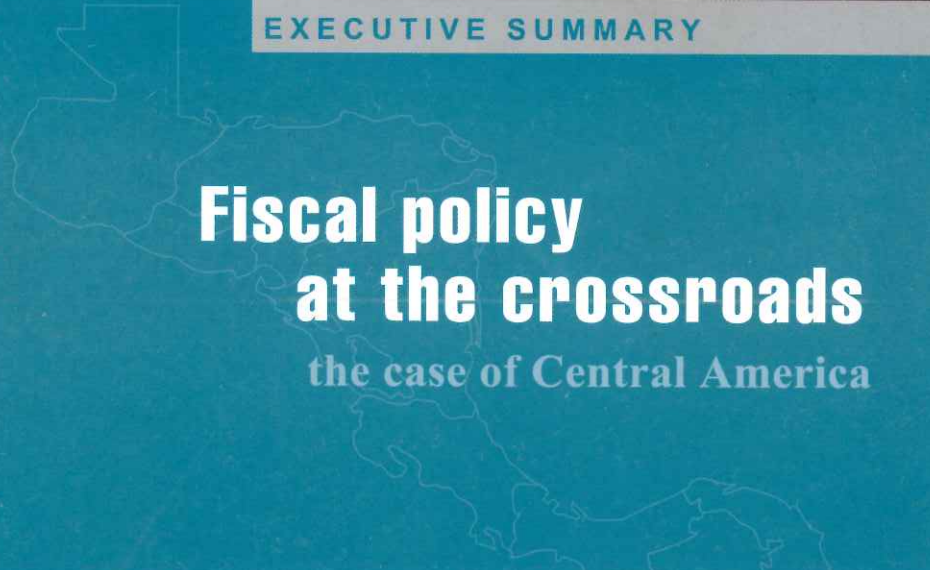




EXECUTIVE SUMMARY



**Fiscal policy  
at the crossroads**  
the case of Central America

**CENTRAL AMERICAN INSTITUTE FOR FISCAL STUDIES**

9 calle 5-21J zona 10

Guatemala City, Guatemala

Telephones: (502) 2361 1570 to 74

[www.icefi.org](http://www.icefi.org)

This is the Executive Summary of the publication "Fiscal policy at the crossroads: the case of Central America" (ICEFI, June 2007, 228 pages). You can find and download the Spanish Version at [www.icefi.org](http://www.icefi.org)

Partial or total reproduction of this document is allowed subject to the reference of the source.

Translation from Spanish: Nikken Cullman

# EXECUTIVE SUMMARY

---

## Fiscal policy at the crossroads: the case of Central America

### A. BACKGROUND

Fiscal policy in Central America faces serious problems. The present levels of investment in infrastructure and public expenditure on education, health and security are clearly insufficient compared to what is required to drive a sustained process of growth with wellbeing and equity in a context of globalization and democracy. Verification of the efficiency with which public resources are used in national and local environment in a systematic, public and comprehensive manner in order to reach the results and goals of development is still a pending assignment. At the same time, the transparency of expenditures, especially at the municipal or decentralized level, leaves much to be desired and accusations of corruption and misuse of public resources are common. The audit mechanisms are deficient in most of the countries. In addition, the legislatures have difficulty in assuring a level of fiscal control that goes beyond denunciations of corruption.

Government income is insufficient to cover the needed expenditure of the countries of the Isthmus. The level of control over tax evaders and the sanctions for punishing them are still extremely weak. The potential of taxes applied to income or inheritance has not been exploited. The taxes applied to consumption continue to be the foundation of taxation in most of the countries of the Isthmus, in contrast to other countries that rely on two pillars, one of taxes applied to consumption and another of taxes applied to income. Part of this weakness is explained by a group of exemptions and exonerations that seriously erode the base of all taxes, but especially the income tax.

