

Development Discussion Papers

Central America Project Series

Tax Structure in Guatemala

Sonia Cavallo

Development Discussion Paper No. 745
February 2000

© Copyright 2000 Sonia Cavallo
and President and Fellows of Harvard College

Harvard Institute for
International Development

HARVARD UNIVERSITY



DEVELOPMENT DISCUSSION PAPERS

CENTRAL AMERICA PROJECT SERIES

A PROJECT OF HARVARD UNIVERSITY, INCAE AND
THE CENTRAL AMERICAN BANK FOR ECONOMIC INTEGRATION



Tax Structure in Guatemala

Sonia Cavallo

Abstract

This paper explores Guatemala's attempts to confront the problems of tax evasion and poor tax administration. Resolution of these problems has become more important as a result of the 1996 Peace Accords, which require larger social spending and thus, an increase in tax revenues. The paper looks at the current tax structure, as well as Guatemala's fiscal challenges, and seeks to suggest priority areas for tax reform in the near future. Among the issues analyzed is Guatemala's low tax burden, high rates of tax evasion, unstable tax structure, and poor tax administration.

Keywords: Guatemala, tax exemptions, tax evasion, tax reform, tax structure, tax administration, Value Added Tax

JEL codes: H200, H220, H240, H250, H260

Sonia Cavallo has an economics degree from Universidad de San Andres, Buenos Aires, Argentina (1996) and a Masters in Public Policy degree from the Kennedy School of Government, Harvard University (1999). This paper was prepared in the summer of 1998 at INCAE where the author was working as Macroeconomics Researcher for the Central American Project, a project of the Harvard Institute for International Development, INCAE and The Central American Bank for Economic Integration.

Table of Contents

I..... INTRODUCTION 1

II. BACKGROUND 2

 A. Recent Tax Reforms2

 B. The Fiscal Implication of the 1996 Peace Accords.....3

III. CURRENT TAX STRUCTURE IN GUATEMALA..... 6

 A. Value Added Tax.....6

 B. Income Tax 10

 C. Taxes on Foreign Trade 16

 D. Excise Taxes 17

 E. Taxes on Property 17

 F. Vehicle Tax 18

IV. CONCLUSION: WEAKNESSES OF THE GUATEMALAN TAX SYSTEM 19

 A. Inadequacy of Tax Revenues to Meet Expenditure Needs..... 19

 B. Low Tax Compliance: High Tax Evasion..... 20

 C. Problems Related to Tax Administration..... 21

VI. BIBLIOGRAPHY 26

V. APPENDIX: TAX EXEMPTIONS 28

List of Tables

Table 1: Goals 1997-20005

List of Figures

Figure 1. VAT Revenues7

Figure 2. Tax proceeds from income taxes as a percent of GDP between 1990-1997..... 11

Figure 3. Revenues from tax on foreign trade 17

I. INTRODUCTION

Guatemala is a country that after years of political and macroeconomic instability is struggling to balance its budget, stabilize prices, liberalize trade, and modernize its political institutions. So far, inflation has been tamed and fiscal imbalances have been temporarily brought under control. However, the Peace Accords signed in December 1996 require substantial additional public spending. The financing requirements of the Central government, the investment in infrastructure and the provision of public goods can no longer be financed by loose monetary policies. Thus, the main fiscal policy challenge is to provide the government with much-needed resources through increased tax revenues while creating a fiscal environment that promotes investment and economic growth.

Guatemala has had multiple and frequent tax reforms in the recent past, yet its fiscal problem remains far from being solved and continues to be its main economic policy issue. Without exception, the last four tax reforms were brought about by concerns about fiscal deficits. Tax reform demands were exacerbated, as a result of the large expenses generated by armed conflicts. Since 1996 the Peace Accords that put an end to the internal struggle involved the government's commitment to engage in unprecedented levels of expenditure.¹

Now, near the end of the nineties, Guatemala is in need of a structural tax reform that could solve its fiscal problems in a long-run perspective. The issues that need to be urgently addressed are the following: (a) low tax burden; (b) high tax evasion; (c) volatility of the tax structure; (d) poor tax administration; and (e) strengthening and enforcement of the tax code.

Tax revenues are necessary for sustainable development of Guatemala. The country lacks social, human and physical capital. All these factors affect labor productivity and the competitiveness of the Guatemalan economy. However, as the tax burden on society is increased, care should be taken that the burden is progressively shared, that productive investment is promoted, that tariff reduction schemes are not reversed, and that creation of new and transitory taxes is minimized

¹ See Palencia and Valdez (1997).

This paper describes recent tax reforms and analyzes the main aspects and shortcomings of the current tax structure. We conclude by suggesting some priority areas in the design of a future tax reform.

II. BACKGROUND

A. Recent Tax Reforms

The political situation of Guatemala has undoubtedly hindered the achievement of successful tax reforms. A recent study reveals that in every situation in which the government attempted to carry out a tax reform without previous political consensus, there were general strikes, the proposal was withdrawn or the reforms were repealed or temporarily suspended by the courts (Palencia and Valdez, 1997). Most studies about Guatemala's tax structure agree that constitutional and political constraints are probably the most serious obstacles to achieving a sustainable tax reform.

In 1992, Guatemala implemented the so-called *Tax Modernization Program*. This reform attempted to increase public sector savings by broadening the base of the Value-Added Tax (VAT) so as to include petroleum products and food,² and improving the structure of the income tax.³ Tax collections dropped from 8.2 percent of GDP in 1992 to only 7.9 percent in 1993. This reduction was attributed mainly to the decrease in personal and corporate income tax rates implemented in 1992, deficiencies in tax collection and a decrease in imports. To make matters worse, the court decided to suspend income tax withholdings.

In subsequent years, tax revenues kept falling and they reached 6.8 percent of GDP in 1994. In November 1994, a new tax reform was passed reversing most of the structural trends initiated in 1992. The main elements of this reform were the following:⁴

An increase in the income tax rates for corporations and in the maximum rate from individuals from 25 to 30%.

² IMF (1995).

³ Tax brackets for individuals were reduced from 16 to 3. Tax rates for corporations were unified and the maximum income tax rate for individuals and corporations was lowered from 34 to 25 percent.

⁴ IMF (1995).

- The introduction of a 1.5% tax on corporate assets (after depreciation).
- The obligation to withhold tax on gross income from some activities, including interest income. This legislation was suspended in April 1995 by the court's ruling. The elimination of some VAT exemptions and of the right to obtain a refund of the VAT credit (except for exporters).
- An increase in the VAT rate from 7 to 10 percent to become effective either in 1996 or one month after the signing of the Peace Accords with guerilla groups (whichever would be earlier). Revenues arising from the 3-point rate hike were earmarked for expenditures associated with the peace process.
- The Assembly also approved the reestablishment of the tax on interest income and created a tax on assets net of credit obligations and other liabilities.

During 1994 and 1995 Guatemala faced a slow increase in total tax revenues and tight fiscal constraints. The new government accelerated the negotiation of the Peace Accords and the final agreement was signed with the guerillas in December 1996.

