No. 2

FISCAL POLICY FOR DEVELOPMENT IN THE DOMINICAN REPUBLIC

MAKING DEVELOPMENT HAPPEN

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DEVELOPMENT CENTRE

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Preface

Mobilising resources to finance a country's sustainable development is a challenge governments have faced throughout the ages. Taxation is clearly the essential tool all countries can use to achieve the difficult task of acquiring sufficient resources to pay for the education, healthcare, infrastructure and other services their citizens need and expect.

However, taxation is about more than just obtaining enough revenue to fund public spending. It is one of the pillars of democracy, and the means by which citizens acquire the right to hold their government accountable for its actions and it is their duty to contribute – according to their means – to funding the state. For this important link between government and society to work, taxation must be built on basic principles of efficiency, equity and mutual trust. The government is also responsible for designing and implementing a fiscal policy to ensure that the necessary goods and services are obtained to guarantee the country's development, and not just in the short term.

Tax reforms must therefore play a central role in a country's medium- and long-term development strategy. In this regard, the present report analyses some of the possible tax reforms in the Dominican Republic within a regional and international context of good practices. The fiscal recommendations are made within the context of the institutional frameworks, with particular emphasis on matters of economic policy that should be considered in the reform process.

We hope that these considerations can contribute to the Dominican Republic's political debate on tax reform.

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Country profile

Territorial and institutional framework of the Dominican Republic

The Dominican Republic is divided into 31 provinces and the "Distrito Nacional", where the capital, Santo Domingo de Guzmán, is situated. The provinces are political and administrative units that facilitate delegation of the authority of the central government at intermediate level. Every province has a civil governor, who is appointed by and represents the central executive power. Each province is composed of two or more municipalities which in turn function as political and administrative units.

Table 0.1. **Main economic indicators of the Dominican Republic, 1960-2010**

Dominican Republic	**1960**	**1970**	**1980**	**1990**	**2000**	**2010**
Population (million)	3.31	4.51	5.79	7.19	8.59	9.93
Unemployment, total (% of total labour force)	-	-	-	-	14.20	14.30
Inflation, consumer prices (annual %)	-	3.82	16.75	50.46	7.72	6.33
Poverty headcount ratio at 1.25 USD a day (PPP) (% of population)	-	-	-	-	-	-
Macroeconomic indicators						
GDP (current USD, million)	672.40	1 485.40	6 631.00	7 073.67	23 996.66	51 576.21
GDP (constant 2000 USD, million)	3 019.31	5 293.14	10 534.04	13 315.13	23 996.66	40 196.11
GDP per capita (current USD)	203.21	329.24	1 144.45	983.18	2 792.92	5 195.38
GDP per capita (constant 2000 USD)	912.47	1 173.24	1 818.07	1 850.70	2 792.92	4 049.04
Gross savings (% of GDP)	-	13.26	15.26	16.07	18.04	8.07
Industrial strcuture (value added)						
Agriculture, value added (% of GDP)	-	23.24	20.15	13.42	7.25	6.22
Industry, value added (% of GDP)	-	26.14	28.29	31.41	35.91	32.04
Services, etc., value added (% of GDP)	-	50.62	51.56	55.17	56.85	61.74
Employment structure (% of total employment)						
Agriculture	-	-	-	-	15.90	-
Industry	-	-	-	-	24.30	-
Services	-	-	-	-	59.80	-
Employment to population ratio, 15+, total (%)	-	-	-	-	54.20	55.50
Trade structure						
Exports of goods and services (current USD million)	172.10	255.90	1 271.00	2 392.77	8 890.16	11 878.94
Exports of goods and services (% of GDP)	25.59	17.23	19.17	33.83	37.05	23.03
Imports of goods and services (current USD million)	126.50	365.30	1 919.00	3 090.58	11 006.50	17 648.14
Imports of goods and services (% of GDP)	18.81	24.59	28.94	43.69	45.87	34.22
Human resources						
Labour force, total	-	-	-	2 850 506.58	3 538 466.29	4 430 037.91
School enrollment, secondary (% net)	-	-	-	-	40.21	62.33
Labour force with tertiary education (% of total)	-	-	-	-	10.30	-
Public spending on education, total (% of GDP)	-	2.64	-	-	1.91	-

Source: OCDE, UNESCO, *World Development Indicators*. Information from 2010 based on national sources.

Assessment and recommendations

This report sets out some of the short-, medium- and long-term challenges for fiscal policy in the Dominican Republic.

The population's spending demands must be met but macroeconomic sustainability must be maintained. In particular, public finances must be sustainable in the long term to create the stable, predictable financing needed to meet the commitments set forth in the National Development Strategy. The environment must minimise the distortions created by tax policy and more broadly by fiscal policy. The recommendations made in this document focus on certain instruments that can generate revenue to finance spending needs and reduce distortions, paying special attention to the role of institutions and the political economy in the reform processes.

The Dominican tax system is highly fragmented, making tax administration difficult and facilitating tax evasion and avoidance.

In particular, the prevalence of tax exemptions reduces the tax bases and makes tax administration very difficult. The tax code dates from 1992, but the bulk of tax legislation lies outside it; this code therefore needs amending to consolidate tax legislation and create stability and legal transparency.

The tax regimes for free zones and for the rest of the economy need harmonising.

International commitments obliging the government to dismantle preferential tax regimes could help to speed up this process. Harmonisation can begin through income tax. By gradually expanding corporation tax to include firms based in

free zones, the government could even permanently reduce the marginal rate of corporation tax. A series of changes to the tax system over the last ten years have left little margin for increasing tax collection. Subsequently, various modifications and corrections have been made to corporate tax, creating uncertainty and horizontal inequity.

Personal income tax must be increased.

Since most individuals (employees) are below the income-tax threshold, other sources are needed to effectively increase tax revenue while helping prevent tax evasion and avoidance. In particular, eliminating differences in tax according to the type of income would help to achieve this goal, and taxation of capital income (avoiding double taxation) would enable the inclusion of non-employed people who have the means to pay tax but on whom the tax authorities have very little information.

Financial institutions can play an important role in tax administration.

Financial intermediaries may act as withholding agents for taxpayers' income, helping to reduce the tax gap and supporting control and supervision by the tax authorities. Importantly, this can be done without violating the privacy of users of financial services, which is protected by banking secrecy.

The Dominican Republic's value-added tax (ITBIS) is the main source of income, but much is squandered through tax exemptions and evasion.

General tax exemptions have been shown to benefit richer members of the population most. The tax base could be broadened to simplify the tax system and increase revenue, while direct transfer mechanisms could be used to mitigate shocks to those who are financially more vulnerable. The experience of the Solidarity Programme could serve as an example of how to achieve this.

Low tax morale is fuelled by a lack of transparency and a poor perception of the quality of fiscal policy.

The highly complex tax system and the constant changes that have been made spawn uncertainty for economic operators, while the quality of public spending is

perceived as low. The Global Forum on Transparency and Exchange of Information for Tax Purposes could be useful for developing tax and fiscal reforms. It has created international standards that ensure peer review through a platform designed for knowledge sharing on useful experiences governments have had in designing and implementing policies.

The economic challenges posed by fiscal policy, such as its sustainability, the capacity to respond to cyclical shocks, and the capacity to meet citizens' demands, are also major challenges for economic policy.

However, all these challenges share one underlying factor: the rigidity of a system designed on a decision-making platform that systematically causes previous promises to be broken and legal obligations to be violated. As a result, fiscal democracy is said to be being eroded.[1] The rigidities introduced in fiscal and budgetary policy mean that current decisions are increasingly dictated by previous decisions, resulting in an impact on future revenue flows. In particular, permanent regimes for both income (for instance, exemptions) and expenditure (automatic allocations) considerably restrict policy makers in their decision-making, thereby limiting their capacity to respond to previously established obligations and drastically reducing their capacity to establish new policy priorities. Automatic allocation of funds must be limited or reduced and regular assessments must be made to determine whether tax-relief schemes should continue.

Some fiscal institutions and rules can help to bring clarity and to draw up a credible roadmap for the main fiscal aggregates in the coming years.

These institutions and rules should base their priorities on transparency criteria and quantitative targets to reduce financial insolvency risks. Given the need to increase spending in areas such as education, fiscal balance targets and debt ceilings could be accompanied by limits on growth in certain areas of spending to below the level of growth in tax collection. Resources could thus be reallocated in the margin without compromising stability. Furthermore, specific restrictions for election years would help to reduce the impact of the political cycle on spending. These measures should be supported by a multiannual macroeconomic framework that should be made public and supported by independent institutions. As the country moves forward in this direction, which will require a broad political commitment, the government will be able to consider more sophisticated fiscal rules to allow better cyclical management of fiscal policy.

Notes

1. Fiscal democracy can be defined as the ability to make decisions on fiscal policy without being bound by past decisions that commit future resources (Steuerle, 2012).

Chapter 1

The macroeconomic position and overall context

This chapter places the Dominican Republic's fiscal policy in a broader short-, medium- and long-term context. It analyses the macroeconomic situation and the close relationship between tax policy and spending policy. The focus is not only on resources but also on the institutional context and certain aspects of political economics that should be considered in the proposed change.

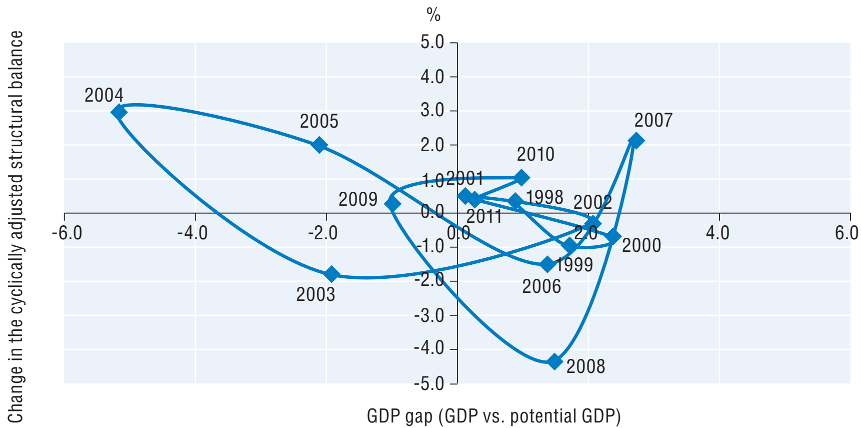
The Dominican Republic has one of the most dynamic economies in Latin America and the Caribbean (LAC), but the country's economic growth is too volatile to have a strong effect on the country's social indicators. Most countries in the LAC region struggle to keep per capita GDP growth high enough to close the gap in living standards between them and more advanced countries. The Dominican Republic, however, has achieved higher growth than other LAC countries. For instance, between the mid-1990s and 2010, the country's per capita GDP (adjusted for changes in purchasing power) grew at an average of 4.2%, compared with an LAC average of 1.7% and an OECD average of 1.5%. However, despite the high average figure, growth has been very volatile, partly because of the country's location on an island in a region hit by natural disasters, but also because of repeated macroeconomic and financial crises. One of the consequences of this instability has been the limited trickle-down effect of economic growth. For example, between 2000 and 2010, the poverty rate rose from 28.2% to 34.4%, largely due to the 2003 banking crisis. So, while per capita GDP grew by 45% between 2000 and 2010, the poverty rate also increased during the same period.

Fiscal policy has not helped to reduce the high macroeconomic volatility. Historically, the Dominican Republic has had a pro-cyclical fiscal policy, i.e. policy has been tightened during weak periods in the cycle (a negative output gap) and the structural deficit has increased during economic booms. The financial crisis in the country in 2003 partly explains the high correlation between the business cycle and the change in the cyclically adjusted primary balance.[1] However, the economy has also been pro-cyclical during economic booms, particularly during election years, as the 2008 figures clearly show. Fiscal policy has therefore done more to destabilise rather than stabilise the economy, and this could have huge social costs. A volatile fiscal policy often makes it difficult to give the necessary continuity to important social programmes and social spending. It tends to reduce the level of welfare for those in society who most need certain services such as healthcare and education and who do not have access to financial instruments and social security to protect them from the volatility (OECD, 2012a).

Greater and better institutional involvement in designing, implementing and enforcing fiscal policy and the budget would help to diminish their pro-cyclical bias. Pro-cyclical fiscal policy is a problem shared by developing countries, especially those in Latin America (Daude et al., 2011). However, the experience of OECD countries, and even some countries in Latin America (such as Chile and Colombia) shows that institutional and budgetary fixes can improve the stabilising role of fiscal policy. These fixes include: *i)* multi-year budgetary frameworks; *ii)* greater transparency in background information, such as through consultation with independent experts in macroeconomic projections to support the budget; *iii)* fiscal rules that take into account the phase of the business cycle; and *iv)* independent fiscal advice. Although each of these reforms has different prerequisites in terms of institutions and

capacities, some are easy to implement (at least the first two, as well as conducting a public assessment of the phase of the business cycle) in the Dominican Republic (see Box 1.1).[2]

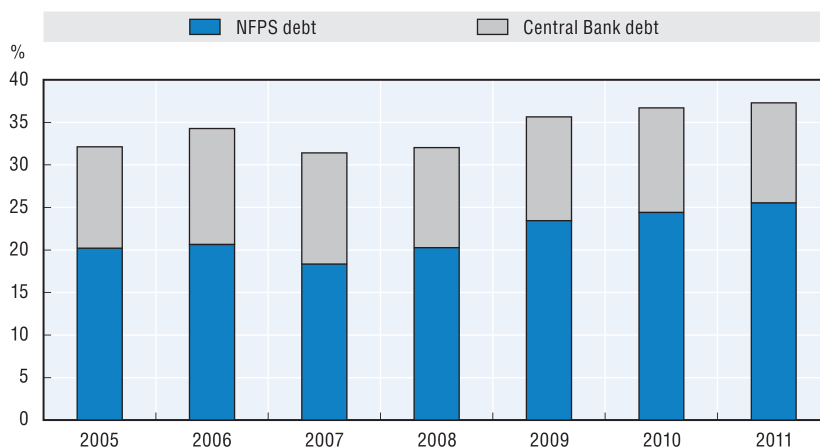
Figure 1.1. **Cyclical behaviour of fiscal policy in the Dominican Republic, 1997-2011**



Source: Based on International Monetary Fund (IMF) data.

