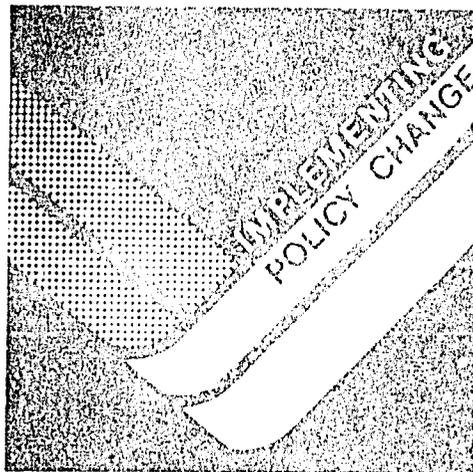


PN-ABQ-631
12/27

A PRELIMINARY EVALUATION OF THE FISCAL SYSTEM OF HONDURAS

September 1993

Presented to:
USAID/Tegucigalpa and
The Government of Honduras



Contractor Team:

Management Systems International
(lead contractor)

International Development Management Center
at University of Maryland

Abt Associates Inc.
Development Alternatives, Inc.

United States Agency for International Development
Bureau for Science & Technology
Project #936-5451

Table of Contents

Introduction and Overview		1
I. General Characteristics and Recent Trends in the Tax System.		2
I.1 Is the Level of Tax Collections Adequate?		3
I.2 Have Revenues Grown Adequately over Time?		4
I.3 What is the Distribution of Tax Burdens in Honduras?		4
I.4 What Are The Excess Burdens and Distortions Created By the Tax System?		5
I.5 How Dependent Is the Tax System On Foreign Trade?		6
I.6 Complexity and Cost-Effectiveness of Fiscal Incentives		7
II. The Structure, Issues and Reform of Individual Taxes		9
II.1 The Sales Tax (VAT).		9
II.2 Individual and Corporate Income Tax.		11
II.3 Taxes on Traditional Exports of Bananas and Coffee.		15
II.4 Excise Taxes		16
II.5 Other Taxes		19
III. Tax Administration		21
IV. Customs Administration.		25
V. A Brief Public Expenditure Review		26
VI. Budgeting and Financial Management		27
VI.1 The Current Budget		28
VI.2 Capital Budgeting		29
VI.3 Public Enterprises.		30
VII. The Need for a Comprehensive Fiscal Modernization Program in Honduras		31
VII.1 The Time May Be Right for Comprehensive Reform		31
VII.2 The Importance of Taking a Comprehensive Approach.		32
VII.3 General Objectives for the Fiscal Modernization Program.		33
VII.4 The Need to Strengthen Tax Administration.		33
VII.5 The Need to Improve Public Expenditure Efficiency and Budgeting.		34
VII.6 A Sample Blueprint for Tax Reform.		34
VII.7 The Next Steps		35
VIII. A Program of Research Activities for UDAPE		36

Introduction and Overview

This report presents a preliminary evaluation of the fiscal system of Honduras based on a four-day visit to Honduras in the summer of 1993. During this visit, meetings and interviews were conducted with representatives of government and of the private sector, and a review of the tax laws of Honduras was undertaken. A list of contacts made and interviews conducted in Honduras is included in the appendix.

The overall objective of the report is to provide an initial assessment of the most important aspects of Honduras' fiscal system, the needs and prospects for reform, and the areas where more investigation will be needed before a definitive direction can be taken. This report is intended to assist the Ministry of Finance of the Government of Honduras in the start-up of the Policy Analysis Unit. The study was conducted under the IPC project under contract by USAID/Honduras with Management Systems International. A copy of the Scope of Work for this assignment is included in the appendix.

The report is organized in eight sections. Section I examines the general features and recent trends of Honduras' fiscal system. Several questions will be asked including the following:

- Has the tax system been raising adequate revenues vis-a-vis similar countries and in light of the persistent government fiscal deficit?
- Has the tax system had high enough built-in elasticity to make revenues grow with the rest of the economy over the past four years?
- Has the distribution of tax burdens been the desired one in terms of horizontal and vertical equity?
- How much does the tax system interfere and distort economic decisions?
- Has the tax system become less dependent on taxes falling on international trade?
- Has the system of fiscal incentives been cost effective?

In Section II of the report, we examine more closely each of the major taxes in order to suggest which aspects may be subject to reform and which other issues will need to be put on the agenda for further study. As an example of the type of issues studied, consider the case of the sales tax (VAT). Should the tax base be broadened by taxing many service activities now exempt and reconsidering the present list of exempted goods and institutions? In the case of

income taxes, rates in Honduras are in the high range of international practice, yet little revenue is collected from this tax. Should individual income taxation go beyond what is collected through withholding by making use of presumptive income methods? How much more integration of individual and corporate income taxes is desirable? The structure of indirect taxes in Honduras is loaded with specific consumption and excise taxes. The integration of many of these taxes in the general sales tax (VAT) would help simplify tax administration and improve economic efficiency in the allocation of resources. Which of these specific taxes should be integrated and which should be kept independent? Is it time to change the way traditional export sectors are taxed via export taxes?

Section III of the report reviews several significant issues in tax administration and the ongoing reform efforts in this area. Despite recent improvements, tax administration in Honduras remains deficient with the result that the impact of the tax system in practice differs considerably from that intended in the tax laws.

Section IV reviews the major problems with the ongoing modernization of Customs.

Section V undertakes a brief public expenditure review, focusing on the efficiency of government expenditures.

Section VI reviews the budget process and financial management.

Section VII summarizes the possibilities for tax reform and argues the need for and convenience of a comprehensive tax reform effort. An integral approach to tax reform is desirable from many perspectives, not the least of which is the political economy of reform. Sacrifices for specific groups may be more acceptable when other taxpayer groups will be similarly affected by other measures and when the reform also brings improvements in other areas. One of the major defects of the Honduran tax system is its complexity which to a large extent has been the fruit of a long history of ad hoc reforms frequently driven by short term revenue considerations and lacking a comprehensive set of goals. It will be argued that this may be the time for the newly elected government to modernize the tax system on a par with that of its economy and its neighbors.

Section VIII of the paper suggests a program of research activities for UDAPE which would support the process of fiscal reform in Honduras.

I. General Characteristics and Recent Trends in the Tax System.

A good way to assess the performance of a tax system is to examine how well it measures up to certain desirable characteristics of any tax system. This section examines the performance of Honduras' tax system in recent years for some of the most important characteristics. In some cases, we will see there is not enough evidence available at the present time to formulate a judgment about the desired direction for reform. In these cases, a more detailed timely study will be needed.

I.1 Is the Level of Tax Collections Adequate?

There are different ways to measure the level of tax effort in a particular country, but the most commonly accepted one is the share of GDP collected in taxes by government. It is important to realize here that these measurements do not represent any normative judgment on the fiscal performance of a country. There is no absolute scale against which one can assess how good or bad a country's relative size of the public sector is. The share of government in GDP reflects, among other things, the collective preferences of a country and obviously there is no right or wrong for this from an economic standpoint. A higher tax effort may be coupled with a higher expenditure per capita on basic education and health or perhaps with higher expenditure per capita on defense. These decisions are a reflection of the sovereignty of the country and there is very little economists can say here.

But, even without passing a normative judgment it is possible to shed some light on this issue by using several possible approaches. One approach consists of comparing Honduras' actual tax effort to an expected effort derived from the behavior of countries at the same general level of development as Honduras. From this perspective it appears that the level of taxation in Honduras is neither low nor high. The average share of central government revenues in GDP for the period 1990-92 was 16.6 percent (up from 14.8 percent for the 1988-90 period). These figures are only marginally higher than the average for a group of countries with similar economic structures. For this group of 33 developing countries (data gathered from the IMF's International Finance Statistics), the average share of government revenues in GDP in the late 1980s was 15 percent. However, the average share of government revenues for all Latin American countries in that sample was 12.7 percent and the average for all Central American countries in the sample (El Salvador, Costa Rica, and Guatemala) was 12.0 percent.

There are two other approaches for ranking the level of tax effort as above or below adequate. By these two other approaches, we will see, the level of tax effort may not be high enough. One of these two other approaches considers the relative level of spending of Honduras in key sectors vis-a-vis comparable countries. For example, in 1991 Honduras spent 2.9 percent of GDP in public education and 2.1 percent of GDP in public health. For the same group of developing countries examined in the previous paragraphs in the late 1980s the average shares were 3.54 percent for education and 1.62 percent for health. For the 11 Latin American countries in the group, the average shares were 3.65 percent for education and 1.46 for health. By this measure Honduras is slightly behind its peers.

The second approach considers the level and persistence of the government fiscal deficit. The premise is that a consistent deficit is prima facie evidence that revenues collected are not enough for what collectively the country wants to spend. The overall central government deficit in Honduras (including the performance of public enterprises) hovered above 7 percent of GDP for 1988-90 and between 4 and 6 percent for 1991-93. By this measure, Honduras should not decrease its level of tax effort, unless the Government decides that public expenditures and transfers can be cut down enough to eliminate the deficit.

I.2 Have Revenues Grown Adequately over Time?

Another important property of a tax system is its ability to generate automatic growth in fiscal revenues over time. Naturally what is adequate depends on the expenditure target of government. A natural bench mark for dynamic performance of a tax system over time is its ability to grow with GNP. Tax revenues increase over time either because tax bases grow with the economy or because changes in the tax laws either broaden tax bases or increase tax rates. When only the first effect is present we measure the elasticity of a system and when both are present we measure the buoyancy. In these terms there was a significant turn around in the buoyancy of Honduras' tax system in 1990. In 1988 government revenues only grew at 8.4 percent when nominal GDP grew at 11.4 percent, implying an elasticity of 0.73; in 1989 the performance was even worse with revenues growing at 6.5 percent when nominal GDP grew at 11.7 percent, implying an elasticity of 0.55 percent.

Since 1990 government revenues in nominal terms have grown considerably faster than nominal GDP. Some of these increases can be traced back to changes in legislation such as the Decree 18-90. If we were to assume that within each year the legal framework stayed the same then the implied elasticities for the last three years were 1.5 percent in 1990, 1.33 percent in 1991, and 1.37 percent in 1992. Besides the changes in legislation, the improvements in collection performance no doubt also reflect improvements in tax enforcement. What needs to be analyzed now, and this is beyond the scope of this report, is whether the present tax system (or a reformed one) is at least unitary elastic so that government resources will grow as fast as national income.

The elasticity property is important because it gives government the ability to respond to increases in the demand for public services without having continuously to interfere with the tax system with ad hoc revenue raising measures, as has been the pattern in Honduras' past.

I.3 What is the Distribution of Tax Burdens in Honduras?

