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# Central American fiscal policy in times of crises

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EXECUTIVE SUMMARY

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## 1. Introduction

The Central American Institute for Fiscal Studies (Icefi), in its first report on fiscal policy in the region, published in 2007, stated that: «[...] fiscal policy in Central America is at a crossroads: it is possible to take steps to enable the isthmus to be on a new path of economic growth ensuring equity and prosperity for all people, but this will require an effort to increase taxation and improve the efficiency of transparent public spending.» This statement was made within the period of the greatest economic growth that the region has experienced in recent times.

This expression is still valid and has a greater sense of urgency after the international economy has suffered one of its worst crises since the great depression of early last century. The global economic recovery has been weak and uncertain, and the low growth of the United States, the debt problems in Europe and the first signs of reduced dynamism of emerging economies show that growth prospects for the region in the coming years are, for most countries and in the best of cases, low.

Fiscal policy in Central America faces, therefore, new challenges arising from the sluggishness that tax revenues might have at a time when social demands grow and test the emerging democracies of the region. Additionally to the behavior of the international economy, new and complex challenges, such as insecurity, drug trafficking and the increasing effects of climate change, are added to traditional ones such as fighting poverty and generating equitable economic growth.

In presenting its second report on Central American fiscal policy, Icefi seeks to achieve three main objectives: first, take stock of the main characteristics of fiscal policy over the last ten years, highlighting the effects of the Great Recession on the economies and countries' tax revenues and the economic policy responses taken by governments. Second, analyze how the main components of fiscal policy affect equity, highlighting in this case, how social policy is an effective instrument to

reduce inequalities. Third, Icefi seeks sustainable fiscal policy that supports growth, promotes equity and adapts to changing conditions in the international environment, which require reforms in the field of revenues, expenditures and transparency.

The report contains four chapters and a final section of conclusions and challenges. The first chapter analyzes the main trends of the Central American economies during the last ten years and how poverty and inequality have evolved. All of this provides a framework for understanding the economic and social context in which fiscal policy is developed. The second chapter presents the structure of fiscal revenues and expenses during the period of analysis, analyzing their implications towards the promotion of equity. Chapter three analyzes the dynamics of income, expenditure, deficit and public debt and poses a broad framework for a discussion on fiscal sustainability. Three scenarios, designed to provide sustainability to public finances in the region, are presented. In the fourth chapter, the report addresses the issue of the political economy of tax reforms. The report ends with a section of concluding remarks.

Fiscal policy influences the decisions and economic achievements of the members of a society and of the society as a whole. As part of its comprehensive and long term vision, Icefi promotes the discussion and reflection of fiscal issues in order to seek consensus and agreements that contribute to the construction of equitable, democratic and prosperous societies and States. That is why this report, is focused on contributing to the understanding of the role of fiscal policy in the promotion of equity in the countries of Central America.

## 2. A turbulent decade in economic terms

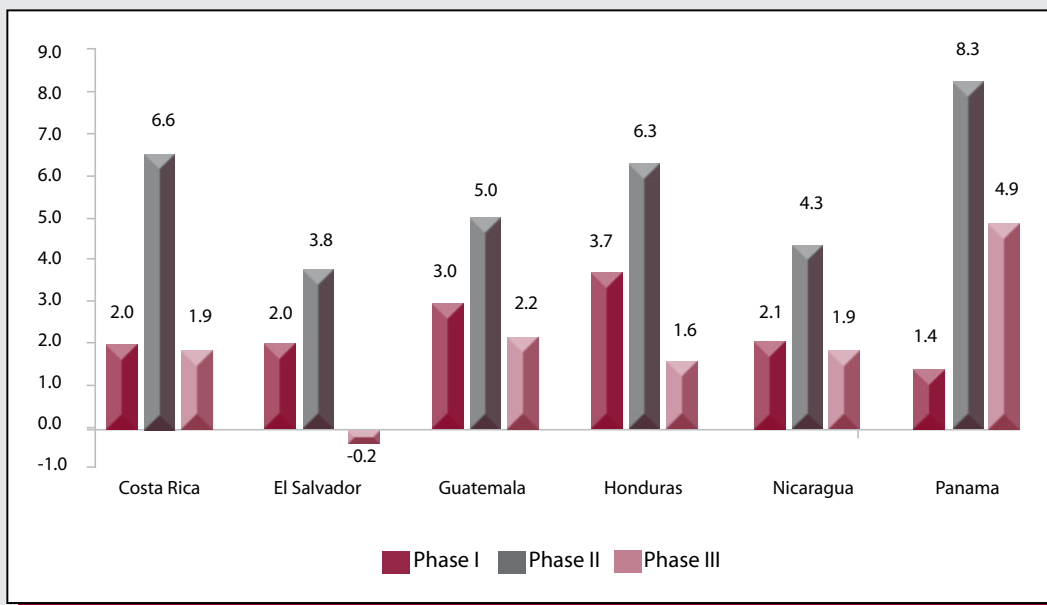
The year 2010 capped a decade of turbulence in the economic stage in Central America. During that time, the economies of the region went through three phases: an initial slowdown, a second phase of economic booms, followed by a phase in which there was an increase in energy and food prices, and an economic recession in most countries. The three phases occurred in all countries, although with a different

magnitude and duration. This has led to a significant economic impact on job creation, poverty reduction and public finance.

The third phase was under the shadow of the *Great recession* of 2008-2009, when the collapse of economic activity could only be compared to the debt crisis which merged with the internal conflict in Central America in the early eighties. During the recession, all countries reported low growth rates, which on average were



**Graph 1: Central America: phases of economic growth (2001-2010)**  
(Percentages of average growth)



**Source:** Icefi, based on official data.

**Note:** Phase I includes 2001-2002 for Costa Rica and Panama; 2001-2003 for Honduras and Nicaragua; and 2001-2004 for El Salvador and Guatemala. Phase II includes from 2003-2007 for Costa Rica; 2003-2008 for Panama; 2004-2007 for Honduras and Nicaragua; and 2005-2007 for El Salvador and Guatemala. Phase III includes 2008-2010 for all of the countries, except Panama, for which it only covers 2009-2010.

between 1 and 2%, with the exception of El Salvador, whose level of activity contracted, and Panama, where the crisis was not as intense. The most critical year was 2009 because, with the exception of Guatemala and Panama, every country faced a recession or a fall in levels of economic activity. In 2008, there was also a crisis situation due to the substantial increase in prices of petroleum products and food. By 2010, there was a modest recovery in the economies of the region.

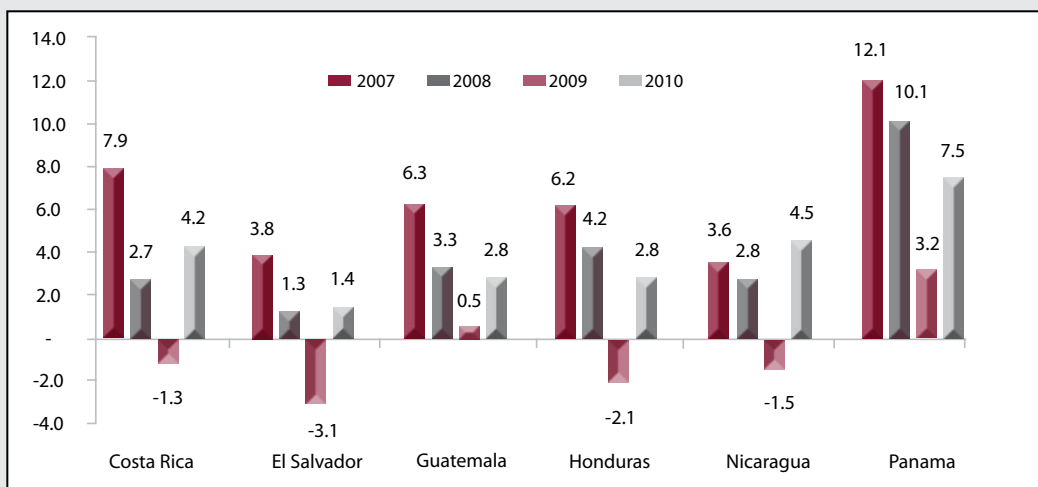
In summary, during the third phase, the country that saw its economic growth most severely affected was El Salvador, followed by Honduras. Both reported a significant difference (almost 6%) between the growth rate observed in 2008 and 2009. Then, Costa

Rica and Nicaragua suffered from falling into a recession since GDP fell in 2009, a situation which Guatemala escaped, but in all three cases, the difference between the previous year and the year of the crisis was about 4% less growth. Finally, Panama came out apparently well, but the contraction in its growth rate was also significant.

