian economy as a whole will gain the required resources to transition from a developing economy to a developed economy.

REFERENCES

"2016 Asia Pacific Indirect Tax Country Guide." KPMG International, Global Indirect Tax Services. 2016. assets.kpmg.com/content/dam/kpmg/pdf/2016/05/aspac-indirect-tax-guide-2016.pdf.

Boylan, Delia M. "Taxation and Transition: The Politics of the 1990 Chilean Tax Reform." *Latin American Research Review*. Vol. 31, No. 1, pp. 7–31. www.jstor.org/stable/pdf/2503846.pdf. Accessed February 5, 2017.

Central Reserve Bank of Peru. "Operations of the Non-Financial Public Sector: December 2016." Notas de Estudios del CRCP. No. 5. www.bcrp.gob.pe/docs/Publicaciones/Notas-Estudios/2016/nota-de-estudios-59-2016.pdf.

De La Vega, Javier. Personal interview with author, October 25, 2016.

Ministry of Economy and Finance. "Investor Presentation: Peru." February 2016. mef.gob.pe/contenidos/english/presentations/Peru_Investor_Presentation_20160218.pdf.

Ministry of Economy and Finance. "Multiannual Macro economic Framework 2014-2016." May 2013. mef.gob.pe/contenidos/english/bulletin/MMF_2014_2016.pdf.

Otto, James, Craig Andrews, Fred Cawood, Michael Doggett, Pietro Guj, Frank Stermole, John Stermole, and John Tilton. *Mining Royalties: A Global Study of Their Impact on Investors, Government, and Civil Society*. Washington, D.C.: World Bank, 2006.

Pantigoso, Paulo, Marco Antonio Zaldivar, Jorge Acosta, Beatriz Boza, Victor Burga, Marcial Garcia, Enrique Oliveros, and Elizabeth Rosado. "Peru's Mining & Metals Investment Guide 2014/2015." Ernst & Young. www.ey.com/Publication/vwLUAssets/EY-Peru-mining-metals-investment-guide-14-15/$FILE/EY-Peru-mining-and-metals-investment-guide-2014-2015.pdf.

"Peru - Income Tax." KPMG International. February 3, 2015. home.kpmg.com/xx/en/home/insights/2011/12/peru-income-tax.html.

"Peru: Thinking beyond Borders." KPMG International. June 8, 2016. home.kpmg.com/xx/en/home/insights/2014/04/peru-thinking-beyond-borders.html.

Post, Colin. "Peru Government to Battle Opposition Over Sales-Tax Reform." *Peru Reports*. November 11, 2016. /perureports.com/2016/11/11/peru-government-battle-opposition-sales-tax-reform/.

"Tax Guide:Peru 2014." Deloitte & Touche S.R.L. March 2014. www2.deloitte.com/content/dam/Deloitte/pe/Documents/tax/tax_guide%202014-rev.pdf.

United Nations Statistics Division. "Country Classification." World Economic Situation and Prospects.2014. www.un.org/en/development/desa/policy/wesp/wesp_current/2014wesp_country_classification.pdf.