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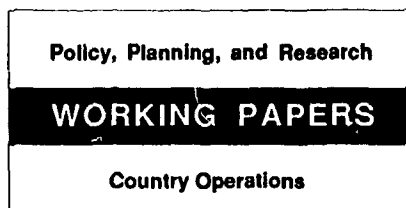
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Harmonizing Tax Policies in Central America

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Transforming the Central American Customs Union into a modern common market can be achieved only by reforming the tariff regime. Here is an action plan for rationalizing and harmonizing Central American tax structures.

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To harmonize tax policies among Central American nations, Baran recommends the following:

- Continuing trade liberalization, by reducing the level and dispersion of effective trade protection.
- Shifting the tax system from reliance on trade to reliance on domestic transactions and income.
- Making the value-added tax (cum selective consumption taxes) the backbone of the tax system, and harmonizing those taxes among the member countries of the Central American Common Market (CACM).
- Improving tax administration
- Harmonizing taxes on inputs and exempting nontraditional exporters from paying import duties.
- Moving toward coordinating taxes on factor incomes (personal and corporate income, property and land taxes, and taxes on financial gains) to avoid double taxation.
- Eliminating all quantitative import restrictions, prior imports deposits, non-common import tariffs, and other restrictions on imports from other CACM members.
- Applying similar principles in designing export taxes on coffee and bananas.
- Not using differential exchange rates to discriminate against regional trade.

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I. INTRODUCTION

1. This report proposes an action plan for the rationalization of tax structures for Central America. The report also outlines broad principles to harmonize taxes among the Central American Common Market (CACM) member countries. For the purpose of this study, the CACM excludes Nicaragua (a member), but includes Honduras (a non-member). A separate study under progress in the Bank will undoubtedly analyze benefits and costs of integration and review conditions under which integration would be economic. This report assumes that harmonization is indeed economic. However, the report's main conclusions on the rationalization of tax systems in Central America would still be valid even if integration is found to be unsound. Furthermore, the report excludes Nicaragua from the analysis due to lack of information. This report does not deal with the issue of expenditure rationalization. Clearly, an introduction of a revenue-yielding tax package should only be considered if expenditures are efficiently spent and all low-priority programs are eliminated.

Background

2. Central American economies are very open, with exports and imports accounting for a substantial share of GDP compared to other countries at the same level of development. The resource endowments of each country in the Region are not as homogeneous as would appear based on a cursory examination. Land/population ratio, for example, is more favorable in Honduras compared to El Salvador. Forest resources are relatively abundant in Honduras and in Costa Rica compared to El Salvador. Costa Rica's literacy rate is the highest in the Region, and hence its workforce is better educated. However, literacy rates in other countries are low compared to most other Latin American countries. On the other hand, all countries have a comparative advantage in traditional agriculture, although each country has a different combination of traditional products (i.e. coffee, bananas, sugar, cotton, and cocoa etc).

3. The degree of resource mobilization in the Region is inadequate, with low tax to GDP ratios (with the exception of Costa Rica) compared to countries at similar GDP per capita levels. Tax systems are rudimentary. Financial disequilibrium of the public sectors is the norm, as evidenced by large--although declining--public sector deficits and domestic financing of those deficits, leading to domestic inflationary pressures. Furthermore, in all the countries in Central America, the elasticity of the tax system is low. As a result, growth in tax revenues has lagged behind that of income and GDP in the recent past.

II. INTEGRATION ISSUES

A. Economic Integration

4. The objective of harmonization of tax systems is to facilitate economic integration among countries joining a common market. As explained

below, there are essentially five different forms of economic integration. CACM fits into the definition of a customs union (ii below) rather than a common market (iii below). Economic integration is intended to expand trade among member countries as well as to encourage deeper industrialization by permitting the utilization of scale economies in production. The following is a description of different forms of integration:

- (i) Free Trade Area: Tariffs are abolished among member countries, but each country retains its tariffs on imports from non-member countries.
- (ii) Customs Union: In addition to abolishing tariffs on trade among member countries as in (i) above, countries also adopt a common external tariff for imports from non-member countries.
- (iii) Common Market: Common market is based on a free trade among member countries and a common external tariff for imports from non-member countries as in (ii) above plus a free movement of factors of production (i.e. labor and capital).
- (iv) Economic Union: In addition to free trade and free movement of factors of production among the member countries as well as a common external tariff (iii above), member countries harmonize economic policies (a la COMECON). In particular, fiscal, monetary and exchange rate policies are closely coordinated and harmonized among the member countries.
- (v) Total Economic Integration: In addition to having all the attributes of an economic union, total economic integration requires an establishment of a supernational authority, which determines economic policies for all the member countries. Decisions of this entity would be binding on all countries.

5. Integration among various countries is prevalent in the world today. The Central American Common Market (CACM) is one of several such integration efforts. Other integration efforts include: European Economic Community (EEC); the Committee on Mutual Economic Assistance (COMECON) for the Centrally Planned Economies in Eastern Europe; European Free Trade Association for north European nations; the Latin American Free Trade Association and the Andean Group for South American countries; the Caribbean Community; the free-trade agreement between the United States and Israel; the Association of South East Asia Nations (ASEAN) that seeks free trade among the six nations of that region; the recently concluded free-trade agreements between Australia and New Zealand, and between the U.S.A. and Canada.

B. CACM (Central American Common Market)

6. Based on the premise that the strategy of autarky is not a viable development option, the five countries in Central America established a Customs Union in 1960. Integration helped accelerate the industrialization of the Region. However, industrialization did not go beyond the easy stage of consumer goods production (i.e. mostly food and textiles). The trade diversion that this integration caused also led to a welfare loss, as the prices of most import-substitutes were higher than their international equivalents. After the mid-1970s, the Customs Union lost its dynamism, with Honduras leaving, following a war with El Salvador. The sharp increase in intra-regional trade in the early 1980s resulted from heavy purchases by Nicaragua to rebuild its internal war-damaged economy. But the expansion in trade proved unsustainable as Nicaragua could not pay all its debts to other CACM members. As a result, the CACM member countries sharply reduced their trade with Nicaragua. Coupled with the fall in GDP per capita in the Region, the accumulated unpaid Nicaraguan debt to other member countries led to a reduction in intra-regional trade after 1983. As a result, intra-regional trade, after peaking at US\$1.1 billion in 1980, fell to US\$757 million in 1983.

7. The present challenge confronting the policymakers in Central America is to transform the Union to a modern common market. This could only be achieved through a strong reform of the tariff regime. This report describes an action plan to achieve this objective. It does not analyze political feasibility of the recommended actions, and assumes that they are feasible. It is important to note, however, that at this juncture, options to grow out of the present macroeconomic problems are limited and hence the timely introduction of reforms is vital to regain high growth rates recorded by the countries in the Region in the past.

8. Given that the economic costs of implementing an import-substitution strategy are higher the smaller the size of a country, CACM attempted to implement this strategy on a regional basis. However, the enlarged regional market proved to be too small for most products, given the larger economies of scale needed for economic operations. Hence, the integration of the regional economies to the world economy is essential for ensuring the viability of the customs Union. This requires that Union members accelerate the process underway in reducing the level and dispersion of effective protection.

9. The Customs Union appears to be in disarray. First, Honduras pulled out from the Union, following its war with El Salvador in 1967 and did not join the Union thereafter, conducting its trade with other CACM members through bilateral treaties. Second, following the 1979 revolution, Nicaragua shifted to a centrally-managed economy, therefore, tariffs became irrelevant for protection purposes in Nicaragua. Also, financial difficulties faced by Nicaragua resulted in a large increase in arrears on its regional trade with other countries in the Customs Union. Third, El Salvador has been going through a difficult period of internal warfare, with a consequent adverse impact on production, investment and on its balance of payments. These factors coupled with the unresolved issue of ensuring equitable distribution of costs and benefits from integration among the member countries have resulted in a weakened Customs Union.

10. To achieve a smooth functioning of trade within a common market with partners of unequal wealth and productive capacity, a number of conditions need to be fulfilled. First, the impact of trade creation should outweigh that of trade diversion. Second, related to the first point, large trade imbalances among member countries may not be sustainable over long periods of time and countries should take measures to reduce them to sustainable levels (i.e. through deflationary domestic policies and appropriate use of the exchange rate). Third, indirect taxes on domestic transactions should be harmonized among the member countries to ensure that these taxes are not used to counterbalance or negate the commonality of the external tariff. Fourth, having a common external tariff implies that all tariffs on imports should be the same for all member countries. Fifth, common external tariffs should cover all product categories and quantitative import restrictions should be phased out. Sixth, harmonization of national policies is also an essential ingredient in the successful functioning of a common market. Specifically, harmonization of fiscal and monetary policies and management of the exchange rate are essential. Otherwise, with widely varying exchange rate and domestic policies, countries may opt to use tariffs as an instrument to achieve their domestic objectives. For example, expansionary domestic policies under a fixed exchange rate regime could lead to the distortionary use of tariffs to protect the balance of payments. For example, Costa Rica heightened existing surcharges and established new ones on imports in the early 1980s to protect its balance of payments as expansionary domestic policies under the fixed exchange rate regime led to an overvaluation of its currency as domestic inflation accelerated. Seventh, for the common market to be successful, all members, including the relatively weaker ones should be given incentives to stay within the common market. Hence, countries with higher levels of wealth and productive capacity should help countries with more limited levels of wealth and productive capacity. Eighth, there has to be a legal framework to monitor the functioning of the common market. Lastly, Governments should accept the fact that membership in a common market implies foregoing part of their power of unilaterally determining domestic policies.

11. The creation of the CACM gave rise to a number of important structural changes. First, it led to a large increase in the share of industry in GDP. For most of the 1960s and 1970s, the growth of industry outstripped GDP growth by a wide margin, while agriculture grew slower than overall GDP. Growth of industry was also facilitated by the expansion in manufactured exports mostly to the regional market. As a result, trade within the CACM--mostly manufactured goods--grew rapidly. These developments also led to a structural shift in the composition of imports, with intermediate and capital goods imports increasing and final consumer goods imports decreasing. The openness of economies in Central America rose, paralleling the expansion in exports to CACM and in imports of intermediate and capital goods.

12. There is a need to review the extent to which the creation of CACM led to trade creation and/or trade diversion. On an apriori basis, it could be assumed that trade was diverted in final consumer goods, while it was created for intermediate and capital goods for the Region as a whole.

13. The agricultural sectors in the Region face a number of issues. coffee and bananas are the most important commodities in export agriculture in virtually all the countries in the Region. Coffee exports are regulated under the International Coffee Agreement. Stagnation in world demand kept production increases to low levels despite yield improvements in coffee. In fact, Costa Rica's yields are one of the highest in the world. Cyclical changes in coffee prices exerted an important impact on money incomes. The large increase in coffee prices during 1976-77 and in 1986 provided large windfall foreign exchange revenues. Banana exports, however, grew very slowly. Because of labor problems and increases in transport costs, one international banana company left Costa Rica. Other traditional products, such as cotton, sugar, and cocoa faced difficulties as a result of reduced international prices, increases in costs and management problems. Overall, the performance of export agriculture has been mixed. On the other hand, basic grains production increased, benefiting from quantitative import restrictions and generous price and interest rate subsidies and credit allocation schemes, which favored basic grains production such as in Costa Rica. In particular, rice production grew substantially because of yield improvements based on new technology. However, since basic grains production is high-cost in the Region, rice had to be exported at a loss, subsidized by the public sector as in the case of Costa Rica. As a result, the increase in basic grains production was obtained at substantial economic and fiscal costs.

C. Review of Experience In Central America

14. The experience in Central America as outlined above did not respond to the requirements for a well-functioning common market. First, the trade diversion effect appears to have dominated trade creation. There have been some calculations on trade creation and trade diversion by Mr. Larry Wilmore. These calculations confirm that trade diversion dominated trade creation in the CACM. This has had significant implications for countries which have a relatively undeveloped productive capacity for exports. For example, within the common market, Honduras would import a large share of its requirements for final consumer goods from other Common Market member countries at prices higher than international prices, leading to a net loss of foreign exchange on its balance of payments. For a country like Honduras with a large disequilibrium in its balance of payments, this presents a serious problem. However, it is difficult to quantify the exact trade diversion and creation effects with any degree of precision without undertaking a serious study.

15. Second, large imbalances have occurred among the CACM member countries in their trade with each other since 1980. For example, by year end-1986, Costa Rica's creditor balances with other countries amounted to over US\$350 million. A large part of this imbalance in trade resulted from Nicaragua's lack of payments for its net debtor balances. Nicaragua stepped up its imports from other CACM member countries in 1980-81, following destruction of some of its productive capacity after the 1979 revolution. However, since the country ran into balance of payments problems, it has accumulated large arrears with the rest of the CACM member countries, and could not sustain the same level of demand.

16. Third, member countries resorted to establishing different rates for domestic transaction taxes on goods imported from other CACM members compared to non-member countries. Differential rates of consumption taxes were used to raise protection over and above those provided by import tariffs and surcharges.

