Executive summary

Costa Rica faces major tax policy challenges

Costa Rica's tax revenues are close to the Latin American and Caribbean (LAC) average but, notwithstanding recent efforts to reduce expenditure, they are insufficient to finance the country's current spending needs. Higher tax revenues should primarily come from broadening tax bases as well as from enhanced efforts to tackle tax avoidance and evasion and to bring in more informal taxpayers within the formal economy.

In addition to raising more tax revenues to balance its budget, Costa Rica needs to address the distortive nature of its tax mix and enhance the redistributive role of its tax system. In particular, Costa Rica should, once a balanced budget has been achieved, shift taxation away from social security contributions (SSCs), which weigh heavily on formal employment, towards less economically distortive taxes including the value added tax (VAT) and environmentally-related taxes. In addition, the role of the personal income tax (PIT) should be strengthened as it currently raises little revenue and does not contribute to reducing inequality.

The excessive earmarking of tax revenues, which strongly constrains the government's public finance decisions will need to be reformed if Costa Rica is to place itself on a path of fiscal sustainability in the long run.

Reforming the corporate tax system

Costa Rica levies a relatively high corporate income tax (CIT) rate on a narrow tax base. Businesses face a tax-induced incentive to finance investment with debt rather than with newly issued equity. Foreign-source passive income is not taxed, which is uncommon. Businesses face relatively high effective tax rates (ETRs) which discourage foreign direct investment (FDI). A wide-range of CIT incentives are in place such as for companies in Free Trade Zones (FTZs). The FTZ tax regime lowers the tax burden significantly for investment from countries with a territorial tax system but not for countries with a worldwide tax system; for those investments, the FTZ regime implies a tax revenue transfer from Costa Rica to the investing country. Costa Rica should regularly undertake a comprehensive cost-benefit analysis of all of its various corporate tax incentives, including its FTZ regime, to assess their net benefits in terms of additional investment, employment and productivity and to evaluate how the design of those tax incentives could be improved.

Strengthening the role of the personal income tax

Social security contributions (SSCs) weigh heavily on formal employment while only few people are subject to PIT. The lack of integration between the PIT and SSC administrations lies at the heart of Costa Rica's labour market challenges. Because social security funds generally have to finance their own expenditure, they end up levying high SSCs. This results in high average tax burdens on labour income and labour costs, thereby reducing formal work incentives and employers' formal labour demand. The limited revenues from PIT also imply that labour taxes do not play a significant role in redistributing income. Collecting greater revenues from PIT, by lowering the income threshold above which PIT has to be paid as well as by introducing additional PIT brackets and gradually raising the top PIT rate, could contribute to reducing income inequality. Costa Rica should aim at better integrating the tax and social security systems, including through improved information sharing between the tax and SSC administrations, and harmonising the tax treatment of different types of labour income to reduce distortions and tax avoidance opportunities.

Putting in place a modern VAT system

Costa Rica does not have a modern VAT system in place. The current general sales tax exempts services except for those that are explicitly included in the law. In addition to reducing the tax's neutrality, this narrow tax base generates a significant loss in potential revenues. The sales tax system is also somewhat regressive, due to the existence of exemptions that primarily benefit richer households. Costa Rica's priority should be to introduce a well-designed and broad-based VAT system, covering both goods and services, to be able to generate additional revenues and remove existing distortions. Additional reforms, notably related to the way VAT credits are granted and to the taxation of cross-border supplies of services, will also be needed to enhance the tax's neutrality.

Using tax policy to address selected environmental challenges

There is scope to improve the environmental effectiveness of tax policy while also increasing revenues. In particular, the excise tax on fuels could be extended to cover all fossil fuels and rates could be aligned better with external costs. Since they create a *de facto* preferential treatment for fuels, the sales and import tax exemptions for fuels should be reconsidered. In addition, vehicle tax design can be adapted to better align with achieving environmental policy objectives such as curbing air pollution and congestion. To level the playing field, the tax treatment of public and private electricity producers could be harmonised. The cost-effectiveness of the Payments for Environmental Services Programme in providing environmental benefits has to be evaluated.

Key recommendations

- Raise more tax revenues to balance the budget.
- Move away from the excessive earmarking of tax revenues.
- Gradually rebalance the tax mix away from SSCs towards VAT, income taxes and environmentally-related taxes as the budget is returned to a balanced position.
- Convert the sales tax into a modern VAT with a broad base that includes services.

- Increase the standard VAT rate to help balance the budget.
- Strengthen the role of the tax and transfer systems in lowering inequality by broadening the PIT base and raising top PIT rates.
- Better integrate the PIT and SSCs administrations, in particular through enhanced exchange of information.
- Reduce exemptions for environmentally related taxes and align tax rates more closely with external costs.
- Broaden the CIT base by taxing foreign-source passive income, introducing a profit-based interest limitation rule, and evaluate the design of the wide range of corporate tax incentives. Over time, the standard CIT rate should be gradually lowered.
- Address tax avoidance and evasion by reinforcing the tax administration, harmonising the tax treatment of different types of income, and strengthening international tax rules.

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