



Project Information Document (PID)

Concept Stage | Date Prepared/Updated: 11-Nov-2019 | Report No: PIDC28059



BASIC INFORMATION

A. Basic Project Data

Country Costa Rica	Project ID P172352	Parent Project ID (if any)	Project Name Costa Rica Tax and Customs Administration Project (P172352)
Region LATIN AMERICA AND CARIBBEAN	Estimated Appraisal Date Feb 21, 2020	Estimated Board Date Mar 26, 2020	Practice Area (Lead) Governance
Financing Instrument Investment Project Financing	Borrower(s) Government of Costa Rica	Implementing Agency Ministry of Finance	

Proposed Development Objective(s)

The project's objective is to improve the efficiency and effectiveness of tax and customs operations in Costa Rica.

PROJECT FINANCING DATA (US\$, Millions)

SUMMARY

Total Project Cost	100.00
Total Financing	100.00
of which IBRD/IDA	100.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Bank for Reconstruction and Development (IBRD)	100.00
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Environmental and Social Risk Classification
Moderate

Concept Review Decision
Track II-The review did authorize the preparation to continue



Other Decision (as needed)

B. Introduction and Context

Country Context

- 1. Costa Rica is one of the most politically stable, progressive, and prosperous nations in Latin America and the Caribbean (LAC).** Since the first presidential elections under the new constitution in 1953, governments have prioritized the social welfare and development of the Costa Rican people. **Political stability, the social compact, and steady growth have resulted in one of the lowest poverty rates in LAC** with strong income growth for many years among the 40 percent of the population with the lowest incomes.
- 2. Costa Rica's outward-oriented policies have transformed its economy.** These policies have centered on trade openness, export diversification, free trade zones, and foreign direct investment. Trade openness has been a critical building block of this model since 1963, when Costa Rica joined the Central American Common Market (CACM). The CACM—made up of El Salvador, Guatemala, Honduras, and Nicaragua—spearheaded trade integration in Central America, eventually leading to a customs union.
- 3. Despite these achievements, the country is showing symptoms of deeper structural problems that could threaten the sustainability of Costa Rica's development.** First, despite reasonable growth and a strong commitment to the social compact, poverty reduction has stagnated, and inequality is rising. Second, Costa Rica's per capita GDP has shown no signs of convergence toward those of countries with higher incomes. And third, fiscal pressures threaten to undermine the sustainability of the country's social compact and green trademark and prevent it from undertaking much needed investments in public infrastructure.
- 4. Budget deficits and public debt are reaching unsustainable levels.** Costa Rica's central government budget went from a surplus of 0.57 percent of GDP in 2007 to a deficit of 6.2 percent of GDP by the end of 2017, largely due to post-economic crisis stimulus measures including significant increases in the public sector wage bill. The Central Bank of Costa Rica (BCCR) has warned that the deficit could reach between 7.1 percent and 7.9 percent of GDP in the next two years. Costa Rica's public debt grew to 52.5 percent of GDP in the first semester of 2019. The Ministry of Finance expects public debt to increase up to 63.2 percent of GDP by 2023 without policy interventions. The Government has introduced a package of revenue and expenditure measures – including caps on the wage bill - to curb the deficit, with debt peaking at about 62 percent of GDP in 2023 and declining thereafter. Market reaction has been cautious: financing costs remain high. Shortly following passage of the reform, three rating agencies downgraded Costa Rica's sovereign credit rating and placed the country on a negative outlook, citing continued worsening of debt dynamics and significant short-term funding challenges.