History demonstrates that the obstacles that prevent change have been formidable. The strong and concentrated opposition of certain economic elites has not permitted the development of a more complete and adequate fiscal system. In more recent times some of these elites have invested in privileged sectors that do not pay taxes and, consequently, oppose the strengthening of taxation, although these sectors are the most dynamic of the economy. The existence of these privileges along with the fact that various segments of the Central American population, of high and low income, do not perceive that they benefit from the services of the State, makes it difficult to reach agreements or social contracts that create long term political sustainability of the public finances.

The establishment of democratic regimes in all of these countries has opened spaces for fiscal reforms to be carried out, although with notable difficulties. A financial dependence persists, in the political parties, on the powerful economic sectors; and a technical weakness persists with respect to fiscal matters, especially taxes. In addition, the absence of parliamentary majorities hinders the expeditious implementation of reforms, and the theme of taxation is not taken as seriously as it should be.

## B. ADVANCES OF FISCAL POLICY

Although serious problems persist, there have been important advances that permit a glimpse of possible changes in the future. The management and transparency of public expenditure, especially of central government expenditures, have improved noticeably in recent years. This has been demonstrated by the introduction of integrated financial administration systems, with information open to the public in almost every country in the region. Public expenditure directed toward driving social development, especially in education, has increased significantly in all of the countries. Most of this expenditure is positively affecting the wellbeing of the poorest homes. Although the results of the implementation of diverse poverty reduction strategies can be controversial, programs of universal primary attention in health and education and other complementary programs that have transferred resources to poor or vulnerable families on the condition that they send to their children to school and participate in programs of maternal-infantile health, have had unquestionable and positive results where they have been applied.

The advances in the realm of taxation have also been important. Higher rates of economic growth have allowed the tax administrations to count on a greater absolute amount of resources. The tax burden, which measures the proportion of the national income directed toward the payment of taxes, has also increased in all countries. This progress reflects partial reforms, generally modest, which have nevertheless reduced some privileges, strengthened tax administration and diminished evasion. The introduction of control and retention mechanisms, especially in the case of the Value Added Tax (VAT), has contributed to the increased tax revenue in some countries, while other micro-reforms, including broader definitions of taxable income or more

precise definitions of allowable deductions, have contributed to a higher collection of income tax.

The legislative branches, through diverse alliances, have managed to introduce these reforms even with the opposition of certain economic elites, and the search for formal or informal "fiscal pacts" has begun to take place in all countries of the Isthmus. The preoccupation with the fiscal subject is clear. Recent reforms oriented toward the achievement of "horizontal equity", which is to say, those that have similar income or consumption levels pay similar levels of taxes, are those that have advanced most. In addition, the strengthening of the tax administration, with strong support from the international community, has shown its potential to make ambitious fundraising efforts.

### C. THE CROSSROADS: THE POSSIBILITY OF CONFRONTING THE CHALLENGES

The advances in the area of public expenditure and taxation establish solid foundations from which it is possible to confront and resolve the problems that remain. With these advances as a base, Central America now finds itself at a crossroads that presents strong possibilities of advancing much further. In the present crossroads, there are at least six challenges in the area of public expenditure and budget management and five challenges in the area of taxation that can be identified, in addition to a significant political hurdle, which must be overcome to achieve effective reforms. All of these are framed within the necessary development of institutions in each country and the Isthmus as a whole, including the strengthening of regulations and rules as well as the reinforcement of the organizations responsible for their implementation.

## 2. The challenges of taxation

The five challenges in the realm of taxation include, first, increasing the tax collection and guaranteeing that it increases the tax burden. This implies, among other things, the inclusion of the most dynamic productive sectors in the tax base. Second, direct taxation must be strengthened, particularly the tax applied to personal income since its level is very low when compared with other countries. This requires the development of a debate on the base of the tax and its treatment (universal treatment of income or different treatments for distinct sources of income), geographic range (world-wide or territorial) and the rates that would be applied (progressive, single rate with a floor, or proportional), in addition to the treatment of exemptions and exonerations.