Although the VAT had been raised as of January 1996, the extra revenues would soon prove to be insufficient. The solution was to create a new, temporary and extraordinary tax, the ISET (*Temporal and Extraordinary Solidarity Tax*). This helped ease the fiscal situation in the short term, by raising the total tax burden to 8.7% in 1997. However, the ISET expired in December 1997. To avoid revenue shortages, in January 1998, another new tax, the IEMA (*Agricultural and Business Firms Tax*) was introduced. Both of these taxes assured minimal revenue flow and contributed to ease cash flow shortages in the short-run.

B. The Fiscal Implication of the 1996 Peace Accords

The Peace Agreements in Guatemala put an end to more than three decades of armed confrontation and thus closed a painful chapter in Guatemalan history. Socioeconomic development, however, requires social equity and sustained economic growth to meet the needs of most of the Guatemalan population.

Among other things, the Agreement on Social and Economic Aspects and Agrarian Situation signed on May, 1996 established that, in order to respond to the urgent needs of the population, the government would:

- 1) Significantly raise social investment, in particular in health care, education, social security, housing, and labor training;
- 2) Restructure the budget favoring social expenditures;
- 3) Prioritize resource allocation to people and regions most in need;
- 4) Improve resource administration and public investment, through decentralization, and reduced bureaucracy; reforming budgetary allocation and administration processes, guaranteeing autonomous and transparent decisions; and strengthening supervision and auditing.
- 5) Develop rural areas, provide basic infrastructure, facilitate access to natural resources and grant financial assistance to small producers.⁵

All of these are necessary conditions for human capital development and improved income distribution. However, they imply large costs and for the Guatemalan government it is extremely difficult to provide further and better social services when it only raises revenues equivalent to 9.4 % of GDP.

The Peace Accords thus require tax policy to be designed in such a way that the government can provide all necessary resources, including funds for peace consolidation, while also fulfilling the principles of fairness, equity, progress, universality and promotion of savings and economic growth. On the other hand, it should also assure efficacy and transparency in tax collection and administration so that it encourages tax compliance and counters fraud and tax evasion. These clauses are in line with the aspiration of most tax systems around the world. However, one clause goes further in committing the Guatemalan fiscal policy. It states that:

“Bearing in mind the need to increase State revenues in order to cope with the urgent tasks of economic growth, social development and building peace, the Government undertakes to ensure that by the year 2000, the tax

⁵ *Acuerdos de Paz firmados por el Gobierno de la Republica de Guatemala y la Unidad Revolucionaria Nacional Guatemalteca, Universidad Rafael Landivar, Instituto de Investigaciones Economicas y Sociales, Guatemala, 1997.*

burden, measured as a ratio of gross domestic product, increases by at least 50 per cent as compared with the 1995 tax burden.” (see Table 1)

In order to guarantee a fair and equitable tax system, the government committed itself to promote legislation that:

- 1) Reforms the tax code, establishing more stringent sanctions to tax evasion, tax elusion and fraud for all of those who are tax liable and for those government officials in charge of tax collection and administration.
- 2) Reforms tax legislation in order to eliminate all rules that allow or facilitate tax evasion.
- 3) Regulates more strictly those exemptions and eliminates all abuses.
- 4) Strengthens and develops new tax administration procedures (interrelated controls, tax identification numbers, tax withholding mechanisms, etc).
- 5) Simplifies and automates the tax administration processes.
- 6) Institutes a prompt and efficient mechanism for the return of tax credits for the VAT.
- 7) Creates a special tax program for large taxpayers.
- 8) Strengthens local government’s tax collection mechanisms.

Table 1: Goals 1997-2000

		Base year 1996	1997	1998	1999	2000	Minimum goal
Economic Performance	Real GDP annual growth rate (%)		4.2	5.1	6.0	6.0	6.0
	Nominal GDP (million dollars)	14,783	17,793	21,124	22,740	25,696	
Tax Performance	Tax Burden as a percentage of GDP	7.6	8.6	10.0	11.4	12.0	
	Percentage increase as of base year		13.2	31.6	50.0	57.9	50.0

Source: *Acuerdos de Paz, 1996*

III. CURRENT TAX STRUCTURE IN GUATEMALA

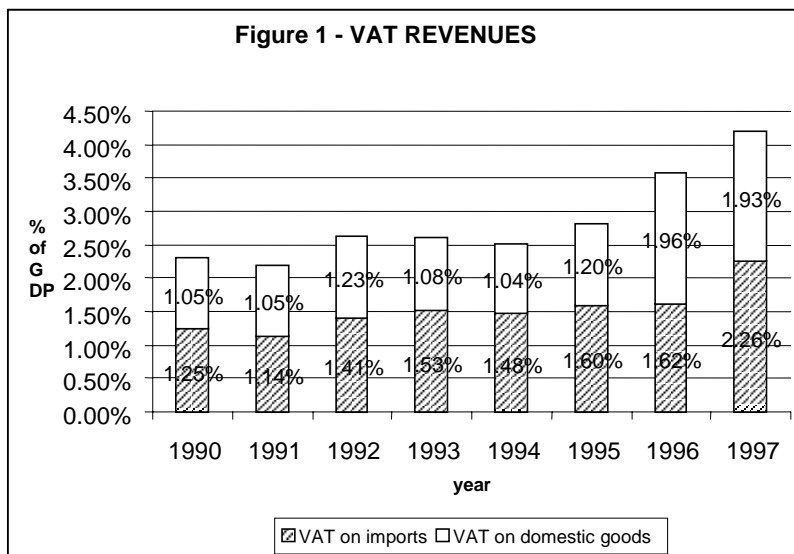
Guatemala's tax structure has improved over the years, especially during the nineties. Tax revenues come from three main sources: (a) A generalized value added tax (VAT) that in 1997 raised 45 percent of total tax revenues, (b) An income tax that by combining all of its components raised 23 percent of total tax revenues, and (c) Taxes on foreign trade that raised 15 percent of total tax revenues. The remaining tax revenues are obtained from a series of excise taxes on fuels, cigarettes, alcoholic drinks, sodas and other minor taxes.

Although total tax burden remains low and tax revenues are insufficient, the Guatemalan tax structure, in general, is not at fault. Rather, it is the particular aspects in the design of its main taxes (reduced tax bases, numerous exemptions and tax incentives, etc.) that are hindering the tax system. This section reviews the tax structure and, its evolution.

A. Value Added Tax

The VAT was introduced into the Guatemalan tax system in 1983 and its structure has been modified several times.⁶ Since the early 1990s, Guatemala has enjoyed the benefits of a widespread value added tax (VAT) with a uniform tax rate, few exempted sectors and exports taxed at a zero rate, which allows exporter to receive a tax credit for the VAT tax paid on their inputs. Figure 1 shows tax proceeds from the VAT as a percentage of GDP

⁶ It was modified through decrees 27-92, 29-94 and 60-94. Some of the changes introduced are described in this section. However, full details of each reform can be found in ASIes (1996).