Sectoral and Institutional Context

- 5. Costa Rica's tax revenues are low and insufficient to finance the country's current spending needs.** Tax revenue has not exceeded 13.4 percent of GDP over the past ten years (from 2009 to 2018). While on par with the regional average for Latin American and Caribbean (LAC) of 13.1 percent, the current level of tax revenue is notably lower than the average for OECD countries (15.9 percent). Tax revenues peaked in 2008 reaching 15.3 percent of GDP and dropped slightly in 2010 (13 percent). Since then, they have been constant at around 13.3 percent of GDP. On the other hand, public expenditure increased from 15.7 percent of GDP in 2008 to 19.8 percent in 2014 (CPF, FY16-20). The increasing trend has been driven mainly by higher public sector remunerations and increased government transfers to finance public sector social programs. Still, public spending as a share of GDP is relatively low by international standards and the share of capital investment is small despite major infrastructure needs (OECD, 2017).
- 6. From a policy perspective, the low tax-to-GDP ratio in Costa Rica is primarily due to inherent weaknesses in the tax system, which include excessive complexity, narrow bases, low tax productivity.** Since 1953, the Legislative Assembly has approved over 1,259 tax exemptions that amount to more than 5.6 percent of GDP (SCD, 2018). Consequently, the policy gap between potential and actual General Sales Tax (GST) revenue for instance is substantive, averaging about four percent of GDP from 2012 to 2016 (IMF, 2018). In addition to their fiscal cost, the multiplicity of tax exceptions introduces significant complexity and distortions into the tax system, as well as increases compliance costs and makes the tax system harder to administer. Furthermore, limited revenue is raised from personal income tax (PIT) because a large amount of employment income is exempt from PIT. Taxes on income, profits and capital gains account for less than 20% of total taxes, contrasting with over a third among OECD countries (OECD, 2018). Revenue collection from property taxes is also limited, accounting for about 6% of total revenues in OECD countries but less than 2% in Costa Rica. In terms of effectiveness, the productivity of corporate income tax (CIT) in 2015 was 0.075 percent, the sixth lowest among a sample of 25 LAC countries (the regional average was 0.12 percent). This implies that there is significant erosion of the CIT base in Costa Rica.
- 7. The Government is aware of these shortcomings and has enacted critical fiscal policy reforms aimed at broadening the tax base and managing the growth of public spending, but additional measures are needed to attain desired results.** As part of a comprehensive fiscal sustainability package, the Government enacted a tax reform bill (*Ley de Fortalecimiento de las Finanzas Públicas*) in December 2018 that seeks to strengthen the country's finances through: i) replacement of the GST law with a value added tax (VAT) that enlarges the tax base by taxing not only the sale of goods but also the supply of all types of services within Costa Rica which, for the most part, were not subject to GST;¹ ii) amendments to prevent the erosion of the income tax base and to introduce a new taxation regime for capital income and capital gains; and iii) reforms to curtail public expenditure, particularly as it relates to the salaries of the Public Administration and the establishment of a fiscal rule to limit public spending. Estimates provided in the IMF's 2019 Article IV report for Costa Rica suggest that the enacted reforms could increase progressivity of the tax system and reduced income inequality. The approved reform, which is the most substantive change to the tax system in recent decades, became effective on July 1, 2019. Based on IMF projections, the adjustments could yield savings of approximately four percent of GDP over five years, leading to a primary balance of 0.8 percent of GDP in 2023. Notwithstanding this, the success of these reforms will be gauged largely by how well they are implemented.

¹ According to EY's 2018 Global Tax Alert newsletter, the new Law includes a 13% general VAT rate, 35 exemptions to the VAT, 12 situations in which the VAT does not apply, and three reduced rates (4%, 2% and 1%).



- 8. However, the General Directorate of Taxes (DGT) does not have the necessary capacity to ensure effective implementation of tax policies and domestic resource mobilization.** The DGT’s capacity to ensure full compliance with the law – including through adequate detection of tax evasion, location of non-filers, collection of payments, and management of risks – is very limited. Foregone tax revenues as a result of tax evasion are very high, particularly for CIT (Table 1.2). As a result of the narrow CIT base and the significant tax evasion, CIT revenues in Costa Rica amounted to only 2.2% of GDP in 2014, which is significantly lower than CIT revenues on average in the LAC region and the OECD. More generally, tax evasion and avoidance represented 8.22 percent of GDP in 2013. Evasion is especially prevalent among liberal professions and corporations.
- 9. A recently concluded TADAT² assessment identified major weaknesses in multiple areas that are impeding the ability of the DGT to fulfil its mandate effectively and efficiently.** These weaknesses include: (i) the lack of integration between the taxpayer registration system and the tax management system prevents completeness and accuracy of data in the register and, therefore, does not allow efficient tax management; (ii) measures taken to identify new taxpayers (businesses and individuals) and broaden the tax base are still insufficient; (iii) tax administrations do not have a strategic framework to identify, assess and mitigate institutional and compliance risks; (iv) Tax administrations do not have an automated accounting system that guarantees the control and the completeness of tax revenue management and no analysis is conducted to estimate the scope of revenue losses; (v) external and internal audit mechanisms are not sufficiently developed to ensure an adequate and systematic control of the tax administrations’ operational and financial activities.
- 10. Finally, the level of computerization within the DGT is minimal.** Several of the DGT’s Information Technology (IT) applications suffer from significant deficiencies that affect their ability to offer taxpayers modern tax services and apply risk-based compliance management. Aging, end-of-life products still form the backbone of the current IT system. This prevents sharing of information between applications and makes it difficult to form an integrated view of taxpayer data and identify risks. The only significant IT system in use is the taxpayer electronic filing system. Still, payment data is entered manually on the taxpayer accounts. This is onerous and prone to data entry errors. Although the DGT is currently running six tax administration IT applications, they are not well integrated and require additional work on consolidating information.
- 11. Customs operations in Costa Rica have costly and inefficient control and clearance procedures.** The Costa Rican General Customs Directorate (*Dirección General de Aduanas*—DGA) applies complex, redundant procedures and manual controls, provides insufficient information, and lacks an efficient risk management system. As a result, the clearance and inspection processes that Costa Rican border agencies require are slow and expensive compared to those in OECD countries. Costa Rica ranked 73 on the Doing Business 2019 for “Trading Across Borders.” Both time and costs of export for exceed OECD country averages (but are below LAC averages). Doing Business 2019 reports that it takes 20 hours to complete the clearance process for exports (of which 1.8 hours are spent in customs) and 80 hours to complete the clearance process for imports (of which 72 hours are spent in customs).
- 12. Current risk management tools do little to strengthen customs controls or facilitate trade.** DGA uses elements of risk analysis to guide its control actions. However, these are applied partially, as selectivity criteria for inspections of customs declarations, without a robust system for collection and analysis of results or engagement of operational units, intelligence, or investigations. The General Comptroller Office (*Contraloría General de la República*) published a study on customs operations in 2016 concluding that it was impossible to identify a statistically significant impact of the “red channel” (physical review of cargo) on tax collection.