The distribution of tax burdens is among the most important issues in determining the desirability of a particular tax system. Is the distribution of tax burdens among Honduran households with different incomes progressive, proportional or regressive? Typically it is assumed that a desirable distribution of tax burdens is one that is in some degree progressive and one in which the poorest households pay no tax.

These questions cannot be answered with any precision in this report. The study of the overall incidence of the present tax system and the incidence of alternative reform packages should be a high priority. At the present time only rough guesses are possible. Under standard assumptions for the shifting of income, sales, and excise taxes and, given the structure of those taxes including the minimum exempt level under the income tax and the exemption of food and medicines under the sales tax, it is possible that the present tax system is (as in most countries) mildly progressive. However, the possibility that the Honduran tax system is regressive exists because of the importance of indirect taxation--sales and excise taxes--in the system. This reliance on indirect taxation has led some observers to anticipate that the Honduran tax system may be regressive. We need to point out, nevertheless that previous studies of countries with similar

dependence on indirect taxes, for example Guatemala a few years back or Egypt, show that heavy reliance on indirect taxation need not imply a regressive overall incidence of the tax system.

Horizontal equity --whether individuals with the same income level pay equal taxes-- is more in doubt. There is evidence that the system does not perform well at all. The individual income tax for example is mostly a tax on the income of employees subject to withholding. Little or no tax seems to be paid by professionals and the self-employed with similar and higher incomes. The quantification of the extent and level of tax evasion is not only a priority in order for us to understand how it affects horizontal equity but also in order to devise more effective methods to combat it.

I.4 What Are The Excess Burdens and Distortions Created By the Tax System?

Another manifestation of horizontal equity is whether businesses are treated equally by the tax system, that is, whether they all face a level playing field. But this question goes beyond equity concerns since to the extent that some activities are more heavily taxed than others it would affect the allocation of resources. Too many resources will be allocated in the lightly taxed sectors and too few in the more heavily taxed sectors. The misallocation of resources produces an excess burden of taxation, which simply means that the economy ends up producing less income out of the available resources. Other forms of excess burdens occur when, for example, the tax system induces a company to invest in buildings when in the absence of tax preferences it would have invested in machinery and equipment, or when companies are encouraged by the tax system to finance their capital through debt rather than equity -- leading to thin capitalization of businesses.

Distortions in economic behavior and therefore excess burden losses are not exclusive to businesses. Individual taxpayers are also exposed to excess burdens when the tax system alters their savings and labor supply decisions. All these issues raise a number of complex questions many of which are beyond the scope of this report. However, some of the questions are addressed below in the review of the structure of separate taxes and the system of fiscal incentives. Many of the recommendations of this report are based on the premise that they will decrease the extent of excess burden losses now present in the system. Note that most of the distortions introduced by the tax system are secondary unintentional effects, but this should not lead us to conclude that they are not important. Reforming the tax structure to minimize tax induced distortions can add significant welfare to the Honduran economy.

We will not attempt to quantify in this report the distortions induced by the tax system. However, the methodology exists now to evaluate how the tax system through each of the individual levies (import tariff, VAT, excises, income tax and export taxes) treats each economic sector. One conventional way to examine this issue is to ask by how much the rate of return to an additional investment of L 1,000, for example, would be decreased (or possibly increased in the case of incentives and subsidies) in different sectors of the economy (manufacturing, banana and so on) as a consequence of the present structure of taxes. This type of study should also be a priority.

I.5 How Dependent Is the Tax System On Foreign Trade?

One of the most important objectives of the recent reforms of the tax structures has been to reduce the relative importance of taxes falling on international trade. The traditional developing country reliance on taxes on foreign trade can be explained by the ease of tax collections. But relying heavily on these taxes is clearly undesirable for efficiency reasons since these taxes distort production and exports and make government dependent on such volatile sources of revenues.

Taxes falling on exports in Honduras include at the present time the traditional products of banana and coffee, as well as a variety of other commodities including meat, shellfish, minerals and sugar. There is also a 1 percent surcharge on the value of all exports. Excepting the more complex case of how to tax traditional exporters, there would appear to be no case at all for taxing any other export activity, especially when it is also government policy to encourage exports through a system of elaborate subsidies.

Collections from export taxes have fluctuated up and down over the recent past especially due to the fluctuations in international markets for bananas and coffee. But in the past 5 years the relative importance of revenues from export taxes has hardly changed. Export taxes represented 5.27 percent of total tax revenues in 1988 and 5.02 percent in 1992. However, if the expected reduction in banana exports due to the EEC quotas actually takes place, revenues from export taxes could be easily cut in half.

In the case of imports, there have been many more changes in the past several years. Since 1990 Honduras has implemented significant reforms in its customs tariff. Fiscal harmony with the other countries in the Central American Common Market will increasingly become an issue in Honduras. Honduras together with Guatemala, El Salvador and Nicaragua have begun the work of dismantling barriers to the free movement of goods, factors of production and financial capital. The group has now a common tariff with the rest of the world and has started free trade negotiations with Mexico and Venezuela. The common tariff with the rest of the countries in Central America has a maximum rate of 20 percent and a minimum rate of 5 percent.

However, in addition to the common tariff, Honduras levies two surcharges on imports. First, there is a 10 percent surcharge which has been progressively reduced over the past months and now falls only on about 25 percent of all imports. There exists a compromise with the IMF for the complete elimination of this surcharge before the end of 1993.

The second surcharge of 5 percent falls on about 90 percent of all imports. Officially it has been justified as a fee for customs services. The GATT has put pressure on the Government to substitute this 5 percent surcharge for a more defensible charge. There is now an initial agreement with GATT for the annual reduction of the 5 percent surcharge of 1 percent per year with the idea that the surcharge will be down to 1.6 percent by 1996. The impact of this reform cannot be ignored, since in 1992 the 5 percent surcharge on all imports represented close to 6 percent of total tax revenues.

Surprisingly, despite the significant changes in the tax treatment of imports, the relative reliance on revenues from import taxes has not changed much over the past five years. In 1988, import taxes represented 30 percent of all tax revenues and by 1992 this figure was still 26.75 percent. But as the 5 percent surcharge is phased out and the other 10 percent surcharge is totally eliminated the relative importance of import taxes in total revenues could fall as much as ten percentage points.

A recent and long needed reform of the "Factor de Valoracion Aduanera" will work to increase revenues from import taxes. The "Factor de Valoracion Aduanera" is the official exchange rate used for computing the tariff, VAT and excise taxes on imported goods. This exchange factor has traditionally been kept well below the open market exchange rate, subsidizing imports. Its introduction was a political maneuver to avoid the official devaluation of the Lempira. This last reform makes the adjustment of the valuation factor to the market rate fully automatic. The new factor is updated according to the weighted average of the exchange rate in the official market over the past month. Clearly, using the market exchange rate for valuation purposes at Customs will have the unambiguous impact of increasing tariff collections in one big jump. The increase in revenues will continue for as long as the Lempira continues to lose value vis-a-vis the dollar and other major currencies. An additional reason why revenues from import taxes have remained high has been the import tax on petroleum introduced in 1990, which represents over 5 percent of all tax revenues.

All in all, Honduras is still out of step with similar countries because it relies too heavily on taxes on international trade. In 1992, 31.75 percent of all tax revenues in Honduras were still coming from taxes on trade. By comparison, the average share in total revenues of taxes falling on trade for all Latin American countries in 1987 was 20.2 percent. The tax system, however, does appear to be moving away, albeit slowly, from its past reliance on taxes on international trade. Further more, a more accelerated pace of change lies ahead if all the anticipated reforms do materialize.

1.6 Complexity and Cost-Effectiveness of Fiscal Incentives

One of the most salient features of Honduras' tax system is the prominent role given over the years to fiscal incentives to exports. Because of its potential cost to the fisc and its pervasive effects throughout the tax system in efficiency and equity, the present system of fiscal incentives should be a priority area for reform.

A key piece in the system of fiscal incentives is the "Regimen de Importacion Temporal" (RIT) introduced by Decree 37 in December 1984. This decree provided exemption from the import duty, the 5 percent import surcharge, and the sales tax (VAT) to imports of any type of commodity, including capital goods, as long as they were used in the production of goods destined to exports outside the Central American market. In addition, exporters were free of income tax on all profits generated in the export activities for a period of 10 years. To help enforce compliance, producers were supposed to keep very specific accounting of what imported materials are used for domestic production and for export. This very generous regime of temporary importation was subsequently scaled down. Decree 190-86 of November 1986 limited the ten-year income tax exemption to industrial or agro-industrial non-traditional exports and to

firms employing at least 25 workers. The Decree 190-86 also tightened control by increasing penalties for those companies abusing the RIT for domestic production.

But the RIT has not always been restrained from its initial generosity. The same decree 190-86 added to the existing advantages by exempting exports under the regime from export taxes, which under general circumstances would be desirable, but more importantly, Decree 190-86 allowed firms to sell their tax-free imported inputs to "other exporters," instead of using them in their own production and still pay no taxes. This measure considerably added to the possibilities of fraud and abuse of the RIT. The Calleja administration's sweeping changes in the tax system in Decree 18-90 (Law on the Structural Organization of the Economy) eliminated many special fiscal advantages but preserved the "Regimen de Importacion Temporal" in its entirety.

Besides the RIT regime, Honduras has special regimes for "free zones" and "industrial zones." The "maquilladoras" work both in the free and industrial zones and do not constitute a different regime. The "free zones" give foreign firms advantages similar to the advantages granted to domestic firms through the RIT. There seems to be abuse of these regimes also, though no careful study has been undertaken so far.

The reform of the RIT and other special regimes should be preceded by a careful study of their effectiveness to date, and cost or fiscal sacrifice - including estimates of the added revenue losses due to tax arbitrage and tax evasion. An estimate of the cost in lost revenues from the RIT for 1993 is L 136 million or close to 20 percent of all tax revenues. This estimate does not include any losses in revenue due to evasion and avoidance, nor the higher tax administration costs induced by the RIT. On the other side, Honduras' private sector has argued that the system of fiscal incentives now in force is necessary for competition with Honduras' neighbors.

Reform of the RIT is already under way. A draft Law reforming the RIT is being discussed in commissions in Congress. This draft law appears to be a step in the right direction on many fronts. The most important change in the draft law is that it would eliminate the exemption for temporary importers from the sales tax (VAT)-- except for the maquila sector-- and it would eliminate also the 10 year exemption from income taxes. Of course, since exports are zero rated under the VAT, the only advantage truly eliminated for temporary importers in the draft Law is the income tax exemption.

The draft Law would also contribute to the more effective control of the regime and reduce induced tax evasion. For example, it limits the time for the suspension of import duties to 12 months, creates the need for a monetary guarantee on the payment of potential taxes, and creates a register of maquiladora firms. On the other side of the coin, the draft Law still provides incentives to partial (in any degree) exporters and subcontractors to make use of the exempted inputs. One of the problems with the present RIT system is that the authority to grant the special status has been given to the Ministry of Economy which has very little incentive to enforce taxes. The auditing of abuses is done jointly by customs and the Ministry of Economy. This is probably a mistake. The Government should get the Ministry of Finance directly involved since it has a much larger interest in controlling abuses.