Source: Ministerio de Finanzas Públicas

Evolution of the VAT

The base of the VAT has been eroded over the years by a combination of zero rates, exemptions and tax evasion. In 1990, a study by the consulting firm KPMG estimated that if all zero-rates (except exports) and all the exemptions were eliminated, the same tax revenues could be raised with a tax rate of 3.5 percent (KPMG, 1990). Using data from 1988, they estimated that the effective VAT rate was in fact approximately 2.1 percent. This gives an idea of the extent of the base erosion at that time.

The first reform that broadened the VAT base took place in 1992, and it incorporated small contributors and created the so-called *factura especial*⁷ in an attempt to incorporate the informal sector into the VAT chain.⁸ This law also brought several activities formerly exempted (transport, insurance, personal services and construction) into the VAT tax base.⁹

⁷ The purchaser of goods from the informal sector issues this type of receipt.

⁸ See Palencia and Valdez (1997).

⁹ ASIES (1996).

Before the reform, Guatemala used to have a restricted VAT on consumption¹⁰ which only allowed limited fiscal credits on capital goods that were directly used in the production of these goods and services. This clause, which arbitrarily hurts investment in commercialization or distribution activities, was short-lived.

The mentioned reform also addressed the problem of horizontal equity by eliminating the distinction between traditional exports, which prior to the law were tax exempt and non-traditional exports (taxed at a 0% rate). The existence of a zero rate regime raised a problem related to fiscal credits. Fiscal credit presently applies to all investments on capital goods and fixed assets, regardless of whether or not they are directly linked to the production of goods and services. For refunds, three different options have been applied since the 1992 VAT law reform: (i) tax refunds in cash; (ii) tax refunds in form of tax bonuses, and (iii) no payment to suppliers with the presentation of a tax exemption certificate.¹¹

The VAT tax credit is no longer refunded with the exception of exports.¹² Exporters for many years complained that the lack of an automatic refund of fiscal credit created a virtual export tax on them. This tax violated horizontal equity since it hurt different exporting activities in proportion to their use of taxed inputs, and it raised the cost of compliance. This problem was apparently solved with the creation of a fund in the *Banco de Guatemala* (funded with 15% of all daily VAT proceeds) which assures that resources are available to exporters for automatic monthly refunds of up to 90 percent of their fiscal credit.

The 1994 tax reform did not damage the VAT structure. Instead, it increased the VAT rate by three-percentage points (from 7 to 10%). It also eliminated cash reimbursements of VAT credit to ease cash flow problems in tax administration and required the inclusion of taxes on the sales receipts.¹³

¹⁰ VAT can be designed to be a tax on products, on income, or on consumption, the difference between these types lies in the nature of the taxable base. A VAT on products would be one whose base are total sales minus total inputs. When the tax base is total sales minus total inputs minus depreciation of capital, it is called a VAT on income. However, this type of tax is difficult to administer because the government has to differentiate between inputs and capital goods used in production. A third kind of VAT, on consumption, whose base is total sales minus total inputs minus capital goods, is preferable.

¹¹ IMF Economic Report, Appendix III.

¹² When the refund is not applicable, credits are carried over to the following period to be used against fiscal debits.

¹³ ASies (1996).

Problems with the VAT

The Exemption Regime Undermines the Taxable Base

Ever since the 1992 VAT law was enacted, there have been both general and specific exemptions. The general exemption regime involves activities not subject to VAT taxation.¹⁴ The sectors or activities favored with specific exemptions do not charge VAT in their sales of goods and services and do not pay VAT for their purchases (it is like a “zero rate regime”).¹⁵

The VAT taxes domestic final consumption. Taxpayers that are not final consumers are liable for the difference between tax charged on their sales (tax debit) and taxes paid on their purchases (tax credit). In theory no one, except exporters (because they are not domestic final consumers) receives a tax credit unless it generates a tax debit. Apparently, legal interpretation of specific exemptions and the application of zero-rates are adversely affecting the tax base of the VAT. The zero-rate should only apply to exports. The activities still favored with this regime, the Guatemalan Social Security Agency, schools, universities and sports committees should pay VAT on their purchases.

High Tax Evasion

Guatemala’s greatest problem with the VAT is evasion. This is explained by inefficient tax administration, lack of sanctions and enforcement, but also by the cultural habits of customers and businesses. There have been several attempts to deal with VAT tax evasion. Authorities have tried different means of getting final customers to ask for a receipt for their purchases (lotteries, authorized receipts, etc.). However, when a customer purchases goods and requests a receipt, it is common to be told that the price to be paid is 10 percent higher as a result of the VAT. Most customers will indeed prefer to avoid the tax and forget about the receipt. In an attempt to fight this type of tax evasion, a tax credit for the VAT paid on purchases was granted towards income tax liabilities.

¹⁴ The general exemptions regime was broadened to include imports by Guatemalan and foreign diplomats, sales by cooperatives, interests on financial instruments, services provided by educational and nonprofit associations for social assistance or religious purposes (previously included in the specific exemption regime), and membership fees to educational and scientific associations, professional enterprises and political parties. For more details, see article 7, Chapter IV in the VAT law 27-92.

¹⁵ FMI Economic Report, Appendix III. Also, see article 8, Chapter IV in the VAT law 27-92.

That is, those who pay income tax, accumulate all their receipts and deduct all the VAT paid.¹⁶ Undoubtedly, the administrative cost is large and the fiscal cost (resources lost to the deduction) is considerable. In addition, it is doubtful whether it helps the enforcement of VAT compliance since only a small percentage of the Guatemalan population is registered as liable for income tax.

A second important impediment to a higher compliance with VAT liabilities has been the tax credit procedures. Getting tax credit refunds has been, even for exporters, a very costly and lengthy procedure, which indirectly raises the cost of compliance.¹⁷ As mentioned earlier, this problem has only recently been tackled with the creation of a special fund. This fund, however, applies only to the exporting sector.

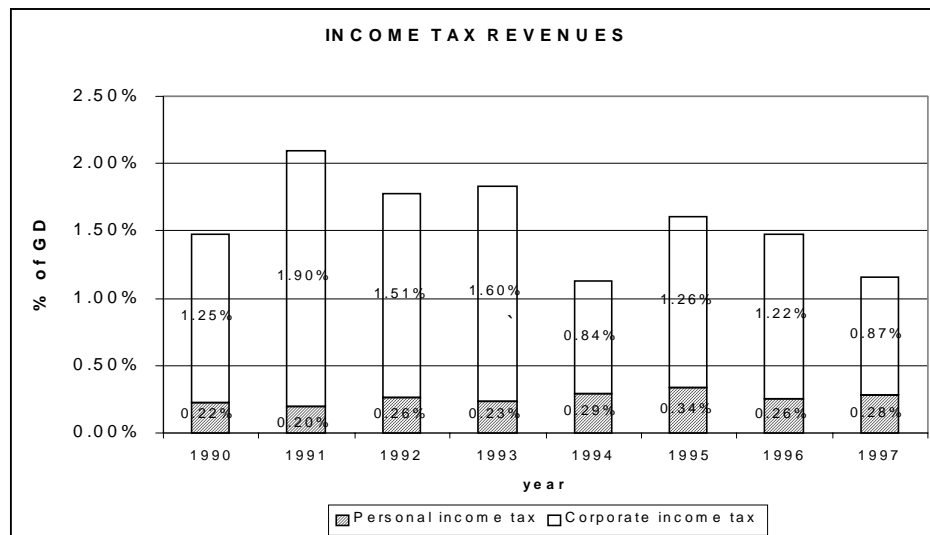
B. Income Tax

In Guatemala, there are three income tax brackets for individuals (15, 20 and 25-30 percent), and a single tax rate on firms (25%). Taxable amounts exclude tax-exempt income (36,000 Quetzals), family medical expenses, fees to professional schools, and donations to the State, non-profit organizations, universities, etc. Figure 2 shows tax proceeds from income taxes as a percent of GDP between 1990-97.