However, the Dominican Republic also needs to strengthen its fiscal solvency. The country faces challenges in ensuring that it meets its debt repayment obligations. Although consolidated public sector debt stands at around 37.3% of GDP, well below the OECD average of more than 100%, other indicators clearly show that the country faces great challenges. For instance, debt as a percentage of tax revenue currently stands at around 280%. To put this into perspective, this is higher than in Portugal (239%) and Spain (195%) – two euro area countries experiencing fiscal problems. Meanwhile, the burden of interest payments has been on the rise since 2005, and in 2010 interest and fees on public debt amounted to 10% of total central government spending, equivalent to nearly 2% of GDP, or almost the total amount of spending on education. From a dynamic perspective we see a combination of two factors: government debt has increased while tax revenue has fallen, especially because of the progressive erosion of the tax base caused by the additional exemptions. Fiscal rules can be an effective tool for providing predictability and credibility to efforts to create a more sound fiscal position under certain conditions (see Box 1.1).

Figure 1.2. **Consolidated government debt by year**
(percentage of GDP)



Source: Based on data from the Dominican Ministry of Finance and the Central Bank.

Box 1.1. **Recent experiences in the use and implementation of fiscal rules**

To address the fiscal challenges and consequences of the recent financial crisis, several OECD countries have changed their fiscal policy frameworks, introducing new fiscal rules and institutions. Meanwhile, several Latin American countries have innovated their fiscal rules. This box presents some of the key aspects and characteristics that should be considered when designing and implementing a fiscal policy framework in the Dominican Republic today.

Overall, fiscal rules can be a useful tool if they allow the government to eradicate time-inconsistent policies, i.e. to achieve and maintain a credible, sustainable commitment regarding its future macroeconomic fiscal policy. If the rules can be broken with no economic or political cost they have no effect on the quality and results of fiscal policy. A clear political commitment to the targets is therefore paramount. Fiscal rules impose additional restrictions on fiscal policy, tying the hands of policy makers. Targets must therefore be credible and realistic, but also ambitious, to achieve a specific result in a specific time frame. Additional factors are also needed for fiscal rules to strengthen fiscal policy and improve welfare. These factors include reliable, transparent and relevant fiscal statistics, clear medium-term projections that support and justify policy actions both in their definition and in deviations from targets, and budget procedures that actually allow the executive (usually the finance ministry) to effectively control budget execution (Kopits, 2001).

Box 1.1. (cont.)

Fiscal rules generally include quantitative targets for certain fiscal aggregates, whether stocks or debt ceilings, or restrictions on capital flows (generally the primary deficit) and growth patterns for certain budget expenditures, which are defined for a specific period of time (often the financial year) but may also include medium-term targets. One must also define which parts of the public sector are subject to those fiscal aggregates. Should they apply only to central government? Or should they extend to public enterprises, government agencies, regional governments and the financial public sector too? And if so, should the latter have the same targets or different ones?

Fiscal rules frequently combine two types of objective, which often coexist: ensuring fiscal sustainability and adopting a fiscal policy that better takes into account the business cycle. Where the focus is on sustainability, a ceiling is generally placed on the primary deficit (or sometimes on net borrowing) to gradually bring down the level of debt. The advantage of sustainability focused targets is that they are usually easy to achieve and monitor. However, such targets clearly do not make it easier to use fiscal policy to stabilise the economy, because fiscal adjustments often have recessionary effects, and rules of this type are usually introduced during a crisis or a recession. Pro-cyclical fiscal rules, meanwhile, tend to set fiscal balance targets that are adjusted for the business cycle and for other factors, such as raw material prices if they provide a significant amount of government revenue. This is what occurs in Chile and Colombia, for instance. Colombia has a structural target that changes over time as the government gradually reduces its level of debt. Also, during the course of the business cycle the structural balance may fluctuate by double the change caused by automatic stabilisers (Interagency Technical Committee, 2010). For such rules to be successfully implemented, institutions and capacities must use transparent methodologies to determine the stage of the business cycle, long-term raw material prices and elasticities of tax revenue. Such rules require institutional development, transparency and a firm political commitment if they are to have any effect on the fiscal accounts (see Ter-Minassian, 2010).

Recent changes in the euro area are an example of multiple objectives and relatively sophisticated rules. These include convergence programmes for countries with budget deficits above the limit of 3% of GDP agreed upon by governments for 2012-14, as well as a medium-term objective for the structural deficit, depending on the size and sustainability of the country's debt. These restrictions are combined with a debt-reduction rule that states that the difference between the 60% target debt-to-GDP ratio and the actual ratio (calculated as a three-year average) must be cut by one twentieth per year. There is also a rule creating a transition period to make the deficit reduction rule compatible with the three-year debt reduction rule without requiring an annual structural adjustment greater than 0.75% of GDP.

Box 1.1. (cont.)

European and national control mechanisms to enforce these rules are being enhanced through measures such as the introduction of automatic penalties. Because there are so many rules and they are so complex, it is hard to quantify what impact they will have on fiscal balances. They also make it difficult to communicate the measures and garner public support for them. Nevertheless, in the long term, once the transition period is over, the fiscal framework is expected to generate a balanced structural budget (see Barnes, Davidsson and Rawdanowicz, 2012).

Given the way it developed institutionally and the results it produced, the experience of Peru is of interest to the Dominican Republic. In late 1999 Peru passed the Fiscal Prudency and Transparency Law (Ley de Responsabilidad Fiscal), which set a maximum fiscal deficit of 1% of GDP for the consolidated public sector and a maximum increase in non-financial spending by general government of 2% in real terms. The law also introduced additional restrictions on spending during election years. For instance, general government expenditure could be no greater than 60% of the budget, and the consolidated public sector deficit during the first six months could be no greater than 50% of the programmed annual budget deficit. The legislation also introduced escape clauses: if GDP fell for three consecutive quarters or repayments of interest on debt exceeded 0.4% of GDP, the restrictions could be suspended and the deficit limit could be raised by one percentage point. The law also created a fiscal stabilisation fund formed by the current revenue from ordinary resources (excluding privatizations) that exceeded the average of the previous three years beyond 0.3% of GDP. The fund also included 75% of privatisation revenue. In terms of transparency, the law stated that the Ministry of Economy and Finance had to publish a report on the multiannual macroeconomic framework that included forecasts of the main macroeconomic variables for the next three years. In the following years, amendments were introduced as Peru's fiscal accounts strengthened. For instance, public enterprises were also included in overall targets; regional and local government targets were set; expenditure increases in the consumer price index (CPI) were calculated using the GDP deflator as the adjustment factor; the deficit limit for the first six months of election years was lowered to 40%; and changes were made to the escape clauses and the stabilisation fund. In the six years from 2000 to 2005, Peru successfully converged to fiscal targets and stabilised the debt-to-GDP ratio. However, spending was still considered to be growing too fast, especially in current expenditure rather than investment. In response, in 2006 the government introduced an additional restriction on growth in current expenditure while imposing no restrictions on investment other than the general restriction on the deficit. This modification significantly altered the composition of expenditure, with more allocated to investment (Carranza, Daude and Melguizo, 2011).

Currently, the Dominican Republic requires an improvement in the primary fiscal balance of around 2.7 percentage points of GDP. Assuming long-term GDP growth of 4.2% and interest rates of 7.2%, the primary balance that is needed to maintain the current level of central government debt is 0.8% of GDP. This compares with a balance of 0.4% in 2011. The balance therefore needs to increase by 1.2 percentage points. Meanwhile, in 2012 some of the temporary tax measures (such as the increase in corporate income tax [ISRPJ] from 25% to 29% and the one-point rise in the tax on financial assets) will expire, reducing tax revenue by 0.4 percentage points of GDP. Furthermore, the central bank had a quasi-fiscal deficit of 10.9% of GDP in 2011. Since the Central Bank Recapitalisation Law states that central government transfers should amount to no less than 1% of GDP, an additional one percentage point of GDP of tax savings is needed for the next 11 years. Several risks are associated with such a scenario. For instance: *i)* external financing conditions might deteriorate at a time when the country does not have a stand-by agreement with the IMF; *ii*) a worsening of the global crisis might slow down economic growth; and *iii)* a rise in oil prices due to geopolitical problems in the Middle East could bring about a rise in fiscal transfers.

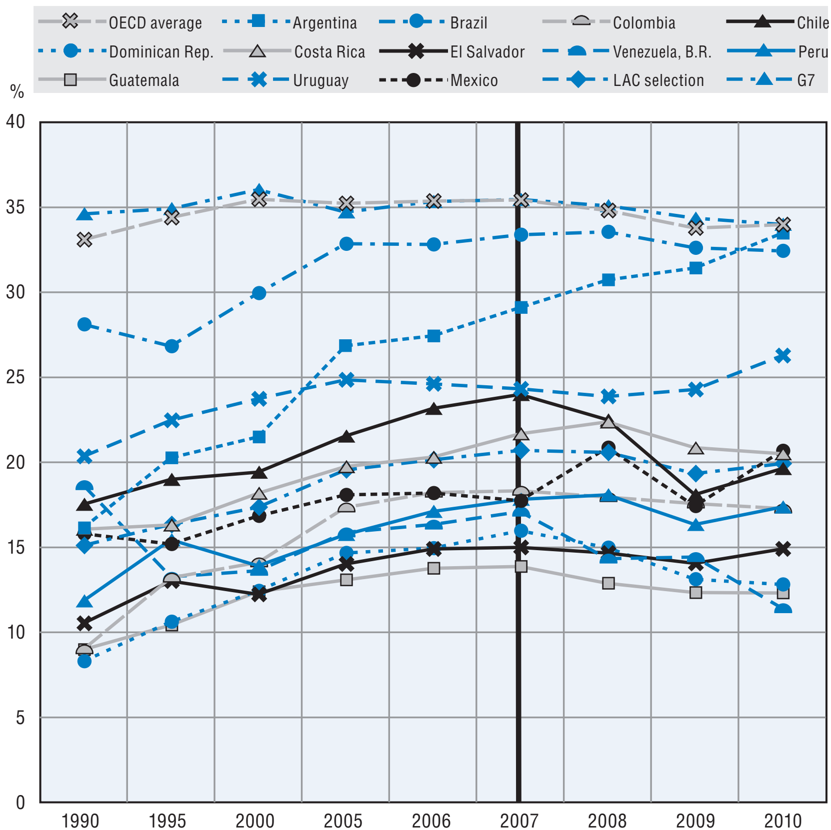
Recapitalisation of the central bank remains a fiscal risk, since bond issues continue to fuel the quasi-fiscal deficit. Recapitalisation is currently subject to the Central Bank Recapitalisation Law (167-07). This law authorises the government to issue bonds for up to DOP 320 billion (Dominican pesos) over a period of ten years.[3] The payment of dividends on these bonds would serve to gradually reduce the bank's operating losses by clearing its outstanding securities (around DOP 245 billion for the first half of 2012). The plan involves gradually phasing out these bond certificates. Interest payments are set by law, starting at 0.5% in 2007 and rising to 1.4% by 2016. After 2016, government transfers will be cut down in stages to not less than 1% of GDP, which will allow surpluses generated by the central bank to strengthen first its own funds and then its general reserve (until both amount to 10% of the bank's liabilities). The remaining surplus would be allocated to paying or redeeming government bonds. To date, the government has made nine bond issues with a total value of just over DOP 82 billion, and has allocated nearly DOP 48 billion to interest payments.

Subsidies to the electricity sector amounted to about 2% of GDP in 2011 (1.1% in transfers to enterprises and 0.9% in transfers to the tariff stabilisation fund). The Dominican Republic is faced with a serious electricity problem, hindering its competitiveness, its growth potential and the welfare of its citizens. There is also a fiscal risk, since transfers depend on the price of oil and derivatives. For every dollar increase in the price of fuel oil, the subsidy to the Corporación Dominicana de Empresas Eléctricas Estatales (CDEEE), the state electricity company, increases by an estimated DOP 464.9 million (approximately USD 11.9 million).

Tax revenue is low and is growing more slowly than GDP. Relative revenue is low not only in comparison with OECD countries, but even in comparison with LAC countries (see Figure 1.3). In particular, for the period 2007-10 the Dominican Republic had the biggest relative drop in tax revenue, which grew at a lower rate than GDP. The main factors behind these lower growth rates are: *i)* cuts to personal and corporate income in 2007; *ii)* the elimination of tariffs (through the Dominican Republic-Central America Free Trade Agreement [DR-CAFTA] and with the European Union); *iii)* increased tax expenditures and special regimes; *iv)* the non-indexation of excise duty on hydrocarbons; and v) the differences between the contribution of each sector to GDP and their respective contributions to tax revenue (for instance, the agricultural sector accounted for 6% of GDP in 2010, but according to the tax administration authority [DGII] figures the sector provided only 0.4% of tax revenue).