The question is whether this draft Law goes far enough in making possible the enforcement of the RIT and whether there are alternative systems, such as drawback that would be as effective in promoting exports and save much more on administration and tax evasion. In this sense the Government should give serious consideration to completely eliminating the RIT. The drawback system may be more costly and cumbersome for honest exporters and their concerns should also be weighed. The point is that alternative systems of fiscal incentives clearly have different costs which are borne by different parties.

One consideration often overlooked in this type of debate is that revenues lost due to different regimes of tax preferences need to be made up with higher taxes in other activities in the economy. These additional taxes can be more distorting to production and to exports than the lack of fiscal incentives. The additional taxes forced by the existence of tax preferences may also produce significant horizontal and vertical inequities. Often it is also ignored in the discussion of fiscal incentives that there is nothing sacred about exports as a form of economic activity. The ultimate objective is to allow the most efficient allocation of resources resulting in growth and full employment. This may be more easily achieved by policies that do not pursue "exports at any cost." Another difficult question is whether Honduras should deviate in the area of fiscal incentives or else continue to go along with its partners in the Central American Common Market with policies that may be less than optimal.

II. The Structure, Issues and Reform of Individual Taxes

In this section we take a more detailed look at the major taxes in Honduras including the sales tax, income taxes, export taxes on traditional products (banano and coffee), and excise and specific consumption taxes. Some more minor taxes are also briefly reviewed.

II.1 The Sales Tax (VAT).

Structure and Problems

The relative importance of the sales tax has been increasing for the past several years. In 1988 the VAT represented 14.52 of all tax revenues and by 1992 this share had increased to 18.27. However the revenue yield appears to be well under its potential due to a combination of tax evasion--reported to be very high- and a tax base that is not broad enough and that exempts many income elastic commodities.

The structure of the sales tax (VAT) is standard. Although not defined as such, the sales tax is properly speaking a value-added tax because it levies the tax on each stage of production in a non-cumulative way allowing a credit for the tax paid in the previous stages of production. The name of a sales tax was kept since its introduction for political convenience.

There is a general tax rate of 7 percent and a special rate of 10 percent for alcoholic beverages and tobacco products. This latter tax is collected at one single stage, ex-fabrica. There is a special treatment for small enterprises. Until this year, those firms with sales of less than L 48,000 per year were exempted from the tax. The Law on the Simplification of Tax

Administration of 1993 changed the exempt level for small businesses to L 120,000 in total sales per year or less; these firms do not have to file a VAT return.

The list of exempted goods was modified by Decree 18-90 and includes most food stuffs, medicines and a long list of specific products including wood products, books and the like. Most agricultural inputs, including machinery and equipment, are also exempt, as are packing materials for all types of products. The Law (art. 16) also exempts from the VAT certain products taxed with excise and special consumption taxes including sugar, gasoline, diesel and new cars sold for private use. Most services are exempt from tax. The services taxed by the VAT are explicitly listed in the law and include hotels and restaurant services, telecommunications and publicity in newsprint, radio and television.

The present tax, correctly, levies a zero rate on exports. This means that exporters do not have to pay tax and have a right to a credit or refund for the VAT paid at the previous stages of production of the exported products.

Reform Issues

The IMF will be providing technical assistance to the Government for the reform of the sales tax (VAT). Notwithstanding this advice, there are several areas that need to be considered for reform.

One such area is the proper treatment of small enterprises under the VAT. At present small enterprises are tax exempt. Other countries have been using a special regime for small enterprises in which they pay a modified and simple-to-administer tax. The increase in the threshold to L 120,000 of total sales per year eliminated about 1,500 enterprises out of a total of around 7,000 and resulted in a sacrifice of between 1 and 2 percent of VAT revenues. It is true that the smaller number of taxpayers will report substantial savings to the MOF in resources until now dedicated to registration, control and audit of these small firms. But there is also a lot to be said for a tax system in which even the smallest firms do contribute, in however small amounts, to the revenue needs of the country.

Another area that will require attention is the treatment of capital goods, equipment and buildings. Until 1993 the credit for the purchase of capital goods was disallowed. The Law on the Simplification of Tax Administration of July 1993 allows credit for those capital goods purchased as inputs in the production of goods subject to tax. Buildings, housing and housing services are not included in the VAT. At present, the sale of real state is subject to a special tax on the market value of the building at rates of 2,3,and 4 percent depending on the location.

Exemptions under the VAT need to be reexamined. In the first place there is the possibility of taxing most services rather than only a selected list as is now the case. Widening the base of the tax in this way is desirable not only from a revenue standpoint but also from efficiency and equity stands. Goods also need to be reviewed. At present the list of exemptions includes not only food and medicines but also many other products that are not exempted in other countries. The base of the VAT could also be extended by including goods now taxed under special consumption and excise taxes. For example the purchase of new automobiles could be

incorporated under the VAT instead of using a separate special consumption tax. These issues are addressed below in the discussion of specific taxes.

Given that there are several sectors which for administrative reasons should not be covered by the VAT such as financial transactions, and perhaps housing and agriculture, then the question to be asked is, what are the most desirable alternative taxes for these sectors? For example there is now a premium tax falling on insurance policies other than life insurance (primarily on property and casualty insurance). Then what is the best way to tax life insurance services and banking deposits and other financial services?

The final important question is whether or not the Government should consider any changes in the tax rate. The general tax rate for the tax was increased from 5 percent to 7 percent in 1990. At that time the special rate of 10 percent on tobacco and alcoholic beverages was maintained. A decision about an increase in the general rate should be made, we will argue in section V of this report, in the context of an integral reform of many other aspects of the tax system. Another question about rates is whether to raise the rate for some goods with negative social externalities such as tobacco and alcohol products or whether to use excise taxes for this purpose.

II.2 Individual and Corporate Income Tax.

Issues and Problems

Despite the tax administration and enforcement effort carried out by the present Government since taking over in 1990, the relative importance of income taxes has not changed much since 1988. Actually, the relative share of income taxes in total revenues declined slightly from 29.11 percent of all tax revenues in 1988 to 28.64 percent in 1992. The present reporting of collections for income taxes by the MOF does not allow a clear interpretation of the behavior of the individual and corporate tax components. The MOF reports separate entries for withholding taxes and estimated taxes and there is no clear way to allocate these to the two types of income taxes.

The structure of the income tax is standard. The law uses the territorial principle taxing only incomes originating in Honduras. The tax on non-residents is levied at one single stage with no adjustment in gross incomes and at rates going from 5 percent on interest income earned by foreigners in Honduras to 35 percent on royalties.

All individuals, with the exception of those subject to withholding, and businesses, are supposed to make quarterly payments for estimated tax.

The tax base includes all types of income and it also includes all capital gains. Besides the normal costs of doing business the allowable deductions are very few. The law allows the carry forward of losses for 3 years limiting the deduction to 50 percent of taxable income in any one year. Individuals can deduct up to L 2,000 for payments for professional services including medical doctors and dentists. The personal deduction and those for dependents were eliminated by the Decree 18-90. Other deductions and special credits were also eliminated by the same

Decree 18-90. Note, however, that since the first L 20,000 are taxed at a zero rate, this is equivalent to the existence of a personal exemption of L 20,000. Individuals with less than L 20,000 in annual income and those receiving only wage and salary income subject to withholding are not required to file the annual income tax return.

The income tax law at present has no provisions for important and complex timing issues in any corporate income tax such as depreciation, inventory valuation and depletion. These matters are relegated to administrative practice. Over time there has been a lack of adjustment for inflation for depreciation allowances in particular. This year the administration has agreed to let companies increase the book value of their assets for depreciation purposes but imposing an extra-ordinary tax of 5 percent on the revaluated balances. The adjustment for inflation had no provisions for other aspects of the tax. The tax on the revaluation of assets is forecast to yield a one-time increase in collections close to L 90 million this year, but since the revaluated assets will be depreciated at the higher levels in years to come, income taxes over time will be reduced by more than the one-time increase in collections coming from the extra-ordinary tax. In effect, it turns out that the tax on the revaluation of assets is a very expensive loan from enterprises to the government.

The rate structure has been reformed several times in recent years, the last in June 1991. For the individual income tax rates there are 6 income brackets ranging from a rate of 12 percent for taxable incomes between L 20,000 and L 50,000 to the highest rate of 40 percent for taxable incomes above L 1 million. There are two surcharges on top of the regular rates for higher incomes. Individuals with annual incomes between L 100,000 and L 500,000 pay a surcharge of 10 percent on the income tax due for the income above L 100,000. For those with incomes over L 500,000 there is a surcharge of 15 percent on the tax due on income above L 500,000.

The present income tax has some elements of an old-fashioned schedular income since only wage and salary and professional incomes are taxed at the regular rates. Income from interest and dividends are taxed at a lower rate, 10 percent.

The tax rates for corporate income are two. For the first L 100,000 of profits the tax rate is 15 percent. For incomes above it, the tax rate jumps to 35 percent. There are also two surcharges. For companies with profits between L 500,000 and L 1 million there is a surcharge of 10 percent on the tax due on the profits above L 500,000. For companies with profits above L 1 million the surcharge is 15 percent on the tax due on profits above that mark.

Given that the individual tax rate on dividends is 10 percent, there is a big jump in marginal rates for business income just below and above L 100,000. The jump is from 25 percent to 55 percent. This, of course, constitutes a powerful incentive for businesses to fragment or remain artificially small. There is also a lack of integration at other levels of income. Ideally, corporate dividends should be taxed by the combination of individual and corporate income taxes in the same way that wages or professional income are treated under the individual income tax. This is far from true under the present tax rate schedules. Note that there exists some sort of integration of the personal income tax and the corporate income tax by virtue of the fact that dividend income is taxed at a lower rate under the individual income tax. But this integration is far from satisfactory.

There does not seem to be any special tax treatment of financial institutions. They are taxed in the same way as other corporations. There is, however, a heavy quasi-tax imposed on banks by the Bank of Honduras through a required reserve in government bonds (encaje) which pays a considerably lower rate than market rates. This burden is not equally distributed either because non-deposit financial institutions (financieras) are not regulated and in particular are not subject to "coeficiente de encaje". Of course, these differences have led banks to own finance companies and legally avoid control and taxes. The law does not deal in any explicit way with the allowed deductions for contingency and actuarial reserves of life insurance and property and liability insurance companies.