¹⁶ Up to 10 percent of their income. This allowance is described in articles 37, 41 and 70 of the Income Tax Law. See Ministerio de Finanzas Públicas, *Decreto 26-92 del Congreso de la Republica, Ley del Impuesto sobre la Renta y su Reglamento, Programa de Fortalecimiento de la Administración Tributaria*, Guatemala, agosto de 1997.

¹⁷ ASies (1996).

Figure 2



Source: Ministerio de Finanzas

Evolution of the Income Tax

As with the VAT, the 1992 tax reform also changed the structure of the income tax. The following were the main aspects of the 1992 reform:¹⁸

- The elimination of the exemption on both interest earned from bank deposits and interest and capital gains from bonds and shareholdings.
- Modifications in taxable income determination. This included the introduction of a fixed deduction instead of allowing a list of deductible expenses, and the VAT credit deduction.

The spirit of the law was to broaden the base of the tax and improve horizontal equity. However, other aspects of the law had the opposite effect. For example, in the case of corporate taxable income, former limits on deductions were removed or raised, thus, reducing the base. In addition, in the name of fiscal incentives, deductions against reinvestment were allowed in certain sectors. Finally, tax rates for non-residents were lowered.

¹⁸ ASIES, (1996).

Before 1992 there were differential rates for dividends and profits, wages, salaries, interest and commissions, and all other categories of income. Since 1992, the law does not discriminate between sources of income. All categories of income are taxed at 25%.¹⁹

For several activities, the 1992 income tax law had established a minimum withholding tax calculated on gross income. The Supreme Court suspended the withholding of income tax on certain activities, including interest income.

Two years later, in 1994 income taxes were once again reformed. This time, the reform only sought to raise short-term tax revenues. The main aspects of the reform were:²⁰

- A shortening of partial payment intervals (to improve cash flows throughout the year).
- Individual income tax rates were raised to 15%, 20% and 30% for individuals in each tax bracket.
- Tax income on firms was raised from 25% to 30%.
- Corporations and individuals with entrepreneurial activities in Guatemala also pay a tax on their assets net of depreciation. This tax is paid quarterly and is credited against income tax. However, if it is higher than the income tax, the taxpayer does not get a tax credit, so in practice it acts like a minimum income tax. The Court suspended this tax in 1995, but new legislation includes a 1.5% tax on net assets of corporations (accumulated reserves and credit obligations excluded from the tax base). The new tax has a smaller base and, thus, raises less revenue (IMF, 1995).

By 1996, the income tax was not generating enough tax revenues and the government decided to ease its fiscal crisis by creating a new, one-time *ad hoc* tax that would be credited towards income tax liabilities. This tax was called the ISET (*Impuesto de Solidaridad Extraordinario y Temporal*) and was accompanied by the issuing of Emergency Treasury Bonds. The ISET law established that in 1996 all individuals, firms

¹⁹ Article 44 in the IncomeTax Law (Dec. 26-92)

²⁰ ASIES (1996).

or corporations with profitable activities plus all dependent labor that earned income above Q36,000 were to pay 1 percent of their 1995 total gross income. The following year they were tax liable for 1.5 percent of their 1996 gross income. Alternatively, they could choose not to pay the tax, but buy emergency bonds²¹ instead for an amount equivalent to twice the ISET tax liability. The amount of taxes paid was to be considered against income tax payments of the corresponding year. This tax raised approximately 6 and 9.5 percent of total tax revenues in 1996 and 1997, respectively.²²

In 1997, before the expiration of the ISET, the government created another ad-hoc tax: the IEMA (*Impuesto a las Empresas Mercantiles y Agropecuarias*). In practice, it operates as a minimum income tax and compared to the ISET has a smaller base.²³

The income tax was reformed once again in 1997 in an attempt to broaden the base of the tax. The expected overall impact of this reform is uncertain because while some exemptions and deductions were reduced (e.g., transport services), the maximum marginal rate was also reduced to 27.5% (and will eventually be lowered to 25%). An important administrative step forward is the introduction of a payment scheme for medium size taxpayers, and the optional withholding of tax liabilities.

Problems with Income Taxation

Some Horizontal Inequities Persist

Although the design of the income tax was improved by the 1992 tax reform, some horizontal inequities persist. Dependent workers, for example, face a progressive tax bracket scheme while professionals and entrepreneurs face a unique (and higher) marginal rate. Furthermore, the former group is allowed deductions such as their Christmas bonus (*Aguinaldo*), further accentuating the discrimination in favor of dependent labor.

²¹ Bonds have a ten-year maturity and pay interest every three months. Principal will be repaid starting in year four in seven yearly installments. 50% of the resources generated by this bond go to cancel public debt and 50% to support monetary policies.

²² CIEN, *Informe al Congreso*.

²³ These taxes could be credited towards the income tax liabilities except for the following period (thus, raising total tax revenues during the first tax period).

Another set of horizontal inequities arises from the fact that residents and non-residents face different marginal tax rates. The latter pay a lower tax rate on interest paid to foreign creditors (inducing foreign debt financing of assets) and pay no taxes on interest paid to domestic financial institutions (Mendez, 1996).

Exemptions Create Distortions

Even when the number of exemptions has been reduced over the years, some activities (e.g., *maquiladoras* and duty free zones), sectors (e.g., tourism, forestry) and firms (public enterprises, non-profits, cooperatives) still enjoy the benefits of tax exemption. In the case of *maquiladoras*, the exemption is valid for a 10 year period, whereas in other cases there is no limit. Consequently, assets and utilities will tend to concentrate on the activities exempted and the liabilities in those not exempted. Finally, there is the tax exemption for firms in which the government owns more than half of the stock. This creates an artificial incentive for state intervention and unfair competition with private firms because the cost of capital for the latter is higher (Mendez, 1996). Not only is the tax base eroded by this tax 'elusion' but it also creates an incentive for tax evasion and affects efficient resource allocation and productive investment.

Fiscal Incentives are Abused.

Forestry and energy generation activities benefit from a 50 percent tax credit against investment. This implies that the government is paying for half of the investment, while 100 percent of the benefits are accruing to the private sector. Selective fiscal incentives should be avoided because they alter the real profitability of economic activities causing resource misallocation. General fiscal incentives are also harmful. For example, the 20 percent deduction allowance on reinvested profits actually lowers the effective marginal rate from 30 to 24 percent for firms. This tax treatment may lead to unproductive over-investment (Mendez, 1996).

