

## Guatemala Tax and Investment Policy Reform Program

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### SCOPE OF WORK

#### *Background*

USAID/Guatemala has requested assistance, in the form of a buy-in from the Fiscal Reform in Support of Trade Liberalization Project, a USAID/EGAT technical leadership activity. This assistance builds upon efforts under the earlier Promoting a Sound and Simple Tax System Project, which initiated as a SEGIR:EP Task Order in 2001.

A Scope of Work was prepared for this buy-in and the assistance contemplated in the SOW includes the following overall technical areas:

1. Assist the GOG to normalize fiscal structures for greater harmonization with the rest of Central America, especially in light of a Central America Free Trade Agreement.
2. Assist the GOG in achieving its revenue targets by means of policy and administrative reforms.
3. Assist the GOG improve the quality of public spending, improve the equity in public spending, and raise transparency.
4. Assist the GOG and the Legislature to strengthen the budgetary process.
5. Help to mobilize a constituency and build support for fiscal reform among key Guatemalan stakeholders.

The first step toward implementing this wide scope of work entailed a visit by The Fiscal Reform Project's COP, Mark Gallagher, to Guatemala to work with Dr. Alex Segovia in the development of this workplan. Gallagher visited Guatemala from January 19 to 21, 2004 for the purposes of initiating this workplan preparation. During this visit, Gallagher and Segovia met with several key counterparts and USAID/Guatemala staff. A list of the people in those meetings is included in the annex.

#### *Current situation*

Much is needed in Guatemala within the context of improving its fiscal system. A number of efforts, of course, are already underway, such as programs in the area of improving fiscal transparency and anticorruption. This brief discussion of needs relates mainly the current fiscal crisis and the areas distinctly covered under the SOW.

The GOG is in acute fiscal crisis, although this is not yet widely recognized. There is no approved budget so the MOF is spending based on 2003 budget allocations. At the same time, a number of Constitutional Court decisions have serious implications for revenues and overall

fiscal balance. The Court has decided that the elimination of the VAT deduction against taxable income represents an unfair or unallowable confiscation of an “acquired right”. The other important Court decision is that the alternative income tax (called the IEMA) is unconstitutional. These two decisions have serious implications for revenues, perhaps costing the GOG a loss of about 2% of GDP in revenues for this year.

A major blow to tax revenue effort in Guatemala appears to have arisen from a marked deterioration in tax administration. Specifically, some members of the GOG, as well as others not in government indicate a need to implement a radical change in leadership at the Superintendencia de la Administración Tributaria (SAT).

Between the recent Constitutional Court decisions and the changes in the SAT, tax revenues may decline to below nine percent of GDP.

With a rigid spending plan imposed by having to spend according to the 2003 budget without respect to the severe revenue short falls, few options seem open to the GOG: raise new revenues, cut spending, or increase deficit borrowing.

Cutting spending is unlikely to be a very useful path. Considering that overall spending in real terms is already about 5% last year, that government spending in Guatemala is lower in terms of GDP than any other country in the region (indeed, in all of the Americas), and no real analysis has been undertaken to guide such an exercise.

Resorting to increased deficit financing is also not considered a very favorable option. GOG budget plans prior to the above-discussed fiscal crunch already contemplated a deficit equivalent to 2% of GDP. A rise in this deficit to 3.5 or 4% of GDP would harm the overall macroeconomic stability of the country and will not be encouraged by the International Financial Institutions.

Not only does the current fiscal crisis threaten macro-stability and proper fiscal management, it puts at risk all the hard-won achievements that have been gained over the years in terms of the Fiscal Pact.

Since the new government took office, its new leaders have recognized the acute fiscal crisis, which has been opened for public discussion. For example: the revival of the Fiscal Pact was announced on 2/4/04 newspapers to be started February 14<sup>th</sup> with the intention of submitting to the President a proposal contained the strategy to re-take the Fiscal Pact. The strategy will be developed taking as the basis the consensus achieved in 2000. A most concrete example of the new government’s willingness to take measures is that it has named a Mr. Willy Zapata to lead the SAT.

The GOG has only a short time to act and to act decisively. Lessons from prior governments have shown that efforts to reform or raise taxes after this initial period have tended to not succeed. At the same time, Guatemalan sectors have felt very disappointed in terms of their dealings with earlier governments and are not likely to support what might be seen as increased taxation without some guarantees by the government that it will take firm measures to clean up the tax administration and to return to the table to discuss new goals and objectives for the fiscal system within the context of a revitalized Fiscal Pact. It also must be pointed out that this government has no majority or even a strong coalition in the Congress and cannot anticipate support from this quarter. At the same time, the Congress was only recently elected and has little understanding of fiscal issues. Gaining support for real, transcendental fiscal measures is both essential and extremely challenging.

The Project Team recommended in January 2004:

- The GOG must make clear to the Congress, private sector, broader society, and the international community its commitment to sound fiscal management.

As discussed above, concrete measures have now been taken in this regard.

- The performance of the SAT must be reviewed and new management appointments, if warranted, should be implemented, and quickly.

The recent replacement of the Superintendent is the most important single step that could be taken in this regard.

- The Fiscal Pact process should be restarted, with the GOG as a partner. Congress or political parties should also become partners in the Fiscal Pact process.