Reform Issues

In the case of the individual income tax there is room for further simplification with the possible adoption of a single deduction to substitute for all the other possible deductions that are left. The elimination of all existing deductions could be coupled with raising the minimum exempt by the equivalent amount of lost revenues. This would simplify tax administration significantly, probably increase tax compliance and result in an overall increase in horizontal and vertical equity. The 1990 reform was generally in the right direction to simplify this aspect of the income tax but it also created some additional problems. For example, even though the marital and dependent deductions were eliminated, a deduction for medical and dental services was increased and an additional deduction for other professional services was created.

Also in the case of the individual income tax there is ample room for tax rate simplification. At present, rates go up steeply from 15 percent to 40 percent. The numerous rates at present could be reduced to two or three. The case of a single flat rate should also be considered. In 1990 the number of rates was reduced from 9 to 7 by eliminating the two lowest rates and increasing the minimum exempt to L 10,000. The 1990 law kept, although modified in application, the two surcharges of 10 and 15 percent on higher incomes.

Another issue that should be considered is whether to index for inflation the personal minimum exempt under the income tax. Until now the changes in the minimum exempt have been ad hoc. In 1990 the income threshold for the obligation to file a return was increased from L 5,000 to L 10,000. This measure eliminated at the time over 85,000 individuals from the tax rolls. In 1991 the minimum exempt was again increased, this time to L 20,000.

One aspect of the income tax that needs reform is the fact that the individual income tax is mainly, if not exclusively, a tax on wage earners. There is a need to consider ways to broaden the reach of the tax to include all types of taxable income besides wages and salaries. There is a special need to tax professional income more effectively. Given the high level of evasion of professional income at the present time the use of presumptive income methods is perfectly justified. Another way to increase effective taxation is the use of more withholding and reporting systems.

A good example of the possibilities in this area is the withholding of 10 percent of interest income on all interest bearing accounts including savings accounts in banks and other financial institutions, private bonds issued by non-financial businesses, and stock market

transactions introduced by the recent Law on the Simplification of Tax Administration. However, interest income from savings accounts with deposits under L 50,000 on average per year are tax exempt. Thus it remains to be seen how effective the withholding mechanism will be as a revenue raising device because the tax can be avoided by keeping each account under the minimum level that is exempted.

In the case of the corporate income tax, there is a need to consider the simplification of the rate structure, using a single tax rate. Most importantly, the existing surcharges could be easily eliminated. The present Administration has contemplated lowering the maximum rate of this tax from its present level of 35 percent (excluding the surcharges). Several opportunities have been missed recently to rationalize the rate structure for the company tax, although much was accomplished in the reform of 1990. Until 1990, companies paid income tax according to the same progressive schedule used for individuals. The existing two rates of 15 percent for companies with taxable income of less than L 100,000 and 35 percent for incomes over this amount date from 1990. However, the Reform of 1990 kept the two surcharges of 10 and 15 percent triggered for taxable income above L 500,000 and L 1,000,000 respectively.

The reform of the company income tax should take into account other tax burdens on enterprises. The overall tax burden on enterprises includes payroll taxes. However, at present these are not very high in Honduras. The firms' contributions to social security is 7 percent of wages, and employees contribute 3.5 percent. (This 7 percent contribution is divided into 2.03 percent for old age, disability and death; and 4.97 percent for health insurance.) In addition to social security contributions, firms contribute 2 percent of payroll to FOSOMI.

In the income tax law there is a need for direct treatment of the important issues concerning the timing of income. In particular, the Law should explicitly address the specification of depreciation rules, depletion allowances if any, and inventory valuation rules. A critical and difficult question to be addressed here is whether enterprises should be allowed to adjust their depreciation allowances and inventories for inflation in an automatic way.

It would also be desirable to study ways to better integrate the personal and corporate income taxes; a number of issues should be considered here including setting the same maximum rate for both personal and corporate income taxes.

Several other questions will require closer scrutiny. For example the income tax law introduces distortions in some methods of business financing. While dividends from equity financing are subject to taxation at the corporate level and at the individual level (at a reduced rate), interest income is only subject to a reduced tax rate at the individual level and businesses can deduct interest as a cost while no such deduction exists for equity capital.

There is also a need to study the actual taxation of financial institutions. The questions to be asked are several including how much tax do banks pay, and are insurance companies escaping taxation through the manipulation of actuarial and contingency reserves?

II.3 Taxes on Traditional Exports of Bananas and Coffee.

Issues and Problems

The tax on the export of bananas, the most important of the two, represented 3.37 percent of all tax revenues in 1992, at similar levels for the past five years.

The export tax on bananas differentiates among production in three different areas or types of producers. For producers in traditional areas the tax is US\$ 0.50 per box. In the new planted areas, production is exempted from tax until 5-22-1994. From that date to 5-23-1997 the tax will be US\$ 0.20 per box, and from 5-24-1997 onward the tax becomes US\$ 0.50 per box. Finally for producers in rehabilitated areas (from disease and natural disasters) the tax is US\$ 0.25 until 5-22-1994 and from there on it also becomes US\$ 0.50 per box.

This has been a convenient way to tax the banana industry which represents about one-half of all exports in Honduras. However, the tax has come into question recently. The degree of competition in international markets and pressure on Honduras' producers is about to increase by the implementation of a new European Common Market system of import quotas. Starting July 1, 1993 the European Common Market adopted a single very restrictive regime for the importation of banana. This is very significant because 20 percent of the Honduran exports go to the ECC. The other 80 percent is exported to the USA market. Honduras exports at present 42 million boxes and competes closely with Costa Rica which produces 60 million boxes and Ecuador which produces 140 million boxes.

There has been mounting pressure from the exporting companies to eliminate or at least reduce the 50 cents-per-box tax. Pressure to reconsider the tax is also coming from Costa Rica which has decreased the tax per box from 50 cents to 40 cents and is planning a further reduction to 30 cents.

To help interpret the possible incidence of the export taxes it is important to review the economic structure of the industry. The structure of the industry domestically is not very competitive. Although independent producers and cooperatives produce around half of the total output, all these smaller producers sell to the two large exporters, Chiquita and Standard. Most of these smaller producers also buy inputs, such as fertilizers and pesticides, from the two large exporters because they can sell at lower prices than in open market due to lower transportation costs. The lower costs come from the use of otherwise empty return ships from USA ports with those materials. Clearly, given the structure of the domestic industry, the two large exporters can easily shift any cost increases to local producers.

Nevertheless, the two large exporting companies in Honduras face stiff competition in international markets. This means that they are price takers in international markets and as such would not be able to shift cost increases to buyers unless those were generalized across all exporting countries. Unless exporters in Honduras have been able to enjoy some non-visible pure rents, the loss in markets and increases in costs will be shifted to domestic producers. This means that there is a good case to reconsider the level and even the existence of this export tax.

For the tax on coffee exports the situation is similar but on a reduced scale. Coffee exports represented only 1.1 percent of all tax revenues in 1992 and nothing is being collected in 1993. The tax is levied at a rate of 7 percent of the FOB value of a sack of 46 kilograms valued at its closing price in New York's stock market. However, the tax on coffee exports is only triggered at international prices above US\$ 80 per sac. The industry nowadays is in a deep crisis because of low international prices and oversupply. There are voluntary restrictions on production. Here Honduras joined a pact with other Central American countries and Brazil and Colombia agreeing to put 20 percent of this year's crop into storage hoping to prop up prices in world markets. But this move is unlikely to prop up prices on any long-term basis.

The government is reconsidering its present policy of input subsidies to coffee producers. If there is over-production it may be better to let the industry shrink naturally, hence keeping the most efficient producers.

Reform Issues

There is an urgent need to study the economic impact of the export taxes and the possible alternatives to these export taxes. At least two possible alternatives exist to the taxation of exports in the traditional sectors. The first approach would integrate the production and export activities completely into the corporate income tax. A second possibility may be to design a presumptive income tax base, for example on the value of land dedicated to the production of the particular crop, the number of employees or even total sales. The study of these alternatives will require paying close attention to the present capabilities of the tax administration.

II.4 Excise Taxes

Issues and Problems

Collectively these taxes are almost as important as the sales tax (VAT). In 1992 they represented 15.91 of total tax collections in comparison to 18.27 percent represented by VAT collections. The most important individual excise tax is the tax on petroleum products amounting to 5.35 of all tax revenues in 1992 or over one-third of all excises. Adding to it the special tax on petroleum imports the revenue yield from taxing petroleum products was over 10 percent of all tax revenues. The next two excise taxes in revenue yield importance are the excise tax on beer which yielded 3.7 percent of all tax revenues in 1992 and the excise tax on cigarettes which yielded 2.75 percent of all tax revenues.

There were significant changes in excise taxes in 1990 (Decree 18-90) with the switch from specific or per unit rates to ad valorem rates. This reform contributed significantly to keeping up the yield and relative significance of excise taxes in the government budget.

All excise taxes are levied at a single stage, generally at the manufacturing or import level. This offers a significant advantage from the viewpoint of administration and enforcement. The following are the main excise taxes:

There is a tax on the consumption of petroleum products at a rate of 15 percent but gasoline and diesel are exempt from the VAT. The excise tax is justified because of the negative externalities imposed by the use of motor vehicles in terms of pollution and congestion. Actually the 15 percent rate is quite low by world standards. There is no apparent justification for the exclusion of petroleum products from the VAT. However, there is also an import tax on petroleum, as important as the excise tax, whose revenues can be said to subsidize prices when the international prices go above a threshold. There is no compensation differential at the present time because international prices are low.

There is a tax on cigarettes falling equally on domestically produced and imported products at a rate of 65 percent. Tobacco products are exempt from IVA but cigarettes are taxed at the special rate of 10 percent. This is a traditional tax treatment; excise taxes on cigarettes are used all over the world on top of the general sales or VAT because of the negative externalities imposed on the rest of society by smokers.

There is an excise tax on the consumption/production of beer (both domestic and imported) at a rate of 33 percent. Beer is also subject to the special VAT rate of 10 percent. Because it is an alcoholic beverage with potential negative social externalities there is also a justification for the discriminatory treatment of this product.

There is a tax on the consumption of matches at a rate of 12.5 percent. This tax represented 0.03 percent of total tax revenues in 1992. The excise tax on matches can be justified on the same basis as the one on cigarettes, but only if all consumption of matches were by smokers.

There is also a tax on the production/consumption of soft drinks at a rate of 8 percent. These products also pay the general sales tax (VAT) of 7 percent. Even though it has some tradition in Central America this tax has much less justification than the excises on tobacco and alcoholic beverages. Guatemala recently eliminated this tax.

There is an excise tax on the sale of new automobiles including those imported for the first time even if they are not new. The tax rate is 5 percent of sales value or CIF value inclusive of customs duty and fees. However, the purchase of automobiles is exempt from VAT.

There is an excise tax on airplane tickets at a rate of 2.5 percent for domestic flights and 10 percent for international flights. These services are not taxed under the VAT at the present time. Note that there is also an exit tax for international travelers of L 95 per person.