Deductions are too Generous

Firms and individuals that pay income taxes are allowed generous amounts of deductions: a flat deduction of up to 7 percent of income in VAT payments, medical and other expenses. The advantages and disadvantages of VAT deductions were discussed earlier. However, it is worth mentioning here that the higher the level of income, the higher the incentive to substitute savings for consumption or for fraud consumption (another form of tax evasion). In conclusion, the fiscal cost that these deductions entail is high. This not only affects the tax base, but also hinders efficient tax administration and creates opportunities for tax evasion.

Tax Evasion is High

Previous studies estimate that individual income tax evasion is of about 66 percent and that it is mainly concentrated among independent workers. Dependent workers, however, are thought to be evading by abusing their deduction allowances, especially medical expenses and VAT credit. Personal income tax evasion amounts to approximately 0.73 percent of GDP. Corporate income tax evasion is estimated at approximately 53 percent (or 1.7% of GDP) and it is believed that it is mostly generated in the informal sectors of the economy (agriculture and commerce). (Mendez, 1996)

Ad-hoc Taxes are a Short-term Solution that Hides a Long-term Problem.

In the last three years, the government has twice relied on *ad-hoc* temporary taxes to ease its fiscal needs. This measure, although successful in raising tax revenues, is arbitrarily punishing those who are registered as income taxpayers and do not evade the tax.²⁴ On the other hand, no matter how easy it is for the government to introduce extraordinary taxes, if the tax base is not broadened, problems will still exist when the tax expires.

²⁴ CIEN, *Crisis Fiscal más allá del corto plazo*, Carta Económica n160, abril 1996.

C. Taxes on Foreign Trade

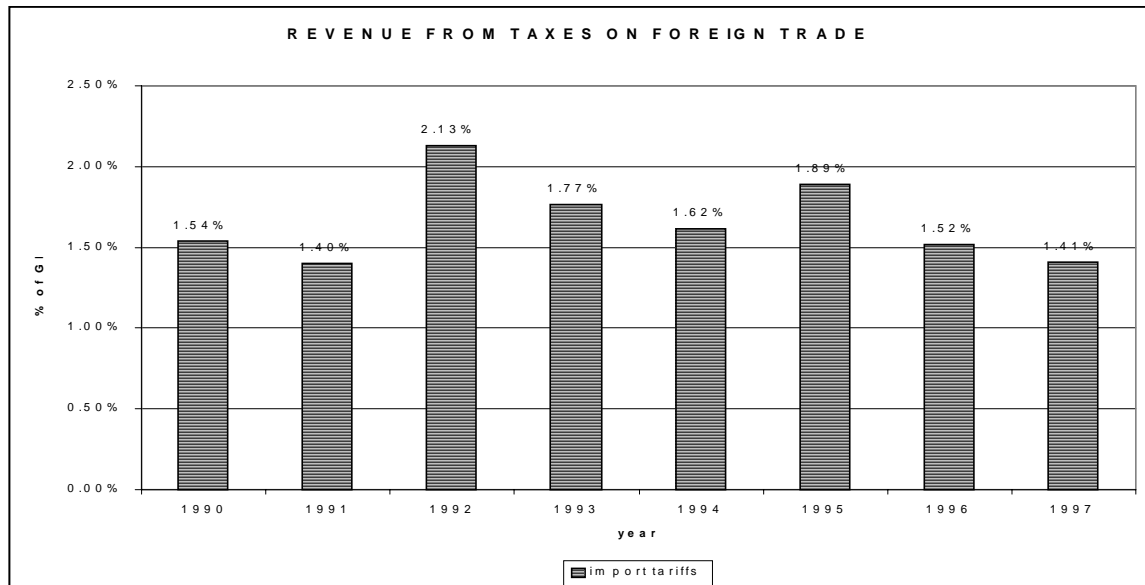
Taxes on international trade (export duties and import tariffs) used to be an important part of tax revenues. As in most Latin American countries, their relative importance has decreased in Guatemala. While during the past three decades, taxes on foreign trade represented almost one-third of total tax revenues, in 1997 they represented only 16.5 percent. In the nineties, tax revenues from this source amounted on average to only 1.6 percent of GDP (see Figure 3).

In Guatemala, protectionist policies were discarded, foreign exchange market was liberalized, taxes on exports were eliminated, and customs tariffs were lowered and simplified. These measures have contributed to the openness and competitiveness of the economy. In fact, Guatemala joined the GATT and the American Common Market (CACM) in 1991 and since then the trend has been to reduce the maximum tariff.²⁵ More recently, tariffs for capital, intermediate and consumption goods have fallen from 20, 15 and 10% to 17, 12 and 7%, respectively. The effective average tariff is 8% and a downward trend is expected. This trend will continue, as all tariffs will be reduced in two percentage points in 1999.²⁶

²⁵ Bahl,

²⁶ Arevalo Alburez, Jose A., *Breve Reporte de las Finanzas Públicas, Ministerio de Finanzas Públicas*, Guatemala, June 1998.

Figure 3



Source: Ministerio de Finanzas Públicas

D. Excise Taxes

Excises apply to both domestic production and imports and are limited to traditional commodities: tobacco products, alcoholic beverages, soft drinks and petroleum products. Tax rates are *ad valorem* except for petroleum products, which pay a specific tax. By the end of 1997, the Congress approved a raise in the tax rates of petroleum products and on alcoholic beverages.

E. Taxes on Property

Ever since 1987 Guatemala has had a tax on property ownership called IUSI (*Impuesto Unico Sobre Inmuebles*), which replaced the old municipal tax on land. Under the old tax, there was only one rate applied to the size of the property. Under the new tax, progress has been introduced through tax brackets and differential tax rates.

In 1994, the law was reformed in an attempt to decentralize its administration and benefit municipalities with tax revenues. Tax proceeds were to be distributed in equal shares to federal and local governments. More recently, near the end 1997, a new reform

was passed but this time controversy and opposition from public opinion frustrated the government's intentions. The new property tax was design to tax urban property based on size and building's characteristics, and rural lands based on extension and categorization (type A or B). After large public demonstrations against the reform, the government was forced to repeal the law in February 1998 in order to maintain social peace.

Critics argue that although it would have raised tax revenues in the short-term, this tax would have had a long-term negative impact on the quantity, location and quality of construction. In addition, arbitrary case-to-case categorization opened the door to subjectivity and would have made it even harder for municipalities to administer and enforce the tax.

F. Vehicle Tax

Until 1987, vehicle taxes were haphazard and complicated. The 1987 reform unified these taxes into a single one, which taxes private vehicles at *ad valorem* rates and those used in commercial activities (such as rental or transport) with specific rates that vary with size, value, and passenger capacity. The 1994 reform included maritime and air vehicles, raised the rates, and established a new distribution of revenues.²⁷ The efficient administration of this tax required the creation of the vehicle registration system. Municipalities would receive between 20 and 50 percent of the revenues from this tax, to be used towards the construction of new roads and bridges. The Central Government would use it towards financing public transportation.²⁸

²⁷ For more detail see ASIs, *Recientes Reformas Tributarias*, December 1996.