Economic growth for the region was lower in the last decade in relation to previous decades. Each of the countries showed different behavior: Panama, Costa Rica and Honduras had higher economic growth, in large due to the strong performance of the service sector. On the other hand, Guatemala, Nicaragua and El Salvador reported lower growth rates than in the previous decade, the



**Graph 2: Central America: economic growth (2007-2010)**  
 (Percentages)



Source: Icefi, based on official data.

most serious case being that of the Salvadoran economy.

The most notable changes in the economic structure of the Central American countries are the growth in services and the lesser relevance of the agricultural sector in the generation of added value. Only in Honduras and Costa Rica was there a higher share of this sector in the economy. The better performance of this sector is related to the evolution of private consumption, which, in turn, was boosted by remittances from the north and the greater availability of credit. Also, due to the investment that went to these activities. On the other hand, the industrial sector is slightly more important in El Salvador, Honduras and Guatemala, while in Panama, the

fastest growing economy, industry has shrunk to a minimal expression.

On the side of aggregate demand, consumption was the most important factor in growth for the Central American economies. However, in countries like Guatemala, El Salvador and Nicaragua it was virtually the only factor, while the fastest growing countries such as Honduras, Costa Rica and Panama, exports and investment combined to obtain higher growth rates. For the last two countries mentioned, private investment grew significantly, while for the other countries it stagnated.

Government spending increased during the crisis years of 2008-2009, which would have cushioned its



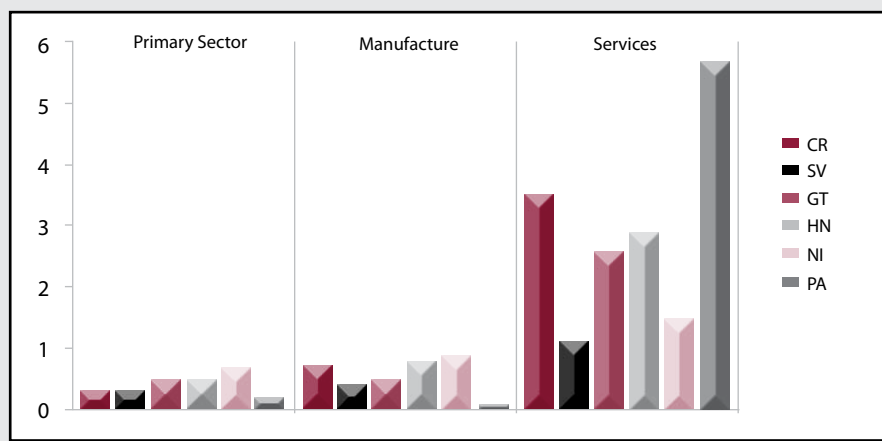
**Table 1: Central America: economic growth (1971-2010)**  
(Annual average growth rate for period)

	1971-1980	1981-1990	1991-2000	2001-2010	1971-2010
Costa Rica	5.6	2.4	5.2	4.2	4.4
El Salvador	2.3	-0.4	4.6	1.9	2.1
Guatemala	5.7	0.9	4.1	3.3	3.5
Honduras	5.4	2.4	3.3	4.1	3.8
Nicaragua	0.3	-1.4	3.4	2.9	1.3
Panama	5.5	1.4	5.1	6.3	4.5
Average	4.4	0.6	4.4	3.8	3.2

Source: Icefi, based on official data and Eclac (historical data).



**Graph 3: Central America: contributions to the economic growth by economic sector (2001-2010) - (Points in the rate of economic growth)**



**Source:** Icefi, based on official data.

impact. It is also noteworthy that no country reduced social spending during this phase, which would have prevented greater costs in terms of equity. However, public spending on recurrent expenditures was increased, which has implications for the financing of public budgets in the future, in terms of the sustainability of public spending.

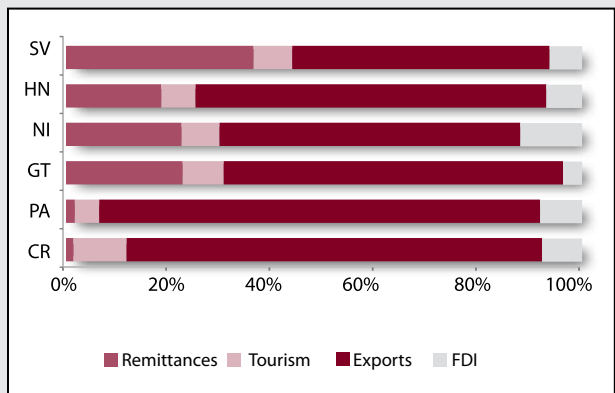
The evolution of economic activity and employment is closely related to the ties of the Central American economies with the outside. Throughout the decade, the contribution of remittances was crucial to the dynamism of economic activity, mainly for CA-4 countries, but for others, like Costa Rica and Panama, it was foreign investment. Tourism has also continued to grow, mainly in Honduras, Nicaragua and Panama.

Exports remain the most important link to the outside. The volumes of exports increased in all countries, but mainly in Nicaragua and, to a lesser extent, in El Salvador. Added to this is the behavior of the terms of trade, which deteriorated over the decade. In 2008, there was further deterioration due to the rapidly rising energy prices, although the prices of some export commodities such as sugar, bananas and coffee improved. Subsequently, in 2009, the trend in the terms of trade was reversed since prices of agricultural goods remained high and there was a drop in oil prices resulting from the global *Great Recession*. The improvement of the terms of trade in 2009 was a buffer to the crisis; a situation that again reversed in late 2010.



**Graph 4: Central America: relative comparison between the flows of remittances, FDI, exports and tourism (2001-2010)**

Percentages of the sum of flows



Percentages of the GDP

	Tourism	Remittances	FDI	Exports
CR	5.9	0.8	4.3	44.7
SV	3.3	16.3	2.7	23.1
GT	3.2	9.5	1.4	25.5
HN	5.1	14.9	5.4	51.7
NI	3.6	11.4	6.3	30.4
PA	4.0	1.4	6.9	75.8

**Source:** Icefi, based on official data and WTTC.

The type of goods exported by Central American countries changed in the last 20 years. Although commodities are still the largest share, this share was reduced in all countries except Nicaragua and Panama. The change in exports towards industrialized goods has been observed in Guatemala, El Salvador and Honduras, but is most notable in Costa Rica. In the case of Panama, exports of services had a remarkable growth during the decade.

The Central American countries have moved at different speeds in the diversification of its export products and partners to whom they sell. Only Costa Rica, El Salvador and Nicaragua agreed to extend the range of its products and its export destinations. Meanwhile, Guatemala

managed to diversify its products, but concentrated export destinations, while Honduras, however, expanded the range of export destinations but did not change substantially the products offered abroad. Finally, Panama had no major changes in the type of goods exported or the places where it sells goods abroad.

The destinations of exports that grew most in the previous decade were South America and Asia. In the first case, exports to South America increased mainly from Nicaragua, and to a lesser degree from Panama, where they were already substantial, and Costa Rica. In addition, Costa Rica and Panama distinguished themselves from other countries due to the growth of their exports to Asian destinations. Finally, Honduras



**Table 2: Central America: structure of the export goods (1990-2010)**  
According to technological intensity - (Percentages of total exports)

	Costa Rica			El Salvador			Guatemala		
	1990	2000	2010	1990	2000	2010	1990	2000	2010
Primary Products	58	26	24	51	28	35	58	51	35
Industrialized Goods	33	74	76	48	69	65	42	49	65
Based on natural resources	11	11	16	13	23	21	21	20	21
Of low technology	13	14	14	22	28	28	10	14	28
Of medium technology	6	12	18	9	12	12	6	11	12
Of high technology	3	36	28	5	6	3	5	4	3
Other Transactions	9	0	1	0	2	0	0	0	0
Total	100	100	100	100	100	100	100	100	100
	Honduras			Nicaragua			Panama+		
	1995	2000	2010	1990	2000	2010	1995	2000	2009
Primary Products	78	53	50	73	72	78	57	61	78
Industrialized Goods	22	47	45	22	24	20	40	39	20
Based on natural resources	16	35	19	16	18	12	22	25	12
Of low technology	5	5	9	4	3	5	11	9	5
Of medium technology	1	6	16	2	3	1	4	3	1
Of high technology	0	0	1	0	0	2	3	2	2
Other Transactions	0	0	4	4	4	2	2	0	2
Total	100	100	100	100	100	100	100	100	100

**Source:** Icefi, based on Eclac data.

**Note:** + The data for Panama correspond from 1995 to 2009, since they were not available for 1990 and 2010.



**Table 3: Central America: classification of countries according to product diversification and export destinations - (2009 compared with 2000)**

		Diversification of products		
		Increased	No change	Declined
Diversification of partners	<b>Increased</b>	Costa Rica El Salvador Nicaragua		Honduras
	<b>No change</b>		Panama	
	<b>Declined</b>	Guatemala		