17. Fourth, member countries also established additional charges on imports--which are not applied uniformly by all member countries. These charges were sometimes applied to imports from other CACM member countries. The imposition of these additional charges on imports implied the break-up of the common external tariff for most products: it assigned different nominal and hence effective protection rates to various industries in each member country and violated the principle of free trade among the member countries. Furthermore, some countries also used the exchange rate as a tool for protection against imports from other CACM members.

18. Fifth, some product categories were excluded from the common external tariff, leading to a weakening of the customs union's instruments. For example, trade in basic grains was regulated in each country through the implementation of quantitative import restrictions and importation by a public sector marketing agency. This arrangement effectively ruled out the use of a common external tariff on agricultural products. Furthermore, member countries excluded some final consumer goods from the common external tariff, and assigned higher tariff rates for these products as discussed in the section on import tariffs. The intention of the authorities in the Region is to reach an agreement quickly on common rates for these products. Given the importance of these products in domestic production (i.e. they account for about one-third to one-fourth of domestic production in Costa Rica), this exclusion clearly weakens the customs Union. Given that most of these products are not competitive, this exclusion and the increased nominal rates reversed some of the benefits of the tariff reform.

19. Sixth, although an effort has been made in the past to coordinate national economic policies, no concrete result has yet been obtained on overall policy coordination, with countries following divergent monetary, fiscal and exchange rate policies. Clearly, those policies reflect not only policymakers' divergent objectives, but they also show diverse social, political and economic conditions in each country. For example, given the political difficulties in raising revenues, Guatemala has generally preferred to follow contractionary domestic policies by cutting expenditures to confront short-term financial difficulties in the recent past. Costa Rica, on the other hand, has opted to increase revenues for the same purpose. Furthermore, management of the exchange rate has not been coordinated among member countries. Frequent changes in exchange rate management coupled with the development of parallel markets has made policy coordination difficult.

20. Seventh, to speed up development in the Region and, particularly, to help Honduras (the country perceived not to benefit from integration in the Customs Union) a Regional Development Bank, CABEI, was established. But, financial difficulties did not permit CABEI to play the role envisaged for it since its inception. A study underway in the World Bank for CABEI would presumably propose a plan of action to help promote an equitable distribution of the development effort in the Region.

21. Eighth, no legal body was created to monitor compliance with the rules of the Customs Union. Lastly, each country preferred to set its own domestic policies, sometimes at cross purposes with the policies of the rest of the member countries. The end result of all these policies has been a weakened Customs Union.

22. The following attributes are needed for a well-functioning common market:

- (i) The net effect of trade creation should outweigh trade diversion;
- (ii) large imbalances in intra-trade should be avoided through the use of appropriate domestic policy instruments as well as by the appropriate use of the exchange rate;
- (iii) indirect taxes on domestic transactions should be harmonized among member countries;
- (iv) all charges on imports, except the common external tariff, should be eliminated;
- (v) The CACM common external tariff should also cover agricultural products and should be the only means of import protection, while quantitative import restrictions should be phased out;
- (vi) All CACM countries should make an effort to coordinate their domestic policies and the management of their exchange rates;
- (vii) CABEI should be revitalized to help the development effort, especially for countries with weaker infrastructures;
- (viii) a legal framework for the functioning of the system has to be prepared and put into place to ensure compliance with the rules of the Common Market; and
- (ix) all countries should accept the fact that integration to a Common Market implies a partial surrender of their national sovereignty in determining domestic policies.

III. HARMONIZATION ISSUES

23. Harmonization of a tax system implies uniformity in taxes, bases and rates as well as compatibility in tax structures. Harmonization of taxes is an essential component of any common market. While uniformity of taxes is desirable in intercommodity relationships, this is not the case in inter-country relationships. As the example of the EEC indicates, a Common Market can function with different tax rates. In Central America, CACM member countries aimed at harmonizing only import tariffs and some fiscal incentives at the inception of the Common Market in 1960. Over time, member countries began to restrict regional trade as well, applying different tariff rates on some products traded with third countries through

the imposition of surcharges (i.e. Costa Rica). Within the context of the 1966 trade reform, member countries decided to set different rates for a selected group of commodities, diverging even further from the rule of the commonality of the import tariff rates among the member countries. Within this context, the recommendations of this report in advocating a deeper harmonization effort may seem far-fetched. Clearly, the aim of this report is not to analyze whether harmonization of tax systems in Central America would make sense. This topic would need to be addressed in a separate report.

24. General principles needed for the harmonization of tax policies in the Region include the following:

- (i) continuing trade liberalization already started through reducing the level and dispersion in effective protection;
- (ii) shifting reliance from trade to domestic transaction taxes;
- (iii) making the value added tax cum selective consumption taxes the backbone of the tax system and harmonizing those taxes among member countries;
- (iv) harmonizing taxes on inputs and exempting non-traditional exporters from the payment of import duties on inputs;
- (v) moving in the direction of coordinating taxes on factor incomes (i.e. personal income, corporate income, property and land taxes, taxes on financial gains) to avoid double taxation and the provision of competitive tax incentives among member countries and/or using factor income taxation to discriminate against nationals of other countries;
- (vi) eliminating export taxes on non-traditional exports outside the CACM;
- (vii) eliminating all quantitative import restrictions, prior import deposits, non-common import tariffs and other restrictions on imports from other CACM member countries;
- (viii) applying similar principles in designing export taxes to coffee and bananas;
- (ix) not using differential exchange rates to discriminate regional trade; and
- (x) improving tax administration.

A. Overview of tax systems in Central America

25. The tax systems in Central America face a number of issues. A large share of the taxes, which provides the bulk of Government revenues in the Region, is indirect leading to low elasticity of the tax system. Over half of the indirect taxes are on trade. Some taxes on trade discourage

exports. Large price fluctuations make the system highly vulnerable to exogenous shocks. Variability in receipts makes it difficult for the authorities to plan public expenditures. Most taxes have high rates, but narrow bases. Until recently, most excise taxes were also specific, leading to reduced collection as domestic inflation rose. In fact, domestic inflation has eroded collection from specific taxes dramatically in the last eight years. Furthermore, a large number of exemptions under most taxes are unnecessarily high and hence they reduce the taxable income base and necessitate higher rates on reduced bases. Another issue is the inefficient collection procedures which result in considerable losses of fiscal revenues. As there is a large discrepancy between statutory and effective tax systems, the tax collection effort in Central America leaves much to be desired.

26. There are other problems. First, the existence of a large number of nuisance taxes increases the cost of collection while not yielding much revenue. Second, there are a number of taxes on the same base, creating distortions and reducing the efficiency of tax administration. Third, some revenues are earmarked to be spent in predetermined ways for pre-determined agencies, reducing the flexibility in assigning budgetary resources. Fourth, frequent changes in the tax systems create uncertainty.

27. Some observations can be made base on an examination of changes in ratios of main categories of taxes as a share of GDP during 1982-87. First, two countries--Costa Rica and Honduras--raised their tax ratios during the period through increasing taxes on domestic transactions and introducing additional surcharges on imports. Second, the reliance on income taxes do not show any correlation with the levels of income. The poorest country in the Region, Honduras, collects three times as much revenue--as a share of GDP--from income taxes than Guatemala. Third, it is important to note the dismal impact of the tax reform introduced in Guatemala in 1983 on tax revenues. This underscores the need to ensure that any rationalization effort should respond to the need for generating sufficient levels of revenues. In fact, despite the coffee boom in 1986, tax revenues as a share of GDP in Guatemala were lower in 1986 than in 1982--a year before the introduction of the reform. Fourth, the substantial impact of coffee prices on tax revenues can be observed in El Salvador during 1986-87. As coffee prices declined in 1986, the drop in coffee revenues of about 3% of GDP caused the tax ratio to fall from 13.1% in 1986 to 9.7% in 1987.

28. Tax Ratios. Table I shows tax ratios (tax revenues/GDP) for all Central American countries for a few selected years. As the table indicates, rates range from 5.6% of GDP in Guatemala in 1984 to 16.2% in Costa Rica in 1985. In fact, tax ratios in Guatemala and El Salvador are two of the lowest in the Western Hemisphere.

29. As countries develop, tax bases grow more than proportionately than the growth of income. Other factors such as the level of urbanization facilitates tax collection. Hence, tax ratios should increase over time. It is important to note that each country in the Region feels pressure to raise different levels of revenues based on their levels of public expenditures, their possibilities of financing deficits as well as the

level of their non-tax revenues. Certainly, the upper limit of taxation could be considered to be that level beyond which taxation would tend to reduce economic growth. It is not possible to state when that ratio would be reached in Central America, but comparative ratios indicate that Guatemala and El Salvador could increase their tax ratios in a significant way without reaching that limit in the next couple of years.

Table I: Central America: Tax Ratios, 1983-86
(Tax Revenues/GDP)

| | 1983 | 1984 | 1985 | 1986 |
|-------------|------|------|------|------|
| Costa Rica | 15.9 | 15.7 | 16.2 | 14.0 |
| Honduras | 12.1 | 14.0 | 14.7 | 13.7 |
| El Salvador | 10.6 | 11.6 | 11.3 | 12.1 |
| Guatemala | 6.1 | 5.6 | 6.1 | 7.1 |

Source: IMF.

30. Various factors play an important role in determining the tax ratio: political willingness to raise revenues as a stabilization tool, the magnitude of the taxable base, the number of exemptions, forcefulness of tax administrations, the rate structure, changes in economic activity, the degree of urbanization, the level of monetization of the economy, per capita incomes, and the degree of openness of the economy. Given the diversity of the economies and differences in some of the above-noted variables--along with similarities such as inadequate tax administration in all the countries--the large range of the tax ratios in the Region is understandable. No effort is made in this report to explain the different tax ratios by changes in the above mentioned variables. It is important to note, however, that given the different degrees of the need for stabilization and development in each country, harmonization of taxes will likely lead to less than a smooth path of transition and it should be consistent with the different levels of tax ratios in each country.

B. Overall Recommendations to Reform the Tax Systems in Central America

31. This report suggests that the taxation systems in Central America should be restructured along the lines discussed below. First, there is a need for rationalizing tax systems by converting specific to ad-valorem base and phasing out exemptions--except for imported inputs used for non-traditional exports outside the CACM. Second, distortion costs should be minimized and taxation should be used to strengthen allocative efficiency by encouraging the growth of sectors in which Central American countries

have an apparent comparative advantage. The reliance of the tax systems should also be shifted from production to consumption-based taxes. Fourth, administrative costs should be reduced. Any revision in the tax system should aim at reducing collection costs as well as compliance costs for taxpayers. For example, it is not desirable to design complicated taxes, which would lead taxpayers to rearrange their financial affairs in such a way as to avoid payment of taxes. Hence, effective tax systems should be approximated to statutory systems. Fifth, changes should be designed to provide progressivity to the tax system in order to ensure vertical equity to the extent possible. Sixth, a large share of total tax revenue should be derived from few taxes and tax rates. Seventh, structural rigidities in tax systems, such as the practice of earmarking of revenues for particular uses or groups, should be phased out. Lastly, frequent changes in the tax system should be avoided.

32. As discussed earlier in the report, tax ratios, with the exception of Costa Rica, are low in the Region. Two obvious options to increase the ratio would be to improve collection and phase out most exemptions. Furthermore, there is scope for increasing revenues on imports and consumption. Through these efforts, taxable income could be approximated to its potential base. However, it is important to note that tax increases should not be recommended unless there are worthy expenditures. Otherwise, the supply side effects of higher taxes may have a welfare cost that exceeds the welfare gains of higher expenditures.

33. Regarding minimizing distortions, the most significant issue relates to trade taxes as discussed in the rest of this report. Particularly, a reduction in effective protection through further tariff reform is discussed. A decrease in exemptions and deductions is also needed to avoid applying higher rates on the remaining lowered bases. Furthermore, shifting the reliance from production to consumption taxes will be needed to decrease disincentives to work and reduce variability in receipts. Lastly, payroll taxes need to be minimized to avoid discouraging employment and output. Efficiency, on the other hand, could be encouraged by low marginal tax rates.

34. Overall objectives of a taxation system. Any action plan to rationalize the tax systems in the Region should aim at the following:

- (i) generating adequate government revenues;
- (ii) minimizing adverse effects on incentives and distortions and encouraging resource allocation based on comparative advantage;
- (iii) encouraging efficiency, output and employment growth as well as savings; and
- (iv) reducing variability in collection to provide better programming of expenditures and to avoid a sharp increase in public sector deficits when terms of trade worsen.

C. Structure of Taxes

1. Indirect Taxes.

1.1. Taxes on International Trade

35. Empirical investigations show that taxes on foreign trade account for 5.6% of GDP and over one-third of total tax revenues in developing countries. In fact, import duties comprise the most important taxable base in developing countries, given that they do not require a very sophisticated tax administration. In open economies, such as those in Central America, the significance of taxes on foreign trade is larger (Table II). However, the significance of taxes on trade should decline over time as the share of taxes collected on domestic transactions in GDP increases.