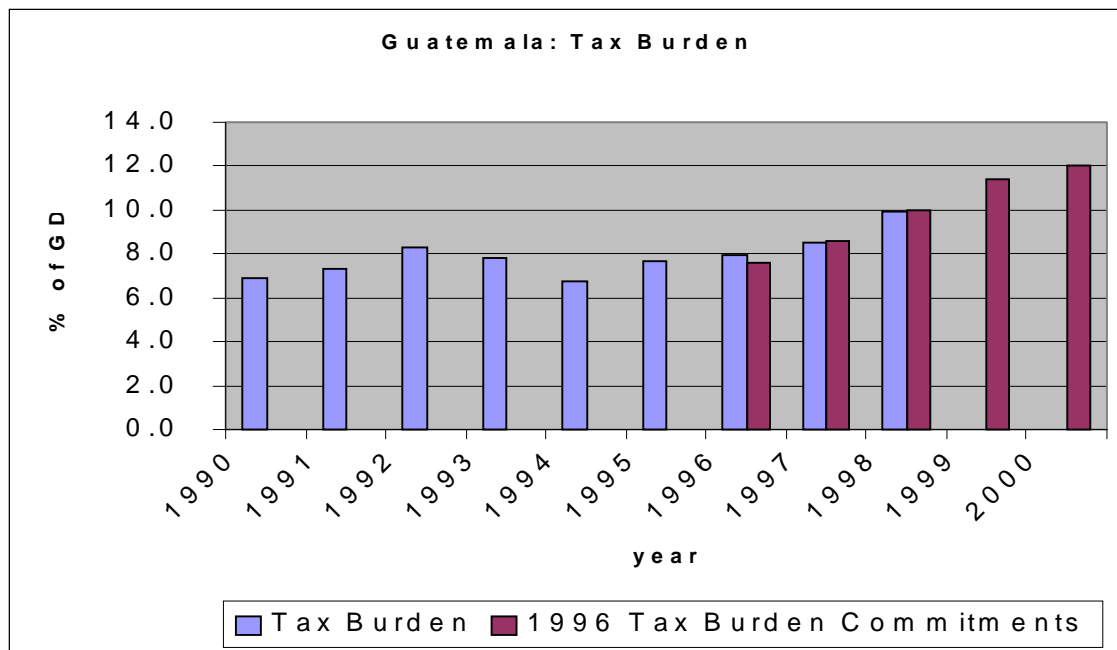
²⁸ FMI Economic Report, Appendix III

IV. CONCLUSION: WEAKNESSES OF THE GUATEMALAN TAX SYSTEM

A. Inadequacy of Tax Revenues to Meet Expenditure Needs

Figure 4 shows the evolution of the tax burden in Guatemala over the last decade. Despite the tax reforms that improved the structure of the VAT and income taxes, total tax revenue in Guatemala has hardly outpaced GDP growth. Negative impact on the tax burden over the years can be traced to the reduction of taxes on foreign trade, the reduction of marginal income tax rates, and the constitutional constraints that the government has faced with every tax reform. However, the reforms of the penal code and some administrative improvements have prevented the tax burden from falling further. It is a short-term challenge for the current administration to permanently increase the tax burden to the levels committed to in the 1996 Peace Accords.

Figure 4



Source: Ministerio de Finanzas Públicas, Dirección Técnica de Presupuesto

Different reports and studies reviewed on the Guatemalan tax structure agree that current tax revenues are inadequate in three aspects: (a) overly low tax rates; (b) a narrow tax base; and (c) high tax evasion. The first two problems are reviewed in this section. Tax evasion is discussed in the next section.

A recent study by Bahl *et al.* (1996) suggests that tax effort in Guatemala is too low. These authors analyzed 66 developing countries and concluded that a “normal” tax effort in Guatemala would be between 12% and 15% of GDP. Thus, Guatemala was below its “potential”²⁹ and presumably continues to be at present.

Other studies have pointed out that the low tax burden is the result of widespread and generous exemptions and deductions that are established not only in the corresponding tax laws, but also in special incentive laws and even in the Constitution. The tables shown in Appendix I list all of the exemptions and deductions, the laws from which they originate, and the sectors that each exemption benefits.³⁰

Many of the fiscal incentives have produced little impact on the growth of the activity that they were designed to benefit. Throughout Central America, there is a consensus for gradual reduction of fiscal incentives, especially those that hinder trade agreements. Recent reforms of the income and VAT laws have put an end to some of these longstanding tax breaks.

B. Low Tax Compliance: High Tax Evasion

Most studies blame tax administration, particularly the lack of auditing and enforcement of tax laws, and a tax culture promoting low compliance with the system. If penalties are too light, tax evasion is encouraged. On the other hand, if the cost of compliance is too high, it may induce taxpayers to evade. Third, taxpayers tend to resist payment because they see no link between taxes paid and services rendered by the government. Throughout the years, different reforms have attempted to persuade voluntary compliance with the VAT. Diverse means have been used to promote receipts

²⁹ In the mentioned study it ranked 61 out of 66 countries in tax effort.

³⁰ See Universidad Rafael Landívar, *Comportamiento Coyuntural de la Economía: El aumento de la carga tributaria en el centro del debate actual*, June 1997.

requests by consumers. Past administrations tried to encourage compliance with authorized receipts, fiscal credit towards income tax liabilities, and the creation of lotteries with receipt numbers. Although some progress has been made, as argued earlier, the fiscal cost of such schemes is high.

Estimates of tax evasion are difficult to make because of its illegal nature. Several authors have tried different approaches. Martini (1997), for example, calculates the productivity of the tax (how much tax revenue is raised by percentage point of the tax rate). For 1996, he estimates a productivity of 35.3 percent using a broad tax base (total expenditure as opposed to the real VAT base). This means that for every quetzal taxed 65 cents is evaded. Productivity had been increasing over the past few years, but it fell after the 3-point hike in the tax rates in 1996.

The results of a study by KPMG (1990) are cited in almost every study that followed. Using data for 1988, they concluded that tax evasion represents approximately 58 percent of the purchases reported. Bahl (1996), citing a model also developed by KPMG, showed that the compliance gap³¹ for the VAT was equivalent to 6.6 percent of the estimated liability for 1991. Although this figure is not an estimate of the overall compliance rate, it gives an idea of how much of the additional revenues are lost to evasion on an annual basis.

The discussion above suggests that, in order to confront tax evasion, the government needs to increase the stringency of penalties, further the effectiveness of tax administration, and change the tax code (so as to place the burden of proof and increase the financial cost of disputes on the taxpayer).

C. Problems Related to Tax Administration

All studies reviewed coincide in their opinion that tax administration inefficiencies, along with narrow tax bases, are the major weaknesses of the system and need to be strengthened. For example, Bahl et al. (1996) concluded: “frequent tax amnesties,

³¹ The compliance gap is defined as the difference between the estimated amount and the actual collections. For a more detailed account of the method used see Bahl et al. (1996).

inadequate audit procedures, and long overdue tax delinquencies were all symptoms of a poorly enforced system”.