There are several other minor excises falling on a diverse list of commodities all exempt from VAT. They include: a tax on the production/consumption of sugar at a rate of 3.15 percent paid by sugar refiners or at the moment of importation, a tax on wood mills and forest development computed using different schedules on the basis of square footage of production, and tax on movies, theaters and other spectacles at a 20 percent rate.

Reform Issues

The use of excise taxes should be limited to those activities that for special reasons are not covered sufficiently or at all by the general sales tax or VAT or because for social reasons, such as the existence of important negative externalities, should be taxed more heavily than the VAT rate allows. There is always the possibility of having special VAT rates but this should be discouraged because they complicate administration considerably. Instead, the proper treatment is the use of excise taxes. As an example, Honduras and other countries include cigarettes in the general VAT (and tax it at a special rate of 10 percent) and then levy the additional ad valorem excise tax at a rate of 65 percent. This is the right treatment and should serve as a model for the rest of excise taxes. Excise taxation is an area that could be simplified and rationalized.

The main question is why levy special excise taxes on goods and services which can be taxed regularly by the sales tax (VAT) and have no special negative externalities, such as soft drinks?

The integration of many of the excise taxes into the VAT could be interpreted as giving away the advantage of a single stage taxation usually at the point of import or manufacturing. This is an argument that carries some weight but can be easily exaggerated. Of course, exceptions can be made in the administration of a general VAT. There is no problem in theory with levying the VAT at a single stage for some goods and still crediting both producers and users of these commodities as inputs. It has been argued that the excises and special consumption taxes could yield higher revenues. By international standards some of the ad valorem rates, especially for those products with negative social externalities, are still relatively low and could be increased. Some specialists have correctly argued that the reduction of the maximum tariff to 20 percent could have been an opportunity to raise revenues from excise taxes. The possibility of doing this is still there in a comprehensive overhaul of the tax system as will be discussed in Section V.

The taxation of petroleum products is at present unnecessarily complicated and it should be rationalized. One way to streamline it is to eliminate the import tax entirely and include petroleum products in the regular VAT. At the same time the excise on petroleum products could easily be increased, but it would be necessary to consider carefully the impact of the higher excise tax on the transport sector. Fortunately, present plans are for the government to get out of this sector and let prices reflect fluctuations in international prices. In particular, the Central Bank does not want to continue to be involved in the buying and selling of petroleum products.

The structure of taxation of cigarettes by both the VAT and an excise tax is the right one and needs no modification. However, the excise rate should be increased. The same exact statements apply to the taxation of beer.

The excise tax on matches is a different issue. The question is whether this small tax should be kept as a special tax at all when cigarette lighters, for example, are not taxed similarly. Or to simplify the tax system, should this tax be eliminated and matches taxed under the VAT?

The simplification of the tax system calls for the elimination of the excise tax on soft drinks within a comprehensive tax reform. However, the tax yields significant revenue at the present time and this cannot be dismissed, of course.

On balance the special excise tax on automobiles provides a favorable treatment to the consumption of automobiles versus other commodities by taxing automobiles at 5 percent rather than the general 7 percent under the VAT. The single important question here is whether there are good reasons to continue with this special treatment for these consumers.

There are not obvious good reasons why products as diverse as sugar, wood products and spectacles should be taxed with special taxes rather than under the general VAT. Administration convenience and tradition may help explain these special taxes but the tax system should be modernized with the times.

Several questions need to be asked about the taxation of air travel. Should it be taxed at a different rate from the general sales tax? If there is a service fee component in the tax in addition to a pure tax component, does the exit tax perform this role adequately? Why should domestic flights be taxed differently from international flights? Is there an equity argument here and if so is it defensible? Perhaps there are more lower income Hondurans flying internationally than domestically.

II.5 Other Taxes

Property Taxation.

Issues and Problems

At present there is a tax levied on transactions of real property collected by the central government. The tax rate varies from 2 to 4 percent depending on the location of the building. Collections in 1992 amounted to 0.68 percent of all tax revenues. Then there is also an ordinary property tax which is administered by local governments. The reassessment of property values at the local level has lagged behind now for many years despite the fact that there have been pronounced increases in property values over the past several years. Some of these increases, it is argued, are a consequence of better infrastructure provided by government, especially roads. One limitation in the yield of the property tax is that the largest land owner by far is still the central government.

Reform Issues

The issues surrounding the property tax at the local level-- cadastre, assessment, administration -- go beyond the scope of this report which concentrates on the central government finances. Nevertheless there is an important need to reevaluate the role of the property tax and modernize its structure.

The tax on "transmission" of real estate at the central level should be eliminated. This creates an incentive to keep property out of the market and is likely to be evaded by

misrepresentation of actual values. Fundamentally this tax should be integrated into the property tax and be left as a municipal tax.

Insurance Premiums

Issues and Problems

There is now an insurance premium tax for casualty and property insurance. Life insurance is exempt from this tax. The rate is 5 percent of the premium. The insurance premium tax is of quite modest importance; it raised 0.25 percent of total revenues in 1992.

Reform Issues

In connection with this tax, there is a need to take a closer look at the taxation of life and property and casualty insurance companies. Some of the questions to be asked include the following: is the premium tax a substitute for income taxation of property and casualty insurance companies? Is a premium tax of 5 percent together with a normal corporate income tax a comparable tax burden to that of other financial institutions and ordinary firms? Is it justifiable to exempt life insurance companies from the premium tax if this tax were to be kept? How are life insurance companies taxed?

Taxes on Motor Vehicles.

Problems and Issues.

The present tax dates from 1990. Then several existing taxes on the ownership and use of motor vehicles were consolidated into a "tax on highway services" with two different progressive schedules depending on whether the vehicle is less or more than 3 years old, and increasing with the horsepower of the vehicle. This tax raised 1.46 percent of total tax revenues in 1992 and could easily increase its performance.

Reform Issues

Ideally this tax should become an ad valorem tax based on market value as fixed in government schedules base on new prices and used car market prices. Because it is cumbersome to administer at the central level and because the tax approximates a user charge for the use of local roads, the tax on motor vehicles in many other countries is left to local governments. This is a reform that should be considered in Honduras also.

Stamp taxes (Timbres y papel sellado).

Problems and Issues.

These are old taxes with high compliance costs inherited from colonial times. In Honduras the tax was simplified in 1993 but still was not been eliminated. These taxes still yield a respectable amount of revenue, 3.1 percent of all tax revenues in 1992. Compliance with the tax

is sometimes favored by the fact that the "stamps" are often considered proof of the legal validity of the transaction or the document.

Reform Issues

Stamp taxes are good candidates for complete elimination. This has been the policy followed in Latin American countries in the last decade. These changes of course would have noticeable impacts on revenue and should be made within the context of a comprehensive reform.

III. Tax Administration

Problems and Issues

Tax administration in Honduras is going through a period of rapid change. Significant improvements and achievements have been made, but important problems remain. The view in the private sector appears to be that even though tax administration has improved in the past several years, it remains underdeveloped, unable to cope with considerable levels of tax evasion and pretty capricious ad hoc enforcement practices. This section reviews some of these recent changes and remaining challenges in tax administration.

1. Simplification of Tax Administration. This is an area of major success over the past four years, although on occasions the drive to simplify and cut red tape may have compromised the ability to enforce tax laws effectively.

The most recent changes in tax administration took place 1993 in the Law on the Simplification of Tax Administration. This law put a stop to the collection of taxes via the old "tax administration offices" and leaves collections basically to the private banking system. In this Law the permits for the sale of alcoholic beverages at the retail level are transferred to local governments (L 150 per year) but manufacturers and wholesalers still need to get the permit from the central government (L 1,000 per year) and payments are still to be made by "timbres" (stamped paper) rather than cash. This Law takes a step forward in the direction recommended in this report, eliminating stamp taxes in all transactions with the exception of notary public acts. (This exception apparently was allowed because the public perceives stamped paper as an important part of the legal validity of the document).

The Law on the Simplification of Tax Administration allows more flexibility in printing higher denominations for timbres and eliminates the need to keep accounting records on stamped paper.

More importantly, the Law increases the VAT threshold for small enterprises which are not required to file returns to annual sales of L 120,000. This has eliminated over 1,000 enterprises from the tax rolls. The Law also reduces taxpayer compliance cost by requiring enterprises to file only the monthly tax return, thus eliminating the obligation to file an annual tax return.

In the personal income tax, a considerable number of individual taxpayers have now been exempted from filing a tax return, because of the increase in the minimum exempt, reducing the number of filers from 150,000 to 30,000. By contrast, and properly so, all corporations, approximately 4,000, have to file a return.

The Law on Simplification has also eliminated the requirement for government contractors for adequate compliance with taxes. This was criticized in some quarters as weakening tax enforcement, though quite obviously the change was made to simplify bureaucratic transactions. But overall the change was a positive move because if the reporting measure was effective before, it would have been only because the MOF had an updated current account for taxpayers against which it could check compliance. But to the extent that the current account does exist there is no reason to require taxpayers to get this information from the MOF to submit again to the MOF.

Nevertheless, some of the recent decisions made to simplify administration may require more careful study. For example, the decision to do away with the official stamping of VAT bills no doubt simplifies administration, but it definitely will lead to higher evasion of the VAT.

2. Registration and Taxpayer Control. Each taxpayer is supposed to have a unique registration number (RTN). There is also a current account for each taxpayer but we got conflicting information on whether the current account is entirely functional and up to date. The IDB has been providing technical assistance to the Government in these areas. It was not possible to evaluate carefully how well the registration and control of taxpayers is working, but there are some indications that many professionals and independent businesses are not registered in the major taxes, income and VAT.

3. Audit Issues and Tax Evasion. Many audit innovations have been carried out. Several auditing programs, both office and field audits, for the income tax and the VAT have been implemented with technical assistance from CIAT. Perhaps the most significant change has been the creation of a unit for "large taxpayers." The large taxpayers amount to 400 enterprises and they are selected on the basis of income tax liabilities. The "large taxpayers" represent approximately 10 percent of all taxpayers but pay around 80 percent of all tax collections. At present the "large taxpayer" unit has 12 teams of auditors, develops an audit plan for the entire year and uses crossed information for integral audits. The large taxpayers are maintained in the group for at least three years and are submitted to an integral audit every year.

Despite these efforts, the level of tax evasion in Honduras appears to be very high. However, no official estimates of tax evasion exist. Unofficial estimates for the VAT put tax evasion at 40 percent of total collections. The income tax is also problematic. It has become a national truism that only those individual taxpayers subject to withholding pay income tax. The level of tax evasion in the corporate income tax appears to be also quite high. Evasion appears high even in some excise taxes which are simple to enforce. But again no estimate of evasion for any of the different taxes exists at the present time.