Figure 1.3. **International comparison of the tax burden**

(percentage of GDP)



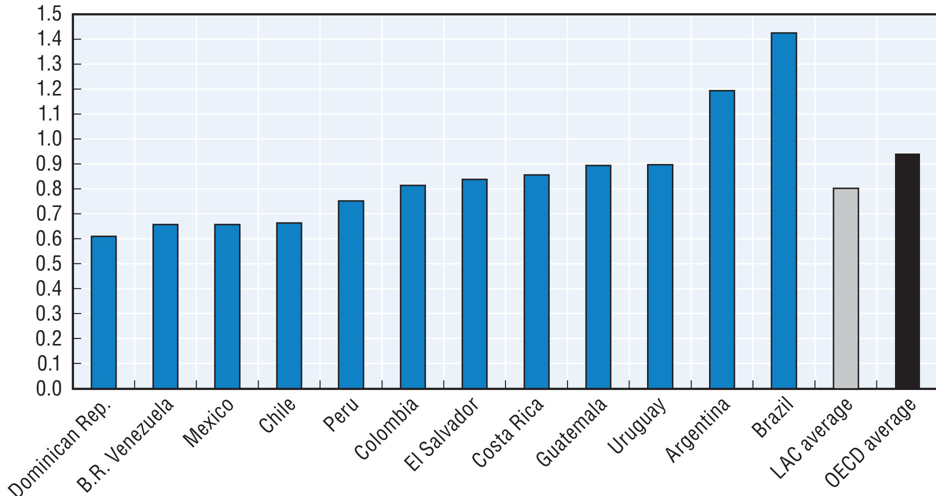
Source: Based on OECD tax data and OECD/ECLAC/CIAT (2011).

Low levels of revenue in the Dominican Republic are the result of tax bases that are limited by law (especially the low direct tax burden and numerous preferential tax regimes) and high levels of tax evasion and avoidance. The many exemptions and preferential regimes reduce tax revenue and complicate the administration of the tax system directly, also creating loopholes, distorting economic activity and opening the door to tax evasion. Furthermore, they create the perception that the tax burden is not fairly distributed, thereby reducing people's willingness to pay taxes.

The Dominican Republic has the lowest fiscal effort of all LAC countries. A more reliable measure of the fiscal effort should take into account that fiscal revenue as a percentage of GDP systematically varies from country to country depending on the characteristics of its economy. The most influential factors include economic development, trade openness and the production structure of the economy (the relative contributions to the economy of the primary sector, manufacturing and/or services). Of the 12 Latin American countries with comparable data, the Dominican Republic has the largest gap between its actual tax revenue and its expected revenue based on the structure of its economy. On average, LAC countries collect only 80% of expected tax revenue based on their level of development, trade openness and economic structure. The Dominican Republic, however, collects only 60%, leaving it with the highest gap among the countries in our sample. Only in Chile, Mexico and Venezuela is this gap anywhere near as high as in the Dominican Republic, but these three countries benefit from large amounts of non-tax revenue from their national resources. Central American countries also collect a much higher percentage of expected tax revenue, including El Salvador (84%), Costa Rica (86%) and Guatemala (89%). To close the gap completely, the Dominican Republic would have to increase tax revenue to 21.5% of GDP, a figure that is probably out of reach in the short and medium term. However, to close the gap to the same level seen in Central American countries, it would need to increase tax revenue by 2.3 percentage points of GDP.

This low tax effort is due to many inter-related causes: narrow tax bases, high tax expenditure, high tax evasion and generally low tax morale. While this report will focus on putting forward solutions to the first problems set out above, we must remember that the low tax effort is the result of this much broader set of factors. In particular, the poor quality of government spending in terms of the public services and goods that people receive in return undermines the social contract between citizens and the state and the state's legitimacy. If a country's citizens do not see the benefits of the taxes they pay, they will consider it legitimate not to finance a state that they believe does not represent their interests. In such a situation, introducing reforms to increase tax revenue is extremely difficult if it is not accompanied by specific, credible action to improve the state's effectiveness, efficiency and transparency in spending that revenue.

Figure 1.4. **Indicator of tax effort**

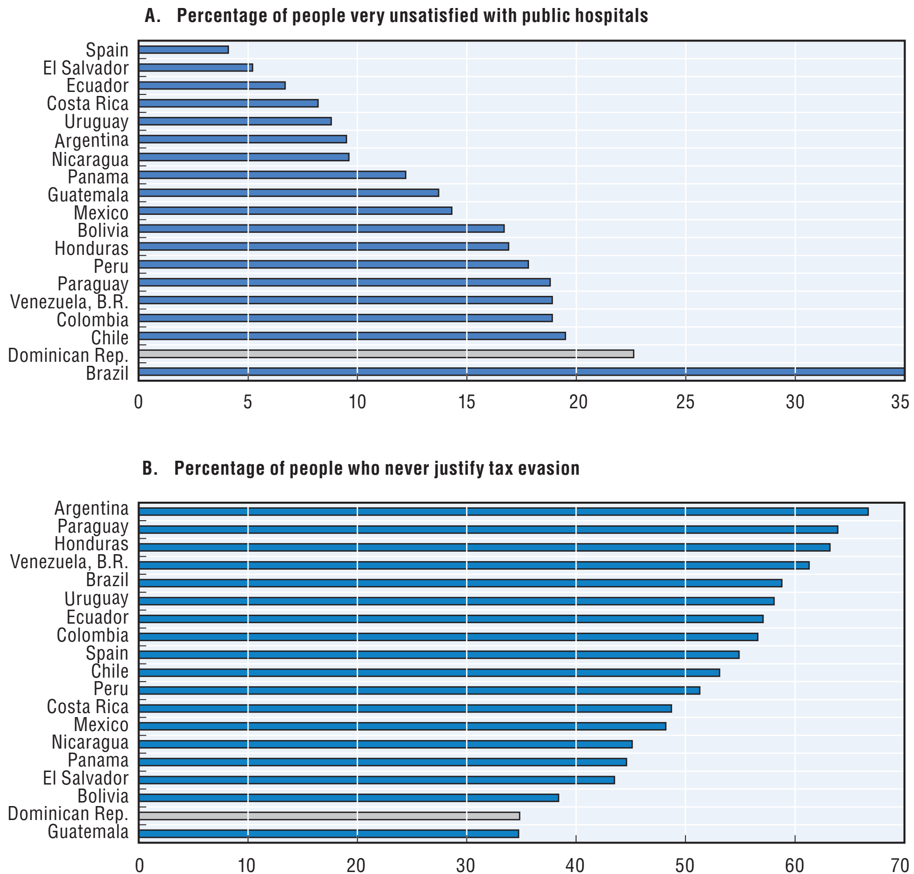


Note: Tax effort is the ratio of tax revenue to GDP in relation to the revenue projected by a linear regression of the ratio of tax to PPP-adjusted (purchasing power parity) GDP, trade openness (exports plus imports as a percentage of GDP) and the share of the primary sector in GDP.

Source: Based on OECD tax data, OECD/ECLAC/CIAT (2011) and the World Bank's *World Development Indicators*.

Dominican people view their public services as being generally of poor quality. For instance, almost a quarter of the population is very unsatisfied with the quality of public hospitals, compared with an average of less than a tenth among all the Ibero-American countries (left panel of Figure 1.5). Low satisfaction with the quality of public services generally leads to a lower willingness to pay taxes (Daude and Melguizo, 2010). It is therefore not surprising that the Dominican Republic has the second lowest tax morale in the region (see the right panel of Figure 1.5). While the average percentage of people in LAC countries who say tax evasion is never justified is 45%, in the Dominican Republic the figure stands at less than 30%. This difference is probably due in part to other factors such as high taxes and corruption, but these factors are not prominent enough to explain this difference from the other countries in the region. Differences in the quality of public services therefore seem to be a prominent factor.

Figure 1.5. **Satisfaction with public health services and tax morale**

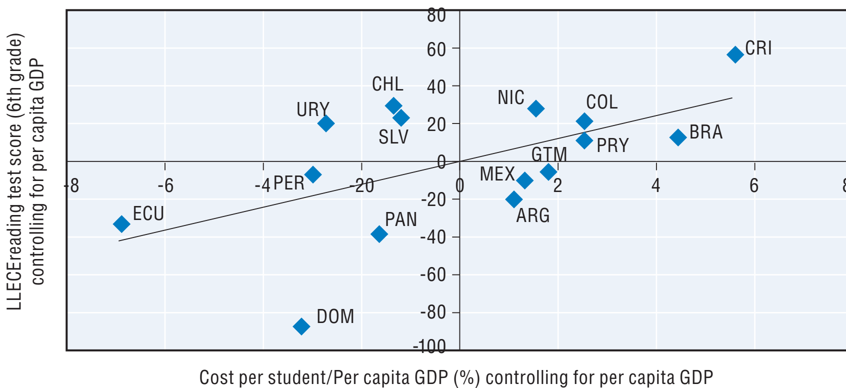


Source: Latinobarómetro, 2010.

In addition to perceived quality, there are also objective measures showing that spending is of poor quality. For example, in UNESCO's cognitive tests the Dominican Republic has the worst results in the region. The average reading score of sixth graders in the country is 395 points, compared with 563 for Costa Rica. Even Guatemala (452) and Nicaragua (470) – much less economically developed

countries – score higher than the Dominican Republic. This is partly a result of the lack of investment in education, but also of the poor quality of education spending. If we break up the difference in sixth-grader achievement between the Dominican Republic and Costa Rica and control for differences in per capita GDP, we find that two-thirds of the difference is the result of the poor quality of expenditure in the Dominican Republic, while the remaining third is the result of the higher level of public spending on education in Costa Rica.

Figure 1.6. **Government spending per student and performance in sixth-grade reading tests**



Source: Based on World Bank and UNESCO data.

In conclusion, the tax reform must not only balance the fiscal accounts but also adopt an integrated approach built on a broad social consensus. If the reform fails to do so, the country will be unable to find a sustainable solution to its fiscal problem or to make fiscal policy more effective as a development tool. The reform must not only bring tax revenue closer to the expected revenue but also cover aspects such as greater transparency and institutional involvement in allocating and assessing tax expenditures, and greater efficiency, effectiveness and transparency in government spending. Since Dominicans perceive the public sector as lacking fiscal legitimacy, spending priorities need to be set through consensus with different sectors of society in an open, transparent consultation and negotiation process. Creating fiscal sustainability must be accompanied by progress in implementing the National Development Strategy.

Notes

1. The cyclically adjusted primary balance was calculated as follows. First, the business cycle was extracted from the annual GDP series using the Hodrik-Prescott filter with a smoothing parameter of 6.25. Then, for tax revenue, unit elasticity with respect to the cycle was assumed and revenue was adjusted accordingly. Finally, it was assumed that no elements of expenditure vary automatically with the cycle.
2. See Frankel (2011) and Hagemann (2010).
3. Since these instruments mature after three to seven years, bonds issued in the final year envisaged by the law will mature in 2024.

Chapter 2

The tax structure and effective tools for increasing tax revenue

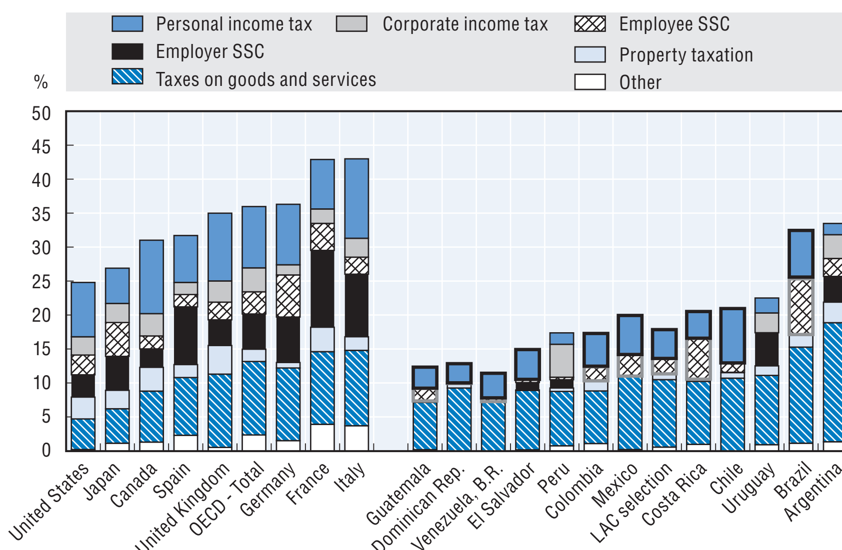
In democratic societies, each country's tax policy reflects political decisions that to some extent respond to citizens' demands and needs within the scope of the institutions' competences. Consequently, no two tax systems in the world are alike, and those that work in one country will not necessarily work in another. However, public policy makers need to share their experiences amongst themselves so they can learn from successes and failures and select from a wide range of options those that best suit the country's needs and capacities. This second part of the report presents various tax-policy options for the Dominican Republic in this context of good international practices.

Characteristics of the tax structure

As mentioned in the previous chapter, the Dominican Republic's tax system collects a high proportion of revenue from indirect taxes and has narrow tax bases. These characteristics are the main reason behind the Dominican Republic's low tax effort, which is the lowest of all LAC countries. By analysing the country's tax structure, we can find tools and strategies for improving tax revenue, taking into account in particular the impact that additional revenue would have on income distribution and economic growth.

Figure 2.1. Tax structures by country, 2010

(percentage of GDP)



Note: For some LAC countries the data do not distinguish between personal and corporate income tax, or between these and social security contributions paid by the employee or the employer. Where this is the case, a brown border has been placed around this data in the graph.

Source: Based on OECD tax data and OECD/ECLAC/CIAT (2011).

As in the other Latin American countries, most of the Dominican Republic's tax revenues come from indirect taxes. In 2010, the country obtained 72% of tax revenue from value-added tax (ITBIS), excise taxes on the consumption of certain goods and services, and customs duties on imports. As in OECD countries, in the last 20 years the region has seen a sharp rise in general consumption taxes (mainly

value-added taxes and sales taxes), which provided 34% of total tax revenue in Latin American countries in 2010, well above the figure of 19% for OECD countries. Meanwhile, the share of taxes on specific goods and services (e.g. excise taxes and taxes on international trade) fell to 13%.