Other often-heard criticisms of the Guatemalan tax administration include:

- Human and physical resources are inadequate (e.g., low numbers of auditors and insufficient training, low salaries.)
- Effort is directed toward small taxpayers instead of those that have higher potential tax liabilities.
- There is insufficient information about taxpayers but even existing information is not wisely used (e.g., there is no crosschecking of reporting).
- Tax evaders’ probability of being caught is very low and evaders know it.
- When tax evasion is detected, the administrative and legal procedure is long and costly for the state.
- Sanctions are not stringent. Penalties for tax evasion are light due to legal restrictions.
- Existing sanctions are not applied in an effective or timely manner.
- Tax amnesties are too frequent and generous. The government has lost credibility through the use and abuse of this short-term tool over an extended period of time.
- Ineffective administration allows widespread overstatement of inputs in the VAT tax (and on income tax deductions) or avoidance in the payment of import duties.
- Auditing procedures are inefficient. Taxpayers are audited based on geographic factors instead of inconsistencies in the information submitted.
- Collection procedures are such that some tax liabilities go uncollected.

All of these problems have been repeatedly discussed in past studies. Some progress was made with the passage of the 1987, 1992 and 1994 reforms in terms of simplification of the different tax laws and improvement of the State’s coercive power. However, in many cases the courts and the Constitution have slowed the implementation of those policies. A recent study by Martini (1997) points out that there are three articles in the Constitution of 1985 that benefit the taxpayer while weakening the position of the tax authority:

- 1) Article 28 states that the taxpayer can not be obliged to pay disputed liabilities beforehand.
- 2) Article 41 prohibits confiscatory fines and fines from exceeding the amount of owed tax.
- 3) Article 243 establishes the ‘payment capacity’ principle, which prohibits confiscatory taxes and double or multiple taxation.

These and other related articles and clauses in the Constitution of Guatemala have allowed the constitutional abolition of particular aspects of past reforms.

One aspect that is worth exploring in depth regards sanctions and penalties. These are often quoted as insufficiently strong. All penalties and sanctions were established in the tax code in June 1991. In this code all tax crimes are classified and sanctions for each crime determined. By 1994, tax authorities, concerned with the increasing tax evasion, reformed the penal code regarding tax fraud legislation. The penalties were tripled and tax evasion was made a criminal offense. It further established the imprisonment sanction (between 2 - 6 years) and a fine equal to the omitted tax.³²

A recent Ministry report³³ stated that the current administration’s tax policy strategy is based on three pillars:

- The strengthening of the State’s coercive power through:
 - Reforms to the Tax Code (*Codigo Tributario*),
 - Reforms to the Penal Code (*Codigo Penal*), and the law against customs fraud and smuggling (*Ley contra la defraudación y el contrabando aduanero*) and the Penal Procedure Code (*Codigo Procesal Penal*).
- The strengthening of tax legislation through specific reforms of each tax law.
- The strengthening of tax administration through the creation of the Tax Administration Superintendence.

³² ASIs (1996).

³³ Arevalo Alburez, Jose A., *Breve Reporte de las Finanzas Públicas*, Ministerio de Finanzas Públicas, Guatemala, June 1998.

Presently, there are three agencies in charge of tax administration: the DGRI (*Dirección General de Rentas Internas*), the DGA (*Dirección General de Aduanas*) and the DICABI (*Dirección de Castor, Avalúo y Bienes Inmuebles*). However, the recent creation of the Tax Administration Superintendency (SAT) in place of the former Tax Administration and Customs agencies is a large step towards the improvement of tax administration in the long term.

The new institution will emulate the well-respected Superintendency of the Financial System. An interesting aspect is that the law establishes tax revenue commitments. It is stated in the legislation (*Ley Orgánica de la Superintendencia de Administración Tributaria*) that tax goals will be agreed upon between the chief executive and the SAT by taking into account past tax revenues, the economic perspectives for the current year, and the budget as approved by Congress. The superintendent will personally commit to the agreed level of revenues and in case of failing to meet this obligation, shall be removed by the President.³⁴

The Superintendency will not be an autonomous agency but will be organized as a new agency and will recruit its own new personnel. Unlike other state agencies, including the DGRI, this new institution will be empowered to hire and fire administrative personnel (Article 4) and will create decentralized regional offices (*Intendencias*) and administrative units, including a special unit dedicated to large or special taxpayers scrutiny (Article 6). Its main source of revenue will be 2 percent of the tax revenues collected on domestic and foreign trade taxes (Article 33).

In order to increase the efficacy of tax administration, the SAT ought to work with outside experts to use best practices in tax administration and tax collection.

The authorities are enthusiastic about the prospects of the SAT and tax administration in the future. Public opinion apparently anticipates greater enforcement and control. A recent reform proposal by CIEN³⁵ anticipates an increase in tax revenues of at least 10% during the first two years. Results are yet to be seen but at least it is a step toward a more rational and efficient tax administration. Any fiscal and tax reform

³⁴ Article 27-g in *Ley Orgánica de la Superintendencia de Administración Tributaria*, *Diario de Centroamérica, Congreso de la Republica de Guatemala*, February 1998.

³⁵ CIEN, *Propuesta Fiscal* Guatemala, August 1998.

would have little chance of success if it were not accompanied by a strong tax administration effort.

VI. BIBLIOGRAPHY

- _____, *Guatemala: los contrastes del desarrollo humano*, Ed. 1998, *Sistema de Naciones Unidas en Guatemala*, Guatemala, 1998.
- Arevalo Alburez, José Alejandro, *Breve Reporte de las Finanzas Públicas*, *Ministerio de Finanzas Públicas*, Guatemala, June 1998.
- ASIES, *Recientes reformas tributarias en Guatemala: la experiencia externa, las reformas legislativas recientes y las declaraciones de inconstitucionalidad*, *Asociación de Investigación y Estudios Sociales*, Guatemala, December 1996.
- Bahl Roy, Jorge Martinez Vazquez and Sally Wallace, *The Guatemalan Tax Reform*, Westview Press, HarperCollins Publishers, 1996.
- Bird, Richard M. and Milka Casanegra de Jantscher ed., *Improving Tax Administration in Developing Countries*, International Monetary Fund, 1992.
- CIEN, *El primer año en tiempos de paz*, Cien-Cipe, year 1 edition 1.
- CIEN, *Informe al Congreso Números 28, 32, 33, 34, 36, 37, 38 y 39*, *PAL: Programa de Apoyo al Organismo Legislativo del Centro de Investigaciones Económicas Nacionales*, Guatemala, May 1996.
- CIEN, *Propuesta Fiscal*, *Centro de Investigaciones Económicas Nacionales*, Guatemala, August 1998.
- CIEN, *Temas Públicos 5: Impuestos*, *PAL: Programa de Apoyo al Organismo Legislativo del Centro de Investigaciones Económicas Nacionales*, Guatemala September 1994.
- CIEN, *Temas Públicos 7: Fortalecimiento financiero de los gobiernos municipales*, *PAL: Programa de Apoyo al Organismo Legislativo del Centro de Investigaciones Económicas Nacionales*, Guatemala, September 1994.
- FLACSO, *Dialogo: El tema fiscal en Guatemala*, *Facultad Latinoamericana de Ciencias Sociales*, Guatemala, May 1998.
- Gobierno de la República, *Encuentros para la Actualización*, June 26th 1997.
- IMF, *Guatemala-Recent Economic Development*, IMF Staff Country Report n.95/57, July 1995.
- KPMG Peat Marwick and the Policy Research Program of Georgia State University, *Análisis Evaluativo del Sistema Tributario de Guatemala*, *Consultoría para Administración Fiscal*, Washington D.C., July 1990.