4. Collection and the Existence of Arrears. The banking system is now used for the collection of most taxes. This has represented a giant step forward in the simplification of tax

administration and in the reduction of compliance costs by taxpayers. However, the tax authorities did not prepare well enough to move tax collections to the banking system. There need to be developed some standard procedures for bank collections, timely transfer of funds to government accounts to reduce losses to the float, and data processing and transmittal. At present there seem to be banks that keep collected tax revenues up to 45 days.

Another significant problem with collections is the large size of arrears. One reason for the large arrears is that the law does not provide real penalties for those refusing to pay their tax obligations. The absence of a "Codigo Tributario" with real penalties has made tax enforcement more difficult.

5. Appeals. Another reason for the existence of arrears and general lack of compliance is an overly generous appeals stem that lets frivolous taxpayers abuse the system and delay compliance some times for ever.

6. Penalties. The lack of severe penalties for tax evaders and the lack of enforcement of the present penalties have equally contributed to the low level of tax compliance in Honduras. There is at present a draft law for new penalties for tax evaders being discussed in Congress which includes the possibility of temporarily closing businesses. However, no jail sentences are considered for any type of tax evasion regardless how fraudulent. These fraudulent activities are not typified in the penal code either. The international experience shows that the severity of some penalties is an important factor for tax compliance, but even more important is the consistent application of penalties no matter how small as long as they do inflict a cost to non-compliant taxpayers.

7. Amnesties. The Government has at the present time under consideration a law on fiscal amnesty. The draft of the fiscal amnesty condones penalties and interest charges. This is not the first fiscal amnesty in Honduras, but is among the more modest.

The use of fiscal amnesties should be discouraged. They are revenue producers in the short run but in the longer run they end costing money to the government because they encourage non-compliant behavior on taxpayers with weak compliance records and tend to alienate compliant taxpayers.

8. Personnel Issues. Honduras has not been immune to one major problem of tax administrations throughout the developing world: the big gap in compensation between the private sector and the public sector and as a consequence, the continued loss of qualified personnel to the private sector. The gap in compensation also has created problems with morale and assertiveness of inspectors.

There is also a need for better training. The vast majority of tax inspectors hold an undergraduate degree in accounting. The Direccion de Tributacion offers several special training courses which have been developed with the technical assistance of CIAT under contract with the IDB, but this may not be enough.

9. Taxpayer Services. The public image of tax administration services appears to have improved over the past several years. There are still other things that the fisc could do to improve this image. One of them will be to actually return funds in cash to taxpayers that are in a credit position with the fisc. At the present time the fisc only gives these taxpayers a credit to pay other taxes or to pay taxes next year, but in no case are there cash refunds. The tax administration also should implement more aggressive taxpayer education programs and taxpayer assistance services.

Reform Issues

The most urgent need is to control tax evasion. There is a need to conduct specific studies of tax evasion for the different major taxes and design a series of specific programs to deal with the evasion of well identified groups such as professionals and small businesses. One methodology that has been successfully applied in other countries with similar problems has been the taxation of presumptive income for businesses and professionals.

There are some procedural issues in tax audit that require careful scrutiny and control. For example, when the auditors of the two big banana companies need to travel abroad (to the USA) the companies pay for their traveling expenses. Paying for these expenses is much cheaper for the companies than trying to bring to Honduras all the necessary information. But it is hard to believe that under these circumstances the tax auditors will have much independence to conduct the proper audit and impose the appropriate fines as needed. The tax administration should pay for its own field audit cost or should demand from the companies that they make available in Honduras all the pertinent information.

The final approval and enactment of the "Codigo Tributario" is of crucial importance to remedy some of the current problems mentioned with arrears, appeals and weak penalties. The new "Codigo Tributario," however, may not go far enough and more legislation will be necessary in the future.

It will be desirable to review the IDB project in the Direccion General Tributaria and complement with USAID technical assistance those areas of tax administration not covered in that project. The IDB project in the Direccion de Administracion Tributaria covers several areas of tax administration including the registry of taxpayers and its automatization, auditing programs for "large taxpayers," general auditing programs, collection, and general management and reorganization programs. It is not possible to assess the scope of this IDB project in this report but it would appear to be quite complete. This, however, may be a good time to take stock and evaluate the effectiveness of the tax administration measures and reforms implemented over the past several years, including the IDB five year technical assistance project.

These are some additional areas which nevertheless we think should be considered for further strengthening the tax administration:

- **Tax Collections:** there is a need to develop programs for the identification of non-filers and stop-filers.

- **Organization and Management:** there is a need to reconsider the creation of an internal audit office and to strengthen the planning and organization capacity of the Direccion General Tributaria.
- **Administrative Laws and the Finalization of the Codigo Tributario:** these are among the most important steps for effective enforcement. There is therefore a need to follow up to ensure that these laws are finalized, streamlines, and implemented fully and successfully.

IV. Customs Administration.

Issues and Problems

Customs administration constitutes, in the words of the current Minister of Finance, the most problematic area of all those under the responsibility of the Ministry of Finance. At present there is no director of Customs.

Perhaps the most significant problem has been the politization of the service and an accompanying high level of corruption. The Customs civil service is not professionalized and jobs in the corps are still viewed as political privilege with the right to additional incomes many times from corrupt sources. This is indeed a serious problem which puts Honduras in the ranks of primitive customs systems.

Another problem area is the lack of coordination between the Customs Administration and the enforcement body, "Policia de Hacienda." This enforcement group is actually militarized and responds directly to Army hierarchy. All anti-contraband activities are the responsibility of the Policia de Hacienda. The relationship between customs (MOF) employees and the Policia de Hacienda has not been always friendly, and the two groups do not have joint meetings or a joint strategy.

At the present time there is no internal police in Customs. There used to be one but it was abolished under corruption charges a short time ago. There is, however, an internal audit unit but it functions only when there is evidence of wrong doing or irregularities.

There are some recent accomplishments which include a "single window" system so far in the borders with El Salvador and Nicaragua and the SIDUNEA program of statistical information of foreign trade implemented with the technical assistance of the United Nations which is almost completed.

Reform Issues

There is no reason to keep the system where all appointments from the highest ranking to the lowest ranking jobs have to be political appointments. The staff in Customs should be made part of the general civil service with promotions based on merit and general professional lathers.

The Government of Honduras has just signed a technical assistance project with the IDB for the modernization of customs. The technical assistance project has a duration of 25 months and \$ 1.37 million funding. The project includes technical assistance on automatization for classification and valuation purposes using the new harmonized nomenclature, organization and management issues, legislation on the customs system, and the prosecution of customs infractions and crimes.

The Ministry of Economy also has requested assistance from GATT in the implementation the new systems of classification and valuation.

It would be desirable to review the technical assistance projects to consider what complementary assistance could be provided from USAID. This task goes beyond the scope of the present report. However, there are two areas where further technical assistance may be desired. The first is training, since the IDB project does not include a great deal of the needed training. The second is a system to keep the valuation information up to date. There are no provisions in the IDB project for this task.

The changes in classification to the Brussels nomenclature will also require a way to harmonize decisions of classification across different Customs points, since the interpretation of the supervisor in each of these places will not necessarily be the same.

Customs will also need to rebuild its own internal investigative service. This service is needed to investigate irregular activities and fraud both in the classification and the valuation of merchandise.

The Government should also consider the strengthening of a team of inspectors within the Customs service to undertake field audits of the use of inputs by enterprises benefiting from fiscal incentives including the RIT, "free zones," and industrial parks.

V. A Brief Public Expenditure Review

The Administration of President Callejas also has important accomplishments in public expenditure reform. The reduction of the budget deficit over the past four years has been due to a large extent to the containment of public sector wages, the reduction in the number of public employees, and the reduction of economic subsidies.

A related important accomplishment has been a reduction in the deficit of several major public enterprises by controlling their borrowing and the more extensive use of cost recovery pricing. Of course improvements in this area have allowed for a decrease in the overall subsidy to enterprises from the central government and the reduction in the deficit of the consolidated public sector.

There have also been efficiency improvements in the composition of public budgets. One indicator is that the share of wages and salaries in all current expenditures dropped slowly but consistently from close to 48 percent of the budget in 1988 to 42 percent in 1992. At the same

time, even though not prima facie evidence of higher efficiency, capital investments have continued to increase as a share of total central government expenditures.

Of course, there is ample room for increased efficiency. To this end, the Government is planning a comprehensive reform program of the civil service and a Law for the Modernization of the State was passed by Congress recently.

A full discussion of the composition of public expenditures falls outside the scope of this report. Here we just want to note that some negative trends are detectable. In 1988, funding for public education represented 13 percent of total expenditures; by 1993 this share had fallen to under 14 percent. This decrease of over one-fifth in the share of public education is hardly desirable given that basic education continues to be the most important engine of development in Honduras. The decrease took place despite Government pronouncements in favor of higher education expenditures. One problem is that the Constitution earmarks revenues for the Universities equal to 6 percent of all central government revenues. These funds should, but can not at present, be channeled to basic education.

Also worrisome is that in real terms maintenance expenditures have declined across the board in recent years. But other trends have been more desirable; for example the share of defense expenditures decreased from 11 percent of all expenditures in 1988 to 5 percent in 1992. However, many defense expenditures, perhaps up to half, are not classified directly as defense but as other types of expenditures. Two categories that enjoyed an increase in the share of all expenditures were public debt service and public works.

One way to further decrease the deficit and increase the efficiency of public expenditures is to reduce present subsidies, including urban transport in Tegucigalpa and San Pedro Sula (L 70 million in 1993) and coffee producers (also L 70 million this year). There are plans to phase out the coffee next year. But of course, it is the privatization of state enterprises that will yield the biggest savings in government funds. This process is well under way but it seems to have stalled considerably when the decision has been to privatize large state enterprises. Until now privatization involved only small enterprises. The arguments presently used within government to justify the slowdown lack merit.

Another issue in public expenditure the Government needs to reckon with is that of the safety net. The present administration has been implementing a safety net program since 1990, but almost the entirety of this program has been financed by international organizations. The Government needs to start fully funding a social safety net program of its own.

VI. Budgeting and Financial Management

This section on budgeting and expenditure control is divided in three subsections: current budget, capital investment, and state enterprises. The brief visit to Honduras allowed only an overview of the budget process.

VI.1 The Current Budget

Issues and Problems

1. Budget Structure and Process. Besides the central government budget there are at present several other budgets in the country including special budgets approved by the Congress for public enterprises. This practice breaks the principles of integrity and universality of the budget.

The budget process itself does not appear to well integrated with the rest of the government's economic policy. It would seem that the budget has a life of its own based on the repetition of the expenditure patterns of past years.

2. Budget Preparation. The techniques used for revenue and expenditure forecasting are quite rudimentary. The staff is quite small and would benefit from training in econometric and forecasting techniques. Nevertheless the job presently gets done with an acceptable margin of error.