Table 2.1. **Tax structures in Latin America, 1990-2010**
(percentage of total revenue)

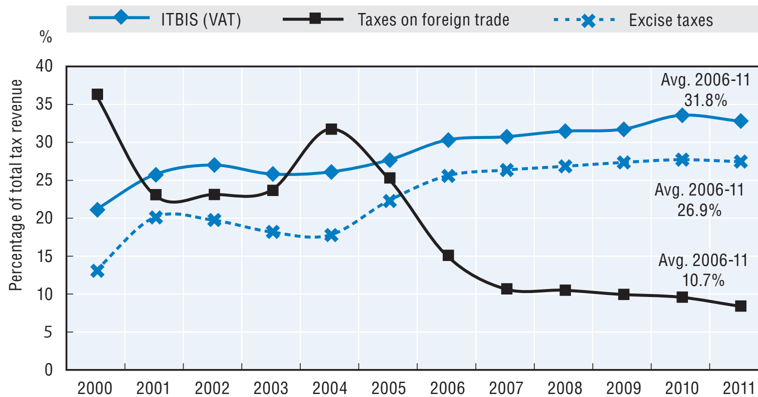
	1990	1995	2000	2005	2010
Income taxes	22	21	21	23	24
Social security contributions	18	19	19	17	19
Payroll taxes	1	2	2	1	1
Property taxes	5	3	4	5	4
General consumption taxes	24	31	32	33	34
Excise taxes	10	8	9	7	7
Taxes on foreign trade	11	12	8	7	6
Other taxes	9	4	5	7	5
Total	100	100	100	100	100

Source: OECD tax data and OECD/ECLAC/CIAT (2011).

In particular, the reduction in taxes on foreign trade has been accompanied by an increase in value-added tax (ITBIS), and in the early years by an increase in excise taxes. Although taxes on foreign trade remain high in the Dominican Republic (8.3% of total revenue), they have been reduced considerably since 2005, especially since the 13% fee on currency exchange (Comisión cambiaria) was abolished and various trade agreements affecting import and export duties came into force. The excise taxes that rose between 2005 and 2010 include the hydrocarbons tax, which still represented 1.8% of GDP in 2010.

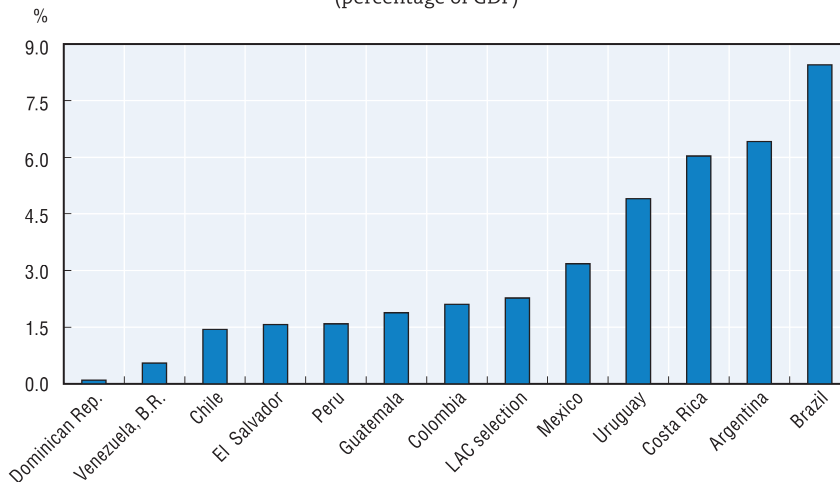
Social security contributions explain much of the difference between the Dominican Republic's tax burden and that of other countries in the region. These contributions represent only 0.1% of GDP in the Dominican Republic, compared with an average of 2.3% for the 12 LAC countries considered in this report and 8.5% for OECD countries.[1]

Figure 2.2. **Indirect taxes in the Dominican Republic**



Note: The term "Excise taxes" includes taxes on goods, cheques, telecommunications and insurance policies. Data updated in 2011.
Source: Morales (2010).

Figure 2.3. **Social security contributions, 2010**
(percentage of GDP)



Source: Based on OECD/ECLAC/CIAT (2011).

Income taxes in the Dominican Republic make a smaller relative contribution to tax revenue than in OECD countries. However, as in the other LAC countries, this contribution is growing, mainly thanks to the higher revenue generated by corporate tax and export taxes.[2]

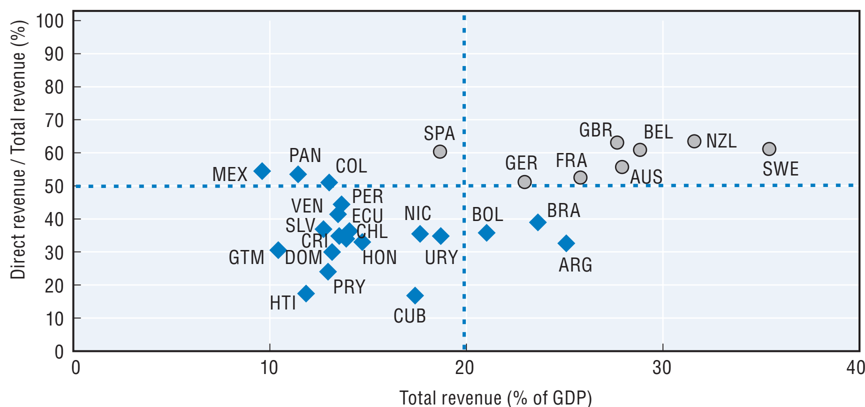
Table 2.2. **Comparison of the tax structure, 2010**
(percentage of total revenue)

	OECD	Dominican Republic	LAC selection
Income taxes[a]	33	22	24
(Personal income tax)	25	7	
(Corporate income tax)	8	9	
Social security contributions	27	1	19
Payroll taxes	1	0	1
Property taxes	5	5	4
General consumption taxes	19	34	34
Specific consumption taxes	8	25	7
Other taxes[b]	7	14	11
Total	100	100	100

Notes:
a) Includes unclassified personal and corporate taxes.
b) Includes certain taxes on goods and services and taxes on foreign trade.
Source: Based on OECD tax data and OECD/ECLAC/CIAT (2011).

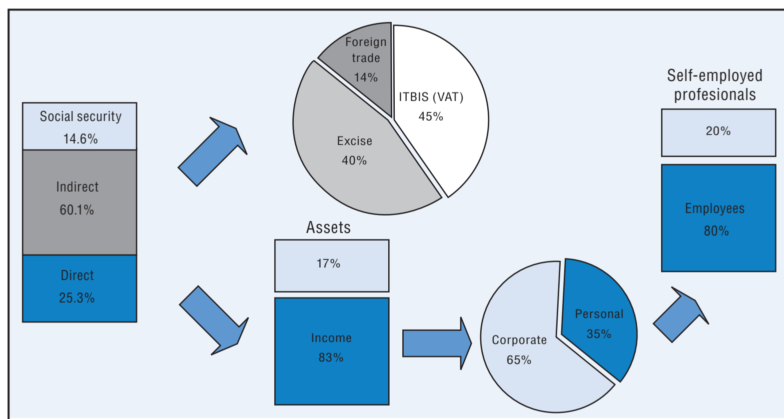
The Dominican Republic's personal income tax (ISRPF) base is still under-exploited, like that of other Latin American countries, limiting the system's progressivity (Figure 2.4). In 2010, personal income tax represented only 7% of tax revenues (versus 25% in OECD countries), four-fifths of which was paid by employees. The main reasons why personal income tax contributes relatively little to tax revenues are: *i)* the high proportion of minimum-wage earners, who are exempt; *ii)* the many exemptions and deductions; *iii)* the relatively low rates of tax (progressive); *iv)* the high level of tax evasion and avoidance, particularly by self-employed professionals; and *v)* the low taxation of non-employment income (e.g. dividends, interest, capital gains and royalties). Similarly, as in the other countries in the region, other factors that make income tax's contribution lower than in other countries are the low capacity of the tax administration to monitor a large number of taxpayers, a lower average income and a smaller "middle class" (Cetrángolo and Gomez Sabaini, 2007).

Figure 2.4. **Tax progressivity and revenue, 2009**



Source: Based on OECD tax data and OECD/ECLAC/CIAT (2011).

Figure 2.5. **Tax structure in the Dominican Republic, 2009**

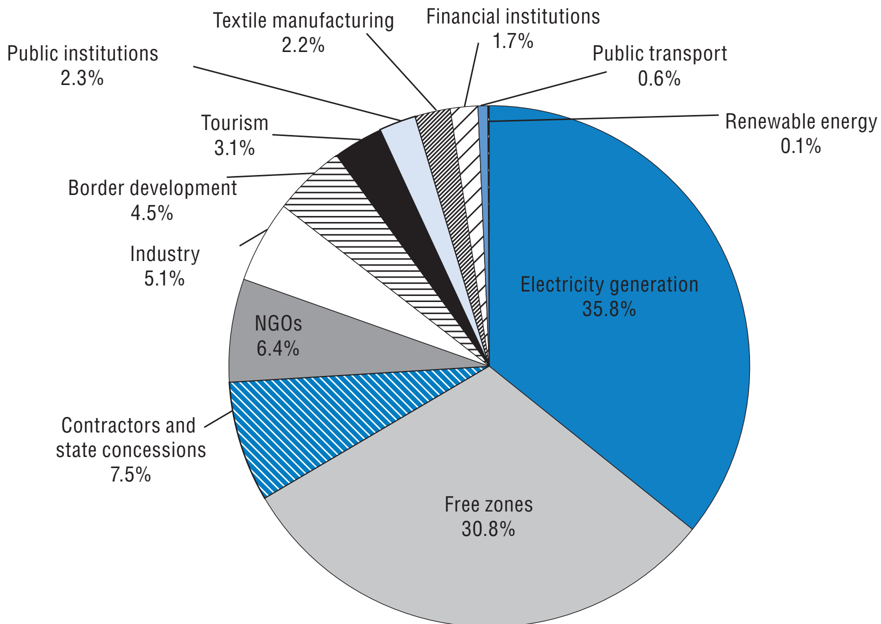


Source: Dirección General de Impuestos Internos (Dominican tax administration).

In particular, there are severe limitations on the Dominican Republic's tax base because of widespread exemptions and special regimes for certain activities, sectors or regions, which exist for all types of taxes. According to Ministry of Finance figures, tax expenditure[3] amounts to 5% of GDP in 2012, with 77.1% of these

reliefs granted through indirect taxes (around DOP 91.7 billion, or USD 2.3 billion). Most of this tax expenditure is in the form of exemptions to electricity generation companies and to companies in free zones, which together account for 66% of total tax expenditure (Figure 2.6).

Figure 2.6. **Tax expenditure by beneficiary sector in 2012**



Note: This breakdown by sector does not include value-added tax (ITBIS), personal income tax (ISRPF), reductions in fuel excise duty (ISC), exemptions from telecommunications and insurance excise duty, exemptions from tax on luxury housing and urban lots (IVSS) and wealth tax (except PROINDUSTRIA).

Source: Ministry of Finance (2011a).

The benefits for free zones in terms of employment and exports do not seem to compensate for their associated costs. In the Dominican Republic and in many neighbouring countries, changes in production and international trade over the past decade have reduced the benefits of free zones in terms of the investment attracted, jobs created and the size of exports.[4] For instance, the contribution of free zones to employment fell by more than half between 2000 and 2009 (from 5.3% to 2.5%), and their contribution to exports also fell from 83% to 69% during the same period.[5]

Another failed objective is that of making the free zones the driving force of the national economy by forming strong economic links between them and the rest of the country. In particular, free zones have failed to raise added value in customs areas through firms providing goods and services to firms based in free zones (Granados, 2003). On the contrary, local firms have moved out to free zones, in part as a means of reducing their tax burden.[6] Tax incentives seem to be moving investment rather than increasing it, with the tax administration authority (DGII) identifying 70 firms that abandoned their taxpaying status by joining the free-zone regime. In the Dominican Republic, this incentive to migrate is not limited to firms that provide services or supply goods. Certain sectors with a comparative national advantage also fall under the free-zone regime. Such sectors include tobacco derivative production, agricultural goods processing and shrimp farming. The free-zone regime is supposed to be reserved for industrial firms (or service providers for foreign clients, such as call centres), especially those in non-conventional, innovative sectors that are important for the manufacturing industry (Coelho, 2011).

Having the two different regimes has led to major distorsions and administrative and compliance costs, and has also made tax planning and evasion easier.[7] It could be impeding the development of a competent industrial fabric (Attali, 2010). The lack of uniformity between taxes paid by the local export sector and those paid by free-zone businesses could erode the competitiveness of some sectors, as well as affecting links with the national economy.[8] The free zones' preferential tax system also opens the door to tax evasion and avoidance, adding to the lost income (2.5% of GDP in 2010 according to Ministry of Finance estimates). Good administration and implementation of the law on transfer pricing is therefore essential to monitor and penalise those who artificially transfer profits to companies located in free zones and/or transfer expenditure to reduce their total tax burden. Another scheme companies use is artificial pricing for loans among subsidiaries (thin capitalisation operations).

It is recommended that the Dominican Republic harmonise taxation of national industry and taxation of free zones in the medium term, especially with regard to corporate income tax. The exemption from corporate income tax ought to be phased out. Eliminating the two-scheme system could provide leeway for a reduction of the overall rate of corporate income tax, especially if it is accompanied by reforms to broaden the tax base in the rest of the tax system and to remove subsidies to electricity generation companies. However, although the overall rate of corporate income tax must be reduced in order to avoid discouraging investment, lowering it too much would cause unnecessary damage to the amount of tax revenue collected.

Regional (supranational) co-operation on tax incentives could help to prevent harmful tax competition. The generous tax and customs exemptions packages in many parts of the region result not so much from well-informed tax-policy decisions

as from trade competition and tax competition among countries in attracting foreign investment, and from political decisions. Thus, the preferential tax regimes for free zones are very similar from one country to another. Competition in the region, or the neighbour effect, is harming all countries. For corporate income tax in particular, competition pressures governments into setting low rates or zero rates, thus harming tax revenue.[9] It would therefore be advisable to encourage certain regional co operation to prevent harmful competition on tax incentives – and not just those for firms in free zones. Although in the short term it will be hard for countries to reach agreements on removing tax incentives, one objective could be a regional agreement on principles of transparency and management of tax incentives. The management and administration of tax incentives can be made less costly and more effective if it is done transparently. Greater transparency makes incentives easier to manage, and their costs and benefits can be better tracked. It also reduces room for discretion in granting incentives. The Dominican Republic does currently follow many of these principles (see Box 2.1).