**Source:** Icefi, based on Eclac data (2010).



**Table 4: Central America: distribution of the employed population by area of economic activity (Average 2001-2010) - (Percentages)**

Economic activity	Costa Rica		El Salvador		Guatemala		Honduras		Nicaragua		Panama	
	2001	2009	2000	2007	2000	2006	2000	2009	1998	2005	2001	2009
Agriculture, forestry, hunting and fishing	15.6	11.9	21.7	18.1	41.3	33.8	32.2	37.1	36.9	35.9	22.3	18.9
Mining and quarrying	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.3	0.0	0.0	0.2	0.2
Manufacturing Industry	15.1	11.9	18.6	16.7	13.2	15.8	16.4	13.1	9.3	14.1	9.1	8.6
Trade	18.9	20.0	23.0	24.4	20.5	19.9	20.2	18.7	20.0	19.0	17.6	17.2
Electricity and Water	1.3	1.4	0.4	0.4	0.3	0.2	0.3	0.4	0.7	0.5	0.9	0.6
Construction	7.0	6.6	5.1	6.1	5.4	6.5	5.3	6.6	4.7	4.2	6.8	9.6
Transport and communications	5.6	7.6	4.7	4.3	2.1	2.9	3.1	3.3	3.7	3.4	7.5	7.4
Public administration	4.7	5.8	5.3	4.1	1.9	2.1	3.0	2.3	3.6	2.9	6.7	5.6
Education	5.5	5.9	3.0	3.7	2.6	4.0	3.5	3.7	3.7	4.0	5.6	5.2
Hotels and restaurants	5.6	5.4	3.3	5.4	0.0	2.8	4.2	3.4	4.0	2.8	3.3	5.4
Financial Services	1.9	2.5	1.2	1.2	2.3	0.6	1.1	1.0	0.4	0.7	2.2	1.9
Business services	6.0	6.7	2.6	3.5	0.0	2.6	1.6	2.1	2.1	2.1	3.3	5.3
Other services	12.8	14.2	11.0	12.0	10.3	8.6	9.0	8.1	10.9	10.4	14.6	14.1

Source: Icefi, on Sedlac data.

was one of the few countries that increased its exports to Europe.

The turbulent performance of Central American economies and international integration did not facilitate a sufficient growth in quality jobs. On the one hand, the proportion of informal jobs and underemployment remained without significant changes. In contrast, there were declines in jobs in the agricultural and industrial sectors

in the employment structure by economic activity, which were offset by growth in services. This has negative implications for the sectors with greatest potential for increased employment absorption, while the buoyant activities, such as financial services, business, transport and communications absorb a limited number of workers.

Although the structure of employment is changing, there was no sig-



**Table 5: Costa Rica, El Salvador, Guatemala and Panama: underemployment (Circa 2010) - (Percentages of the EAP as features)**

	Phase I			Phase II			Phase III		
	Visible	Invisible	Total	Visible	Invisible	Total	Visible	Invisible	Total
Costa Rica	4.3	3.2	7.5	5.2	3.0	8.2	4.4	3.0	7.3
El Salvador	3.9	28.1	32.0	5.1	29.1	34.1	6.6	33.0	39.5
Guatemala	15.5	...	...	16.2	...	...	21.9	...	...
Panama	...	...	...	3.7	14.7	18.3	4.3	11.2	15.5

**Source:** Icefi, based on official data.

**Note:** the data for El Salvador corresponds to the urban area.

nificant progress in the quality of jobs, since informality or underemployment was maintained or increased. On the other hand, sectors with the greatest economic growth absorb few jobs, and those with greater potential to do so grew less over the decade.

Improvements in poverty reduction observed at the beginning of the decade seem to be affected by the negative social effects of the crisis. This was the result of factors such as higher unemployment, underemployment and informality, and the rising prices of food and petroleum products. According to available data, poverty increased in the years 2008-2009. In general, inequality has not been reduced significantly, either before or after the crisis.

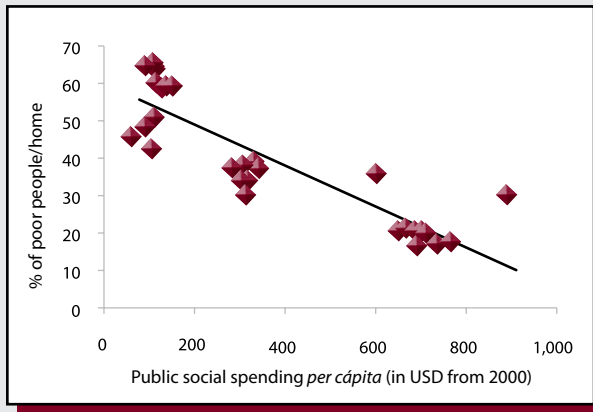
### 3. The challenge of reducing inequality through fiscal policy

As a result of the economic performance of the previous decade, the challenge of making fiscal policy more equitable remains. To achieve this task it is necessary to provide a bigger stage to fiscal sustainability, which not only means to balance fiscal accounts but also to recognize the importance of higher levels of economic growth and governance in order to make sustainable fiscal policy over the medium term. In addition to the traditional challenges of fiscal policy, it is important to note the emergence of new needs such as the increasing attention to natural disasters and the increasing deterioration of national security in the countries of the region.

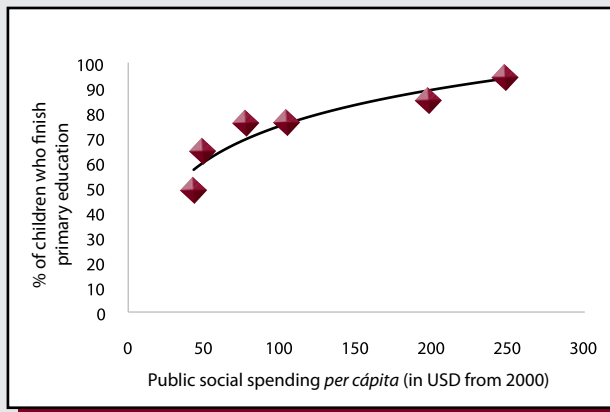


**Graph 5:** Central America: the relationship between social indicators and social spending *per cápita* (In USD from 2000)

### Poverty and public social spending *per cápita*



### Completion of primary and public spending on education *per cápita*



**Source:** Icefi, on the basis of household surveys, public budgets and Eclac.

Fiscal policy can influence equity depending on who benefits from the services provided by the public sector, who receives government transfers and who helps to finance it by paying taxes. It seems reasonable to conclude that in the short term, public spending is a much more powerful redistributive instrument than the tax

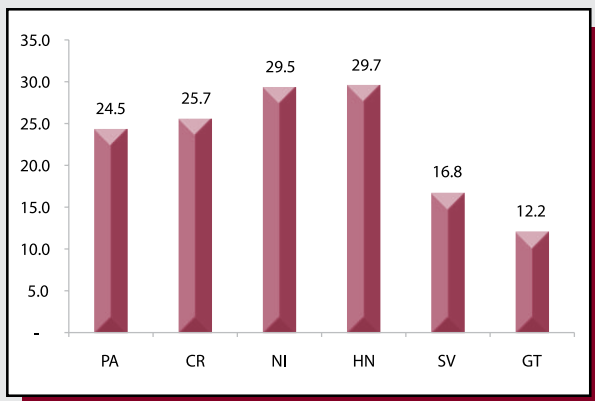
system. However, in the long run, a progressive system of income taxation can greatly help to avoid increasing levels of inequality.

An example of how social spending influences equity is the ability it has to reduce the poverty status of people: when poverty levels are considered

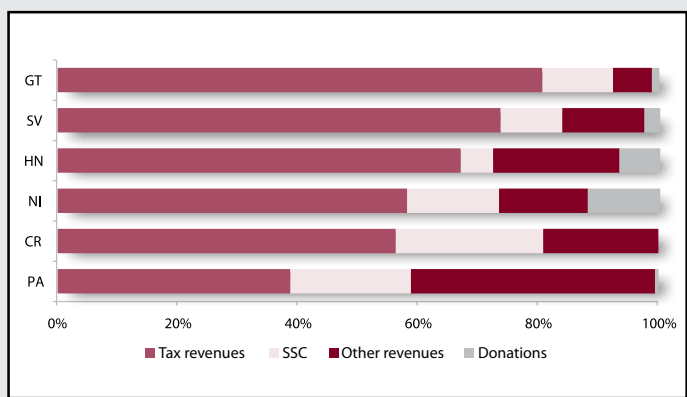


**Graph 6: Central America: total revenues and grants from the NFPS**

As a percentage of GDP (average 2001-2010)



Percentages of participation (2001-2010)



**Source:** Icefi, based on official data and that of the IMF.

**Note:** the data for Guatemala corresponds to the General Government; in the case of the participation percentages of the revenue from NFPS for Panama, Guatemala and Honduras, they are estimates for the year 2007.

together with social spending *per capita* -measured in dollars at 2000 prices-, there is a strong inverse correlation between both dimensions. There is also a positive relationship between education spending *per capita* with educational achievements.