The budget preparation is still a traditional accounting exercise. Basically the budget is prepared on the basis of the last year's budget and no contingencies are made on how to cut expenditures by, say, 5 or 10 percent. But more importantly, the budget still has to become an instrument of the Government's coordinated economic policy.

3. Budget Execution and Control. The main instrument for budgetary control both for budget preparation and budget execution is the "budget ceiling" given to each ministry and major spending units, including both recurrent and capital expenditures.

The execution of the budget is at the present time over centralized. Even small expenditures have to be approved directly by the Direccion General del Presupuesto. For each payment there has to be a payment order with a specific bank reserve made or check written. Even though this system imposes desirable controls and therefore has some virtues, overall the system is way too cumbersome and inefficient. The same control can be exerted by more decentralized means.

4. Budget Evaluation. At present there is no budget evaluation of any kind and consequently there is very little control and understanding of the relative efficiency of public expenditure. Capital investment projects are followed up every three months but the check is for physical progress rather than whether the project is fulfilling the functions as planned. It would be desirable for the Ministry of Finance to examine ex-post how well the goals of government expenditure programs were met in the process of budget implementation. This information then should be fed back into the budget preparation of the following periods, to increase, decrease or eliminate funding altogether from individual expenditure programs. Two particular areas of public expenditure which would benefit from this approach are education and health. These ministries are reported to have relatively bloated central administration bureaucracies at the expense of the operational programs.

5. Recommended Technical Assistance. At present there is no technical assistance being provided to the Honduran government in budgeting. However, good budgeting techniques are as important as, if not more important than, a good tax system. There is a possibility for USAID technical assistance in this area.

Specifically, technical assistance could be provided in the following budgeting techniques and procedures:

- Budget structure and public accounting methods.
- Long term budgeting (development of 3 to 5-year budgets).
- Budget preparation and forecasting.
- Budget execution and control with more emphasis on programs and objectives and less in cash control.
- Budget evaluation and ex-post audit.

VI.2 Capital Budgeting

At the present time no agency formulates a program of capital projects with the proper evaluation techniques and the proper comparison across areas of investment. The law gives SECPLAN the power to analyze the quality and desirability of all projects although the ultimate funding decision rests with the Ministry of Finance. SECPLAN has been trying to play a constructive role in this area.

However is not clear whether the authority to effectively control capital investment should be left outside the Ministry of Finance. The need to better coordinate recurrent and capital budgets speaks against it. On the other hand, SECPLAN has personnel better trained in capital investment and evaluation techniques. Another possibility would be to transfer SECPLAN personnel to the Ministry of Finance. All these options need to be carefully weighed.

Whoever is finally in charge, it is clear that the country needs to develop a program of public investment projects. The importance of the role that SECPLAN is trying to play now is that there will be a coordinated view of the consolidated plan of capital investment for the entire public sector including local governments and state enterprises. The motivation for a coordinated control has been to rein in enterprises and other agencies that continued to spend over what was budgeted.

Projects from the IDB, World Bank and UNDP are providing technical assistance in project evaluation techniques and capital budgeting. The SISPU (Sistema de Inversiones del Sector Publico) being developed with this technical assistance may be the starting point for the needed public sector investment program.

VI.3 Public Enterprises.

Problems and Issues

What is understood as "public enterprises" in Honduras is a mixture of public utilities, autonomous and financial institutions and simply regular enterprises that happen to be owned by government. They include among "autonomous institutions" the Social Security System (IHSS), Universidad Nacional Autonoma (UNAH), and several other educational and sports organizations; among public utilities, the Water and Sewage Company (SANAA), Empresa Nacional de Energia Electrica (ENEE), the Telecommunications Company (HONDUTEL), Empresa Nacional Portuaria (ENP) and five others; and among public financial institutions the Central Bank, and the Development Bank (BANADESA).

The control of public enterprises is at the present time overcentralized and bound to be ineffective. Something uncommon in other countries is the fact that all public enterprises in Honduras must have their budgets approved by Congress. The process starts with the enterprise formulating a draft budget with the technical assistance of the Tesoreria de las Instituciones Descentralizadas. The draft budget is accompanied by a formal opinion from the Ministry of Finance and is sent to the Office of the President; from there the draft budget is finally sent to Congress.

Rather than serving the purpose of expenditure control, the role of Congress often has been to mix politics with business decisions and increase overall expenditures and losses in the sector.

The "Tesoreria de las Instituciones Descentralizadas" was created in 1993 to lend technical assistance to all agencies entering the national budget and not belonging to the central government. The actual motivation for the creation of this institution appears to have been to find a way to control the expenditures of some enterprises which in the past had exhibited little fiscal discipline and were always exceeding their budgets.

Because of the big problems with expenditure control of public enterprises the Tesoreria has instituted a system of controls to oblige them to follow their budget plans. This system controls the ability of public enterprises to write checks. This system may have gone too far but it has been in reaction to the lack of financial discipline of many public enterprises in the recent past. The plan by the Tesoreria is to develop an information system for all of the decentralized agencies, guard that these agencies do not deviate from their approved budgets with adequate controls, and develop a uniform set of accounting rules to be followed by all entities in the public sector.

One of the big problems with public enterprises has been that there are no accounting standards and that until recently there was no serious follow up from government on the conduct of business. Even now there is no complete information on the complete inventory of state property. The "Tesoreria" is offering help with analysis and control of information but it is not clear whether doing this is taking over some of the responsibility of the Controleria of the Republic which audits ex-post the activities of all state agencies including public enterprises.

The operations of public enterprises continue to represent a burden for the central government. The only major public enterprise that has not needed central government subsidies in recent years has been the phone company (HONDUTEL). The Empresa Electrica (ENEE) has been somewhat of a problem and SANAA has been a real problem. The other major decentralized public entity, the IHSS -- the social security--has not represented a financial drain so far.

Reform Issues

There is a need to review the present role of the "Tesoreria de las Instituciones Descentralizadas". In particular, is there a better way to hold enterprises accountable than to treat them the same as government spending agencies? The process of budget approval by the Congress invites political partisanship in the realm of business decisions and reduces business flexibility. In reality some public enterprises have been out of control because of the interference of congressmen in their finances.

The other major question is whether there is a better way than having the budget of each enterprise approved separately by the Congress? Of course, none of this would be necessary if public enterprises were privatized. Until that happens, there is a need for an approach to budgetary control that leaves the executive and legislative branches out of the daily operations of the enterprises. But enterprises should still remain accountable to the public authorities. A review of the experiences of other countries should prove useful.

VII. The Need for a Comprehensive Fiscal Modernization Program in Honduras

In this section I propose that the time may be right for a comprehensive modernization of Honduras' tax. The approach to reform, however, should be an integral approach because politically this may be the only way to address certain sensitive features of the tax system, and because from the theory of tax policy reform this is the right way to do it. I propose a list of general principles that should guide the entire modernization plan and argue for the importance of accompanying the tax modernization plan with an improved tax administration and customs systems and more efficiency in public expenditures and a streamlined budget process. This section also proposes a preliminary agenda for specific changes in individual taxes. Last I briefly outline the next steps that need to be taken to get the process going and the possible appointment of a "blue ribbon commission" to spearhead the "Fiscal Modernization Program."

VII.1. The Time May Be Right for Comprehensive Reform

President Calleja's administration will be leaving office at the end of 1993 with a successful list of economic accomplishments: reducing inflation rates from the double digit levels of past years, and renewing real economic growth in the economy. The Calleja administration also is leaving office with a good, if not impressive, reform record in many areas of economic policy. These include the decontrol of interest rates in the financial sector, the complete liberalization of foreign exchange markets, the reform of the trade regime, the uplifting of most price controls, privatization of many state enterprises.

The fiscal accomplishments, although still important, are more modest. In tax administration there are ongoing efforts to strengthen enforcement but it is hard to quantify what effects these efforts may have had on revenue collections. Despite significant improvements, there is substantial evidence that tax evasion remains high. In tax policy, with the important exception of the Decree 18-90 discussed in this report, the present administration has continued the old ways of making use of ad-hoc revenue raising measures. For 1993-94 the administration is planning to raise revenues by introducing a temporary tax on the revaluation and several other piece-meal measures. This hardly constitutes the kind of tax policy program that the country needs.

The tax system in Honduras has been continuously reformed in the last several decades. However, the changes introduced in the tax system have often been ad hoc, driven by short term revenue considerations instead of by structured reform efforts set to accomplish particular economic policy objectives. These policies have resulted in a tax system, we have seen, that presents serious shortcomings, that is overly complex, and that lacks common desirable properties. There is a clear need for a comprehensive review of Honduras' public finances. Politically, the country is in a period of transition between administrations making it the right time to take stock and set into motion a comprehensive review which should lead to an integral reform of Honduras' tax system.

VII.2. The Importance of Taking a Comprehensive Approach.

There are some isolated plans currently to reform specific aspects of the public finances. For example, the government is presently reviewing with technical assistance from the IMF the possibilities for broadening the base of the sales tax (VAT). This effort would be more fruitful if undertaken within a broader framework: modernization of Honduras' entire tax structure. The entire tax system, not only the sales tax, in many ways still reflects the economic base of the past. Reforms in the VAT need to be complemented with other reforms in the system of indirect taxes.

There are many advantages to taking a comprehensive approach (as opposed to a piece-meal approach) to the modernization of the tax system. The fiscal system is an interconnected system. It is usually flawed, for example, to consider the progressivity or regressivity of individual taxes because it may be very costly in terms of other objectives to achieve progressivity for a specific tax and because the relative regressivity of one tax can be offset with the simultaneous use of more progressive taxes.

Similarly, tax administration reform should be accompanied by tax policy reform since many of the difficulties with tax administration are caused by particular aspects of the tax laws. One example of the advantage of a comprehensive approach is provided by the present difficulties encountered with the reform of the RIT. The opposition to the reform of the RIT may not be so pronounced if it were made part of a larger reform in which some enterprises may lose some privileges but would also benefit from other changes in the tax system. It is also in the context of a major comprehensive reform that "untouchable" issues such as the automatic exemption from income tax of all school teachers can be properly addressed (eliminated).

VII.3. General Objectives for the Fiscal Modernization Program.

The modernization of Honduras' fiscal system should be guided by several objectives which could give more structure and coherence to the system. These objectives could include the following. First the tax system should yield adequate revenues as thought necessary to provide the level of services desired by government. Revenue sufficiency or adequacy should be of paramount importance. If the share of the public sector in GDP is currently thought adequate then the reform of the tax system could be a revenue neutral reform. In this case the main challenge of the reform would be whether the government could mobilize the same level of revenues more consistent with macroeconomic policy objectives, less distortionary of business decisions and therefore more conducive to economic growth and in a way that is more fair.