Table II: Share of Taxes on International Trade
in Total Central Government Revenues, 1975, 80, 84
(%)

| | 1975 | 1980 | 1984 |
|---------------------------------|------|------|------|
| World | 4.8 | 5.1 | 4.4 |
| Industrial Countries | 1.8 | 1.5 | 1.4 |
| Developing Countries | 14.1 | 16.1 | 14.0 |
| Non-Oil Developing Countries | 15.5 | 17.4 | 14.6 |
| LAC | 10.8 | 14.4 | 8.3 |
| Asia | 19.5 | 20.1 | 20.1 |

Source: IMF, UNDP.

1.1.1. Import Tariffs

36. Empirical investigations show that import duties contribute about 4.5% of GDP and over one-fourth of total tax revenues in developing countries, although there is considerable variation in their relative importance among the countries. It is also a known fact that all the great users of taxes on imports make little use of taxes on domestic transactions and conversely virtually all the great users of domestic transaction taxes on goods and services make little use of import duties.

37. Import tariffs are used mostly to generate revenue. But those taxes are also utilized to provide protection to domestic industries, reduce imports and discourage consumption.

38. In open economies, high tariff protection could result in the misallocation of resources in the economy. Resources could move into

sectors in which countries do not have a comparative advantage. Furthermore, during balance of payments crises, tariffs could also be used as a substitute for devaluation and hence help postpone needed adjustment efforts.

39. The CACM framework establishes the import tariff regime. This framework consists of a Common External Tariff (CET) on imports from countries outside the CACM, while exempting import duties for regional trade. The rate structure is complex and is based on the principle of made-to-measure protection by assigning higher nominal rates to regionally produced goods.

40. Previous studies conducted for the countries in the Region have indicated that prices of importables have been higher than their domestic equivalents, showing the impact of trade protection. Furthermore, tariffs have been used as an instrument for protecting the balance of payments. For example, the San Jose protocol surcharge was established by all the CACM countries (i.e. equal to 30% of the Common External Tariff) in 1975 when the Region was facing acute balance of payments difficulties. These surcharges also helped raise revenue to compensate for the reduction in tariff revenues from imports--caused by the introduction of incentive policies of the CACM. Additionally, Costa Rica and Honduras set up high surcharges on imports in the early 1980s, when terms of trade for the Region worsened.

41. The rate structure is designed to provide protection to regionally produced goods. First, higher rates are applied to final consumer goods. Second, lower rates are assigned to intermediate and capital goods, with relatively higher rates on regionally produced intermediate and capital goods. Third, generous tax exemptions are provided for non-regionally produced raw materials, intermediate and capital goods. Some "essential goods" (i.e. wheat) are either exempt from the payment of import duties or are taxed at low rates.

42. Before the introduction of the reform on January 1, 1986, CET included both an ad-valorem and a specific component. With increasing international inflation, the specific component of the import tariffs declined over the years. Following the introduction of the reform of the tariff regime, all rates on imports were converted into ad-valorem rates.

Issues

43. Honduras is not a legal member of the CACM. It left the Customs Union after a war with El Salvador in 1967. Since then, it has traded with the other CACM members mostly on the basis of bilateral treaties. Being the least developed country in the Region, Honduras has demanded special favors from other CACM members.

44. As the Region began to face balance of payments difficulties, each country introduced restrictions on their trade, including trade within the CACM. First, following the overvaluation of currencies after 1981, parallel markets for foreign exchange developed in most of these countries. Quantitative restrictions on imports were established, while foreign exchange restrictions were intensified. Costa Rica also imposed surcharges on imports and Honduras raised import surcharge rates.

45. Costa Rica's surcharges on imports served several purposes. Those on inputs and capital goods (2% - 5% - 10%) and low rates on final consumer goods (12.5%) were designed for revenue purposes. Higher rates on final consumer goods (40% - 50%) were designed to provide protection for regionally produced goods, while higher rates on final consumer goods (i.e. 100% and 200% in 1984) were intended to reduce or avoid imports.

46. Nicaragua's new economic direction after 1980 presents a challenge. Since the country switched to a centrally managed economy, the significance of tariffs in resource allocation and in regulating trade became irrelevant. As the country faced enormous balance of payments difficulties, other CACM member countries reduced their trade with Nicaragua to low levels to ensure that their creditor balances do not increase further as discussed earlier in this report.

47. Countries in the Region have not harmonized their import regimes for basic grains. In fact, most countries maintain quantitative import restrictions on the importation of basic grains.

Results of high import protection

48. High import tariffs on final consumer goods coupled with low rates on non-regionally produced intermediate and capital goods led to high effective protection rates for industrial products. Quantitative restrictions on imports of basic grains also resulted in high effective protection for basic grains. Furthermore, dispersion in nominal rates led to even larger dispersion in effective rates.

49. High effective protection rates led to a number of results. First, it resulted in misallocation of resources by stimulating the growth of sectors in which the countries in the Region do not have an apparent comparative advantage. Even, some activities with low value added were created, indicating inefficiency and waste. Most domestic prices have been well over their international price equivalents. Furthermore, the granting of exemptions on imports encouraged high capital and import-intensity in manufacturing and favored the creation of low employment generating jobs, aggravating the already serious unemployment problems in these countries.

50. The implementation of the tariff regime also led to an expansion in the share of industry in the economy. Before the CACM was created, industry accounted for a small share of GDP in all the countries in the Region. Following the creation of the Common Market, however, this share rose considerably. The sub-sectors which developed rapidly were mostly final consumer goods, in which CACM countries presumably have comparative advantage. However, high effective protection provided to industry did not create incentives for firms to become internationally competitive. Import substitution in final consumer goods should not create a chronic deficit in the trade balance since input imports are generally smaller than output imports. As industry developed and regional imports were exempted from the payment of tariffs, regional trade also grew substantially. It now accounts for a little less than one-fifth of total exports in the Region.

51. Since the new industries which developed in response to the granting of new incentives relied heavily on the importation of

intermediate and capital goods, import intensity in all the countries rose substantially. This created a rigidity in the balance of payments, since reduction in imports--during a balance of payment crisis--depresses output and employment. Furthermore, heightened import intensity in industry led to a chronic deficit in the trade balance of the industrial sectors in the Region, making it difficult to adjust to external shocks.

52. The implementation of the regional tariff regime also had a significant impact on the structure of imports. Following the creation of the CACM, and the consequent sharp growth in the industrial sector--mostly in final consumer goods--the share of consumer goods in total imports fell, while the share of intermediate and capital goods imports rose.

53. Trade policies pursued so far have been successful in stimulating industrial development based on regional import-substitution. By the early 1980s, however, the possibilities for further efficient import-substitution have been virtually exhausted. For example, the production of many consumer goods industries was limited in Costa Rica before it joined the CACM. By 1980, however, imports fell to about one-tenth of total supply in many consumer goods industries, such as in food products, beverages, tobacco, clothing and furniture.

54. The anti-export bias of the trade regime. The protection system discourages the growth of exports. The regional tariff regime created a significant bias against exports to markets outside the CACM in general and against export agriculture in particular, where the Region's comparative advantage lies. For example, in Costa Rica, effective protection provided to regional import substitution activities averaged about 126% in 1982 compared to 15% for non-traditional exports to markets outside the CACM. As a result, the growth of non-traditional exports outside the CACM was sluggish in the past. Compared with other small sized developing countries such as Hong Kong and Singapore, growth of non-traditional exports was very slow in the recent past.

55. The tariff regime also led to an erosion of the tax base on imports. First, imports from other CACM countries were exempted from duties. Second, generous tariff exemptions were granted to intermediate and capital goods. These exemptions led to large fiscal losses, averaging about 5% of GDP a year for some countries in the Region. Third, prohibitively high tariffs on final consumer goods also reduced fiscal revenues by limiting the growth of imports.

Progress in import liberalization

56. After having remained unchanged since the inception of the Common Market, Central American countries took an initial step in rationalizing their trade policies and in beginning to reduce the anti-export bias in their trade strategy by introducing a new regime on January 1, 1986. These reforms were supported by a US\$80.0 million SAL I Loan by the World Bank to Costa Rica. Costa Rica took further and stronger steps in import liberalization during the Second Tranche disbursement of SAL I by eliminating import surcharges on final consumer goods. Costa Rica plans to continue to reform its trade regime and reduce the level and dispersion in effective protection in the next several years. The World Bank is

supporting these positive efforts of the Costa Rican authorities through a US\$100 million SAL II operation. Although the reforms, both implemented and planned, are in the right direction, there is a long way to go in achieving a fully satisfactory liberalized trade regime in the Region. This report suggests targets to be achieved to eliminate the anti-export bias in the trade regime of the Region within a Common Market. The suggested policies could well be introduced by one or several countries or they could be adopted by all the Common Market members. Although it is desirable that these policies be adopted by all the members, if the negotiations for reaching a common understanding fail to materialize, then each member would obviously weigh the costs and benefits of staying in the Common Market versus taking a unilateral action. This report does not deal with the strategy of introducing reforms in the Region, but it favors a joint action.

57. Because of the importance of the tariff reform supported under the SAL I operation for Costa Rica, the following describes the progress achieved in the liberalization of trade:

- (i) eliminated all specific rates in nominal tariffs and converting them to ad-valorem rates;
- (ii) converted the classification system for goods from the Central America classification system (NAUCA) to the Brussels nomenclature;
- (iii) terminated all tariff exemptions under the Central American Agreement on Fiscal incentives;
- (iv) abrogated the regional investment incentives and the San Jose Protocol (a 30% surcharge on the common external tariff; and
- (v) created a Central American Council for tariffs and customs with authority to establish and modify import tariffs without the need for legislative action by member countries.

58. In terms of the modification of rates, the Regional Treaty aimed at the following targets;

- (a) goods produced outside the CACM (non-competing imports):
 - (i) essential final consumer goods, raw materials, intermediate and capital goods: a minimum 5 percent rate, and exemptions for goods which are considered to be strategic for development on an exceptional basis; and
 - (ii) non-essential final consumer goods and inputs used in the production of these goods: a 10 percent rate.
- (b) goods produced within the CACM (competing imports):
 - (i) raw materials, intermediate and capital goods: a 10, 20 or 30 percent rate, depending on the level of processing; and
 - (ii) final consumer goods: a rate ranging from 35 to 70 percent, with few exceptions for fiscal and balance of payments purposes up to and including 90 percent.

59. Since the effect of the planned regional tariff regime in lowering effective protection was small, the Costa Rican Government agreed to go beyond the regional agreement to further reduce effective protection by undertaking the following modifications to the regionally agreed rates:

- (a) intermediate and raw material goods produced outside the CACM (non-competing goods): a minimum 10 percent; and
- (b) capital goods: a minimum 20 percent.

To achieve these rates, the Costa Rican Government agreed to add the indicated rates through import surcharges:

- (a) raw materials and intermediate goods (non-competing goods): a 5 percent rate; and
- (b) capital goods: between a 10-15 percent rate.

60. Implementation of tariff reform. Based on regional negotiations, the following rate structure emerged:

TABLE III: COMPARISON OF OLD TARIFF REGIME, NEW TARIFF REGIME AND PLANNED REGIME
(%)

| | <u>Old Regime</u> | | <u>New 1/ Regime</u> | | <u>Planned Regime</u> |
|---|-------------------|-------------|----------------------|-------------|-----------------------|
| | <u>Max.</u> | <u>Avg.</u> | <u>Max.</u> | <u>Avg.</u> | <u>Avg.</u> |
| Final Consumer Goods | | | | | |
| Regionally Produced | 530.2 | 92.5 | 143.0 | 65.4 | 32.6 |
| Non-Regionally Produced | | | | | |
| Essential | 130.3 | 40.6 | 65.5 | 15.2 | 5.4 |
| Non-Essential | 314.2 | 135.0 | 253.0 | 18.4 | 34.0 |
| Intermediate Goods and Raw Materials | | | | | |
| Regionally Produced | 1393.4 | 54.3 | 203.0 | 34.1 | 20.9 |
| Non-Regionally Produced | 332.8 | 32.6 | 108.0 | 11.2 | 5.0 |
| Capital Goods | | | | | |
| Regionally Produced | 248.5 | 73.9 | 153.0 | 35.6 | 24.7 |
| Non-Regionally Produced | 73.0 | 23.7 | 28.0 | 15.1 | 5.5 |

1/ The two rows indicate the planned rates as of January 1, 1986. Some of the parameters might likely have changed since then, as Costa Rica modified some surcharge rates.

Source: SIECA, Central Bank of Costa Rica, Bank Staff Estimates.

61. The initial reform reduced effective protection and its dispersion in a modest way. The decrease in effective protection resulted mainly from the introduction of import duties on raw materials, intermediate products and capital goods. The impact of the reduction in high legal tariff rates on lowering effective protection was limited. Increases in tariffs for competing raw materials, intermediate and capital goods raised effective protection for these goods.

62. The structure of protection remained similar to the previous regime. Rates for final consumer goods are still high and rates for intermediate and capital goods are low and are exempted under national incentive schemes as compared to the regional one prior to the reform.