The ways in which tax revenues are captured and their volume have an

influence on equity. On the structures of public sector revenues in Central America, there are three types of structures, based on the level of income and funding sources.

- A group of countries with high income levels as a proportion of GDP, but with income concentrated in taxes and

dependent on international cooperation, is made up of Honduras and Nicaragua.

- The second group consists of middle-income countries, with more diversified sources and larger social security coverage, such as Panama and Costa Rica.
- Finally, Guatemala and El Salvador have the lowest income levels and rely heavily on taxes to finance public spending.

Some of the main features of tax systems remain over time, but others have suffered some minor changes. First, the tax burden rose, although the volume of resources is still insufficient in the face of the needs of public spending and investment. Second, the most important source of tax revenues in Central America corresponds to indirect taxes, mainly the general consumption tax or VAT. Other indirect taxes such as the ones of selective consumption, which have a great variability in range and rates throughout the region, remain with a poor performance in revenue due in part to the use of taxes imposed on the physical quantity consumed and not on value (*ad valorem*). The importance of taxes on foreign trade continues to decline. Although the revenue from import tariffs has been

reduced, tax revenues are still very dependent on foreign trade because the collection of VAT that applies to imports is significant.

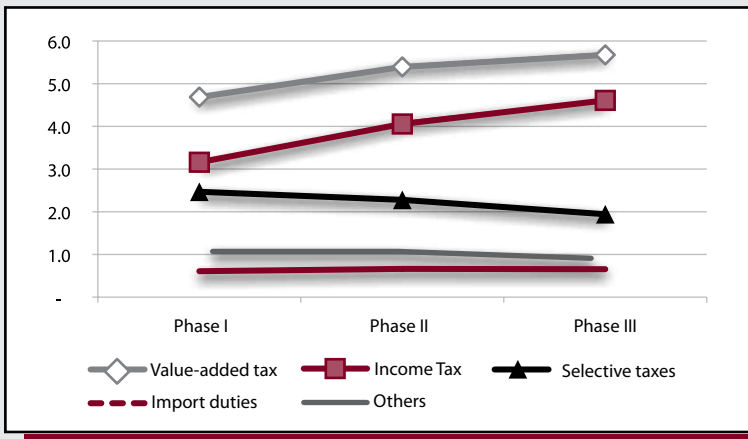
Third, the importance of direct taxation<sup>1</sup> continued to increase slightly. At the end of the nineties, the ratio of indirect to direct taxes was 4 to 1, whereas in 2007 the relationship approached a 3 to 1 ratio. This improvement was observed having an income tax that maintains the same characteristics, in spite of attempts to reform it into a dual scheme. Almost all of the countries apply the principle of domestic source income instead of global income. The tax structure remains *schedular*, instead burdening by total income, which would give it a global character (Gomez-Sabaini, 2005). This makes *horizontal equity* of the tax system, meaning that taxpayers with similar incomes pay a similar amount of taxes, virtually impossible. Under a schedular system, this is not possible because two taxpayers with similar incomes, if the incomes come from different sources and they are taxed at different rates, would not pay the same. Additionally, in every country there are extensive lists of tax exemptions or favorable treatment in the income tax, reducing tax revenue capacity and generating inequality in payment.

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<sup>1</sup> This includes the income tax applied to the income of businesses and individuals, and real estate taxes.



**Graph 7: Central America: evolution of the average tax collection (2001-2010) - (Percentages of GDP)**



**Source:** Icefi, based on official data.

**Note:** the data corresponds to a simple average for the phases identified in chapter I. Phase I goes from 2001 to 2002 for Costa Rica and Panama; from 2001 to 2003 for Honduras and Nicaragua; and from 2001 to 2004 for El Salvador and Guatemala. Phase II reaches from 2003 to 2007 for Costa Rica; 2003 to 2008 for Panama; 2004 to 2007 for Honduras and Nicaragua; and 2005 to 2007 for El Salvador and Guatemala. Phase III is composed of 2008 to 2010, with the exception of Panama, which encompasses 2009-2010.

Other features that remain in the income tax are the favorable treatments to capital gains and dividends. In addition, there are special schemes for small businesses in Costa Rica and Panama as well as a variety of special treatments for cooperatives, for the taxation of dividends depending on whether the company making the distribution is registered or not in the stock market, among others. This results in obvious faults of horizontal equity in the taxation system. Finally, the income taxation of employees shows very similar characteristics in all countries.

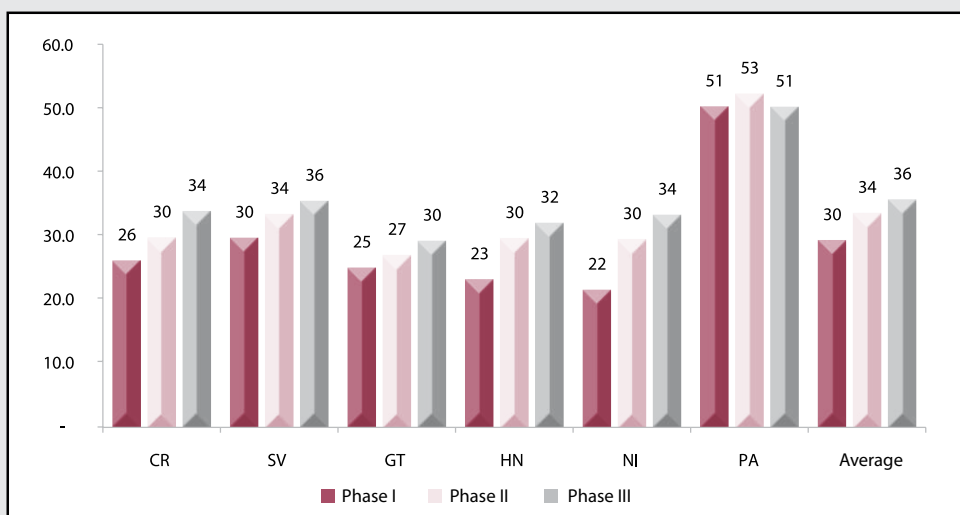
During the period between 1990 and 2010, the share of direct taxes in total

tax revenues consistently increased in line with what would normally be considered an evolution towards a more equitable tax system. While this increase has been relatively slow, cumulative effects are not insignificant: direct taxes accounted for 29.6% of total tax revenues during the first years of the decade and reached 36.0% during the crisis years of 2008-2009.

Direct taxes have a low collection because very little is collected from individuals and because there are high levels of evasion and avoidance. The low collection from individuals is influenced by the difficulty of taxing the income generated outside the territory, the exclusion of certain personal



**Graph 8: Central America: share of direct taxes in tax revenues (2001-2010) - (Percentages)**



**Source:** Icefi, based on official data.

**Note:** the data corresponds to a simple average of the phases identified in the above section.

income from the tax base and the existence of preferential treatment for capital income. On the other hand, there has been an extensive use of tax exemptions as a mechanism to promote the development of certain sectors, which has created problems for equity and has reduced revenues. Moreover, by being non-transparent and by not being evaluated, there is uncertainty about the effectiveness of tax exemptions. Thus, some countries have initiated reforms to comply with WTO agreements, rationalize these benefits and have them contribute to the development of the country. Finally, evasion and avoidance significantly reduce the uptake of direct taxes (to a greater degree in

the case of the income tax, compared to taxes such as the VAT).

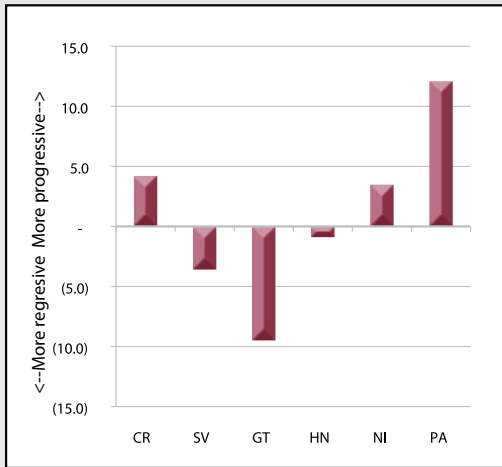
The low share of direct taxes, compared to the high contribution of the VAT, influences the tax systems to be regressive. However, the redistributive impact of the tax system is minimal, both in cases where the tax system is regressive or progressive, due to the low levels of tax revenue that exist in Central America.