Second, the system should be revenue elastic over time meaning that government's share in GDP would at least keep pace with the growth of income in the entire economy. This revenue elasticity will keep government away from the temptation of introducing ad hoc new tax measures simply for raising revenues to keep up with ordinary increases in the demand for public services.

Third, the tax system must be a horizontally equitable system imposing equal burdens on those with equal ability to pay. This will mean that tax bases will be broadened and the overall structure of taxes simplified in order to make tax evasion harder. The tax system will also need to have an adequate degree of progressivity, but this will ultimately be a political decision.

Fourth, the modernization plan should pursue a more efficient tax system which minimizes the distortions introduced in business decision making by providing a more level playing field and one that interferes much less with the decisions by individuals as consumers and suppliers of inputs of production. An increase in efficiency will call for the continued reduction of the relative share of taxes on foreign trade.

The rationalization of taxes and tax administration should also increase the public's confidence in the tax system. The public has a harder time complying with a system that seems unreasonable or that it does not understand. This may be the case if no credit is allowed for the VAT paid on capital inputs or if there is no inflation adjustment of tax deductions in situations with a high rate of inflation for example. The public will have no confidence either in a system that appears arbitrary in its enforcement; for example, taxes are collected only when they appear to be easy to collect, as in the case of withholding.

An effective way to rationalize the tax structure, decrease excess burdens and reduce compliance costs is to simplify the system by eliminating small taxes and broadening tax bases by treating most taxpayers uniformly. Special provisions are a major source of inequities and give opportunity for tax avoidance and evasion.

VII.4. The Need to Strengthen Tax Administration.

Changes in the tax laws have to be accompanied by stronger efforts to increase enforcement of the tax system via an improved tax administration and a tougher system of

penalties. The experience of tax reform for the past decade in many countries shows that policy reforms of tax structures have little chance for success if the reform is not accompanied by a heightened tax enforcement effort. But even considering the demands on tax administration of a new tax structure, there are now significant problems in tax administration which need to be addressed beyond the present level of effort and irrespective of the existence of structural reform. Honduran taxpayers at present have all the reasons to believe that if they do not pay their taxes there is a small chance that they will get caught, and that if they are caught the penalty will not amount to much. The lack of confidence in tax administration is a consequence of poor audit practices, past amnesties, an exceedingly generous appeal system, and substantial unpaid arrears. Corruption, fraud and lack of a professional corps in Customs have been significant contributors to the lack of confidence in the tax administration system.

VII.5. The Need to Improve Public Expenditure Efficiency and Budgeting.

The fiscal modernization plan should also increase the confidence of the public in government by increasing the quality, equity and efficiency of public expenditures. Ultimately, there is no way for a tax system to evolve toward one with higher voluntary compliance if taxpayers perceive that government is not accountable and responsive to their needs and that there is waste and fraud in public expenditures. The way to increase confidence in this area is improved budgeting and program evaluation techniques and continuous evaluation of budget performance to discontinue ineffective programs and expand successful ones.

VII.6. A Sample Blueprint for Tax Reform.

It is entirely premature to suggest a final blueprint for reform of the tax structure. But given the preliminary analysis in the previous sections of this report, it is possible to sketch a blueprint for tax reform that will be quite compatible with the principles of tax reform outlined above:

- Sales Tax (VAT). Broaden the tax base to include most of the services currently not taxed and some of the commodities that are now exempt. Incorporate in the VAT base those goods and services now subject to special consumption taxes but exempt from VAT. Keep zero rating exclusively for exports. If necessary raise the general VAT rate to keep the overall reform revenue neutral. Eliminate the special VAT rate of 10 percent and rely on excise taxes imposed on top of the general VAT to tax more heavily goods with negative social externalities such as tobacco and alcohol products. Call the sales tax officially the Value Added Tax.
- Income Taxes. Simplify the individual income tax further by eliminating all deductions and raising the general minimum exempt (perhaps to L 25,000 or L 30,000). Raise the minimum exempt more if more overall progressivity is desired. Index the minimum exempt for inflation. Simplify the tax rate schedule for the individual income tax down to three or even one single rate. Coordinate these rates with VAT rate to assure revenue neutrality of reform. Introduce presumptive income taxation for professionals and businessmen.

For the corporate income tax, address explicitly timing issues of depreciation and inventory valuation in the law, simplify rates to one single rate equal to the maximum rate (or single rate) for individuals. Integrate individual and corporate income taxes better to avoid the bias against equity financing.

- Excises and Special Consumption Taxes. Incorporate into the general VAT all the commodities taxed by special consumption taxes and excise taxes presently not covered by the VAT. Eliminate all these taxes with the exception of those goods and services for which consumption should be discouraged because of their negative social externalities such as alcohol and tobacco products for health reasons or petroleum products for environmental reasons. Raise the rates for the excise taxes (which will be levied on top of the VAT) to world standards.
- Export Taxes. Find alternative taxation for the banana and coffee industries (several possibilities are discussed in the report) and eliminate all export taxes.
- Import Taxes. Keep the tariff at its present levels in harmony with other countries in the Central America Common Market. However a uniform and overall lower rate will be preferable. All other import taxes should be eliminated.
- Timbre and Other Minor Taxes. Eliminate completely the stamp duty tax which is a vestige from the past and consider the elimination of many other minor nuisance taxes. The inheritance tax could also be eliminated but it may be desirable to keep it for political reasons.
- Property Tax and Tax on Motor Vehicles. Revamp these two taxes, and eliminate the tax falling on transmissions of real estate. Transfer these two taxes completely to local governments.
- Other Issues. Cease earmarking tax revenues for particular activities. Recompile each of the tax laws into a single document (the sales tax law has been modified 16 times since its inception and the income tax law 28 times and they were never rewritten).

VII.7. The Next Steps

The best way to proceed with an orderly process of fiscal reform is for the Government (the President) to appoint a "Blue Ribbon Commission" with bipartisan membership of congressmen, private sector representatives and even of union representatives. The Commission will have as its staff for research add policy discussion papers UDAPE. In turn UDAPE will work with a team of international experts, within a USAID financed project. The project will train Honduran economists in analytical techniques and quantitative models needed from the continuous evaluation of fiscal policy. One key word in all tax policy issues in recent times in Honduras has been consensus with the private sector. The proposed plan would continue this desirable approach even more actively.

Until the elections are held in late 1993, UDAPE could conduct a series of seminars with several leading groups to start the process of letting the new administration take ownership of the idea of a comprehensive reform. Without committed participation at the level of the new Minister of Finance, no comprehensive tax reform process will take place at the end.

VIII. A Program of Research Activities for UDAPE

This section presents a list of possible research activities for UDAPE with immediate policy relevance in the fiscal arena:

1. Comparative Business Tax Burdens: Honduras vs. The Rest of Central America. There is a need to study the effective tax burden on Honduran businesses vis-a-vis the tax burden in similar countries. It is important to harmonize tax burdens for Honduran businesses with their most proximate competitors. There appears to be a belief in the Honduran private sector that the Honduran businessman is the most heavily taxed in all Central America. In addition, the costs of doing business are also believed to be higher in Honduras than in the rest of Central America, because of higher tariffs for electricity, phone services and seaport loading among others. How much of this is true and how much is fiction that may help perpetuate resistance to full tax compliance? The study will also need to consider the quality and quantity of services in the countries in the sample.
2. Fiscal Incentives. A second study should analyze the cost and effectiveness of the present system of fiscal incentives, preferences and advantages, including but not limited to the RIT. This study should document the system of fiscal advantages in all other countries of Central America. It should consider the experience of other developing countries that may have opted for a simplified approach to fiscal incentives. One important principle of this research paper should be to look at both the relative effectiveness of fiscal incentives and also at their costs. Which tax incentive mechanisms should be kept, which should be reformed to make enforcement more possible and which should be eliminated? Particularly important issues are the status of partial exporters and the possibility of indirectly extending benefits to subcontractors or other firms that are not exporters. To reduce unnecessary revenue losses to the Government the study should also explore the possibility of negotiating tax sparing agreements with countries that use worldwide income as the income tax base. The study should also consider alternative ways to administer and enforce fiscal incentive regimes.
3. Effective Marginal Rates of taxation. Study the effective marginal rates of taxation for Honduran businesses. The advantage of this comprehensive approach is that all taxes affecting the profitability of business activities are taken into account at the same time.
4. Alternative Taxation of the Traditional Export Sectors. A fourth study to be undertaken by UDAPE is of the tax treatment of the banano sector. This study will include a comparative analysis of the tax treatment of the banano industry in Honduras vis-a-vis that in other countries and in particular its most direct competitors, Costa Rica and Ecuador. The study should include an evaluation of the incidence of the present tax and how it may be affecting the competitiveness of Honduras' producers in international markets. What options would improve cost effectiveness

of the present system of fiscal incentives? Would it be better and still feasible to rely on a drawback system?

5. Computable General Equilibrium Model for Free Trade Agreements. Another study for UDAPE with lower priority is a computable general equilibrium approach to study the consequences of a free trade agreement with Mexico and other countries.

6. Tax Evasion and the Underground Economy. An important and necessary study for tax reform and tax administration is the study of the size of the underground economy in Honduras with specific calculations of the level of tax evasion by major type of tax.

7. Incidence of the Tax System. Another important study for UDAPE will be the study of the incidence of the entire tax system. Little is known now in Honduras about the overall incidence of the tax system but many political declarations and even actual policy are based on assumed incidence of the present system

8. Local Government Finance. An area of study with second priority at the present time but nevertheless important is the system of local finances. The system has been recently reformed by the Law of Municipalities, but still presents serious problems. It would be appropriate for UDAPE to develop an expertise in this most important issue to inform government of the possibilities of further reform down the road. Under the present system municipalities receive a transfer from the central government equal to 5 percent of all tax collections, excluding the customs tariff. Actually the new Law of Municipalities establishes a gradual phase-in for this revenue sharing scheme with 3 percent in 1992, 4 percent in 1993, and 5 percent in 1994. Of this 5 percent of revenues, 20 percent of it is distributed in equal parts to all municipalities. The other 80 percent is distributed according to population size. No allowance is made therefore for special population needs or local tax effort. An important restriction is that only 10 percent of these funds can be used for current expenditures; the other 90 percent have to be used in capital investment projects. In addition 4 percent of all revenues from the custom tariff are also earmarked for the municipal governments.

Local governments have in addition some discretion for raising their own revenues. Congress allows municipalities to establish their property tax rate between 2.5 and 4.5 per thousand. Municipalities may also levy a tax on commercial establishments which falls on the volume of sales. There is also a capitation tax, a tax on agro-industries, and a tax on the development and extraction of natural resources. Municipalities also have freedom to set service fees at high enough levels for complete cost recovery. Unfortunately, municipalities and municipal enterprises have made little use of full cost recovery fees.