63. Member countries could not agree on common rates for some of the rates (Part II of the new tariff schedule). This category of products includes mostly textiles, clothing and paper. Rates for some of these products were actually raised under the new system, leading to increased effective protection. These products were heavily protected under the previous tariff regime and are important in relation to domestic production. It is essential that rates for these products be unified within the overall target rates in the next stages of the tariff reform.

64. Member countries agreed to set rates for some products (Part III of the new tariff schedule) on a national basis. This agreement broke the common external tariff concept for this category of goods. The main item in this group is petroleum.

65. The Costa Rican Government phased out surcharges on final consumer goods during SAL I - Second Tranche negotiations, reducing effective protection. But, the Government also decreased surcharges on intermediate inputs and capital goods, increasing effective protection after the Second Tranche of the SAL I was disbursed.

66. The net impact of the tariff reform in 1986 on reducing effective protection should be explored in more detail. The preliminary evidence shows that the reform reduced only the water in the tariff, while effective protection was increased for some products, which were heavily protected before the reform.

67. To improve resource allocation as well as to harmonize taxes on imports, it is essential that tariffs not be used as an instrument to protect the balance of payments and hence tariff-like surcharges should not be imposed on top of regional tariffs.

Targets for tariff reform

68. There is a need for specifying targets to be achieved for the next few years to reduce effective protection. Owing to difficulties in decreasing tariffs in one step, a staged approach is suggested. The next stage of the reform would need to aim at reducing the highest tariff rate to 40%, while increasing the lowest tariff rate to 20%. The increase in the lowest rate would not only help reduce effective protection, it would also generate government revenues. However, the lowest tariff should not be allowed to increase much further than the suggested 20% rate since

raising low tariffs on intermediate products and capital goods discriminates against exports by raising the anti-export bias of the incentive system and results in an appreciation of the exchange rate.

69. If the increase of the lowest rate to 20% is not politically feasible, then a reduction of the highest rate is vital for decreasing effective protection in a meaningful way. Without raising the lowest tariff rate, a reduction in tariff rates on final consumer goods would not lead to a significant decrease in overall effective protection rates. Obviously, the above-mentioned targets could be modified to take into account the political difficulties in raising the floor rate. This could be achieved by scaling down the highest rate to 30%. Likewise, maintaining the present 5% floor rate would be consistent with a highest tariff rate of 25%. Clearly, it is desirable to establish a higher minimum rate to ensure that changes in tariff rates would not lead to reduced government revenues. In case politically viable options rule out raising the floor tariff rate over 5% and fiscal revenues decline, then authorities in the Region will need to raise other revenues to compensate for the fall in revenues from imports. Raising selective consumption taxes or increasing the rate of the value added tax would be options to consider.

70. Agreement on a politically viable target floor tariff rate presents a number of problems. First, imported inputs used in producing non-traditional exports would need to be exempted from payment of duties. It is vitally important to exempt the export sector from payment of duties to ensure that it purchases inputs at world market prices. It is important that all the countries in the Region follow these principles to avoid creation of any disadvantage to any particular country, providing exemptions.

71. Second, the minimum rate on capital goods should be high enough to encourage employment of labor in view of the underpricing of capital and the need to encourage firms to use domestic inputs by making these inputs cheaper compared to domestically available inputs, but low enough to ensure reactivation of the economies through high levels of investment. Third, since the Region does not possess an apparent comparative advantage in the production of most capital goods and intermediate goods, it is important not to provide excessive protection to these goods. This is especially important if these products are used as inputs to non-traditional exports to markets outside the CACM. Those products would need to be produced at a high quality if they are to be produced domestically and used in exports as inputs. In any case, countries should provide exemptions on regionally produced inputs if they are utilized in manufacturing exports outside the CACM. Fourth, given the large share of these products in total imports as well as in GDP, they provide a good taxable base. Exempting them from import taxes would unnecessarily lead to large reductions in potential tariff revenues.

72. Fifth, it may also prove to be difficult to reduce higher rates, hence an increase in the floor rate is needed to reduce effective protection. Sixth, since at the final phase of the tariff reform, rates should be unified, unification at the minimum rate of 5% does not seem to be realistic. Therefore, the minimum rate will need to be raised in later stages of the tariff reform if unification is to be achieved. Hence, this paragraph underscores the need for establishing a floor tariff rate of at least 10% (which indicates that the highest rate should be no more than

30%). Seventh, no other non-distortionary revenue source could match the magnitude of revenues which could be collected from this source. Eighth, taxing imports of intermediate and capital goods used in the manufacture of goods sold in the regional market will increase the relative profitability of non-traditional exports outside the CACM, which will be exempted from such duties under various drawback schemes discussed in this report. Lastly, sustainability of a trade reform hinges on maintaining financial stability. To the extent additional revenues, which could be collected through raising the import tariff floor rate, compensate for the fall in revenues caused by the tariff reduction and help maintain macro-financial stability, they would contribute to the sustainability of the tariff reform.

73. Regarding the highest tariff rate, it is important to note that some exceptions to the rule could be accepted on infant industry protection grounds. But the principle of harmonization indicates that the rate should be set on a regional basis, be applied to few commodity groups for a definite time period. If these exceptions are provided to non-competitive products and for long periods of time, the benefits from trade liberalization will not likely be obtained. In this context, it is important to note that most countries in the Region still prefer to provide high protection to inefficient industries such as textiles and footwear for at least the next few years. This report suggests that this policy be reversed and trade liberalization for this group of products be accelerated.

74. Another issue regards the preference of the countries to tax luxury imports through high tariffs or surcharges on imports. These rates could encourage the development of domestic industries producing such goods. This report suggests that these imports be taxed through domestic transaction taxes, which would be levied on both domestic and imported goods at the same rates.

75. Intermediate goods. Considering that tax rates on intermediate products would be increased, those goods may require some degree of protection after the introduction of further stages of the tariff reform. However, additional protection to be granted to intermediate goods has to be reviewed carefully on a product-by-product basis to ensure that inefficient production of these goods not be given undue encouragement.

76. Complementary exchange rate policies. Implementation of an active exchange rate policy during a period of reduction of high tariffs on consumer goods would be needed to ensure that the trade balance in the balance of payments not deteriorate unnecessarily. To achieve a real depreciation, however, the authorities in the Region should drastically reduce or eliminate public sector deficits. Otherwise, real devaluation coupled with domestic financing of high public sector deficits--given that external financing is limited--would likely lead to inflationary pressures and would not permit an improvement in the trade account of the balance of payments.

Sustainability of tariff liberalization efforts

77. The World Bank has released interim conclusions of a study on lessons to be derived from trade liberalization episodes based on a study of various countries. According to this study, some resource-poor and small countries have undergone successful trade liberalization efforts. Since Central American countries fit well into this category of countries, it can be inferred that being small and resource-poor should not preclude any of the countries in the Region from undertaking a successful trade liberalization program. The main conclusions for the successful liberalization episodes include the following:

- (i) maintaining a depreciated exchange rate in real terms;
- (ii) having a low budget deficit;
- (iii) achieving favorable export performance;
- (iv) being implemented under extreme duress;
- (v) introducing strong reforms ("strong liberalization attempts tend to be sustained. These are mostly episodes which start with significant, rather than minor and marginal steps of liberalization"); and
- (vi) maintaining political stability.

78. This report does not analyze to what extent the conditions in countries in Central America fit into the criteria deemed to be desirable for achieving and sustaining a successful trade liberalization effort. However, it is important to note that further changes in trade liberalization should be strong to lead--presumably--to robust export growth--through eliminating the anti-export bias of the trade regime--needed for the survival of the reform efforts.

Revenue implications of a tariff reform

79. This report suggests that the next steps in the tariff reform would need to take account of revenue implications of the reforms. Assuming that both the exchange rate and import volumes remain unchanged following trade liberalization, reductions in tariffs on final consumer goods would lead to a loss in fiscal revenues by the amount of the decrease in tariffs. If the reform also includes an increase in the floor rate, revenues would likely increase. Given the share of intermediate and capital goods in total imports and depending on the amount of the increase in the floor rate, overall tariff revenues would likely expand. However, if import volumes respond to changes in tariff rates, fiscal revenues could increase slowly, given that price sensitive category of capital goods and some intermediate goods would likely decline if tariff rates are increased. Expansion in final consumer goods imports, however, could offset the rate decline proposed for final consumer goods. If a real devaluation accompanies the tariff reform, then tariff revenues could increase, despite lower volumes and lower rates on final consumer goods.

80. Assuming that the tariff reform does not include an increase in the floor rate, then the impact of the tariff reform on fiscal revenues will likely be negative. In the absence of a real devaluation, a decline in high rates would lead to a decrease in tariff revenues, while a volume increase would expand it. A real devaluation would lead to an expansion in fiscal revenues in domestic currencies, but the final impact depends on changes in import volumes and in tariff rates.

1.1.2. Export taxes

81. In general, the structure of production and exports is a major determinant of the tax structure. This is especially important, regarding the choice of corporate income taxes and export taxes. Empirical investigations of tax structures of developing countries indicate that countries which rely heavily on export taxes make little use of corporate income taxes and vice versa.

82. Empirical investigation of developing countries also indicate that, on average, export taxes generate 11% of tax revenue (1.7% of GDP) for low income countries and less than 3% (0.5% of GDP) for middle income developing countries. The ratio of export taxes to exports is 11% for the low income groups and about 4% in middle income developing countries.

83. Export taxes account for a large share of fiscal revenues in Central America. Because of the relative ease of administration, countries in the Region rely on these taxes as a substitute for income tax. The share of these taxes in total Central Government revenues also correlate positively with the share of exports in GDP. Since export growth is a critically important objective--badly needed to put the Region on a sustainable growth path--care needs to be exercised in not overtaxing exports to the point at which export growth is discouraged.

84. Taxation of exports shows differences according to commodity groups. It is mostly concentrated on traditional commodities, and specifically on coffee and bananas. Those two commodities provide the bulk of revenues from exports. Exports to CACM are exempted from taxation as noted earlier in this report. Similarly, non-traditional exports outside the CACM are either not taxed or taxed at low rates.

Conclusions

85. It is desirable to implement common principles regarding export taxation. However, there is no point in harmonizing these taxes among the member countries. Taxes on coffee exports are discussed in the following section. In the short-term, taxes on banana exports should be maintained as a substitute for income taxes. However, care needs to be exercised to ensure that tax rates are maintained at the same or similar levels and at ad-valorem rates, and that their levels are set in such a way that they are not permitted to discourage exports. Since marketing for banana exports is in the hands of the large multinational corporations in the Region, some form of taxation as a proxy for income tax would be useful. However, taxation of these companies has to take note of the circumstances of the international banana market and the possibility of banana companies leaving Central America to other countries which do not have a similar tax burden.

Regarding taxation of non-traditional exports, it is strongly recommended to eliminate any tax which might exist in any country in the Region, given the urgent need to encourage the growth of these exports. In fact, taxing non-traditional exports coupled with granting of incentives for the same category of goods does not make sense.

1.1.2.1. Taxes on coffee exports

86. Coffee has a significant impact on the economies in Central America. The five countries of the CACM are, as a group, one of the largest coffee producers in the world. Since these economies are relatively small, the coffee sector plays a key role in each of those countries. All the countries in the Region produce and export coffee. The Coffee sector accounts for a significant share of fiscal revenues and export earnings in all the countries in the Region. The degree of dependence of each country on foreign exchange earnings from coffee, however, is different.

87. There are various reasons for the importance of export taxes on coffee. First, coffee exports, as mentioned earlier, account for an important share of GDP in all the countries in the Region. Second, the sector hardly pays any income tax, and hence export taxes can be considered as a substitute for income taxes. Third, low collection costs and easy administration of the tax makes it an attractive instrument. Fourth, the supply elasticity of exports is relatively low, with limited possibilities of diversification into other crops, at least in the short-term, while slow growth in international demand limits exports. As a result, taxation of coffee exports can be considered a second-best alternative to taxing incomes from export earnings.

88. Coffee exports need to be taxed as long as the International Coffee Agreement (ICA) operates. Each country in the Region has a different set of taxes on coffee exports. These differences stem from:

- (i) different levels of production costs in each country, resulting in varying levels of a tax-free threshold price; and
- (ii) the particular method by which windfall profits are shared between producers, exporters, and the public sector.

Conclusions

89. The design of a tax on coffee exports needs to take into account the large swings in the international price of coffee. Given the importance of the commodity in the Region, a good macro management of booms as well as reduced prices is crucial to avoid inflationary pressures in the case of increases in coffee prices as well as recessions during drops in coffee prices. Taxation of coffee exports appears to be the most effective tool to achieve the above-noted objectives. The Central American countries should be in a position to capitalize on and improve growth and debt-servicing prospects during windfalls. Poor management of booms has generally led to over-consumption, with the public sectors starting or

expanding inefficient investments as well as increasing current expenditures. The experience of the countries during 1976-77 as well as in 1986 are good examples of bad management of coffee booms. For example, Costa Rica undertook an ambitious public investment program and expanded current expenditures while borrowing on a large scale. Conversely, high taxes on coffee exports could accelerate the initial recessionary impact of a drop in coffee prices.