Tax revenues can prevent increases in inequality, but their greatest contribution to equity is through the funding of public spending. Although social spending has a more direct influence on equity, public investment

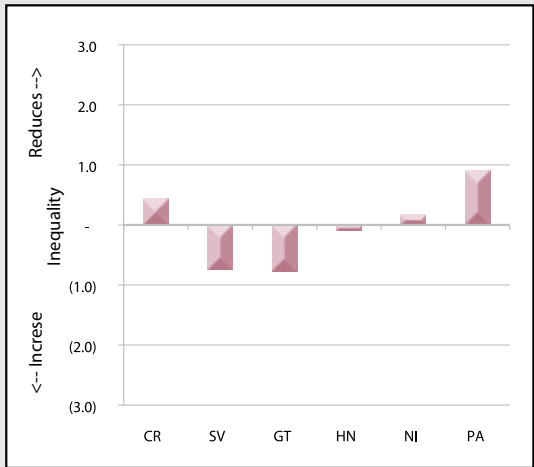


**Graph 9: Central America: progressivity and redistributive impact of taxation**

Progression / regression  
(Kakwani index)



Distributive impact  
(change in after-tax Gini)



**Source:** Barreix, Bes and Roca (2009).

**Note:** the estimates for Costa Rica are for the year 2004; El Salvador, 2006; Guatemala, 2000; Honduras, 2005; Nicaragua, 2001; and Panama 2003.

is also relevant, since access to infrastructure is uneven across the region and creates significant barriers that impede all citizens to have access to better opportunities.

The comparison by growth phases of the social spending behavior<sup>2</sup> allows to conclude that there has been a significant change in the region by protecting social spending in a recession and to make a countercyclical effort to protect such important expenses such as education, health

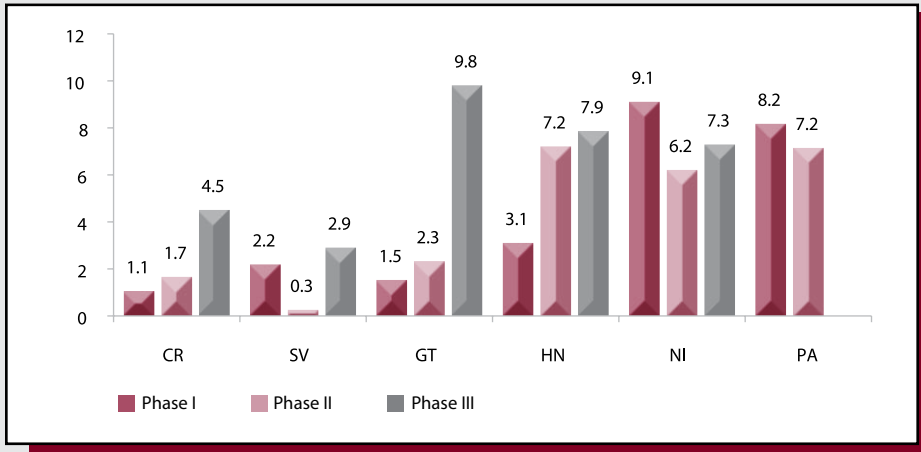
and social protection (either through contributory or noncontributory programs). It is worth pointing out that although Guatemala, Nicaragua and Honduras display a lower social expenditure, they made a major fiscal effort to increase it. However, the most striking fact is that in all countries, social spending increased over the previous decade.

In addition to increased social spending levels, the Central American countries made efforts to promote

<sup>2</sup> It is considered here as social spending, typically made in social programs such as education, health, pensions, welfare and other social protection programs, as housing and other community services, among others.



**Graph 10: Central America: real growth of social spending (2001-2010) - (Percentages)**



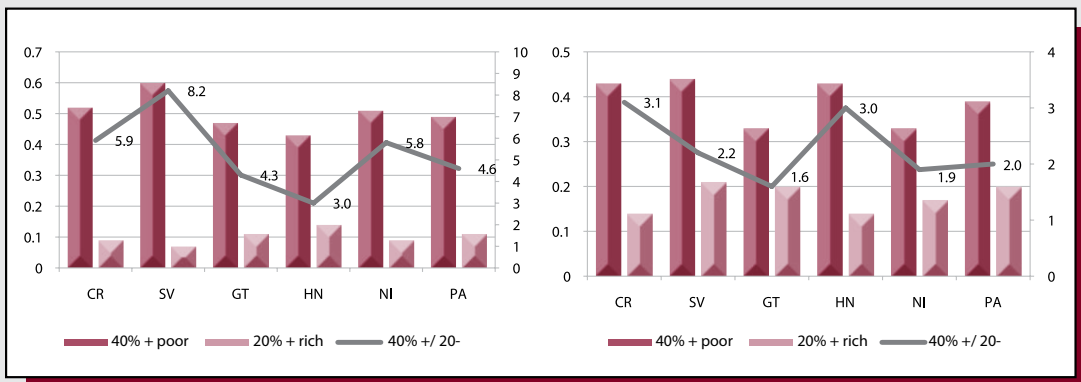
Source: Icefi, based on social public spending.



**Graph 11: Central America: impact of public spending on education and health**

Spending on pre-, primary and secondary schools

Health expenditure



Source: Barreix, Bes and Roca, 2009.

new social protection programs such as conditional cash transfers and non-contributory pension schemes. These policies address the weaknesses in the coverage of social protection systems based on formal employment, which have a greater impact on the CA-4 countries.

According to analyzes conducted for the region (Barreix, Bes and Roca, 2009), spending on education is more progressive than spending on health and, quantifying the distribution of its benefits, it is found to have enhancing effects on equity. The higher redistributive capacity of public spending on education in relation to health is due to the fact that the former absorbs a significant proportion of resources allocated to social issues in all countries.

Overall, spending on health shows a lower progressive capability than spending on education, as well as less visible effects in redistribution. The results are related to the lower orientation of public resources to the sector (a level problem), to the fragmented guidance of social security spending related to its low coverage due to the labor market structure, particularly in the CA-4 countries (a target problem), and to organizational and articulation problems of an integrated health system (institutional and inefficiency problems).



#### 4. Sustainability beyond the short term

The sustainability of fiscal policy in Central America is influenced by the dynamics of income and expenditure of the last ten years. A positive aspect is that tax revenues from Central American countries increased during the previous decade. This increase was driven primarily by improvements in the tax burden. However, Guatemala and Panama still have some of the lowest tax burdens in Latin America.

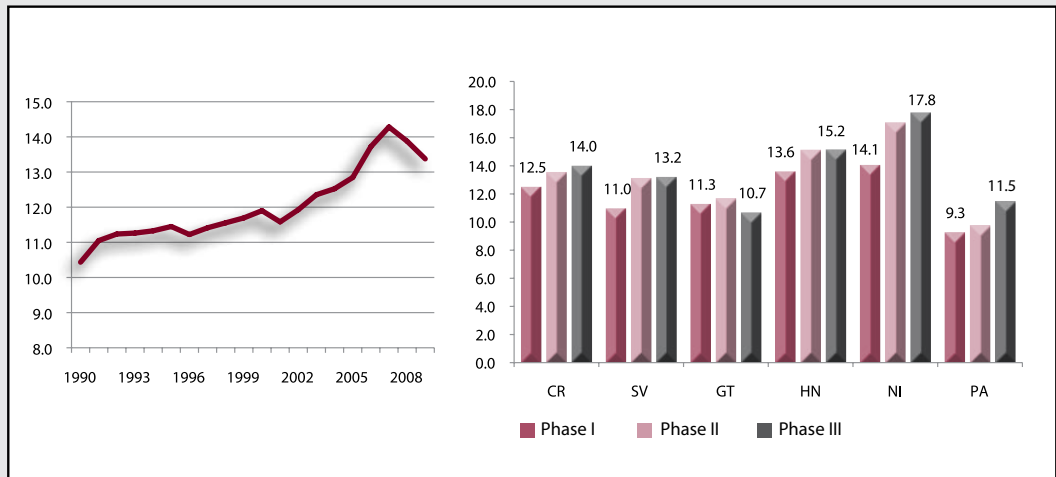
Growth in fiscal revenue was interrupted in 2009 due to the economic crisis, where there was a contraction in tax revenues of between 1 and 2% of GDP. The decline in revenues occurred because they are pro-cyclical, meaning that its variation is very sensitive to the economic cycle. The relationship is very strong with the evolution of imports, which fell in 2008 and 2009. This happens because tax revenues are heavily dependent on imports.

The total public sector expenditure increased over the previous decade, which was driven by higher fiscal revenues. This situation was not interrupted by the fall in tax revenues resulting from the crisis, since the expenditures were not cut as in previous crises.