² Costa Rica Tax Administration Diagnostic Assessment Tool (TADAT) Report 2019.



- 13. Costa Rica uses an outdated information system for its customs processes and procedures. The bespoke Information Technology for Customs Control System (TICA) was developed** in the 1990s. TICA does not cover many processes and procedures, hindering control and contributing to delays in border clearance. Initial audits have revealed serious security issues. The system does not function well on mobile devices or tablets, and the main site itself does not respond quickly and effectively to clients. DGA's application portfolio of does not include tools—such as apps, websites for mobile devices, and service chats—that are common in many other countries.
- 14. The DGA and the DGT manage their information systems independently and the exchange of information is minimal.** This leads to data duplication, fosters under-invoicing and low collection, and makes it difficult to identify tax evasion and monitor exemptions. The Ministry of Finance's Directorate of Technologies and Communication (DTIC) lacks the staff and resources needed for it to play a role in the design and management of information systems that obtain and exploit information in the quantity and quality necessary, manage compliance risks, optimize resources, and assure sustainability.

Relationship to CPF

- 15. The proposed Costa Rica tax and customs modernization project is consistent with the World Bank Group Country Partnership Framework (CPF) with the Republic of Costa Rica for FY16–20.** The CPF identifies fiscal sustainability and productivity as a key pillar of engagement. The fourth objective of the CPF highlights improvements in fiscal management and support for fiscal consolidation efforts, by increasing public revenues and limiting expenditures. The CPF also stresses the importance of implementing policy reforms and revenue generation and expenditure limiting measures to achieve a robust public financial management system.
- 16. The proposed project closely aligns with the World Bank Group's twin goals of shared prosperity and poverty reduction.** First, implementation of the reforms will contribute to improving Costa Rica's fiscal stance. This is a necessary condition for achieving and sustaining the country's social objectives, and it is essential for further progress and protecting past gains on reducing poverty and inequality. Second, by improving taxpayer services, the project may have an additional positive impact on certain types of firms that can face disproportionate tax compliance burdens (for example, small businesses) by addressing and reducing the barriers they face as taxpayers or potential taxpayers. The team will further explore this equity lens during project preparation, focusing on the most vulnerable segments of the population, particularly in the sub-component on Improving citizen- and business-centric taxpayer services. In addition, the team will explore linkages to the country's broader environmental strategy and commitment to climate change, and the project will support relevant measures, such as efforts to become paperless and increase on-line transactions.

C. Proposed Development Objective(s)

The project's objective is to improve the efficiency and effectiveness of tax and customs operations in Costa Rica.

Key Results (From PCN)

- a. Increased compliance with domestic taxes, measured as a reduction in VAT gross compliance gap;
- b. Improved efficiency of tax administration, measured by a reduction in time to pay taxes;



- c. Reduced Time Release Study, time required for the release goods, measured by the World Customs Organization (baseline and targets TBD, calculated from the time of arrival until the physical release of cargo);
- d. Customs export clearance facilitated, measured as a drop- in export clearance and inspection time required by customs authorities (the Doing Business ‘trading across borders’ indicator) from 1.8 hours to 1.3 hours;
- e. Customs import clearance facilitated, measured as a drop-in import clearance and inspection time required by customs authorities (the Doing Business ‘trading across borders’ indicator) from 72 hours to 48 hours.

D. Concept Description

17. The proposed project will support the modernization and enhancement the tax and customs administrations in Costa Rica. The project is a five-year IPF comprising three components: Enhancing the operational efficiency and effectiveness of the tax administration; Enhancing customs controls and services; Strengthening the institutional and operational environments of the tax and customs administrations and promoting their digital interoperability. This structure allows for clear lines of accountability to departmental leadership during project implementation. The structure was validated during consultations and technical discussions with Government. An alternative component structure by cross-cutting thematic issues – business process reengineering, information technology and human resources - was considered. Such a structure would promote functional integration of tax and customs administrations but was discounted because it would focus accountability for project activities and results at the level of the Vice-Minister rather than on departmental heads responsible for day-to-day implementation.

18. The operation will combine input and results-based financing. The project will finance technical assistance, the acquisition of information systems and equipment. The use of Disbursement Linked Indicators (DLIs) is intended to create incentives for the timely completion of important milestones in the reform process and for the achievement of service delivery outcomes. Annex 2 presents and indicative set of DLIs focused on the reform process. Outcome-related DLIs will be defined during project preparation. The team considered the use of a Program-for-Results but determined that this instrument would not be appropriate because there are large procurement package where the Bank’s procurement process will assist in securing value for money and contract management.

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts



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APPROVAL

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