90. An expansion in domestic demand following a boom in prices could lead to a sharp increase in imports and hence a deterioration in the balance of payments of these countries. However, if restrictive fiscal and monetary policies are introduced, international reserves could be strengthened, permitting a higher rate of domestic investment over the coffee cycle while coffee prices return to normal levels.

91. If international coffee prices increase, authorities are faced with various options. These include: (i) strengthening international reserves; (ii) reducing foreign liabilities; (iii) raising domestic capital investment (i.e. public investment); and (iv) increasing current public sector expenditures. This report suggests that part of the windfall revenues should be saved to increase international reserves. To the extent that capital expenditure programming is possible, increased capital expenditures is also recommended to utilize the windfall to enhance development. Given that price increases are generally temporary, however, care needs to be taken in planning these expenditures, including planning and budgeting for the current expenditure requirements for those investments.

92. The use of fiscal policies is more appropriate than monetary policies in dealing with problems created by coffee booms. Following an increase in coffee prices, liquidity in the financial system expands. To absorb the excess liquidity, authorities could either use monetary policy by increasing reserve requirements, reducing credit or they could use fiscal policies by introducing higher tax rates. In the latter case, the public sector would absorb part of the windfall.

93. Tight monetary policies would likely lead to large swings in the availability of credit, whereas restrictive fiscal policies could be used to stabilize economic activity through taxing part of the increased revenues. When prices rise, a part of the increase in international reserves would be transferred into a coffee stabilization fund. Conversely, when prices drop below a pre-determined level, funds accumulated in the coffee stabilization fund would be utilized. Hence, the functioning of the fund could help stabilize economic activity, limit excessive increases in consumption, and permit a better use of financial availabilities through helping to finance a carefully screened and evaluated investment projects.

94. Any tax on coffee exports should take into account the need to protect production and employment in the sector. Hence, it is recommended to exempt coffee exports from the tax when international prices fall below a pre-determined level. This level could be set above the highest cost of production in each country. The coffee sector is generally labor-intensive and wage costs and availability of labor varies in each country in Central America. As a result, unit production costs need to be taken into account

in establishing an export price below which exports will be exempted from taxes. In the case of Honduras, for example, average production cost per quintal (i.e. 46 kg.) was estimated by the Honduran authorities to be equal to 165.0 lempira (US\$82.5 at the official exchange rate) in 1988. Hence, the World Bank Mission, which visited Honduras during January 1988, recommended a floor price for exemptions on taxes on coffee exports equalling 180.0 lempira per quintal, to allow for a possible increase in the cost of production in the next few years.

95. Regarding the structure of rates, it is recommended that beyond a pre-determined export price (i.e. a high value, perhaps US\$ 2.0 a pound), a 50% tax rate be established on the price exceeding that limit. This structure would permit the public sector to share windfall gains with producers/exporters in equal proportions. It is to be noted that the floor-ceiling prices for the price stabilization fund do not necessarily have to coincide with minimum and maximum tax rates.

96. There is no obvious reason to harmonize taxes on coffee exports in the Region. Given the differences in unit cost of production, and the reliance of the tax system on these taxes (i.e. much more significant in El Salvador compared to Costa Rica) and lack of interdependence among member countries on coffee exports, a specific rate structure in each country does not necessarily have to be the same. However, the main principles described in this section of the report could be applied to all the countries in the Region.

97. Another issue concerns the multiplicity of taxes on coffee. For example, in Costa Rica, coffee is taxed both at the producer level as well as at the exporter level through two taxes, whereas in Honduras, there is only one tax on exports. The proliferation of taxes on coffee exports is not a good policy. This report suggests that coffee exports be taxed through one tax. The structure of the tax could allow intermediate rates in between the maximum and the minimum rates. The taxable base in each price range would be determined by the excess of each price over the preceding rate. This report suggests that the number of such rates be held to a minimum: perhaps two rates.

1.2. Domestic Transaction Taxes

98. Empirical investigations indicate that domestic transaction taxes on goods and services account for about 4.5% of GDP and over one-fourth of total tax revenues in developing countries. In fact, some countries collect more than 10% of GDP and collect 40% of total tax revenue from domestic transaction taxes (i.e. Chile).

1.2.1. Sales Tax

99. All countries in the region have some form of a sales tax, either in a cascading or a value added form. In Costa Rica, Guatemala, and Honduras, the sales tax takes the form of a value added type, while in El Salvador, it is a cascading stamp tax. Rates in each country are also different, with a range of 10% in Costa Rica and 5% in Honduras. Collections from sales taxes have generally been significant, accounting for about one-third of total tax collections in some of the countries.

100. It is important to avoid cascading. First, cascading encourages undue vertical integration along the chain of production and distribution. Second, as the structure of an economy becomes more complex, the chains of production and distribution tend to get longer, amplifying the adverse effect of a cascading tax.

101. This report suggests that a value added tax be the backbone of the tax system in the Region. Value added tax rates need not be harmonized for the countries in the Region. In fact, VAT rates will remain different in the EEC even after 1992. In the case of El Salvador, a conversion of the cascading sales tax at 5% to a value added tax at a 10% rate is estimated by the Salvadoran authorities to lead to a loss in fiscal revenues. The Salvadoran authorities estimated that the value added tax rate has to be set at 14% to obtain the same level of revenues collected from a cascading sales tax at a 5% rate. Given the present and projected fiscal difficulties in El Salvador, further loss of revenues are clearly not desirable. Therefore, El Salvador may have a higher VAT rate, while other countries in the Region (i.e. Honduras, Guatemala) may have slightly lower rates.

Conclusions

102. The value added tax should be a uniform rate and applied on as broad a base as possible, since multiple rates create considerable administrative complications. Furthermore, to the extent possible, the tax should include services, and specifically those sold by the public sector.

103. A change to a value added tax is needed in El Salvador to rationalize the tax system by substituting it for the cascading sales tax. Given that a value added tax has a built-in enforcement aspect, its introduction would help facilitate cross-checking among firms to help reduce evasion.

104. As presently applied, sales revenues collected from imports exceed 50% of total collections from this tax in most countries in the Region, while a low share of domestic value added is subject to this form of taxation. Hence, broadening the base of the tax requires incorporating small retailers--that do not keep adequate accounts--in a value added tax.

105. Regarding the desired attributes of the tax, the following changes are suggested:

- (i) applying the tax with a single rate rather than with multiple rates;
- (ii) incorporating small retailers into the tax while exempting very small firms (i.e. those with revenues not exceeding a certain level) from the payment of the tax in order to make it administratively manageable;
- (iii) eliminating exemptions to simplify administration with the exception of basic necessities such as food, medicine and school books to lessen the regressivity of the tax;

- (iv) levying the tax both on domestic transactions as well as on imports at the same rate while eliminating the cascading feature as practiced in El Salvador;
- (v) increasing the base of the tax by incorporating services, including those provided by public sector enterprises; and
- (vi) exempting all exports and imported inputs and capital goods used in manufacturing non-traditional exports to markets outside the CACM.

1.2.2. Selective Consumption Taxes

106. This report suggests the establishment of a broad-based selective consumption tax in the Region to complement the value added tax. Costa Rica already has a well-developed selective consumption tax, although with some undesirable features such as excessively high rates for some products. This report suggests that other member countries should also adopt a similar tax along the lines of the Costa Rican tax, but without its undesirable features. This type of tax would be useful in: (i) improving resource allocation by discouraging production and consumption of luxury items; (ii) strengthening the equity of the system by providing progressivity; (iii) offsetting loss of revenues owing to the implementation of further tariff reform; and (iv) contributing to the reduction in financial disequilibrium to the extent higher collection is made possible and not spent on new public programs.

Conclusions

107. The following are the recommended attributes of the proposed tax:

- (i) keeping the number of rates to at most three or four to simplify the administration of the tax and avoiding excessive rates to reduce incentives for evasion;
- (ii) levying the tax at the manufacture level for domestically produced goods to avoid cascading;
- (iii) taxing these imports at the same rates as domestically produced goods and imports and applying the same rates for imports from CACM as well as imports from countries outside the CACM; and
- (iv) covering a limited range of commodities under the tax, focusing on goods whose income elasticity of demand is larger than unity.

108. The successful implementation of the tax requires several other factors. First, a freely determined market-oriented price system would help the system function better. Otherwise, establishing a selective consumption tax with excessive price controls runs the risk of distorting relative prices. In other words, the imposition of this tax should follow or coincide with the action of implementing a program to decontrol prices.

Second, it is important to coordinate the introduction of this tax with further stages of import liberalization efforts to avoid losses of fiscal revenues and to protect the balance of payments. Taxing commodities at similar rates for both domestically produced and imported goods will ensure that no undue protection is provided to domestic production of luxury goods. Third, taxing imports both from the CACM and those from outside the CACM is vital for harmonizing the tax regime in the Region. Fourth, as indicated above, this tax will also ensure stability in revenues. Fifth, taxing luxury goods will provide a degree of equity and progressivity to the system. In view of the difficulties in raising income taxes in the Region and given the need to encourage private investment to regain past growth rates, it is essential to introduce this tax in all the countries in the Region. Lastly, selective consumption taxes should not be used to discriminate against imports from other CACM member countries.

1.2.3. Excise Taxation

109. On average, excise taxes account for 2% of GDI and about 12% of total tax revenues in developing countries. Collections from three products--alcohol, tobacco, and petroleum--generate the largest share of revenues from this source.

110. All the countries in the Region have a number of excise taxes on some standard group of products such as cigarettes, beer and alcohol. Some of the rates of these taxes are specific. Rates are low in some product categories and excessively high in others. Collection from this group is substantial in some countries. In El Salvador, for example, excise tax collection amounted to about 9% of total tax revenues in 1986.

111. Conclusions. This form of taxation aims at generating revenue and reducing consumption of certain products. It is recommended to keep the rates of excise taxes at moderate levels, convert all rates into an ad-valorem base and eliminate those which generate insignificant levels of revenue. Excessive rates could lead to evasion or smuggling, given the openness of the countries in the Region. Harmonization of excise taxation would be desirable, but it is not vital.

112. Cars. Presently, cars are taxed at high rates by excise taxes or by import surcharges mainly for balance of payments purposes. However, generous exemptions are also granted such as for cars for taxi drivers and cooperatives in Costa Rica, leading to unjustified increases in imports and a waste of resources. It is recommended to tax importation of cars by an ad-valorem domestic excise tax, which would be applicable both on imports and domestically produced cars at the same rates to protect balance of payments and increase revenues as well as to provide equity to the tax system. Although, it is not realistic to expect that any of the countries in Central America would produce cars in the foreseeable future, this report suggests not giving any protection to domestic production.

1.2.4. Taxation of Petroleum Products

113. In most of the countries in the Region, retail prices of petroleum products are higher than their international equivalents. Some products, however, such as diesel and kerosene, are generally subsidized to reduce the cost of public transport and food items.

114. Institutional differences exist in petroleum imports-refining and marketing in each country in the Region. For example, in Costa Rica, the state refinery, RECOPE, imports both crude and refined petroleum products and markets them at prices established by the Government. A part of the financial surplus generated by RECOPE is transferred each year to the Central Government as well as to other public sector entities in the form of transfers. For example, during 1986-87, RECOPE's surplus was used to finance the construction of private houses, intermediated through a public sector bank. Therefore, petroleum pricing is used as an instrument to tax petroleum products, while there are no explicit taxes on petroleum products. In fact, petroleum imports and domestic sales are exempt from all taxes. In Honduras, a foreign refinery, TEXACO, refines crude petroleum products, while an inter-ministerial public agency is responsible for importing refined petroleum products for domestic consumption. The difference between the refinery gate import price and domestic selling price is transferred to the Central Government as a petroleum differential tax. There are other small excise taxes in the sale of petroleum products. Guatemala is a producer of petroleum.

115. When international petroleum prices were about US\$26-28 during 1982-83, fiscal revenues from taxation--either through pricing or taxation--were very low. Following the decline in international prices in 1986, large fiscal gains were realized from petroleum marketing since domestic prices were not reduced. Compared to international prices, high domestic petroleum prices penalized domestic production and acted as a further constraint on the profitability of exporting to markets outside the CACM.

Conclusions

116. To encourage export growth, and to protect output and employment, there is a need for moving domestic petroleum prices to their international equivalents. This means lower revenues from petroleum for Central Governments. For countries facing fiscal problems, this is not an easy task. However, a medium-term program needs to be prepared and implementation started according to that program for each country to achieve this objective concurrently with other measures as discussed in this report. Additionally, there is a need for phasing out cross-subsidies among different petroleum products. Again, this is a politically sensitive issue, since phasing out subsidies for kerosene and diesel will likely increase transport and food costs, and aggravate the poverty problem, prevalent in most of these countries. Hence, cross-subsidization among different products should be eliminated only over time.