**Graph 12: Central America: evolution of the tax burden**  
(Percentages of GDP)

Central American average (1991-2010)      Average by country, by phases (2001-2010)



**Source:** Icefi, on the basis of data from the Ministries of Finance and Central Banks.

**Note:** Phase I is composed of 2001-2002 for Costa Rica and Panama, 2001-2003 for Honduras and Nicaragua, and 2001-2004 for El Salvador and Guatemala. Phase II goes from 2003-2007 for Costa Rica, 2003-2008 for Panama, 2004-2007 for Honduras and Nicaragua, and 2005-2007 for El Salvador and Guatemala. Phase III is composed of 2008-2010 for all the countries with the exception of Panama, which only encompasses the period 2009-2010.



**Table 6: Central America: evolution of total expenditure of Central Government and the NFPS (2001-2010) - (Percentages of GDP)**

	Central Government			NFPS		
	I	II	III	I	II	III
Costa Rica	17.4	15.9	17.5	27.7	25.7	29.4
El Salvador	15.4	14.9	17.1	18.1	18.1	20.8
Guatemala	14.2	14.2	14.1	14.2	14.2	14.1
Honduras	20.3	19.9	23.3	29.2	30.0	34.2
Nicaragua	22.1	23.0	22.9	24.6	27.5	31.3
Panama	19.1	19.2	20.3	26.0	25.4	26.2

**Source:** Icefi, on the basis of official data that of the IMF.



**Table 7: Central America: evolution of expenditure of Central Government, economic classification (2007-2010)2010) - (Percentages of GDP)**

	I	II	2007	2008	2009	2010	I	II	2007	2008	2009	2010
	<b>Costa Rica</b>						<b>El Salvador</b>					
Total	17.4	15.9	14.9	15.3	17.5	19.8	15.4	14.9	15.1	15.8	17.6	17.9
Wages	5.1	4.8	4.4	4.6	5.6	6.0	5.1	4.5	4.4	4.5	5.2	5.2
Goods and services	0.5	0.5	0.5	0.6	0.6	0.6	2.0	2.2	2.2	2.4	2.6	2.8
Interest	3.2	3.3	3.3	3.2	3.5	3.7	1.7	2.4	2.5	2.4	2.5	2.3
Transfers	5.8	5.6	5.6	6.2	7.3	8.6	3.0	3.2	3.3	3.6	4.4	4.3
Capital Expenses	1.4	1.1	1.3	1.8	1.8	2.4	3.6	2.6	2.6	2.8	2.9	3.2
	<b>Guatemala</b>						<b>Honduras</b>					
Total	14.2	14.2	14.7	13.7	14.2	14.6	20.3	19.9	22.1	22.8	24.7	22.7
Wages	4.7	4.1	3.9	3.9	4.5	4.7	8.8	8.5	9.2	9.3	11.2	10.5
Goods and services	1.4	1.2	1.8	1.9	1.9	1.9	2.2	2.4	3.0	2.6	3.1	2.4
Interest	1.4	1.4	1.5	1.4	1.4	1.5	1.4	1.1	0.6	0.8	0.7	1.2
Transfers	2.3	2.6	2.7	2.1	2.3	2.4	3.4	3.7	4.1	5.0	4.2	4.9
Capital Expenses	4.4	4.9	4.8	4.5	4.1	4.1	4.6	4.1	5.2	4.9	5.3	3.8
	<b>Nicaragua</b>						<b>Panamá</b>					
Total	22.1	23.0	23.1	22.4	23.6	22.7	19.1	19.2	19.4	20.1	20.3	...
Wages	5.9	6.4	6.9	7.3	8.1	7.6	5.7	5.2	5.0	4.8	4.9	...
Goods and services	2.7	2.4	2.4	3.2	2.6	2.5	1.3	1.5	1.3	1.6	1.5	...
Interest	2.5	1.8	1.5	1.2	1.4	1.4	4.2	4.2	3.9	3.3	3.1	...
Transfers	5.4	6.7	7.3	6.5	7.5	7.4	4.7	4.2	4.0	4.1	4.1	...
Other current expenses	0.8	1.0	1.1	1.3	1.2	1.1	0.5	0.3	0.2	0.3	0.4	...
Capital Expenses	4.8	4.7	3.8	2.9	2.9	2.7	2.7	3.9	4.9	5.9	6.3	...

**Fuente:** Icefi, on the basis of official data.

The promotion of social spending programs was guided by the anti-crisis plans, which, although not implemented as planned, contributed to lessen the effects of the crisis. The content of these programs was based on an increase in transfers and wages. The scarified expenditure was public investment, which can damage the competitiveness of Central American countries and their potential for economic growth, negatively affecting equity.

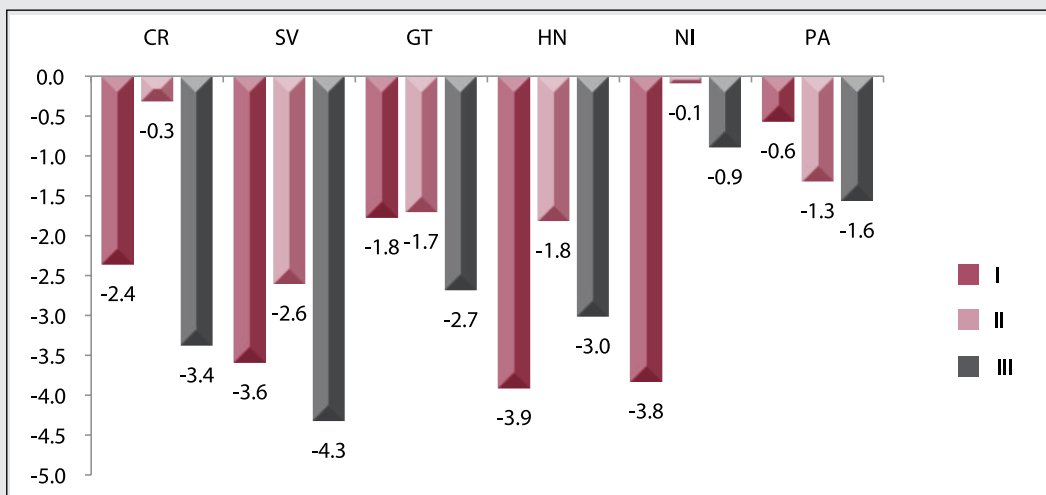
Fiscal deficits were closely linked to the economic cycle. In the boom phase, the fiscal deficit was reduced. By contrast, in the phase of the crisis it increased, mainly because of low tax

revenues and to a lesser extent, by boosting public spending programs.

In fact, the decline in revenue during the crisis was offset by increased borrowing by governments. This was possible through the support of the international cooperation since in the previous years the countries had significantly reduced their debt levels. On average, from 2000 to 2007, the public debt of Central American countries fell by 9 percentage points of GDP. The most prominent case is that of the highly indebted countries (Honduras and Nicaragua), where thanks to debt relief programs, debt was reduced between 30 to 90 percentage points of GDP. Other



**Graph 13: Central America: evolution of the NFPS deficit (2001-2010)**  
(Percentages of GDP)



**Source:** Icefi, on the basis of official data and that of the IMF for Guatemala.

**Note:** the data for Guatemala correspond to the central government.

aspects to highlight in the past decade are the lowest share of foreign debt, in addition to some Central American countries improving their risk rating.

Due to the crisis, the sustainability situation of the public debt went through some changes and there are some warning signs which must be addressed. Using three criteria, public debt to GDP ratio, which in El Salvador, Nicaragua and Panama it is over 40% of GDP; public debt to fiscal revenue, which in El Salvador and Guatemala is near a rate 250%; and needs of short-term financing (including deficit, plus debt relocations), where the clearest case is Costa Rica, warning signs of varying intensity for the Central American countries have emerged.

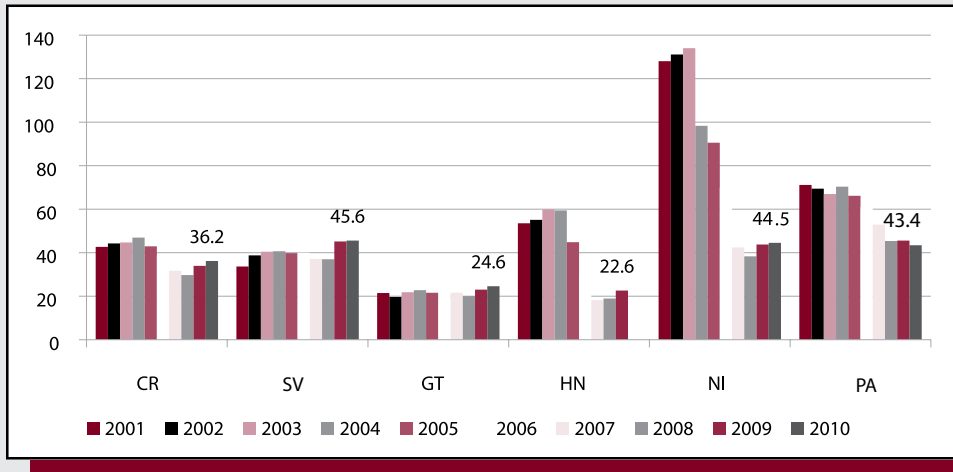
There are three possible scenarios that the Central American countries can follow to provide sustainability to public finances. In the first scenario, where the only concern is to take care of the short term issues, countries would carry out public spending cuts to balance fiscal accounts. A severe adjustment program in the short term would continue sacrificing public investment and the expansion of educational and health coverage, which would present heavy costs for growth and equity. In short, this scenario does not warrant removing the fiscal gaps. It is, in any case, a politically unfeasible scenario and with high social costs.