- Méndez González, Juan Carlos, Los Principales tributos en Guatemala: Análisis y Sugerencias, January 1996.
- Ministerio de Finanzas Públicas y Banco de Guatemala, Perspectivas de la Situación Macroeconomica 1998-2002, Guatemala, August 1998.
- Ministerio de Finanzas Públicas, Decreto 26-92 del Congreso de la República, Ley del Impuesto sobre la Renta y su Reglamento, Programa de Fortalecimiento de la Administración Tributaria, Guatemala, August 1997.
- Ministerio de Finanzas Públicas, Decreto 27-92 del Congreso de la República, Ley del Impuesto al Valor Agregado y su Reglamento, Programa de Fortalecimiento de la Administración Tributaria, Guatemala, September 1997.
- Ministerio de Finanzas Públicas, Decreto 6-91, Código Tributario y Decreto Numero 103-96, Legislación penal específica, ambos del Congreso de la República, Programa de Fortalecimiento de la Administración Tributaria, Guatemala.
- Palencia Mayra y Fernando Valdés, Estado, Liderazgo Empresarial y Políticas Tributarias: un estudio de cinco casos, FLACSO, Guatemala 1997.
- Shome Parthasarathi, Tax Policy Handbook, Fiscal Affairs Department, International Monetary Fund, Washington D.C., 1995.
- Universidad Rafael Landivar, Comportamiento Coyuntural de la Economía: El aumento de la carga tributaria en el centro del debate actual, Guatemala, April-June 1997.

V. APPENDIX: TAX EXEMPTIONS

SECTORS THAT ENJOY EXEMPTIONS OR TAX DEDUCTIONS ESTABLISHED IN THE NATIONAL POLITICAL CONSTITUTION	
Privileged sector	Exception or deduction
1. Universities	All kinds of taxes and contributions
2. Private educational centers	All kinds of taxes and contributions
3. Autonomous Sports Confederation and Guatemala's Olympic Committee	All kinds of taxes and contributions
4. Social Security Institute of Guatemala	All kinds of taxes and contributions
5. Individuals or legal entities who make donations	Donations granted to universities, cultural or scientific entities, deductible of net taxable rent with income taxes
6. Religious entities	Property destined to religious activities, education and social assistance enjoy a tax and contribution exemption

SECTORS BENEFITED BY FISCAL INCENTIVE REGIMES		
Privileged sector	Law that grants exemption	Type of exemption
1. Non-traditional product exporters, with destinations outside Central America	Development and Promotion Law of Export and <i>Maquila</i> Activity	ISR (10 years) Value Added Tax (VAT) on imports, tariffs
2. Maquiladoras firms	Development and Promotion Law of Export and <i>Maquila</i> Activity	ISR (10 years) Value Added Tax (VAT) on imports, tariffs
3. Commercial users	Free Trade Zone Law	ISR (5 years), Tariffs, Stamp Tax
4. Industrial or services users	Several authors point out the need to reform the Tax Code (raise the sanctions on evasion, elusion and fraud). Law	ISR (12 years), Tariffs, Stamp tax
5. Managing entities	Free Trade Zone Law	ISR (15 years), Tariffs, Stamp tax IUSI for 5 years
6. Individual or judicial persons who investigate, promote or develop activities for protected areas	Protected Areas Law	Up to 50% ISR, IUSI
7. Commercial aviation firms of Guatemala	Law of Promotion of Guatemala's Commercial Aviation	ISR, VAT, Tariffs, Stamp tax, IUSI
8. Editorial firms	Book Promotion Law	ISR, VAT on imports, VAT on book trade
9. Energy sector firms	Law of Promotion of New and Renewable Sources of Fuel.	ISR, VAT, Tariffs
10. Media (radio, television, etc)	Law of Incentives to the Media	Tariffs for 5 years
11. Sugar producers	Sugar Enrichment Law	Tariffs, VAT, VAT on imports of machinery, mechanical equipment and Vitamin A.
12. Tourism Firms	Tourism Promotion Law	Tariffs and IUSI (10 years)
13. Hydrocarbon sector firms	Hydrocarbon Law	Up to 33% of ISR on net rent
14. Maritime National Transport Firms	Law of Promotion of Merchant Marine	VAT, Tariffs, Stamp tax, IUSI (10 years)
15. Mining companies	Mining Law	Tariffs
16. Rabbit products	Rabbit Promotion Law	VAT, Tariffs (for the first 5000 rabbits)
17. Milk and related products	Law of Promotion of Milk	Tariffs, Stamp tax, IUSI

18. Firms that produce gum obtained in Guatemala's forests	Congressional Decree 1005, Presidential Decree 356 and Decree 99-96	VAT, Tariffs, IUSI, Stamp tax
19. Craft producers	Law of Protection of Arts and Crafts	Tariffs
20. Coffee producers with output under 100 hundredweight	Coffee Law	Tariffs, VAT and VAT on imports
21. Firms who trade products on fairs or international expositions	Decree Law 240	Tariffs, VAT
22. Residents, retirees and foreign rent earners.	Decree 7-97	Tariffs, automobile import and house appliances

Source: Constructed from the specific promotion laws.

SECTORS EXEMPTED BY THE INCOME TAX LAW

1. State organisms and their decentralized entities, autonomous; municipalities and their firms.
2. Legally authorized universities.
3. Legally authorized non-profit seeking associations or foundations.
4. Religious institutions.
5. Legally constituted cooperatives.
6. Individual or judicial persons with address in the country that obtain dividends and utility participation.
7. Individual persons who receive pensions or indemnity payments.
8. Individual or judicial persons hired by foreign governments or institutions that offer technical services to the local government or official institutions.
9. Individual residents who receive social security and pension when these originate in the country.

Source: Income Tax Law and Reforms. Congress Decree 26-92.

SECTORS EXEMPTED BY THE VALUE ADDED TAX

General Exemptions	Specific Exemptions
1. Cooperatives on furniture imports.	1. Public and private educational centers.
2. Individual or judicial persons benefited by the temporal import regime.	2. Universities.
3. Goods and services export.	3. Autonomous Sports Confederation and Olympic Committee of Guatemala.
4. Financial entities and banks supervised by the Bank Superintendence, and Stock Exchange Markets authorized to operate in the country, for the services they provide.	4. Social Security Institute.
5. Individual or judicial persons who obtain interest from credit titles and other obligations emitted by the mercantile societies and negotiated in the Stock Exchange Markets.	5. Diplomatic and consular missions.
6. Individual or judicial persons who make contributions or donations to educational, cultural or religious associations, foundations or institutions.	6. International organisms.

Sources: Value Added Tax Law. Congress Decree 27-92 and reforms.

Source: Universidad Rafael Landivar, *Comportamiento Coyuntural de la Economía*, June 1997.