117. Domestic petroleum prices have to be determined within the framework of an overall energy strategy in the Region. All the Central American countries have hydro-potential and they have tapped this source in

different degrees through constructing a series of hydro-dams. With the exception of Guatemala, the Region relies exclusively on imported petroleum. Even in the case of Guatemala, imports cover a large part of the country's domestic needs. Hence, countries in the Region are faced with a challenging task. They need to minimize their reliance on petroleum and maximize the use of hydro-power to the extent technically feasible. This requires that pricing of petroleum products should be used to conserve the use of this imported input, while encouraging the use of domestically available hydro energy. From this point of view, somewhat higher petroleum prices over international prices can be justified. There is also a need to establish an explicit and hence a transparent tax on petroleum products. This would also facilitate the collection effort.

2. Direct (Income) Taxes

118. Income taxes are used mostly for revenue purposes. Additionally, they can also be used to provide equity in the distribution of the tax burden among different income groups. Empirical studies indicate that the share of income taxes in GDP and in total tax revenues averages about 6% and 31% respectively. Income taxes vary from less than 1% of GDP in Nepal to almost 25% in Trinidad and Tobago, or from 6% to 82% of total tax revenues.

2.1. Personal Income Tax

119. Although industrial countries raise well over half their revenues from personal income taxes, developing countries collect revenues from personal income tax of about 1.9% of GDP and 11% of total tax revenues.

120. Effective taxation of personal income is hindered by the low level of literacy (i.e. except Costa Rica), poor accounting standards, a large share of the agriculture sector in the economy, and the fact that a significant part of economic activity takes place in small establishments. These adverse factors are exacerbated by other factors. First, there are generally a large number of taxable income brackets, which makes administration difficult. Second, a large number of deductions and exemptions are granted. Third, existence of different taxes on different types of income creates incentives for tax payers to recharacterize income to avoid taxation. Fourth, coverage is limited. Some sectors, such as the self-employed sector and farm income, easily avoid the tax. As a result, a small share of the population pays income taxes, with the result that incomes of the wage and salary earners provide the largest base from which the tax is collected. Fifth, the most elastic tax bases (i.e. incomes from the non-traditional exports to markets outside the CACM) are parts of the economy that the authorities in the Region achieve rapid growth, providing them incentives through various schemes as described later in the report.

Conclusions

121. The exemption level under the personal income tax should be set at a level high enough to limit the number of taxpayers consistent with the administrative capacity of each country. The poorer the tax administration of the country, the higher the level of exemption should be. The objective

of the initial rate of the tax should be to generate revenue, while high rates should be used for equity reasons.

122. Options to modify the tax are limited, given the depressed private investment and the previous record of capital flight from the Region and the need to reactivate economies through private sector participation. It is to be noted that there is no point in harmonizing income tax brackets owing to different income levels in each country. The following suggestions are made to reform the income tax to ease its administration and minimize its impact on increasing distortions in the economy.

- (i) establishing a relatively high threshold level for exempted income. (This is needed to provide equity and reduce collection costs by focusing on high income earners);
- (ii) decreasing deductions and exemptions to keep the base of the tax as wide as possible;
- (iii) reducing the number of income tax brackets and keeping the progressivity of the rate moderate;
- (iv) reducing the maximum marginal rate to 35%-40% and
- (v) expanding the coverage of the tax over time through incorporating the self-employed sector and farm income, the latter being accomplished by shifting the commodity to income taxes.

2.2. Taxes on Company Incomes

123. The main objective of taxes on corporations is to generate revenue, and to some extent provide equity to the tax system. Since economic development leads generally to an increase in collections from corporate income taxes, it is expected that the reliance of the tax systems of Central American countries on taxes on company incomes will likely increase over time. Empirical studies indicate that corporate income taxes account for about 3% of GDP and 17.5% of total tax revenues in developing countries.

124. The tax generally falls on large-scale manufacturing. In fact, few large enterprises generate a substantial share of the tax. It is easy to administer the tax on large enterprises. One known advantage of this type of tax is that it responds quickly to fluctuations in economic activity.

125. Company taxation as practiced in the Region faces a number of issues. First, high marginal tax rates discourage the formation of new companies. Second, high statutory tax rates adversely affect payment of dividends and hence development of new ventures. Third, existence of a large number of exemptions and deductions under the corporate income tax tends to reduce collection. Fourth, complex rate structures make administration difficult. Fifth, high and excessive tax rates for foreign companies discourage direct foreign investment. Sixth, different concepts

of gross income and deductions among the countries also make it difficult to calculate and compare after-tax profits. Lastly, the tax discourages the growth of companies by equity, but favors growth through debt financing.

Conclusions

126. Taxation of companies should be used to improve resource allocation and the equity of the system. Similar rules have to be provided for foreign and domestic companies to make the tax neutral in investment decisions. A free movement of capital among these countries will be encouraged through eliminating discrimination against foreign firms. A consideration has to be given to harmonize this tax in the Region. Given the scarcity of capital and the need to encourage investment, taxation should be designed to attract foreign capital.

127. The following recommendations are made with the intention of improving the tax:

- (i) reducing the highest marginal tax rate to 35% - 40%;
- (ii) eliminating most existing allowances under the tax;
- (iii) setting only a few rates to simplify administration;
- (iv) taxing foreign and domestic corporations at the same rate in order not to discriminate against foreign companies and to attract foreign capital;
- (v) harmonizing fiscal incentives at the regional level as practiced before the 1986 tariff reform;
- (vi) taxing non-distributed retained earnings at a lower rate compared to dividends to encourage reinvestment of retained earnings for expanding existing plants and establishing new ones; and
- (vii) developing and implementing a coherent set of rules to define income, deductions and exemptions.

2.3. Property taxes

128. Property taxes generally do not generate substantial amounts of revenue in developing countries, accounting for less than 0.5% of GDP. However, they can be used to provide equity to the tax system and contribute to the cost of managing large cities if their use is assigned to local governments. Hence, countries with a highly uneven income distribution and with a large concentration of wealth (i.e. Guatemala) should make a greater effort in collecting this tax. Additionally, countries with a higher level of urbanization should also make greater use of these taxes.

129. The property tax as implemented in Central America suffers from a number of issues, including low tax rates, generous exemptions, infrequent adjustments for inflation, lack of updated assessments, resulting in low levels of statutory rates. Factors such as poor administration, incomplete tax rolls and low collection efficiency reduce effective tax rates. As a result, collection from property taxes have remained low.

130. Conclusions. There is a need for increasing property tax collections. This will not only help raise revenues, but will also provide equity to the tax system. Property tax collections could also encourage private savings. Taking into account those considerations, it is recommended to set high tax rates for luxury housing. To raise collection, it is suggested to create cadasters or update them if they exist. It is important to note, however, that the implementation of these suggestions and hence higher revenues from this source will take time to materialize.

2.4. Land Taxes

131. Despite the existence of land taxes in the Region, they are not sufficiently enforced and rates are low. As a result, collection from these taxes have remained insignificant.

132. Conclusions. There is a need for using the scarce land resources effectively, especially in countries where land is in short supply compared to population. To ensure effective exploitation, there is a need for introducing a tax, or--if it already exists--increasing rates to meaningful levels, on vacant land. This tax could help in raising the cost of holding land vacant for its owners and hence it could encourage efficient utilization of land. Owing to different levels of scarcity of land in each country as well as other country-specific factors, rates can not be harmonized, but the principle of application of the tax could be applied by all member countries in the Region.

2.5. Taxes on Financial Transactions

133. Taxes on Capital Gains. There are essentially two broad types of taxes on capital gains: one on real estate and the other on capital appreciation in financial securities. In Central America, collection from both of these taxes has been insignificant. In view of the rudimentary stage of development of financial markets in these countries and the need to promote financial savings, introduction of new taxes on capital gains is not suggested in the short-term. Furthermore, even if such a tax is imposed, capital losses should be made tax-deductible--an unrealistic proposition, given the low level of sophistication in financial matters and the underdeveloped nature of the financial markets. Additionally, such a tax will likely inhibit development of the financial and capital markets. Harmonization of policies on this tax is needed to avoid the flow of financial assets from countries with a tax or a tax with a higher rate than the rest of the countries to countries without the tax or with lower tax rates. However, it is suggested to enforce collection on capital gains on the transfer of luxury houses (to be defined in an appropriate way). To enable successful implementation of the tax, it is suggested to update cadastral values with frequent intervals. Again, harmonization of policies, but not rates, is suggested among the member countries. Each

country would wish to design its own rate structure, taking into account variables such as level and distribution of income among other relevant factors. It is also suggested to separate the collection of this tax from the ordinary income tax to facilitate collection. This might conflict with the objective of ensuring horizontal equity, but administrative difficulties rule out taxing incomes earned from different sources in the next several years. In the future, it is suggested to give a serious consideration to the introduction of a capital gains tax on financial assets, once financial and capital markets reach a higher level of maturity.

134. Taxation of Interest Earnings. All the countries in the Region face challenges in deepening financial intermediation and in stimulating financial savings. A consideration has to be given also to encourage financing the growth of companies through selling equity rather than debt. It is, therefore, suggested to eliminate taxes on interest earnings so as to encourage savings. Similarly, maintenance of exemptions of interest earnings on securities from taxation is suggested. Exemptions on interest earnings on savings deposits will be needed to encourage institutionalization of savings. Harmonization of these matters within the Region is suggested.

2.6. Labor taxation

135. Unemployment and underemployment rose in all the countries in the Region in the recent past, partly as a result of declining economic activity and partly as a result of the impact of the incentive policies which overprice labor compared to capital. In view of the expected high growth of the labor force in these countries, taxation of labor has to be low enough to encourage the use of labor-intensive technologies by reducing labor costs. High rates of labor taxation clearly contributed to the problem in the past, reducing competitiveness of exports by inflating wage costs and encouraging capital-intensive technologies.

136. In each country, social security institutions are institutionally set up in a different way. In Costa Rica, there is a well-developed health and pension system. In addition to the Social Security Institute (CCSS), there are 14 different pension schemes, mostly for public employees. In Honduras, there are five different agencies administering social security. The rates of the tax and contributions by the employers, employees and the Government differ under each scheme in Honduras. Some of these entities carry out health-care functions in addition to providing pensions (disability, old age, and death), while others are in charge of administering pensions.

137. In Costa Rica, social security taxes have gradually increased from 20% to 32% of the payroll in ten years. Employer contributions have risen 2.5 times during the same period. Employer contributions expanded from 9% to 22%. If all other charges are included, social charges amount to 58% of the payroll costs in Costa Rica. The ratio is high compared to the country's level of economic activity. In fact, Costa Rica has the highest payroll tax in the developing world.

138. The countries in the Region have relied on rate increases in the past to cover public sector deficits. In some cases, surpluses have been invested in low-yielding government securities, hampering long-run viability of pension systems.

139. Coverage of the systems also differs in each country. In Costa Rica, for example a large share of the population, mostly urban, is covered under the system. In Honduras, on the other hand, only a small share of the population, mostly public sector employees, is covered by pensions, while agricultural employees and independent workers are not insured. This creates distortions in the production costs across sectors.

140. Although most pension plans have strong finances in the short-term, the financial prospects of most of these entities are bleak in the long-term. For pension plans, expected increases in retirement benefits could lead to financial imbalances in the future. One reason for the short-term comfortable financial situation of some of these entities is that pension plan surpluses are transferred to health-care program to finance the latter's losses at a zero cost. In fact, finances of some institutions (i.e. IHSS in Honduras) is shaky even in the short-term owing to delays in payment of the Government's commitments. In other cases, where the program is new and is not merged with a costly health-care program as in INJUMPEMP in Honduras, current savings could be substantial (2% of GDP in 1987). Other factors which lead to high-cost operations include excessively high operating costs (i.e. due to overemployment), inadequate fees for medical services, capital-intensive technology employed in medicare as well as large-scale tax evasion.

141. The level of development of the social security systems in the Region varies. Costa Rica has a well-developed and high coverage system, whereas in other countries, the development is incipient.

142. Conclusions. An effort has to be made to harmonize taxation of labor to facilitate free movement of labor across countries. Those countries with high labor taxes may not attract capital owing to implied high costs. Obviously, the skill level of the workforce is another important factor in the decision of the investors. Nevertheless, labor taxation should not be permitted to become an obstacle to export growth.

2.7. Inflation-Adjustment

143. With an increase in domestic inflation, a bracket creep on income taxes for some taxpayers occurred in some countries. Similarly, the increased nominal value of monetary assets resulted in high effective rates for corporations.

144. It is suggested to introduce automatic indexation allowances to income and to corporate incomes under the income tax. Particularly, it is recommended to apply progressive rates to constant real incomes rather than to constant nominal incomes.

3. Sectoral Issues

145. This section discusses issues related to taxation of agriculture and public sector enterprises.

3.1. Taxation of the Agriculture Sector

146. All the countries in the Region produce both exportable traditional products (i.e. coffee, bananas, sugar, cotton, and cocoa) as well as basic grains (i.e. rice, sorghum, and corn). Wheat is imported, mostly from the U.S. under the PL-480 program. In general, the countries in the Region have a comparative advantage in the production of traditional products. However, basic grains production is inefficient and it is not obvious whether the Region has a comparative advantage in the production of basic grains.