This step was taken in the beginning of February 2004.

There is support for the GOG from the private sector. For example: CACIF expressed its willingness to discuss with GOG, under the framework of the Fiscal Pact, alternatives to overcome the decline in revenues due to IEMA.

- New Fiscal Pact targets should be determined and rescheduled. This includes:
  - o New revenue targets and specific revenue measures.
  - o New expenditure targets that will help to foster a more development-oriented Guatemala and reduce economic inequalities.

### *Project Activities*

The Project will undertake the following:

1. **Update the Benchmarking Study:** This work will be led by Art Mann. Extra focus will be placed on Customs operations, human resource matters, and legal aspects of taxation as they relate to the SAT.

Total LOE: about 55.

2. **Roundtable to discuss urgent revenue measures:** There is considerable literature already available from the PSSTS Project as well as papers prepared by the IMF and NORAD/IDB that propose measures that can raise revenues. The Project will facilitate a roundtable with GOG counterparts and a select group of Guatemalans outside of government, to discuss these and other recommendations, prioritize the measures, define steps, and for a GOG position.

Prior to the roundtable, the project team will develop a matrix of proposed tax system (policy, legal and administration) reforms, including economic rationale for reforms, indication of likely social effects and effects on groups, and revenue implications.

The project team will coordinate with the FUNDESA/IDB project (Dr. Hugo Maul). An initial roundtable could focus on the consensus within the Government with regards to fiscal policy. Any suggestion of proposed tax will be under the umbrella of the Fiscal Pact.

Project participants will include Mark Gallagher, Alex Segovia, and Art Mann.  
Total LOE: about 15 days.

3. **Build consensus:** Consensus building will be necessary for any efforts to reform the fiscal system. The following actions are anticipated:
  - a. Attend, and report on, donor-coordination meeting(s) on the issues of fiscal system reform.
  - b. Hold numerous meetings with **stakeholders** (including GOG, private sector, civil society, and congress) to discuss their perceptions, suggestions, and willingness to participate in a revived Fiscal Pact process. Project will provide a written report to USAID/G on a twice a month basis.
  - c. A **training** in fiscal systems would be provided for the Finance Committee of Congress. This must be coordinated with USAID and meetings need to be set up with Congresspersons.
  - d. Perhaps hold three **mesas redondas** with specific groups to discuss revisions to the Fiscal Pact and new measures.
  - e. Provide assistance in developing a **popular outreach program** to get the messages of fiscal pact and public finance reform out to wide expanses of Guatemalan society. This might also include funding the printing of the PSSTS Project documents as a book that would be widely distributed.

Project participants will include Alex Segovia and others for the mesas redondas, as may be required.

LOE: 30.

Other input would likely include a subcontract with a Guatemalan public education/strategic communications firm.

4. **Comparative public expenditure study:** The study will review overall government finances and particularly expenditures, compare public expenditure with other countries in the region and in emerging markets, compare social and other development indicators, review other studies of Guatemala's public expenditures, social services, and infrastructure needs, and develop a series of targets for improving public expenditure allocations and regional and sector allocations. This study will be key in assisting those working on the rescheduling of the Fiscal Pact to establish new, reasonable, verifiable expenditure targets.

LOE: 44.

5. **Study of tax aspects of the national constitution:** This study will investigate all aspects of Guatemala's constitution that provide the enabling environment for taxation in the country. Recent decisions of the constitutional court have tied the GOG's hands in terms of its ability to appropriately manage its tax system. In particular, the decision that the

Alternative Income Tax/Asset Tax and the repeal of the VAT deduction against income taxes have severely hampered the GOG's ability to meet its fiscal targets for 2004. Similar aspects of the constitution have had similar impact on taxation decisions and applications in the past. The project will hire a local legal expert with specialization in taxation and the national constitution. This expert will review and express in an orderly manner all of the constitution's articles and paragraphs that might affect taxation, do the same for past tax-related decisions of the Constitutional Court, and other related legal actions, and provide recommendations for constitutional change and/or approaches the GOG can take to exercise greater domain over the legal system with regard to tax system policy and management.

LOE: 20

### *Deliverables*

The project team will produce the following deliverables:

1. Updated tax benchmarking study.
2. Report on roundtable to suggest fiscal strategies.
3. Reports on consensus-building activities.
4. Training for congresspersons (exact specifications must be determined).
5. Report on expenditure incidence
6. Report on tax aspects of the national constitution.

### *Performance indicators*

In the short amount of time for this set of activities, it will be difficult to establish hard and fast performance indicators or to program them during the few months remaining. Nonetheless, by end of project (September 30, 2004) we expect to achieve the following results with indicators:

Result	Indicator
1. Strengthened short-term fiscal stance	a. Agreed fiscal strategy resulting from roundtables b. Approved standby with IMF
2. Improved public awareness of fiscal issues	a. Robust participation in new Fiscal Pact discussions
3. Movement to more equitable fiscal system	a. New Fiscal Pact includes greater attention to tax fairness b. New Fiscal Pact includes specific measures to improve expenditure incidence
4. Strengthened medium-term fiscal stance	a. Measures of fiscal sustainability included in new Fiscal Pact b. Recommendations for constitutional corrections presented to Congress