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How can Central American countries improve their tax systems?

Economic performance in Central America—Costa Rica, El Salvador, Honduras, Guatemala, Nicaragua, and Panama—and the Dominican Republic improved markedly in the 1990s, but important challenges remain, particularly in reforming the tax system. In a recent IMF Working Paper, "Central American Tax Reform: Trends and Possibilities," Janet Stotsky and Asegedech WoldeMariam identify steps to strengthen public finances and increase revenue yields.

Central American countries have modern tax systems—notably including value-added taxes (VAT)—but there is scope to improve them and help governments meet their revenue needs. These small open economies could benefit, for example, from harmonizing their tax systems and enabling their producers to compete with those in their larger neighbors, such as Mexico and Colombia, and from avoiding harmful tax competition for such scarce resources as capital and skilled labor.

According to Stotsky and WoldeMariam, the main challenges for these countries are threefold:

- Strengthen revenue collections and tax efficiency. Tax policies that have eroded tax bases and continuing weaknesses in tax and customs administration have caused many problems.
- Harmonize taxes on domestic goods and services, primarily VATs and excise taxes, to improve both revenue collections and tax productivity.
- Raise property taxes and other, more locally based charges or taxes, which could help strengthen the budget and spur fiscal decentralization.

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Recent trends

Central American tax systems, Stotsky and WoldeMariam point out, are diverse in certain respects, most notably in terms of the overall ratios of revenue to GDP. Between 1990–94 and 1995–99, all the countries experienced an increase in their ratios of tax revenue to GDP. Nicaragua and Panama had a high ratio of tax revenue to GDP (above 20 percent in 1995–99), while Guatemala had the weakest revenue ratio, at 8.9 percent during the same period, largely because of its prolonged civil conflict.

The average ratio of tax revenue to GDP for Central American countries differs little from that for Latin America more broadly, despite the lower average level of income in Central America. The average ratio for Central America rose from 14.5 percent of GDP in 1990–94 to 16.5 percent of GDP in 1995–99, paralleled by a similar change in total revenues to GDP and by an increase in tax revenues in Latin America between these two periods.

Popularity of the VAT

Domestic taxes on goods and services—consisting of the VAT, excises and selective sales taxes (sometimes applied to an extensive array of goods), and other consumption taxes—are the broadest and most robust source of tax revenue. Their yield, the authors report, rose from 39.5 percent of the total to 48 percent between 1990–94 and 1995–99, mirroring a similar rise in Latin America overall.

The VAT, having risen from 22.7 percent of tax revenue to 32.8 percent between these two periods, is these countries' main source of revenue from domestic goods and services. The standard VAT rate varies from country to country but has tended to rise over time, increasing the dominance of this source of revenue. As of 2001, all Central American countries except Nicaragua and Panama had a standard VAT rate of 12 or 13 percent (Nicaragua's was 15 percent and Panama's 5 percent). VATs are relatively easy to administer, but some questions remain about how efficient they are at generating revenues. While it is difficult to measure the productivity of a VAT, according to one commonly used measure (the "c-efficiency" ratio), average VAT productivity in Central America has declined over the past few years.

How can these countries strengthen their VAT collections? First, Stotsky and WoldeMariam argue, it is best to limit the VAT to a single rate because administrative complexity increases more than proportionately to the number of rates. Second, VATs should have few exceptions. Only exports should be zero rated (that is, sales should be exempt from the VAT), and exempt items should be limited to educational, medical, and social services, as well as financial intermediation, housing rentals, and a few other goods and services.

Excise taxes—typically levied on tobacco, alcohol, and petroleum, but also on other goods, such as motor vehicles and consumer durables—are a useful supplement to VATs and other broad-based sales taxes. In 1995–99, excise taxes generated 19 percent of tax revenues. Excise tax rates tend to vary considerably from one country to another, as does the manner in which they are levied. That said, the rates in Central America are, in general, not high compared with those in other

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countries. There is thus scope, according to the authors, to increase excises on key goods, in several countries.