147. Tax collection from the agriculture sector is low, except for traditional export crops. First, the share of the sector in the economy in all the countries has declined over time. Second, a very low share of agriculture income is subject to income taxation. Third, subsistence farmers retain a significant share of their production for home consumption and hence avoid paying taxes.

148. While export agriculture is taxed, basic grains are subsidized. Coffee production is handled mostly by large firms in Guatemala, although small firms dominate production in Honduras and in Costa Rica. In El Salvador, the authorities tried to break up the large coffee holdings through land reform after 1979. Banana production is mostly in the hands of foreign companies. The countries in the Region provide subsidies to basic grain producers to achieve self-sufficiency. Producers are mostly small except for those producing rice. Consumer prices are also subsidized to protect the urban population. The public sector finances subsidies from the budget. Since yields are low compared to world averages, production is high-cost. Despite the subsidies, domestic prices--both at the producer and the at consumer level--are higher compared to international prices. The policies are implemented by public entities responsible for marketing basic grains in the Region. The losses of some of these entities were large in the past and contributed to the increased overall non-financial public sector deficits. The SAL I operation in Costa Rica, for example, aimed at reducing losses of CNP--Consejo Nacional de Produccion, the basic grains marketing agency--while moving domestic prices toward international price equivalents.

149. Agriculture sectors in Central America are discouraged by import-substitution policies. These policies have led resources to shift from agriculture to industry. Export agriculture was further penalized by taxes, which led to negative effective protection. Within agriculture, however, basic grains agriculture was encouraged not only through price subsidies given to producers as well as to consumers, but also by quantitative import restrictions and subsidies on inputs, low-cost credit and exemptions from import tariffs. It is not possible to quantify at this time the relative profitability of basic grains vis-a-vis import-substitution activities in industry, but clearly effective protection accorded to basic grains is high. Assistance provided to non-traditional

export agriculture, however, remains limited. This latter point is important to explain why non-traditional exports have not achieved spectacular growth rates as some scholars on Central America expected based on the granting of some limited incentives.

Conclusions

150. Efforts should be made to develop the sector and accelerate production, exports and employment. Taxation policies should be used to bring about needed structural changes. First and foremost, quantitative restrictions on imports would need to be phased out. To achieve these objectives, domestic prices of basic grains need to be aligned with international equivalents and subsidies phased out. Furthermore, assistance to non-traditional export agriculture has to be stepped up.

151. The net impact of the suggested changes on government finances should be favorable. Phasing out subsidies to basic grains should lead to a reduction in the overall deficit of the public sectors in the Region. This should also contribute to a more rational allocation of resources in these countries. However, increased assistance to non-traditional export agriculture will likely require additional public outlays.

152. From the point of view of taxation, agricultural income could be classified into following four categories:

- (i) subsistence sector;
- (ii) primary exports;
- (iii) incomes in the agriculture sector; and
- (iv) agricultural property.

Taxation of subsistence agriculture is not recommended at this stage, given low incomes and rural poverty as well as consequent political difficulties likely to be faced as a result of a tightened collection effort. Hence, basic grains should be exempted from domestic taxes. Taxation of primary exports is discussed separately in the report. Taxation of agriculture income through income taxes is difficult. As discussed elsewhere in the report, it is suggested that selective export taxes be used as a substitute for income taxes in the short-to-medium term (i.e. tax on coffee and banana exports). In the long-term, however, it is suggested that income taxes replace commodity taxes. Taxes on agricultural property and land would need to be increased and forcefully applied. In countries such as El Salvador, where land is scarce and the distribution of land and income is unequal, land taxes could serve the objective of equity. The distribution of income as well as to improve utilization of land. Fiscal reform in agriculture has to be accompanied by the liberalization of agriculture sector policies, in particular, pricing and trade policies. Phasing out price controls and quantitative import restrictions should contribute to revenue growth in all the countries in the Region.

3.2. State Economic Enterprises

153. In the Region, there has been a proliferation of the number of public enterprises in the past several decades. In some countries, such as

in Costa Rica and Honduras, both the number and financial significance of these enterprises grew steadily. In the case of Guatemala, the public enterprise sector remained limited as the authorities did not wish to have a large public sector to maintain financial equilibrium, given the historically low tax ratio noted elsewhere in the report. In El Salvador, a number of enterprises were established to execute and monitor the Agrarian Reform after 1979.

154. The impact of state economic enterprises on public sector finances is significant in the Region. In some years and for some countries, the deficits of state economic enterprises accounted for the bulk of the total non-financial public sector deficit. Pricing and investment decisions play a key role in the net impact of these enterprises on their overall finances. Not adjusting prices in line with increasing domestic inflation and devaluations as well as undertaking ambitious public investment programs without ensuring prudent levels of financing also add to the financial problems of these countries.

155. There are also dissimilarities regarding the adjustment experience in the Region. In Costa Rica, for example, there has been a demonstrated willingness on the part of the Government to adjust public sector prices in line with financial requirements. In Guatemala, however, the scope for revising prices has created difficult political problems. In Honduras, the fixed exchange rate policy of the Government has ruled out most public price adjustments.

156. The overall finances of state economic enterprises do not show a uniform pattern in the Region. Some enterprises have incurred large deficits on their current accounts as well as on their overall finances. In part, these deficits stem from inefficiencies in operations (i.e. overemployment). Almost all power companies in the Region have faced or are facing difficult financial situations (i.e. ENEE in Honduras, ICE in Costa Rica, and INDE in Guatemala), whereas telecommunications and port operations are generally profitable (i.e. The Port Authority in Honduras). In general, public enterprises run large arrears on their payment obligations to other public utilities (i.e. to water, electricity, telephone companies), leading to a deterioration of finances of the creditor entities and failure to pay for taxes leads to distortions in resource allocation in the economy. Whereas in Costa Rica, the Central Government was the recipient of transfers from the rest of the public sector on a net consolidated basis, in Honduras the Central Government transferred resources to the rest of the public sector, and mostly to ENEE to finance its investment program and in some years even for the entity's working capital requirements.

157. Some of the enterprises have been established in those areas in which the private sector has a comparative advantage. In addition, some enterprises have been inadequately managed, resulting in inefficiency and waste. Both Costa Rica and Honduras began to divest some of these enterprises (i.e. The Public Development Bank, CODESA, in Costa Rica and the Public Development Bank, CONADI, in Honduras). Honduras is also in the process of defining the coverage of enterprises it intends to privatize in the next few years.

Conclusions

158. Public enterprises should be subject to the same tax regime as private firms. In other words, public enterprises should not be given a competitive edge or a privileged treatment under public policy such as subsidized credit or other forms of subsidies. These enterprises should be required to determine the prices of their outputs at marginal costs and pay the opportunity cost of their inputs. In other words, their outputs and inputs should be valued at marginal economic costs. Given the scarcity of capital in these countries, these enterprises should earn a satisfactory rate of return on invested capital, and recover at least operating and maintenance costs, including debt service, as well as a reasonable amount of their capital expenditures. Subsidies given to public sector enterprises should be made explicit and budgeted. These entities should also charge other public sector entities for the sale of their services and output and begin to eliminate arrears to each other that they have accumulated over the years. Central Governments should be required to pay the relevant public entities for the use of electricity, water and telephone charges. To rationalize operations and reduce financial disequilibria, these enterprises should also reduce their redundant and inefficient work force.

159. The privatization efforts underway in these countries, especially in Costa Rica and Honduras, should be continued. The authorities may wish to consider closing down enterprises, whose continued operations are not justified under the present circumstances. One option to reduce the size of the public sector in these countries is to break down functions of public enterprises into various components to determine which ones could be terminated, reformulated or passed on to the private sector through sale, management contracts or other instruments. One such example of a public enterprise is IHCAFE in Honduras. The entity is currently in charge of a series of functions which are already being fulfilled by other public and private sector entities. If those functions are transferred to the corresponding entities, IHCAFE should then be closed down. Care has to be taken to ensure that future growth of public enterprises does not crowd out the private sector.

160. It is essential that public sector institutions which generate financial profits, such as telecommunications and ports, be taxed. As long as prices are determined based on marginal costs, and the investment programs of the entities in those sectors respond to the structural adjustment needs of the countries, overall surpluses of these entities would need to be transferred to Central Governments in taxes.

4. Fiscal Incentives

161. Central American countries have provided various incentives to different productive activities since the inception of the Customs Unions. Some of those incentives were granted to reinforce the regional import-substitution policies, while others were provided to increase the profitability of exports outside the CACM. The provision of the latter type of incentives failed, in the past, to alter the anti-export bias of the CACM trade regime in any significant way. In general, the fiscal incentives aim at the following:

- (i) increasing gross revenues from exports;
- (ii) reducing the cost of imported inputs for domestic industries; and
- (iii) increasing after-tax profits of corporations through reducing profit tax liabilities.

4.1. Tax Exemptions

162. In Central America, virtually all taxes allow a large number of exemptions. Especially large exemptions under the import tax are significant. In Costa Rica, the fiscal cost of exemptions under the import tax averaged about 4% - 5% of GDP in the recent past. In El Salvador, the yield from the import tax averaged only about 1% of GDP. Exemptions are generally granted to diplomatic representatives, international organizations, cooperatives, military, religious groups, and tourists. Major exemptions, however, are given to industry (previously under the industrial incentive scheme) as well as agriculture and public sectors. Cooperatives are exempted from income taxes in most countries in Central America.

163. The granting of exemptions has unfavorable consequences. First, they reduce the yield and collection from existing taxes. Second, exemptions under the import tax intensify already high effective protection to the industrial sector. Third, exemptions given under the income tax distort the form of ownership, favoring cooperatives and discouraging other forms of ownership such as corporations. They also reduce the already low share of direct taxes in total taxes. Additionally, exemptions granted to the public sector generally lead to the inefficient use of imports by the public sector and they discriminate against private firms which are required to pay taxes on their imports competing with public sector firms.

164. Conclusions. Any meaningful tax reform should aim at phasing out exemptions--except those provided for imported inputs for non-traditional exports to markets outside the CACM. Clearly, the action program should be carefully planned and executed over a number of years to allow firms to adjust to new economic realities. Elimination of public sector exemptions is vital to induce the public sector entities to increase their efficiency and reduce waste.

4.2. Taxation of Inputs

165. The objective in the taxation of inputs is to permit non-traditional exporters to markets outside the CACM to purchase their inputs at competitive world market prices. To achieve this objective, a free trade status for exporters should be established. Additionally, export sectors should be able to obtain non-tradable inputs (i.e. public goods and services such as electricity) at efficiency prices. The former can be ensured through establishing and maintaining an effective draw-back system as discussed in this report. The latter requires an efficiency pricing system for public goods.

4.3. Investment Incentives

166. The previous CACM trade incentive framework provided for investment incentives for industrial enterprises under "industrial contracts" to promote private investment through income and import tariff exemptions on capital goods. The objective of providing such incentives was to lower production costs in order to promote investment and exports as well as employment. They were also used to provide generous incentives to encourage industry to locate in relatively backward areas and thus reduce the geographical concentration of industry around the capital cities. Following the introduction of the new trade regime on January 1, 1986, the regional investment incentive scheme was abolished. In its place, each country introduced new investment incentives on a national basis, mostly retaining the features of the previous investment incentives.

167. In the case of Costa Rica, the new scheme provides partial income tax exemptions for new investments, with priority assigned to the regional market. The incentives are granted on the basis of various criteria, including domestic content of production, net generation of foreign exchange by firm, regional location of industry, and form of ownership - with preference being assigned to cooperatives. Investment incentives assign priority to production of intermediate products, light machinery, equipment and tools, as well as to agro-industrial products.

168. While the need to encourage private investment is a high priority, it is not evident to what extent the investment incentive scheme as implemented in the Central American countries is an effective vehicle for achieving this goal. First, there is the possibility that firms could be promoted in non-competitive areas through these incentives. Second, these incentives intensify the capital-bias of the trade regime and discourage the use of labor-intensive technologies. Third, the provision of investment subsidies for products consumed in the Region heightens the regional bias of the trade regime and reduces incentives for non-traditional exports to markets outside the CACM. Fourth, tax exemptions for capital goods reduce effective protection for those items and distort the incentive system regarding the choice of products.

169. In the case of Costa Rica, the new investment incentives have an anti-export bias. Since exports are already exempt from income taxes, industrial incentives are useful only for non-exporting activities. The sectors in which the authorities assign priority do not seem to be those in which Costa Rica has an apparent comparative advantage. Furthermore, the new incentives are inconsistent with the strategy of promoting exports to markets outside the CACM. Lastly, these incentives reduce the already low share of direct taxes in total revenues.