Box 2.1. **Principles for improving the transparency and governance of tax incentives for investment in developing countries**

With developing countries having maximised their efforts to mobilise domestic financial resources for development, some tax incentives for investment could be counter-productive. Creating a set of governing principles is the starting point of international efforts to promote the transparent, coherent management and administration of tax incentives for investment.

In 2011, the World Bank, IMF, OECD and United Nations presented a joint report to the G 20 on the development of effective tax systems in developing countries, which looked at the importance of the governance of tax incentives.[a] The OECD's Informal Task Force on Tax and Development, for its part, identified the need to create a global framework for the transparency of tax incentives for investment. The aim of this framework is to promote transparency in decision-making, expand the information available on costs and benefits, limit the use of discretion and enforce accountability.

The estimates of revenue forgone as a result of tax incentives published regularly by the Dominican Ministry of Finance are a step in the right direction towards assessing their cost effectiveness. Furthermore, by incorporating these estimates into the annual budget process, the Dominican Republic provides policy makers with the information they need to make sound policy decisions. However, it would be desirable to conduct a performance appraisal of tax incentives once every so many years, including a cost-benefit analysis and an analysis of the progress made in achieving the objectives.

Box 2.1. (cont.)

The principles

Governments must act to:

1. Make public all tax incentives for investment and their objectives within a governing framework.
2. Provide tax incentives for investment only through tax legislation.
3 Consolidate all tax incentives for investment under the authority of one government body, where possible.
4. Ensure that tax incentives for investment are ratified through the law making body or parliament.
5. Administer tax incentives for investment in a transparent manner.
6. Calculate the amount of revenue forgone attributable to tax incentives for investment and publicly release a statement of tax expenditures.
7. Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives.
8. Highlight the largest beneficiaries of tax incentives for investment by specific tax provision in a regular statement of tax expenditures, where possible.
9. Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives.
10. Enhance regional co-operation to avoid harmful tax competition.

Regarding management of incentives, a good practice is, for example, to offer temporary incentives (with a sunset clause). A sunset clause can facilitate a performance appraisal of tax incentives when they expire. The practice in the region is either that the law does not recognise their temporary status, or that, if it does, in practice the incentives are formally or informally extended. According to Dominican law, an exemption from corporate income tax is for a specifically defined period of time, but in practice the exemption lasts as long as the company remains in business.

The main measures introduced in the Dominican Republic to make tax incentives more transparent include the following obligations: *i)* tax incentives must be included in the general budget (Art. 36 g) of the Public Sector Budget Law, in force since 2008); and *ii)* an estimation must be made of the revenue forgone generated by tax incentives. Additionally, the Ministry of Finance examines tax-exemption applications to check that they are made according to the correct procedure (Decree 162 11). However, further progress is still needed. In particular, the government ought to develop a single set of regulations comprising all tax incentives rather than the current 32 provisions offering tax incentives to different sectors.[b]

Box 2.1. (cont.)

	Time limit of tax exemption on corporate income tax	Time limit extension
Costa Rica	- 18 years (12 years total relief, 6 years relief on half the tax) - GAM Area: 12 years (8 years total relief, 4 years relief on half the tax)	Legal possibility of an extension
Guatemala	10 years (subject to the absence of foreign tax credit)	
Honduras	- Unlimited in free trade zones - 20 years in industrial processing zones (ZIPS)	
Nicaragua	10 years	60% exemption after 10 years
El Salvador	20 years	
Panama	Indefinitely	
Dominican Republic	- 15 years - 20 years (in border areas)	Decision of the National Free Zones Council

Note: Colombia and Mexico do not offer complete exemptions from corporate income tax on profits made from operations in free zones. Colombia offers certain firms (commercial users of free zones are explicitly excluded) a reduced rate of 15% (compared with the 33% general rate). Mexico allows companies that qualify under the IMMEX programme to pay only the flat IETU business tax on net profits, and not the ISR income tax too. This provision was originally due to expire at the end of 2011, but was extended by two years to the end of 2013.

Source: Coelho (2011).

The management of incentives for free zones ought to be made more transparent too. Although the preferential treatment given to the zones is set out in tax legislation, the incentives scheme is managed by a national council, the Consejo Nacional de Zonas Francas de Exportación, which has the discretionary authority to regulate and extend the incentives offered. The council is formed by members of the private sector and by government bodies, including members representing the Ministry of Finance. It is important that the requirements to enter free zones be kept simple and transparent to keep down management and compliance costs and prevent too much use of discretion.

a) Supporting the Development of More Effective Tax Systems (2001), a report presented by the IMF, OECD, United Nations and World Bank to the G 20 Development Working Group: www.oecd.org/dataoecd/54/29/48993634.pdf.

b) Most of the main Dominican taxes are defined in Law 11 92, which created the Tax Code, and its amendments; Law 14 93 on Customs in the Dominican Republic and its amendments; and Law 112 00 on Hydrocarbons. Other taxes and fees are scattered among many different laws.

Generally, the high cost of tax expenditures in terms of revenue forgone, distortions, inequality and administrative and management costs suggests that their cost-effectiveness should be reviewed. Though such preferential treatment may often have a legitimate economic justification, such as when it is used to correct market failures, empirical evidence questions its effectiveness, and especially the use of free zones and total exemptions on corporate income tax (ISPRJ), or “tax holidays”. First, the income lost as a result of preferential treatment has a fiscal cost, with other taxpayers having to foot a higher tax bill and the public sector having less money to spend (or higher borrowing). Further, preferential systems create major economic costs in terms of the proper allocation of resources, making the national economy less effective and less productive. They also make the tax system less fair, increase the administrative costs of monitoring and auditing, and increase compliance costs. Having different systems creates incentives to request further exemptions, deductions and preferential rates for certain groups based on personal interests (OECD, 2010a).

However, we must mention some of the progress the Dominican Republic has already made in rationalising tax expenditures, thus broadening the tax base. For instance, March 2011 saw the creation of the Interinstitutional Tax Expenditure Commission within the Ministry of Finance’s Audit and Evaluation Unit. In addition to estimating the revenue forgone in tax expenditures, the commission’s main role is to conduct cost-benefit analyses of the exemptions envisaged in legislation and to ensure they are used for the purposes for which they were designed (Ministerio de Hacienda, 2011).

In addition to these limitations on the tax base, there is a high rate of tax evasion in the Dominican Republic. For instance, evasion of value-added tax (ITBIS in the Dominican Republic) amounted to 31% of potential revenue (based on national accounts) in 2006, one of the highest rates in the entire region.10 Although international comparisons are useful in terms of providing a reference, clearly it is more useful to look at how tax evasion has evolved within a country. In the Dominican Republic, since 2006 the tax administration (DGII) has gone to great efforts to prevent tax evasion. Recent prevention measures include those aimed at increasing the perceived risk of tax evasion and raising penalties for those who engage in it. The DGII is also leading the way among tax authorities in the region in adopting new technologies. For instance, it introduced tax printers in 2008, enabling the large-scale computerisation of business transactions and reducing non-compliance with ITBIS payments by 14.7 points between 2004 and 2008 (DGII estimates). However, the complexity of the tax system, with its numerous exemptions and preferential regimes, as well as its continuous changes, limit the effectiveness of the tax authorities in combating tax evasion (see the section on “The tax administration”).

The size of the informal economy (57% of the working population) also contributes to the erosion of the country’s tax base.11 Recent measures to attract those

in the informal economy to the formal sector include, in particular, the introduction of a much wider-reaching Simplified Tax Regime than that which already existed. In the new simplified regime, the tax base is based on purchases for sole traders (including a simplified value-added tax scheme) and on revenue for self-employed professionals. Although this regime has attracted many small taxpayers (around 3 000), the transitional arrangements to link this special regime to the general system are not clearly designed, possibly creating disincentives for some businesses to grow.

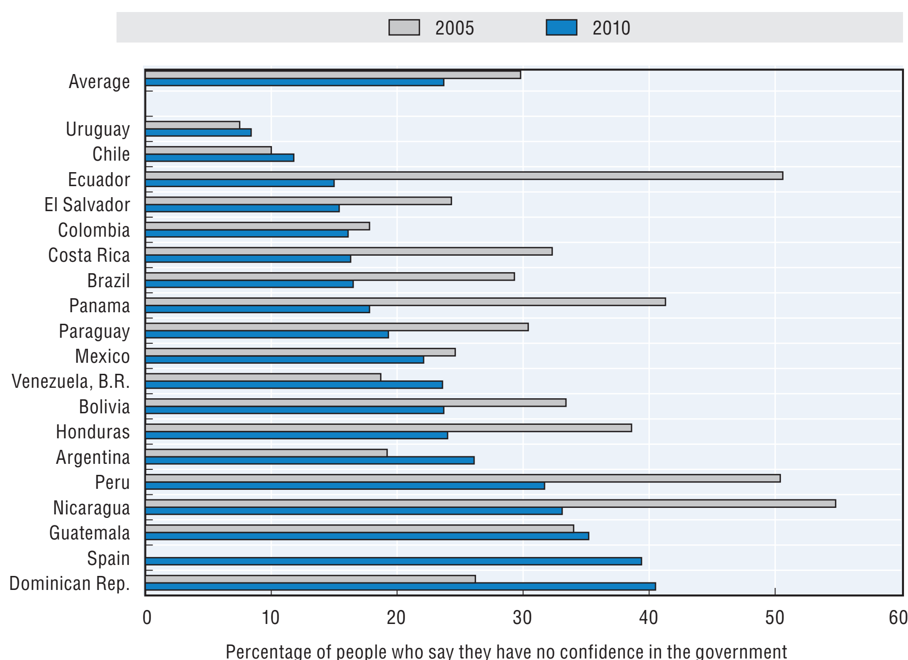
Table 2.3. **Comparison of rates of tax evasion in the LAC region**

Country	VAT		Income tax			
	Estimated evasion	Year	Estimated evasion			
			Total	PIT	CIT	Year
Argentina	21.2	2006	49.7	--	--	2005
Bolivia	29.0	2004	--	--	--	--
Chile	11.0	2005	47.4	46.0	48.4	2003
Costa Rica	28.7	2002	--	--	--	--
Colombia	23.5	2006	--	--	--	--
Ecuador	21.2	2001	63.8	58.1	65.3	2005
El Salvador	27.8	2006	45.3	36.3	51.0	2005
Guatemala	37.5	2006	63.7	69.9	62.8	2006
Mexico	20.0	2006	41.6	38.0	46.2	2004
Nicaragua	38.1	2006	--	--	--	--
Panama	33.8	2006	--	--	--	--
Peru	37.7		48.5	32.6	51.3	2006
Dominican Republic	31.2	2006	--	--	--	--
Uruguay	26.3	2006	--	--	--	--

Source: Gómez Sabaini and Jiménez (2012).

Confidence in institutions is essential to ensure that the social contract between citizens and the state stays intact. Under democratic systems citizens are more likely to voice their social preferences, especially those related to income redistribution and expenditure policy. However, data from the Latinobarómetro survey shows that the Dominican Republic has the lowest rate of confidence in central government in the region (it is also lower than in Spain). In 2010, 41% of survey respondents said they had no confidence in the government, almost twice the regional average (see Figure 2.7). Significantly, the result is worse than the 2005 figure of just 26%, which was actually below the regional average (30%). This change is all the more surprising when compared with the general upward trend in confidence in government in general, especially in Ecuador, Nicaragua and Peru, where the figures moved by just as much, but in the opposite direction.

Figure 2.7. **Confidence in the government**



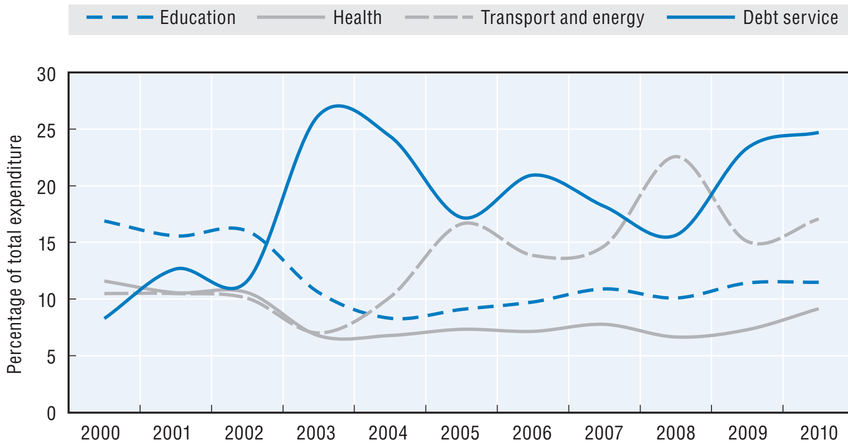
Source: Latinobarómetro (2010).

Low public confidence in government harms tax morale. As stated above, this poor perception of government and of public services reduces people's willingness to pay taxes. A lower willingness to pay taxes (or lower tax morale) brings with it an additional problem: that of setting spending priorities and deciding how to finance them. The National Development Strategy outlines development policies until 2030, and tax revenue needs increasing to finance those policies. If public services are perceived as being of low quality, tax morale suffers; and if less taxes are paid, a gap opens up between the revenue needed to spend on development and the revenue collected. This fuels a vicious circle whereby development-policy priorities do not match public finances in the medium and long terms.