Broadening the tax base

Taxes on personal income and enterprise income or profits are another main source of tax revenue. In contrast to domestic consumption taxes, this component of taxation is relatively weak in most Central American countries, averaging only 19.2 percent of tax revenues in 1990–94 and 20.3 percent in 1995–99. These shares are slightly lower than in Latin America as a whole, although the trends diverged between the two periods, with the income tax share rising in Central America and dropping in the larger group of countries.

Enterprise income taxes form the larger of the two revenue sources in Central America. The top rate averaged 43.3 percent in 1986, declining to 28.4 percent in 1997, and then roughly stabilizing at this level through the most recent year (either 2001 or 2002, depending on data availability). Free trade zones and special incentives are quite common in developing countries. But the authors argue that a better way to attract additional investment would be through generous depreciation allowances and provisions for carrying losses forward and, possibly, some limited investment tax credits.

All countries in Central America levy personal income taxes with graduated rates, but the number of rate brackets, the income level at which the brackets apply, and the coverage of income—labor and capital income—vary from country to country. In Central America, the top and bottom bracket rates fell, on average, between 1990–94 and 1995–99. The current average range (2001 or 2002) is 10.3–27.3 percent.

Although all Central American countries define the tax base as including income from wages and salaries, most do not fully tax income from bonuses and fringe benefits. This creates inequities between taxpayers who earn these kinds of income and those who do not and disproportionately benefits higher-income employees. Personal income taxes, Stotsky and WoldeMariam argue, must be levied on higher-income taxpayers and those earning capital and other nonwage income.

Some countries have used the property tax as a key source of local revenues because the tax base is immobile. It has the potential to become even more important in Central America and should be strengthened. But, first, countries must have an accurate register of property and an up-to-date assessment of property values.

Improving administrative performance

The implementation of tax policies, the authors say, should be supported by the establishment and maintenance of modern and professional tax administrations based on the rule of law. Central American countries are taking a number of steps to enforce tax laws adequately. For example, they are expanding and improving withholding taxes, implementing self-assessments, improving audits, and computerizing.

However, recent unpublished estimates suggest that evasion of the VAT may be as high as 40 percent in some Central American countries. Although not unusual for developing countries—and even some developed countries—such high rates suggest that there is considerable scope for strengthening collections through general administrative practices, such as improved audits and tax structures.

More generally, Stotsky and WoldeMariam stress that there is a need to adopt rules (and supporting regulations) for corporate and personal income taxes—in particular, to deal with cross-border issues, such as transfer pricing, thin capitalization (excessive use of debt to remove earnings from a country through high interest deductions), and other devices used by multinational corporations. Because wealthy individuals may keep a large proportion of their wealth abroad, it is important both to extend the jurisdiction of the tax system to global income and to develop the tools and relationships with other countries that will make it possible to capture income from assets held abroad.

Equal is better

International issues have become increasingly important in tax policy reform in recent years. Central American countries, the authors argue, could gain through greater regional integration of their tax systems. Movement toward a common market would imply freer movement of tax bases.

In Central America, an increasing emphasis on regional tax harmonization has first entailed movement toward more uniform tariffs and the elimination of internal tariffs. Harmonization of domestic tax systems would also benefit Central American countries, given their natural links and small size. One goal might be to aim for a single VAT rate of 15 percent, as in the Caribbean region. Similarly, it might be useful to set certain minimum rates for excise taxes, as in the European Union, rather than a single set of rates, given the importance of flexible excise rates in meeting immediate budgetary needs. Over the medium term, the authors also indicate that a greater harmonization of income taxes—especially tax incentives—would be highly desirable. ■

Copies of IMF Working Paper 02/227, "Central American Tax Reform: Trends and Possibilities," by Janet Stotsky and Asegedech WoldeMariam, are available for $15.00 each from IMF Publication Services. See page 73 for ordering information. The full text is also available on the IMF's website (www.imf.org).

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