A second scenario would be the pursuit of financial sustainability over the medium term. This option is superior to the previous scenario since it would allow funding a level of public services similar to that already provided by the States in the region and would gradually incorporate minor alterations to the extent necessary. The reforms under this scenario should be focused to increase fiscal resources, rationalize public spending, promote greater transparency and implement a framework of medium-term budget planning, which leans toward the establishment of certain fiscal rules designed around the economic cycle. In this scenario, the needs to meet improvements in equity, the effects of the demographic change on public spending, and the improvement of external competitiveness would not be taken into account. New demands, such as addressing the impact of disasters associated with natural phenomena, or the increased levels of insecurity would also not be considered.

Sustainability is something that goes beyond just balancing fiscal accounts. A more ambitious vision of medium and long term should have three pillars. The first is to strengthen public finances, giving them more resources to meet public expenditure needs sustainably. Second, it is necessary to increase the mechanisms that give legitimacy to public spending, such as improving equity, quality and



**Graph 14: Central America: total public debt of the NFPS (2001-2010)**  
(Percentages of GDP)



Source: Icefi, on the basis of data from the Ministries of Finances and Central Banks.



**Table 7: Central America: indicators of total public debt (2001-2010)**  
(Percentages)

	% Short term debt			Debt as a % of total revenue			Total debt (% of GDP)		
	I	II	III	I	II	III	I	II	III
CR	22.4	22.4	21.7	176.9	162.5	121.3	43.5	40.9	33.3
ES	2.5	3.4	4.9	232.5	225.2	228.6	38.4	39.0	42.6
GT	4.2	11.5	1.6	160.2	169.8	187.8	21.5	21.7	22.6
HN	-	0.4	2.5	345.8	212.4	120.4	56.2	38.1	20.8
NI	0.6	2.5	5.1	508.1	252.9	131.2	131.0	75.3	42.2
PA	2.5	1.9	2.0	274.4	256.0	176.3	70.3	60.5	44.5

Source: Icefi, on the basis of official data.

Note: the data corresponds to NFPS, except for Guatemala and Honduras, which are from the central Government.

transparency of public spending. Third, opportunities must be generated for the entire population, which require a scheme that enhances a broad-based economic growth, where there is a benefit to workers and employers, supporting public finances. This approach to sustainability must be able to respond to new challenges such as climate change and the strategies to promote public safety and dealing with organized crime.



### 5. The great political challenge of carrying out reforms

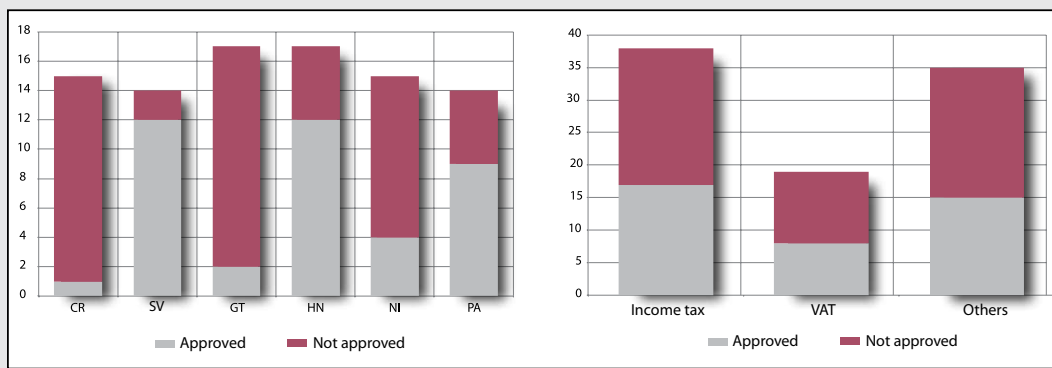
In light of what was mentioned in the previous sections, the need to strengthen the States in order to provide sustainability to fiscal policy and to contribute to equity requires an enormous fiscal effort, which

should produce a sustained growth of the financing sources of public spending, in a framework of political and economic stability. To make the financing of public expenditures sustainable public revenues should be strengthened, mainly taxation as a viable option to overcome the most serious problems in the region.

In fact, all of the Central American countries were involved in the process of tax reforms in recent years due to the collapse in tax revenues resulting from the recent crisis. According to the scope of the reforms, most countries have focused directly on reforms aimed at raising funds exclusively. There were also attempts to fully modify the tax system, which faced major problems in its adoption. Indeed, the measures that were adopted were only those of incremental nature.



**Graph 15:** Central America: characteristics of the proposed and approved tax reforms (2008-2011) - (Number of measures)



Source: Icefi, based on official data.

However, carrying out tax reforms is not easy, especially if one considers that the history of some countries in the region is full of conflict and of failed attempts to reform fiscal policy. In this context, the economic elites have exercised their power and expressed their vision of economic development in the setting of fiscal policy under historical conditions that marked the formation of the Central American States.

In the region there is diversity in the models of formation and reform. Following a simplified logic, the State model and, in particular, the prevailing fiscal policy are the result of the distribution of power between the sector with the largest portion of resources (usually the private business sector, the traditional opponent of a tax reform that favors equity) and beneficiaries of programs and projects funded with an equitable tax system (popular sectors, who are considered allies of the tax reform theorists).

Fiscal policy depends on the political process or the relationships of power. Therefore, a change in the relationships of power will allow a reform of public finances, as long as the conjunction between emerging elites and groups with greater social mobility occurs. Processes that are impacting the region, such as economic globalization and the growth of the Central American migrant community abroad, pose

potential and new opportunities to be explored and analyzed. In the case of new emerging capitalist sectors, they identify policies and institutional arrangements necessary to take advantage of international market opportunities and negotiate with other groups and State authorities to promote an agenda to form and reform the State according to interests.

The little or lack of success in attempts to achieve a comprehensive and profound tax reform in the Central American countries is associated with the fact that there is not a coalition that brings together the interests of transnational elites, the urban middle class and the popular sectors. In order for a coalition of this nature to be formed, its members should be able to overcome the temptation to ally with the sectors that are sure to oppose a tax reform aimed at achieving a capable, universal and progressive tax system. In this sense, the transnational elite should find the motivations and incentives to move away from the traditional opposition and move towards the strengthening of the State through tax reform, and the popular sectors should move away from patronage and funding patterns.

However, although there has been some increase in the tax burden in the countries of the region, reforms have not been very successful in mobilizing resources in a sustainable manner, especially regarding the contribution

of the most dynamic economic sectors. Furthermore, the most benefited sectors by the new patterns of integration into the global economy are the most resistant to contribute their own resources to finance public goods.

Even when the emerging elite succeeds in pushing its agenda (the case of El Salvador and partially Honduras), it shows no motivation or incentive to continue to contribute its resources to maintaining the State it controls (incentives such as infrastructure, security or stability). Instead of increasing its contribution, it prefers to shift costs to other groups or simply let its agenda be unfinanced or incomplete. In Guatemala, the elite has left the agenda for the formation and strengthening of the State in crisis, due to its refusal to increase its contribution.

The control of the media and the generation of negative perceptions of the State are other tools by which elites exert their power. Through these tools, they have succeeded in blocking changes that threaten their share of power, especially when it comes to fiscal reforms. It is through financing or equity control of media companies that elites have successfully managed to manipulate the perceptions of the popular sector, who otherwise would act as natural allies of reform, precisely because they are the recipients of its effects. For this reason, the popular sector often tends to show

its opposition, moved by indignation of exaggerated perceptions about corruption in government or opacity in governance.

One of the main obstacles in the region to balance the distribution of power among actors capable of influencing fiscal policy is the weakness of the popular sectors. Historically, elites have eclipsed their counterparts in civil society, which have suffered internal divisions, economic dependency, but above all, a profound poverty exacerbated by the unequal distribution of wealth and violent repression. After the processes of democracy and peace in the region, the current weakness of the popular sectors is the accumulated heritage of repression and competition for scarce resources to finance its operation.