Public spending is distributed in a way that is harmful to sectors that have the greatest potential to create economic growth, and in a way that feeds the low expectations of public spending. Generally, the distribution of public spending has somewhat neglected development-policy priorities, reflected particularly in spending on education and health. The government has been forced to take care of other

commitments, such as servicing its debt, which requires massive fiscal resources (Figure 2.8). The graph shows that spending on health and education remained relatively stable – albeit low – between 2000 and 2010, while debt servicing used 15% 25% of the annual budget after the 2003-04 crisis. In production infrastructure, such as energy and transport, much of the boost in spending over the past five years has come from mass-transit infrastructure.

Figure 2.8. **Central government expenditure**



Source: Based on Ministry of Finance data.

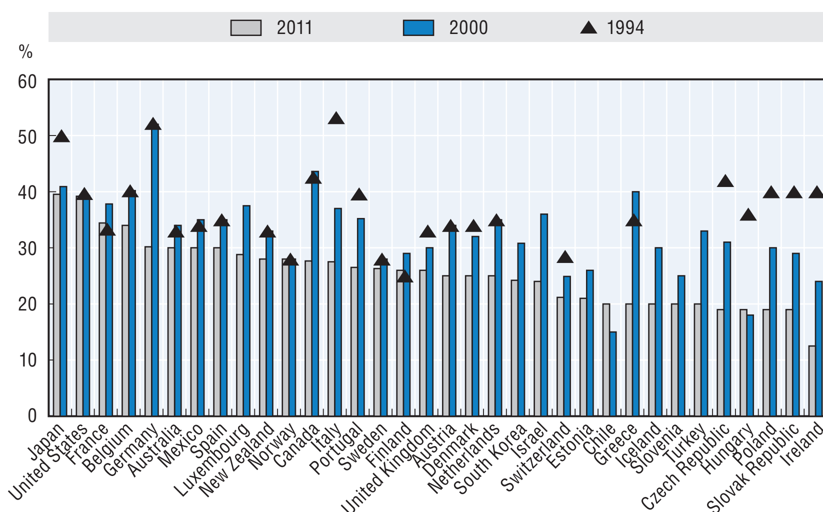
The Dominican Republic's budgetary policy has major rigidities that affect the government's ability to conduct an effective expenditure policy. When drawing up the budget of income and expenditure for the fiscal year, the tax authorities find that a third of their spending obligations have already been assigned. Around twenty special laws pre-allocate budgetary resources to various functions and institutions (Ministry of Finance, 2011b). According to several estimates, these obligations commit almost half the national budget before it has even begun to be executed, and there is a bias towards the automatic growth of current expenditure. This situation is harmful to public investment (Jaque García, 2006). According to several estimates, when other quasi-rigid items are added (such as civil-servant salaries, government-debt servicing and subsidies), the proportion of the budget automatically allocated rises to 60-70%.[12]

Tax rates and other tools to increase revenues in an effective manner

As mentioned above, the main cause of low tax revenue in the Dominican Republic are the narrow tax bases caused by legislation and by tax evasion and avoidance. The country's tax rates are very similar to those of many other countries in the region, and are even higher than those of some countries. This section discusses the various options for reforms aimed at broadening the base and reducing the tax rates. Empirical evidence shows that such reforms have a positive effect on economic growth and income redistribution (OECD, 2010a; OECD, 2010c; Heady et al., 2009).

Corporate income tax

Figure 2.9. **Statutory corporate income tax rates in OECD countries, 1994, 2000, 2011**

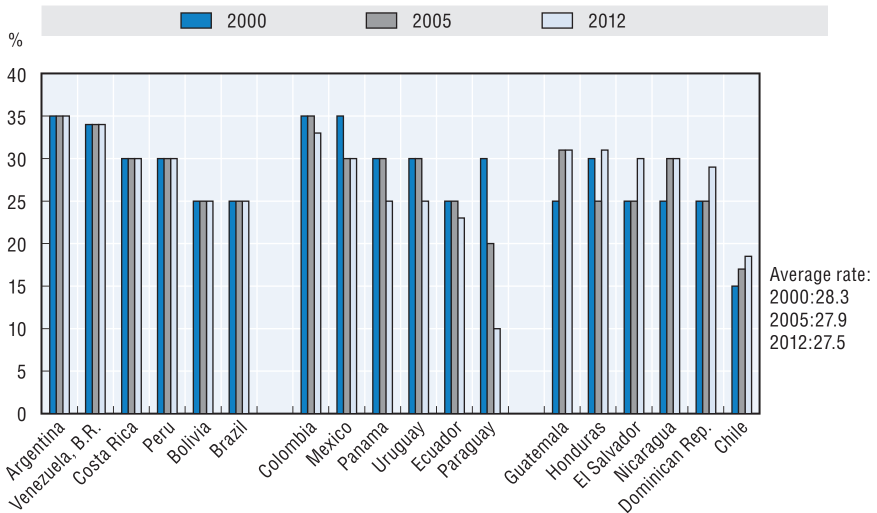


Note: Combined rate, including devolved taxes.
Source: OECD tax database.

Corporate income tax rates have been falling since the 1980s, and the rate at which they have fallen has been greater in OECD countries than in Latin America. In 1981, no OECD country had a rate below 30%, but by 2011, corporate income tax stood at less than 30% in 26 of the 34 OECD member countries. The main reasons

for the downward trend in corporate income tax rates have been reforms aimed at reducing distortions (increasing the tax system's efficiency), increasing tax revenues and simplifying the tax system. These rate reductions have generally resulted in wider tax bases and a more uniform treatment of the amortization of different assets (there are also some limitations on the deductibility of interests, particularly in the OECD). International efforts to share information for tax purposes have also enabled progress to be made in protecting the tax base.

Figure 2.10. **Statutory personal income tax rates in Latin American countries, 2000, 2005, 2012**



Source: Based on Inter-American Center of Tax Administrations (CIAT) data.

The Dominican Republic has a relatively high rate of corporate income tax (29%) compared with OECD countries (average of 25.5% in 2011) and LAC countries (average of 27.5% in 2012).[13] Trends in corporate income tax rates for the period 2000 11 seem to suggest that rates are generally converging both in OECD countries and in Latin America. However, in analysing these reductions, the size of a country's economy must be considered: countries with a larger GDP and therefore larger domestic markets generally have higher rates. While the trend in both regions is for larger tax cuts in smaller countries, the average-sized LAC countries have higher rates of tax than the large LAC countries (Brazil and Mexico).

Table 2.4. **Statutory personal income tax rates in Latin American countries by size of the economy**

	2000	2005	2012
Large LAC countries	30.0	27.5	27.5
- Brazil, Mexico			
Medium-sized LAC countries	29.8	30.2	30.1
- Argentina, Chile, Colombia, Peru, Venezuela			
Small LAC countries	27.3	26.9	26.3
- Bolivia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Paraguay, Dominican Republic, Uruguay			
LAC average	28.3	27.9	27.5

Source: Based on CIAT data.

However, the effective tax rates in the Dominican Republic are low and often zero. The Dominican tax system makes widespread use of preferential treatment to reduce or eliminate taxes for certain activities, sectors and regions. For instance, the sectors with their own tax regime are tourism, manufacturing (Proindustria), textiles and footwear, the film industry, exports, free trade zones, state contractors and border areas, electricity generation, agriculture, restaurants, grocery stores, pharmacies, retail stores, banks and the stock market. Generous exemptions and incentives offered under these regimes result in low effective rates of corporate income tax, sometimes even zero rates (including, for instance, for free trade firms, border areas, investment in border projects, textiles, leather and footwear) or in many cases rates very close to zero.

The use of exemptions, incentives and special regimes is not unique to the Dominican Republic. It is a situation that has spread throughout the LAC region, perhaps suggesting a partial race to the bottom, i.e. effective rates close to zero for investments made under these special regimes. This means that countries in the region are competing in a race to the bottom in only part of the tax system (the part in which capital is much more mobile), while keeping tax rates on other capital high (Abbas et al., 2012).

Experience shows that a general tax cut would be more cost-effective than tax incentives for certain sectors or regions.[14] This is because taxes create distortions (among businesses, industries, types of assets and types of finance), so a general reduction in taxes on capital should improve welfare (Barreix, 2013a; OECD, 2008b; OECD, 2001). Ireland is a good example of successfully attracting foreign investment. In the area of taxes, rather than providing exemptions and focused preferential systems, the main benefit Ireland offers is a low rate of tax on profits and the possibility of carrying forward tax losses to future fiscal years indefinitely (though one point of contention is whether the low tax rate was sufficient to secure the

necessary tax revenue). This type of benefit thus supports all economic investment, not just investment in certain sectors or regions, and in theory it should not create distortions. Additionally, the role of non-tax factors, such as European Union membership and a huge skilled English-speaking workforce, are key factors behind Ireland's success.

The effectiveness of these special regimes to attract mobile capital is questionable, and depends largely on how the incentives are designed. Also, these regimes often lead to tax evasion and avoidance (see Box 2.2). Broadening the tax base would also help to reduce tax rates in general and to eliminate incentives for taxpayers to change their actions simply for tax purposes. In particular, effective rates that are close to zero incite businesses to transfer their profits to the special regimes or to artificially transfer profits using tax-planning tools. Thus, one would expect a reduction in the statutory tax rate to have little impact on investment: the rate becomes irrelevant because the investment for which tax payments are a determining factor is done under the special regimes. Similarly, this transfer of profits to special regimes could explain why increasing the rate of tax would probably not greatly increase tax revenues, even in the short term.

Box 2.2. **Investment incentives through corporate income tax: which incentives are most effective?**

Globally, the most widely used tax incentive is a cut in corporate income tax (or profits tax). However, use of the incentives in the list below varies between developed and developing countries. In OECD countries, the most common incentives are accelerated depreciation, specific corporate income tax deductions and cuts to other taxes (including regional and local taxes). Developing countries, on the other hand, tend to prefer total corporate income tax exemptions (or "tax holidays"), exemptions from taxes on imports, and repeated reduced rates of corporate income tax.

The impact of incentives on attracting additional investment depends largely on how they are designed. Theory predicts that investment-based incentives (such as deductions or credits for investment,[a] immediate deduction of capital investment and accelerated depreciation) increase investment by a greater amount for each unit of revenue that is forgone. Unlike profit-based incentives such as corporate income tax reductions and complete exemptions, investment-based incentives (also known as "up-front incentives") only benefit new investment. They therefore reduce the effective tax rate on investment at a lower cost, taking into account the impact of taxes on both profits and marginal costs. But reducing the rate of corporate income tax benefits both new investment and previous investment, so part of the forgone tax revenue is merely transferred to investors.

Box 2.2. (cont.)

	Advantages	Disadvantages
Total corporate income tax exemption	Relatively low compliance costs Simple to administrate	Benefits both new and old investment No access to certain tax deductions (depreciation and interest) Relief depends on when the exemption begins and treatment of losses Relief depends on when the exemption begins and treatment of losses Difficult to control due to the limited obligations for financial reports
If only for exporters		Discriminates between export and non-export firms Against EU and WTO rules
Reduced rate of corporate income tax for certain sectors	Attractive for mobile investors	Discriminates against businesses in other sectors
	Dynamic effect on stimulating the economy	Zero or negligible tax rate can encourage tax planning
	Simple to administrate	Limits certain deductions (depreciation and interest)
		Tax-planning opportunities
If based on location		Can encourage offshoring rather than increasing investment
Accelerated depreciation	Eases liquidity constraints during first few years	Revenue forgone depends on corporate income tax rate
- Machinery and equipment	Facilitates investment in new equipment and machinery	Can result in excessive investment (e.g. unutilised buildings)
	Facilitates the development of industrial parks	The treatment of losses is important: firms only benefit if deductions can be carried forward to future tax years if they make a loss
Investment credits	Greater impact on the effective rate at a cheaper cost	Discriminates between new and old investment
	Can be focused on forms of investment with greater externalities	Greater impact with short-lived assets because a larger % of tax revenue can be offset for a given amount of revenue
	Eases liquidity constraints	Greater administrative costs
		Benefits depend on treatment of losses: may discriminate against investments with delayed returns
Deductions for certain costs - staff training costs - R&D - marketing costs for exports	Technology transfer if accompanied by other measures	Discriminates between new and old investment Greater administrative costs Benefits depend on treatment of losses
Exemptions on indirect taxes (VAT, import taxes)	Reduces contact with the tax authorities (important for complex processes and if there is corruption)	Little benefit in terms of VAT if there is credit for inputs Open to abuse: easy to falsely label purchases

Box 2.2. (cont.)

It is important to note that choosing from among the various types of incentives largely depends on the country's specific characteristics. For instance, because of the possibility of tax planning, up-front incentives should be used cautiously in countries with relatively low rates of corporate income tax if refund provisions – such as credits for foreign investment – exist in the country of origin (see OECD, 2008b). In addition to encouraging investment, low corporate income tax creates incentives for more productive use of inputs to generate profits (despite the negative impact that a low rate has on interest deductions if the finance is through debt and on depreciation values), while reducing the possibility of using tax planning. However, when tax revenue comes mainly from existing capital stock, a low rate of corporate income tax results in an unexpected profit, or "windfall gain", for that capital, so the loss in revenue could be considered excessive.

a) Tax deductions or credits for investment, whether general or focused, directly reduce the amount of corporate income tax to be paid. The main advantage of credits is that they are independent of the rate of corporate income tax.

The complexity and instability of the tax system and the poor control of public finances do not help to create an investment-friendly business environment. In choosing where to invest, investors prefer a simple, stable, predictable tax system rather than tax incentives. Yet the Dominican tax system has moved in the opposite direction, becoming less general and more complex. The system is also quite unstable, having undergone six reforms in the last nine years, and is difficult to administer because there are so many special schemes. Abolishing these regimes would cut compliance and administrative costs, freeing up resources to be used for other, more productive purposes.

More generous tax expenditures cannot compensate for the Dominican Republic's poor business climate. In particular, there is a lack of good infrastructure (such as transport and a reliable electricity supply) and education is poor. Because of this situation, the incentives mainly erode the tax base, resulting in low tax revenue (OECD, 2001).