170. Conclusions. This report suggests phasing out investment incentives as implemented in Central America. It is suggested to provide exemptions on capital goods planned to be used for manufacturing non-traditional exports outside the CACM for a limited period. Other incentives could be designed to encourage private investment, such as accelerated depreciation and tax holidays for less developed regions of the countries in the Region. In the latter case, tax incentives should not be used as a substitute for the provision of adequate infrastructure. Among

the countries, it is important to ensure uniformity of incentives, including those that relate to granting of incentives for foreign firms on repatriation of earnings, land titling and provisions governing employment of labor. Harmonization of incentives is needed to avoid ruinous competition, which might ensue among the countries in trying to outbid each other to attract foreign investors. Hence, harmonization of incentives on this issue is essential.

4.4. Export Incentives

171. To reduce the anti-export bias of the trade regime and encourage the growth of exports, virtually all the countries in the Region attempted to provide export incentives to non-traditional exports to markets outside the CACM. These incentives generally take two forms: (i) direct subsidies to a defined group of non-traditional exports outside the CACM on the basis of either value added generated in exporting or on a FOB export value basis; and (ii) permitting firms to use imported inputs at world market prices through various draw back schemes. The first type of incentive is granted as a CAT and a CIEX in Costa Rica, and the second type is granted under various schemes such as draw backs, maquilas, and export contract regimes (i.e. which offers a package of incentives to exporters through a defined program of export growth). Rebates on taxes are either given as a share of FOB value (as in CATs) or as export increments (as in CIEXs). Regarding the latter incentive, tariff exemptions are granted both to imported intermediate and capital goods. The fiscal loss associated with both of those schemes have been high in the past, forcing governments to abandon granting of CATs or decreasing the range of products eligible to receive these incentives in cases of fiscal difficulties.

Conclusions

172. Given the tight fiscal situation in all the countries in Central America and the high fiscal cost of these incentives, this report suggests that export subsidies be phased out and exchange rates be relied upon as the main vehicle for promoting exports. In the short-term, it may be useful to retain this incentive, given the difficulties of adjusting the exchange rate adequately in virtually all the countries in the Region.

173. Given the strong anti-export bias of the trade regimes of these countries, however, these subsidies offset to some extent the cost disabilities faced by exporters, and hence retaining them in the short-term should not be objectionable. However, GATT rules require that all subsidies be eliminated. Costa Rica, for example, applied to GATT for membership in 1987 and GATT rules require the elimination of the CAT subsidy in order for Costa Rica to be able to join this multilateral institution. In view of this requirement, rapid dismantling of tariff barriers coupled with more flexible and aggressive management of the exchange rate will be needed to achieve export competitiveness in the absence of this export incentive.

174. Regarding the various draw back schemes, it is suggested that this feature of the incentive system be maintained, but its administration should be improved. This scheme allows exporters to obtain inputs at world

market prices. This is essential to meet quality demands of stringent export markets. This report also suggests that these inputs be exempted from domestic transaction taxes and indirect exporters obtain access to these exemptions (i.e. both from import and domestic transaction taxes for both capital and intermediate inputs). Obviously, the incorporation of indirect exporters to the scheme will likely take time, but an effort has to be initiated in that direction.

175. To have successful draw back and maquila schemes requires the elimination of tax exemptions granted to imports under various schemes. If a large share of imports are exempted from the payment of import duties, the differential impact of this scheme on the relative profitability of non-traditional exports to markets outside the CACM vis-a-vis import-substitution activities should improve.

176. There is also a need for separating exemptions granted for capital goods from those given to raw materials and intermediate products. The former should be handled through a longer-term contract such as an export contract as practiced in Costa Rica, while administration of the latter should be automatic. Development of reliable input-output coefficients is a prerequisite to a well-functioning draw back scheme. Without those coefficients, it may prove to be difficult to monitor an effective functioning of the system. Leakages (i.e. use of exemptions for purposes not related to the original purpose of the scheme) could well be high, with other exports (i.e. those to CACM and traditional exports) also benefiting under the system and offsetting the benefits assigned to non-traditional exports to markets outside the CACM.

4.5. Income tax exemptions for non-traditional exports outside the CACM

177. This incentive includes exemptions from income earned on non-traditional exports outside the CACM. For example, Costa Rica introduced a 100% income tax exemption on profits generated by non-traditional exports to markets outside the CACM. This scheme is estimated to provide a subsidy of roughly 10% of the FOB export value. Administrative costs and delays reduce the benefit of this exemption.

178. Conclusions. Incentives are granted to non-traditional exporters through various incentive schemes (export subsidies, exemptions from import taxes on inputs and capital goods). A flexible management of the exchange rate should provide adequate financial profitability to this category of exports. Hence, further incentives in the form of exemptions from import taxes is not suggested. It is important that this aspect of the tax system be harmonized.

5. Institutional Issues

179. This section deals with issues related to institutional rigidities in the tax systems of the Central American countries. One such major institutional rigidity is the practice of earmarking as explained below.

The Practice of Tax Earmarking

180. Most countries in the Region have an established practice of earmarking revenues to be spent for pre-determined activities or institutions in pre-determined ways. Costa Rica has the most extensive earmarking system, where about 100 individual taxes are -- partly or wholly--earmarked. Major taxes, including income, payroll, sales, and export taxes, are all earmarked. Some earmarked taxes accrue solely to the Central Government, some are shared by the Central Government and other entities and some are collected by entities outside the Central Government. Many of the taxes have multiple beneficiaries. In the rest of the Region, a certain percentage of current revenues are earmarked for universities as well as the Supreme Court of Justice (i.e. 6% of current revenues in Costa Rica).

181. The practice of earmarking has led to various distortions and problems. It reduced governments' discretionary spending powers, and their ability to set expenditure priorities and fund new and better programs. It also decreased fiscal discipline and encouraged expenditure growth through perpetuating programs, some of which may have outlived their usefulness. Since revenue increases are immediately converted into expenditures, they also contribute to the fiscal deficit.

182. Conclusions. Over the years, vested interests have developed to maintain and even expand this practice. Especially in Costa Rica, virtually all new taxes introduced since 1980 were, partly or wholly, earmarked. Thus, any change in the direction of eliminating or even reducing earmarking will prove to be politically very difficult in the short-term. Within the context of its medium-term program, Costa Rica agreed not to introduce any new earmarking. However, it is important for all the countries to move in the direction of phasing out the practice of earmarking, with the pace dictated by the political realities in each country.

6. Tax Administration

183. Tax administration is weak in all the countries in Central America. As a result, it is believed that large evasion exists in almost all taxes. Obviously, it does not make sense to continually revise tax rates without a corresponding effort being made to improve collection through reforming the tax administration.

184. Large evasion in most taxes results from a number of factors. First, penalty payments are not called for in case of delinquencies. Second, both the number and training of tax inspectors are inadequate. The remuneration of tax administrators is widely believed not to be adequate to induce them to work honestly. Third, the enforcement effort spread over a number of taxpayers and enterprises dilutes the tax effort. Fourth, a unified tax registry does not exist. Fifth, collection lags are high, leading to reduced revenues in real terms, especially in high inflation countries. Collection lags are usual for about six months for some taxes in El Salvador. Sixth, various taxes are collected by different entities. Lack of coordination among these entities (i.e. customs administration for taxes on trade and internal revenue service for domestic transaction taxes

and for personal income and corporate taxes) makes it difficult to cross-check information, especially between income and sales taxes as well as between customs revenues and domestic transaction taxes. Seventh, existence of a large number of taxes with limited yields and complicated tax structures make it difficult to administer taxes and increase tax compliance costs for taxpayers.

185. One result of the weak administration of taxes has been the low number of contributors for taxes. Table IV shows the number of individual contributors and tax paying legal entities under major taxes in El Salvador as an example.

Table IV: Number of Contributors Under Major Taxes in El Salvador, 1987

| <u>Taxes</u> | <u>Number of Contributors</u> |
|------------------------|-------------------------------|
| <u>Income Tax</u> | <u>51,657</u> |
| Individuals | (49,376) |
| Legal Entities | (2,281) |
| <u>Property Income</u> | <u>14,480</u> |
| Individuals | (11,931) |
| Legal Entities | (2,549) |
| <u>Sales</u> | <u>8,086</u> |
| Individuals | (6,549) |
| Legal Entities | (1,537) |

Source: IMF, Bank Staff Estimates.

186. Conclusions. To reduce evasion and increase collection from existing and proposed taxes, the following actions are suggested:

- (i) establishing reasonable penalty rates for tax delinquencies and forcefully implementing them (i.e. high penalty rates would likely prove to be politically difficult to apply);
- (ii) providing training and technical assistance to tax administration agencies, adjusting salaries of tax administrators in line with changes in the cost of living in order to reduce incentives for seeking other sources of income and firing staff in cases of demonstrated lack of integrity;
- (iii) concentrating tax collection efforts on large corporations and on wealthy people;
- (iv) establishing a unified tax registry;

- (v) implementing a program to reduce collection lags;
- (vi) eliminating small taxes with limited yields;
- (vii) establishing and maintaining close coordination among the various units in charge of tax administration to facilitate cross-checking information; and
- (viii) simplifying tax administration and complicated tax structures to reduce collection and taxpayer compliance costs.

D. Impact of Liberalization Policies on Fiscal Revenues

187. The countries in the Region have started or are in the process of considering undertaking liberalization measures in financial sectors and in agriculture. On balance, the impact of liberalization policies on fiscal revenues should be positive. First, if further tariff reform is accompanied by an increase in the tariff floor rate and a reduction in exemptions, fiscal revenues should expand. Moreover, growth in financial aggregates--as a result of financial liberalization--should lead to higher tax collection in response to an expansion in economic activity. Similarly, liberalization of agricultural policies should increase revenues as efficient production is encouraged. Additionally, reduced subsidies on basic grains (in which comparative advantage does not seem to exist in the Region) and increased tariff revenues from liberalized trade (i.e. through phasing out quantitative import restrictions) should provide additional fiscal revenues.

E. Medium-Term Economic Goals

188. The medium-term objective of all the countries in Central America should be to regain an acceptable growth rate consistent with a sustainable balance of payments position. Taxation policies should be consistent with this medium-term objective. In particular, they should contribute to improving resource allocation through modifications in taxes on trade and in domestic transaction taxes. Reduction in effective protection will make exporting profitable compared to selling in the regional and domestic markets. Elimination of taxes on exports except those on coffee and bananas will improve their profitability. On the other hand, increased taxation of domestic transactions would tend to increase exportable supply by constraining domestic consumption and improve balance of payments through reducing import demand.

F. Phasing of Reforms

189. The medium-term objective of the tax reform should be to shift reliance from taxes on trade to those on domestic transactions and income. This goal can not be achieved in the short-term, given the current weak tax administration capacity in the Region. It also has to be noted that the

countries may not be able to undertake complicated reforms. The speed with which rationalization measures can be implemented will be constrained by revenue needs as well as administrative capacity in each country.

190. Three points deserve mentioning regarding the rationalization of tax structures. First, it is not realistic to expect a simultaneous introduction of all changes in one stage. Hence, there will be a need for sequencing of reforms to ensure that the rationalization process does not lead to net losses of government revenues. Second, incremental changes need to be consistent with the long-term desired tax structure, and temporary changes should not be introduced just to generate revenues. Third, the number of tax changes should be minimized.

191. Given the openness of the economies in Central America and the inability to control smuggling through the borders as well as the ease with which traders can underinvoice export receipts and overinvoice import expenditures, tax rates on trade (both on exports and imports) should be set at reasonable levels.

G. Main Conclusions

192. General principles needed for the harmonization of tax policies in the Region include the following:

- (i) continuing the trade liberalization process, already started, through reducing the level and dispersion in effective protection;
- (ii) shifting reliance of the tax system from trade to domestic transactions and income;
- (iii) making the value added tax cum selective consumption taxes the backbone of the tax system and harmonizing those taxes among the member countries;
- (iv) harmonizing taxes on inputs and exempting non-traditional exporters from the payment of import duties on imports;
- (v) moving in the direction of coordinating taxes on factor incomes (i.e. personal income, corporate income, poverty and land taxes, taxes on financial gains) to avoid double taxation and provision of competitive tax incentives among member countries, or using factor income taxation to discriminate against nationals of other countries;
- (vi) eliminating export taxes on non-traditional exports outside the CACM;
- (vii) eliminating all quantitative import restrictions, prior imports deposits, non-common import tariffs and other restrictions on imports from other CACM members;
- (viii) applying similar principles in designing export taxes on coffee and bananas;

- (ix) not using differential exchange rates to discriminate against regional trade; and
- (x) improving tax administration.

193. The present challenge is to transform the Central American Customs Union to a modern common market. This could only be achieved through strong reform of the tariff regime. This report makes suggestions for an action plan to achieve this objective. It does not analyze the political feasibility of the suggested actions, and assumes that they are doable. It is important to note, however, that at this juncture, options to grow out of the present economic problems are limited in the Region and hence the implications of not undertaking the suggested reforms would likely be politically greater than introducing those reforms over time. If implemented, --along with other structural reforms--it is hoped that these reforms would help spark the latent growth potential in Central American economies.

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