This explains why repeatedly in every attempt to carry out a tax reform governments are prepared to face the business elite as the main opponent of the reforms, hoping to achieve the maximum possible degree of agreement, often acting as if there were no allies in the popular sector. The logical answer to this scheme is that governments should seek to develop a more inclusive political process and, thus, get support for comprehensive reform proposals, not maul the components designed to reduce privileges, including the space that the elites have enjoyed to evade and avoid paying taxes.

As for the possibilities to balance the imbalance of power in the design of fiscal policy in the region, it is clear that the elites need the State, which is why they influence its institutions and policies to meet those needs. For the elite corporations operating in global production processes, these interests include macroeconomic stability, security, infrastructure and supply of skilled labor. This is in contrast to the fact that one of the main obstacles in the region to balance the distribution of power among actors capable of influencing fiscal policy is the weakness of the popular sectors. As new capitalist sectors emerge, they identify policies and institutional arrangements necessary to take advantage of international market opportunities and negotiate with other groups and State authorities to promote an agenda of forming and reforming the State according to their interests. Their success and the nature of the agenda they promote are reflected in the tax systems and their reforms.

Therefore, it is necessary to have paradigm shift whereby the governments move from worrying only about the common enemy of reform, considering that the State needs a broad base of support within the popular sectors, where reform has to reach the privileged elite (especially the hard to tax sectors). The tax reform effort must be coupled with the recovery of public trust, and the mobilization of popular sectors, especially those who are seen

as beneficiaries of the reforms. In this regard, a comprehensive reform of fiscal policy is essential for strengthening democracy and governance in Central America.



## 6. Reflections on the future challenges of fiscal policy in Central America

The persistency of imbalances and serious problems in the financial system after the global economic crisis that erupted in 2008, coupled with inadequate policy responses in developed countries, especially in Europe, are reflected in a global economy with completely uncertain prospects. For the economies of countries like those of Central America, which are small and open, dependent on trade, financing, investment and technology from abroad, this presents an additional challenge to the fiscal challenge posed in Icefi's first report, published in 2007. At that time, it was argued that the challenges of fiscal policy were to increase revenue, particularly taxation, public expenditure and to ensure higher quality and more transparency. There has been some progress, but on top of what remains to be accomplished, now there are additional challenges.

There have been significant improvements in Central America in relation to tax revenues and government spending. Although the tax burden fell as a result of the crisis, it then recovered

and several countries were able to push tax reform, of direct taxation in particular, more categorically than in the recent years. These reforms were noticeable in countries where the executive power had a parliamentary majority supporting it, like Panama or Honduras, or where a majority could be secured through partnerships, such as Nicaragua and El Salvador. Guatemala and Costa Rica, however, faced major problems due to the difficulty of forming legislative majorities. However, there have been comprehensive reform proposals in both countries and in both there is a growing recognition that its fiscal sustainability and its economic and political viability would be seriously compromised if these or other proposals were not implemented.

It is significant that in both countries, and in El Salvador, despite an extensive discussion process, it was not possible to reach broader agreements that could be transformed into legislation. After all, as in Honduras and Panama, political action has been decisive to achieve a parliamentary majority and not total national consensus. This also poses a challenge for democracy in a region where business elites and parliamentary minority veto proposals that have the consensus of the majority, and where the weakness of the majority is tied to the greed and intransigence of business or political minorities that practice what could be described as a “tyranny of minorities.”

The difficulties to achieve solid parliamentary majority that would enable to promote comprehensive and profound tax reforms in the countries of Central America, and to prevent them from being eroded gradually through a series of exemptions for the most dynamic, a danger that has occurred in some countries such as Honduras or Nicaragua, where they approved tax reforms, has an explanation: the absence of majority coalitions in Central America that combine the interests of the most dynamic transnational elites, the urban middle class and popular sectors. In order for a coalition of this nature to be consolidated, transnational elites, which are those that are benefiting from economic growth recently, should overcome the temptation to ally with the more traditional sectors, characterized by their traditional opposition to tax reform in order to achieve an efficient tax system. But even among the middle class and the popular sectors there is not necessarily an awareness of the need to move forward with reforms that favor not only taxation but also effective and transparent spending, especially given the ideological view that the State is the origin of all problems and of corruption. In this sense, the challenge of political actors in the region is highly demanding: to make the transnational elite find the motivations and incentives to move away from the traditional opposition to strengthening the State through

tax reform, to ensure that the popular sectors are not dependent on patronage and funding patterns and to improve the confidence of the middle class in the State.

Progressing with the increase in State revenues also entails a better use of other sources of income, as some countries, such as Guatemala and El Salvador, have taxes as almost the only source of financing for public expenditure. A better management of public assets is needed, both State-owned enterprises as concessions or royalties from extractive industries. It also requires a medium and long term vision from political actors, in order to patiently take advantage of any political space to progress. Recent advances in relation to direct taxes, even slowly, are remarkable, and the fact that the region lags behind in its management capabilities of such taxes, the possibilities for improvement in the area of tax administration are considerable. This would also allow the reduction of tax avoidance and tax evasion. Finally, a great task to improve equity in the payment of taxes has to do with building wealth taxes, which may constitute an important tool for the finances of municipal or cantonal governments.

Besides the uneven progress in tax matters in recent years, there were those in the field of public expenditure, especially social spending. In the previous report done by Icefi (2007),

there was already evidence of some progress in this area. But unlike earlier stages where social spending was sacrificed due to the need to undertake fiscal adjustments, during the 2008-2009 crisis most governments increased social spending to protect the most vulnerable. Conditional transfer programs or non-contributory pensions were strengthened, although sometimes with a weak institutional base because of an insufficient articulation of these programs with the social development strategy of each country. Moreover, in most countries there was a modest but significant effort to try to compensate for the reduced private spending with increased public spending, in keeping with the Keynesian idea that in times of recession it is up to the State to make a countercyclical effort to revive the economy, or at least to avoid a deep recession. Given the limited fiscal space (difference between sustainable debt and debt already incurred) of most countries in the region, this effort could not last long, which is a critical input to uncertainty - and the possibility of recession- of the world economy resulting from the crisis in the Eurozone in particular.

In an uncertain international environment it is difficult to expect a dynamic growth of the Central American economies, which could be a basis to generate more resources for the Treasury to meet the needs of not only traditional social and

infrastructure development but also to ensure security, now threatened by international organized crime, and to adequately address extreme events, earthquakes, floods and drought, related at least in part to climate change. The reforms that have already been made or are underway also may lead to increased resources but do not seem sufficient to deal with the old and the new challenges. Part of the fiscal agenda should include, therefore, a great effort to improve the efficiency and effectiveness of public spending, starting with a very clear way to determine an order of priorities in each country, reflected in explicit and transparent budget allocations. In light of these, the continuous evaluation of programs and social and public investment, the transparency to generate information to clearly identify benefits (often disguised as tax exemptions), an extreme care in assuming obligations by the State as consequences of public-private alliances (as in Portugal, which is partly responsible for its fiscal crisis), and the elimination of expenses that are not tied to results, probably require the same degree of attention and political priority as tax reforms.

Moreover, the uncertain international environment has also led to recognize, although subject to dispute, that fiscal policy should play a greater role to moderate booms and recessions that are part of the imbalances that characterize the world economy.

These processes, with consequent increases or decreases in income and employment, have profoundly unequal and negative effects for sustainable growth. Adequately addressing these imbalances and fluctuations requires strengthening the capacity of fiscal policy to play a countercyclical role. This can be done through discretionary spending adjustments when the growing economy or recession situation warrants it, through multi-year fiscal rules, as in Chile and Colombia, or via automatic stabilizers (certain types of spending or income that is adjusted depending on whether a country is booming or in recession), like those that exist primarily in certain European countries. As a precondition, it is necessary to build the fiscal space in Central America, defined as the difference between the maximum sustainable debt and current debt. This is, basically, to have greater debt capacity, but in a sustainable manner. In the case of Central American countries, with differences of degree between them, it initially requires moderate fiscal deficits through lower growth of revenue expenditure. Achieving this involves assigning an even higher priority to the mobilization of additional resources and the rationalization and increased efficiency of public spending.

But fiscal policy is also destined to play a more active role in its interaction with other macroeconomic and prudential policies, as the global

financial crisis has highlighted. This is a broader challenge of economic policy, especially fiscal policy, based on the recognition that each macroeconomic policy (fiscal, monetary, exchange or macro prudential) alone is not capable of meeting the increasing challenges of growing with stability in an uncertain international environment. This new challenge, coupled with the pending fiscal agenda that existed before the outbreak of the global financial crisis, means that Central American policy makers should give fiscal policy a much more important role than the one it has held in the past.



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