Personal income tax

Personal income tax in the Dominican Republic is progressive, but the high amount of non-taxable income (2.1 times the average income, or 1.01% of GDP) makes it less progressive than it should be. The tax has three marginal rates – 15%, 20% and 25% – with the lowest rate applied to annual income above DOP 399 923 (DOP 33 326.92 a month, or around USD 854), so around 90% of wage-earners are exempt from the tax. In other words, nine out of ten potential payers of personal income tax are not obliged to pay it because their taxable income is below the legal threshold. And the threshold is adjusted every year in line with inflation, so unlike in other countries the effects of inflation do not lower the threshold in real terms. However, though most middle-class households are not subject to income tax, they often end up paying for health services and private education because of the deficiencies in public services.

Table 2.5. **Tax-exempt allowance in selected LAC countries, 2010**

Country	Tax threshold (local currency)	Tax threshold (USD)	Minimum rate %	Average income per capita	Threshold/ Avg. income	GDP per capita (USD PPP)	Threshold/ GDP per capita
Argentina	44 200	11 333	10.0	29 914	1.5	15 941	0.71
Brazil	17 990	10 222	7.5	14 099	1.3	11 202	0.91
Chile	6 092 010	11 939	5.0	5 858 279	1.0	16 044	0.74
Costa Rica	2 890 000	5 496	10.0	4 256 213	0.7	11 601	0.47
Mexico	5 953	471	1.92	63 064	0.1	14 564	0.03
Peru	25 200	8 905	15.0	9 871	2.6	9 499	0.94
Dominican Republic	349 326	9 363	15.0	163 946	2.1	9 308	1.01

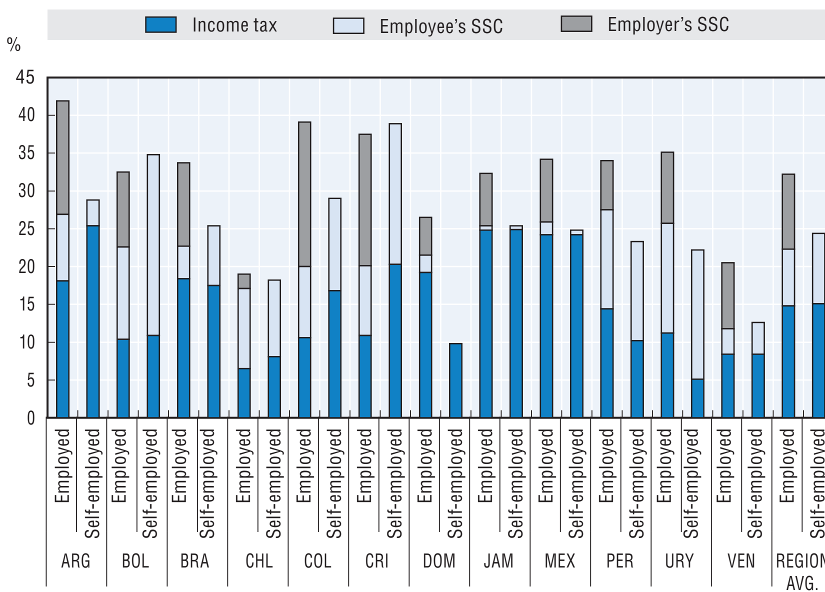
Source: OECD Tax Database. Per capita GDP and exchange rates taken from the World Bank database.

Deductions also make the tax less progressive, since higher earners benefit most from them. Exemptions on personal income tax are granted for social security contributions, Christmas bonuses (regalía pascual) and other extraordinary payments (gratuities, Christmas boxes and bonuses). Additionally, taxpayers can deduct their education expenses and those of their dependents. Notably, when the purpose of these deductions is to cover social costs, the way they are designed plays an important role in the progressive nature of the system. Since the deductions are to the tax base, their value is greater for those who pay higher marginal rates. Consequently, those who are better able to pay their tax costs benefit most from deductions, so personal income tax is less progressive.[15] In recent years, the trend in OECD countries has been towards replacing these deductions by tax credits

(i.e. deductions from the amount of tax paid once the marginal rate has been applied).[16] This makes it possible not only to create uniform incentives, but also to award uniform benefits across the income scale. Some of these credits are designed to be refundable: if the amount of tax due is less than the credit, the tax authorities make a payment to the person or household. This allows low-income people to fully benefit from the credit even if they do not have enough income subject to personal income tax.[17]

In the Dominican Republic there is a wide gap between the tax burden of employees and the self-employed (Figure 2.11). The main reason for this gap is the lower tax burden for the self-employed resulting from the different social security systems and the opportunity for the self-employed to deduct the costs and expenses needed to preserve their source of income (these deductions also increase the opportunity for the self-employed to engage in tax evasion and avoidance).[18] Self-employed professionals have access to an exemption on interest income and a deduction on education costs, and they are also eligible for the simplified tax scheme.

Figure 2.11. **Tax expenses for employees and self-employed people by component**
(annual income of USD 60 000)

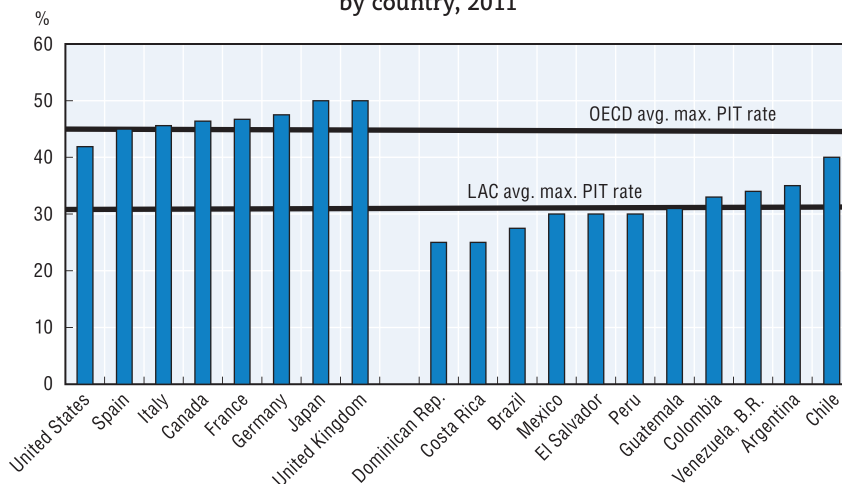


Note: The Dominican Republic envisages a system whereby self-employed workers earning more than the minimum wage must pay into the Subsidised Contributory Regime and the state pays employer contributions. However, this regime has not yet been implemented, so it is not included in this chart.

Source: IDB (2012).

The region has also seen a trend towards converting tax rates. As in OECD countries, personal income tax has become less progressive in Latin America. The number of income brackets has been reduced and the difference between the highest and lowest marginal rates has been narrowed. There is also relatively little variation in the maximum marginal rate (Figure 2.12).

Figure 2.12. **Comparison of maximum marginal rates of personal income tax by country, 2011**

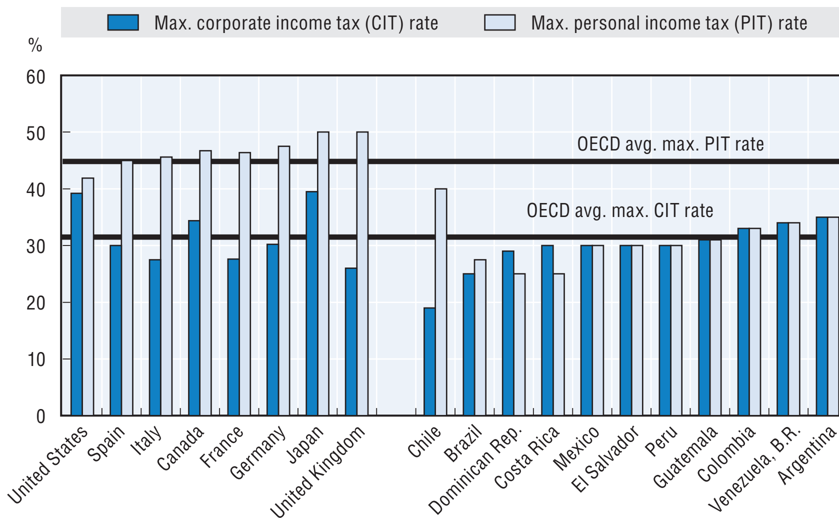


Source: OECD Tax Database for OECD countries; CIAT for Latin American and Caribbean countries.

However, the Dominican Republic has one of the lowest maximum marginal rates in the LAC region. OECD countries have higher maximum marginal rates for personal income tax (average of 41.5%, vs. 31% for LAC countries and 25% for the Dominican Republic). This is partly explained by the higher income per capita in OECD countries (Jimenez et al., 2010).

There is also a trend throughout Latin America towards parity between maximum marginal rates of personal and corporate income tax (Figure 2.13). This parity existed in the Dominican Republic until 2011, and is set to return in 2013.[19] Parity between the two rates can help to reduce distortions regarding business start-up and growth (the choice between being self-employed or salaried and the way in which companies are organised) and the decision whether to operate in the formal or informal economy.

Figure 2.13. **Comparison of maximum marginal rates of personal and corporate income tax by country, 2011**



Source: OECD Tax Database for OECD countries; CIAT for Latin American and Caribbean countries.

To prevent distortions and inequalities, personal income tax should also be applied to capital income. To prevent double taxation, many Latin American countries do not apply personal income tax to capital income, since they consider that such income has already been taxed through corporate income tax. Also, while nominal interest is taxed by law in the Dominican Republic, there is an exemption for interest earned from the regulated financial sector and for yields on fixed-income securities traded through the stock exchange (according to Ministry of Finance estimates, this tax expenditure in terms of revenue forgone amounted to 0.1% of GDP in 2011). This more favourable treatment for capital income can lead to distortions in choosing savings instruments (including those from foreign sources for those people whose tax residence is in the Dominican Republic) and investment instruments or in the means of financing investment. Additionally, it is creating inequalities, since access to savings, financial assets and real estate is more concentrated in the sector of the population with higher incomes.[20] In the last few decades some countries have introduced flat taxes, the main aim being to reduce compliance costs for taxpayers and to make the system easier to manage. However, a flat tax also affects the system's efficiency and equity, which must be carefully considered. Reforms aimed at broadening the tax base are usually more effective in achieving the goal of a simple, efficient and equitable tax system (see Box 2.3).[21]

Box 2.3. **Flat taxes**

In the last few decades several countries have introduced flat taxes. Experience shows that the effects of a flat tax on tax revenues, distribution of income and compliance costs depend on how these taxes are designed.[a] The Slovak Republic's experience serves to illustrate the characteristics of this type of tax.

In 2003, the Slovak Republic had five personal income tax brackets with rates ranging from 10% to 38%. A taxpayer with average income paid a marginal rate of 20%. Corporate income tax stood at 25% and the standard VAT rate was 20%. In 2004, all these rates were replaced by a single rate of 19%. As part of the reform the government significantly raised the income-tax threshold (to more than twice its previous level) and broadened the tax base by eliminating most deductions (it maintained some deductions, such as married couple's allowances and deductions for additional contributions to pension plans, savings insurance or life insurance, and it replaced child allowance with refundable credits).

By comparing the effective tax rates for different levels of income, we can analyse the impact of the reform. Table 2.3A presents a comparison of these rates between 2003 and 2004 for unmarried individuals whose income is 67%, 100% and 167% of the average person's income. The table shows that the tax wedge (the effective tax rate on labour income taking into account employer and employee social security contributions, thus expressing the difference between what the employer has to pay and what the employee actually takes home) is lower in 2004 for all three levels of income, while the effective income-tax rate (the effective tax rate on labour income excluding social security contributions) remains stable or decreases. Notably, the greatest reductions are for the top earners. These high tax wedges reflect the high social security contributions (13.4% for employees, and 34.7% and 36.5% for employers in 2004). Also, employee contributions are tax deductible.

The 2004 reform simplified the tax system and made it more transparent. It also strengthened incentives for investment and for entrepreneurial activities, reduced distortions in the distribution of capital and increased the system's efficiency by broadening the tax base. However, the positive effects should not be exaggerated. The high dependence on social security contributions (levied on gross income) also means that, in practice, revenue from taxes on labour income remain higher than revenue from taxes on capital income. The reform did not affect tax revenue either, because income tax provided little tax revenue both before and after the introduction of the flat tax.

Since the 2004 reform the flat rate of 19% has remained in place, but certain changes have been made, including a refundable tax credit (introduced in 2009) for low earners who work for a minimum number of months. However, deductions for additional contributions to pension plans, savings insurance and life insurance were abolished in 2011.

Box 2.3. (cont.)

Table 2.3A. **Average tax rate and tax wedge for an unmarried person before and after the reform (% of gross income)**

	67% of average wage		100% of average wage		167% of average wage	
	2003	2004	2003	2004	2003	2004
Income tax	5.5	5.0	8.2	8.8	13.1	11.9
Tax wedge	40.9	39.6	42.9	42.5	46.3	44.3

Broadening the tax base is generally more efficient than introducing a flat tax in terms of increasing simplicity, efficiency and equity.

Simplicity: By making the system less complex, a flat tax for all types of income (labour and capital) also reduces incentives to shift income between the corporate and personal sectors and among different sources of income (interests, dividends, etc.). However, even with a flat tax, incentives remain because of social security contributions.

Efficiency: If progressive taxes are replaced with a flat tax, some taxpayers will see their rate of tax rise while others will see it fall. It is thus difficult to determine whether the total cost of distortions will increase or not. Nevertheless, a reform towards broader tax bases is probably more effective than a flat tax.