The third challenge is agreeing to improve the equity of the tax systems, ensuring that they are perceived as just and, in particular, that they do not facilitate abuses or evasion. To face this challenge means strengthening the tax administration, an institution whose importance must be strongly emphasized. A fourth challenge is to improve the technical aspects of the taxes so that they do not favor certain activities or sectors more than others, and do not promote inefficiency and increased risk and uncertainty, which discourages investment. The fifth challenge consists of achieving a convergence and possible harmonization of the Central American tax systems. The history of tariff harmonization along with the will to establish a customs union and to avoid a "war of incentives" over the attraction of foreign investment is the foundation of this challenge.

## 3. The challenge of implementing a strategy of reforms

The last great challenge is of a political nature, and it is the priority. It relates to the implementation of the required reforms, especially

the tax reforms, in order to confront the previously identified challenges. The history of the political economy related to taxation in Central America provides some elements for reflection on this subject.

In the first place, the agreement to conceive a strategic alliance is raised, which can go beyond the parties and the legislative branch –without dismissing their protagonism as a basis for democracy– to include other social and business organizations. Historically, the strong and concentrated opposition of the economic elites to taxation, in particular, suggests a selective focus on them, presuming less opposition on the part of those factions that are more distant from the traditional agrarian matrix and demand less exemptions and exonerations to grow and compete.

Secondly, the content of the reforms could generate minor opposition in that they favor horizontal equity, thus transmitting a sense of justice and opposition to anticompetitive practices. Integration of tax reforms with other reforms – simultaneous or previous – of public expenditure, meant to improve transparency and allocation, and favor equity as much as growth and competition, can enhance taxpayer compliance and also create the foundation for a broader social contract on the topic of fiscal policy.

Thirdly, the international context and the role of external actors can favor the reforms, although without being necessarily decisive. To advance in this sense can mean obtaining support from the multilateral finance organizations and the international community; to transmit a message of clear rules for foreign companies that generally see themselves as more pressured to comply with their tax obligations than their national counterparts (even when they adopt more sophisticated techniques of evasion, such as transfer pricing); to adjust to international norms like the obligation of the

World Trade Organization (WTO) of not exonerating income tax for exporters; and to take into account the opinions of the credit rating agencies, which increasingly identify a solid fiscal policy not only as a condition to maintain macroeconomic stability but also as a requirement to assure governability.

Finally, the probability of success for a strategy of reform will be greater if it is pushed forward as part of a rising national conscience regarding the transcendence of public finances for the development of the countries of the Isthmus. It would have to include greater voluntary compliance on the part of taxpayers and an increasing honesty and effectiveness in the use of public resources, as well as the social sanction of those who seek exemptions and exonerations at the cost of the national wellbeing.

## **CENTRAL AMERICAN INSTITUTE FOR FISCAL STUDIES**

The Central American Institute for Fiscal Studies (ICEFI by its acronym in Spanish) develops economic research and technical analyses related to fiscal issues in Central America. Founded in 2005, the Institute is independent from any kind of political, social or governmental group. ICEFI also provides information, training and consultancy about fiscal policy to governments, parliaments, social and political organizations, and private institutions to positively influence in the creation of public policies that build thriving, fair, and democratic societies.

ICEFI also promotes respectful debates and analytical reflections about fiscal issues in Central America, with a long term and integral vision, and technical grounds in search of political and social consensus on fiscal policy.

### **THE INSTITUTE ENGAGES IN WORK WITH THE FOLLOWING OBJECTIVES:**

1. Simplify the fiscal policy's complexity through giving comprehensible information about the issue
2. Promote openness in governmental management
3. Favor governmental accountability reports
4. Provide credibility for fair fiscal policies
5. Improve the formulation and implementation of a fair fiscal policy



[www.icefi.org](http://www.icefi.org)



9 calle 5-21J zona 10

Guatemala City,

Guatemala

Telephones: (502) 2361 1570 to 73

Fax: (502) 2361 1574

E-mail:

[comunicacion@icefi.org](mailto:comunicacion@icefi.org)