Equity: While a flat tax may be more effective in achieving horizontal equity (equal treatment for taxpayers in equal situations), progressive systems are more effective in achieving vertical equity (the distribution of after-tax income should be narrower than the distribution of income before tax), at least for a given income-tax threshold. Reforms towards broader tax bases will also affect the distribution of income by eliminating the preferential treatment granted to certain taxpayers (horizontal equity) and limiting the greater benefits that higher earners obtain from those preferential treatments (vertical equity).

a) There are different types of flat taxes:

- Proportional flat tax: a single rate of tax on all (positive) income with no basic allowance.
- Marginal flat tax: a single rate of tax on all (positive) income above a basic allowance.
- Hall-Rabushka flat tax: all (positive) income is taxed at a flat rate, except income from savings, on which personal income tax is not levied. It is equivalent to a tax on consumption with a basic deduction. This tax has the same rate for all types of income (corporate and non-corporate), so all income from savings and investments is taxed as business income rather than as personal income, thus preventing double taxation.
- Single rate, with a refundable tax credit (basic income): the tax credit is of equal value to all individuals, regardless of their income levels (in practice it is therefore a negative income tax at low income levels). This is also called the "basic income flat tax", in which the basic income should replace all social security benefits and a single tax rate is applied to all personal income.

In the collection of personal income tax, financial institutions play an important role as intermediaries by withholding income tax on interest. In 22 OECD countries, financial institutions are required to withhold tax on interest paid to resident taxpayers. In many countries, financial institutions also help the tax authorities with monitoring and auditing by providing information on the income of account holders. This enables the tax authorities to cross-check taxpayers' bank accounts against their own data. The United States, for instance, has been able to close the gap in taxes from interest thanks largely to this form of cross-checking. In some countries (including Australia, Denmark, Finland, the Netherlands, Norway and Sweden), this information is also used by the tax authorities to provide pre-filled tax returns, thus greatly reducing the administration costs for the tax authorities and the compliance costs for taxpayers. In a few countries, financial institutions also help with audits and investigations into tax fraud by providing access to the financial information of specific taxpayers. However, the bank secrecy laws of some countries (the rights of financial institutions not to reveal banking data and private information about their customers) could be an obstacle to effective tax compliance.

Value-added tax (ITBIS)

Value-added tax in the Dominican Republic has a very small tax base. Although the standard ITBIS rate of 16% is the average standard rate of value-added tax among countries in the region and among OECD countries, many products are exempt. These exemptions amount to 48% of goods and services according to data from the National Household Income and Expenditure Survey. If goods and services subject to excise taxes are excluded from the list of exemptions, this percentage falls to 42%. Exempt goods include export goods, basic food products, medication, fuel, fertilisers, books and magazines, financial services, health services, services for pension and retirement plans, land transport for people and cargo, electricity, water, waste-collection services, home-rental services, and personal-care services. Given the vast range of sectors and activities exempt from the tax, narrowing the tax base would reduce distortions and increase revenue without considerably worsening income redistribution.

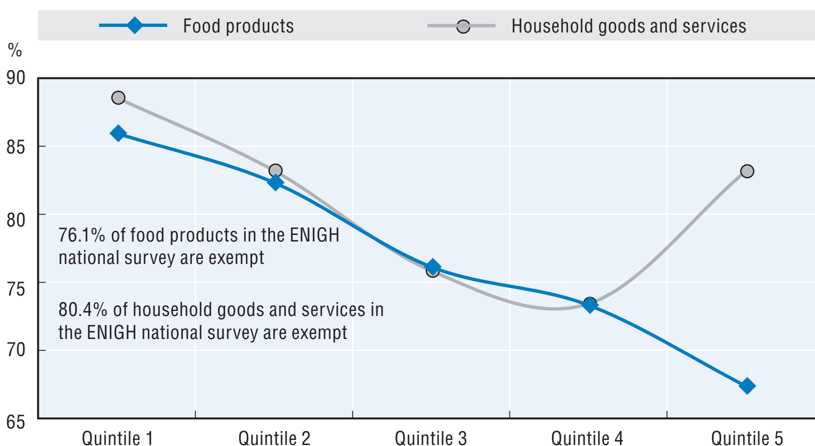
Eliminating exemptions and zero-rated products would not only increase the potential revenue that could be collected through ITBIS, but also reduce the potential for tax evasion. Among OECD and non-OECD countries there is a wide range of value-added tax (VAT) rates, exemptions and thresholds. The experience of OECD countries shows that complexities in VAT create additional administrative costs and reduce compliance, so eliminating ITBIS exemptions and zero-rated products would increase the potential revenue from ITBIS and reduce the potential for tax evasion. Barreix et al. (2013b) estimate that around 20% of potential ITBIS revenue is lost because of tax expenditures due to exemptions and reduced rates in the

Dominican Republic. Furthermore, the potential revenue lost as a result of tax fraud and distortions in tax management (including the use of special regimes for small taxpayers and farmers) amounts to 50%. Consequently, only 30% of potential ITBIS revenue is collected. In other words, for every 100 pesos of potential revenue, 30 pesos are collected, 20 are exempted (tax expenditures), and the remaining 50 are lost, mainly through tax evasion.

Similarly, the many exemptions and zero-rated products make the tax difficult to administer. For example, the numerous deductions and zero-rated transactions generate a disproportionate level of refunds and reduce compliance because of transactions that are incorrectly zero-rated. This has a significant cost for the tax authorities and reduces their capacity to focus resources on monitoring and auditing.

Zero rates and exemptions are generally introduced to make value-added tax less regressive, but tax incidence analysis shows that higher-income households benefit most. In the Dominican Republic, 51% of goods and services subject to ITBIS are consumed by the economy's richest quintile, while 86% of food products and 89% of home services purchased by the first quintile are exempt. However, households in the uppermost quintile also benefit from many exemptions (see Figure 2.14). There is a long list of exempt food products and there are also exemptions, for instance, on tickets to sports events, concerts, cinemas, theatres and other events attended mainly by those in the top quintile. A reduction in tax on certain products is unlikely to improve redistribution of income, because with the exception of a few select goods, higher earners consume more of all types of goods – subsidised or not – than lower earners. This is particularly true in the Dominican Republic and the rest of Latin America, where income is heavily concentrated.

Figure 2.14. **Percentage of ITBIS-exempt goods in household consumption**



Source: Morales (2010).

As well as simplifying the tax system and reducing evasion, a broader ITBIS base would generate additional revenue. Some of this additional revenue could be redistributed to lower earners, thus offsetting the removal of subsidies on the consumption of certain food products. Some simulations (see for instance Barreix et al., 2013b) show that even after such a redistribution, there would still be some remaining revenue that could be allocated to public spending on social programmes. There are various means of providing compensation to lower-income categories. One option, for instance, is through direct income transfers, such as those already successfully implemented in other countries. A prime example among countries in the region is the Dominican Republic's Solidarity Programme.

Tax administration

The Dominican Republic has one of the five best tax administrations in the region, which will help the successful implementation of changes in tax policy. A good tax administration is vital for efficient and effective tax policies, and vice versa. The Dominican tax administration, the DGII, has been modernised, particularly through the reforms that began in 2005. These reforms have strengthened the DGII, enabling it to successfully tackle the many challenges faced by tax administrations today. One major factor is that its civil servants are competent, trustworthy and have good management skills. In fact, 64% of DGII civil servants have university qualifications, compared with an average of only 56% for all the countries in the region.[22] Also, the good distribution of staff between regulatory and operational departments (34% and 66%, respectively, compared with an average of 24% and 76% for all Latin American countries) has undoubtedly contributed to the successful implementation of a good strategic and operational plan.

The DGII strives to improve its services for taxpayers and is able to adapt to new technologies. For example, between 2006 and 2010 the DGII and the Argentinian tax authorities saw a fivefold increase in the number of times people accessed tax information via the Internet, and 66% of Dominican tax returns were submitted on line in 2010. The DGII is also one of only five tax administrations in Latin America (along with the Argentinian, Chilean, Mexican and Peruvian tax authorities) to provide taxpayers with returns that are pre-filled with all the information it has about the taxpayer.

In the area of monitoring and auditing, a good, reliable database allows the DGII to concentrate on improving selective audits and thus to make progress in the area of tax intelligence, mainly through taxpayer profiling.[23] For example, it has made remarkable progress in combating tax evasion, especially evasion of ITBIS. The measures introduced include a "tax receipt number" and "tax printers", and between 2004 and 2008 they successfully cut ITBIS non-compliance by 14.7 percentage points.

Current plans to progressively roll out tax printers to all sectors will improve the monitoring of taxpayers and simplify administrative procedures such as claiming ITBIS refunds.

However, even though the Dominican Republic has one of the best tax administrations in the region, this is not reflected in the level of tax revenue collected. The administrative effectiveness of the DGII is reduced by the difficulties it faces in managing a complex, unstable tax system marked by too many exemptions and preferential systems that encourage tax evasion and avoidance. Regular legislative changes also affect the normal running of the tax administration, forcing the DGII to change its strategy, make adjustments to its annual planning, and redirect resources to change systems, forms, procedures, etc. to bring them in line with the new regulations.[24]

Restructuring the organisation towards more centralised functions would help to increase the DGII's efficiency and effectiveness. The present situation, with the various functions in the process fragmented, is not conducive to improvements. Recent OECD studies (OECD, 2012b; OECD, 2011)[25] indicate that centralising different functions – from administrative and back-office procedures to audits, appeals and tax collection – raises efficiency, improves processes and optimises the use of powers (which are normally scant), and also provides economies of scale for processes requiring substantial investment. The tax administrations of many countries say that a change of structure is one of the most effective means of improving their efficiency and facilitating taxpayer compliance (see Box 2.4).

Box 2.4. **Towards smarter approaches in structuring tax administrations***

All tax administrations are continually working on strategies to reduce costs while protecting the tax base and reducing the gap in taxes. The tax authorities of many countries identify a change of structure as one of the most effective means of improving their efficiency and facilitating taxpayer compliance.

The most common trend is a redesign of the organisation to make it more centralised, using new technologies (e-services, call centres) and new strategies to improve compliance. Centralisation can take many different forms, from merging different bodies to reducing the number of tax offices. Many countries' tax administrations have set up business lines for the entire country under a single, centralised management. Each business line is for a certain type of taxpayer, tax or process (e.g. audits and information for taxpayers).

These new organisational structures centralise functions under a single management body and concentrate those functions in fewer locations. There has been a strong trend of centralising different functions, from administrative and back-office procedures to audits, appeals and tax collection. All these initiatives lead to greater efficiency, improved processes and optimal use of competencies (usually scarce), and provide economies of scale for processes requiring substantial investment.

For many tax administrations, smarter approaches also require business processes to be redesigned and optimised. Some administrations use the "lean" principles (focused on preserving the product value using less work) or similar principles to analyse their processes and find strategies to improve them.

Another area with potential for working smarter is the automation of tax administrations' workflows. Investing in the automation of work seems to be one of the most successful strategies in cutting the costs of processes, since it speeds up and simplifies data processing and management among different departments. However, the degree of automation varies widely from one administration to another, so there is much potential that remains to be explored.

There are also some interesting examples of knowledge management and outsourcing. Many tax administrations make efficient use of databases to share information among all their staff and to maintain and pass on this knowledge when employees change jobs. Another resource-saving method identified by some administrations is the private-sector practice of outsourcing.

*One of the four areas identified as having the potential to improve the efficiency of tax administrations is their structure. The other three areas are *i)* compliance; *ii)* legislation; and *iii)* service delivery (see www.oecd.org/site/ctpfta/49428156.pdf).

For more information on this study, see "Working smarter in structuring the administration, in compliance, and through legislation", OECD 2012 (www.oecd.org/site/ctpfta/49428209.pdf).

Further progress is needed in the area of international taxation, including transfer pricing. Compared to the other LAC countries, the Dominican Republic has made a good start in controlling transfer pricing. It is important to emphasise the efforts of the DGII to develop reliable public data sources to conduct a transfer pricing analysis in the tourism sector. With no available information on comparables, the approach used by the DGII to identify useful data and to negotiate a price on a resale-minus basis lead to a use of public data that is practical and also to a fairly solid transfer pricing analysis given the available data.[26] Other areas where further progress is considered necessary include: *i)* better legislation on transfer pricing to include an explicit obligation to apply the arm's length principle;[27] *ii)* an increase in the number of specialised staff with experience in transfer pricing so that effective audits can be conducted;[28] *iii)* access to the necessary taxpayer information to choose which taxpayers to audit and make audits more effective; and *iv)* access to more information on comparables.

Better regulations on transfer pricing will limit the massive losses in tax revenue. Domestically, these improvements will reduce the amount of revenue forgone as a result of profit transfers among different tax regimes, such as from the general regime to the special regime for free trade zones. Globally, the improved legislation can prevent inequities in the allocation of tax resources among different countries by limiting the misallocation of profits by multinationals.

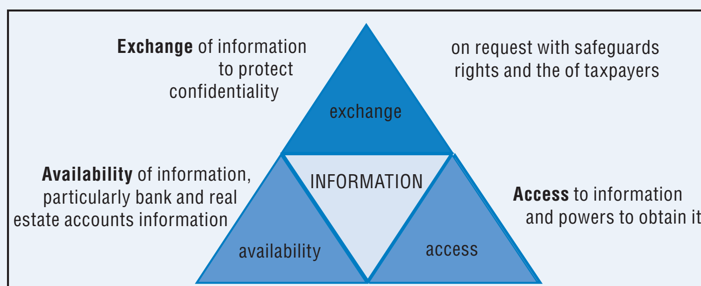
For transfer pricing and anti-abuse measures to work, an effective information exchange mechanism is needed. Although the DGII can obtain information from the Superintendency of Banks, its capacities need strengthening and regulations need updating so that it can meet international standards. For example, in the area of transparency, the Dominican Republic needs to change its Trade Act and its Companies Act, which still allow the issue of bearer shares and the corresponding voting rights.

In this regard, the DGII should join the Global Forum on Transparency and Exchange of Information for Tax Purposes and carry out the necessary reforms to meet international standards.[29] The Global Forum is an international organization with 101 members to date, including most Central and South American countries.[30] Through a comprehensive, rigorous and robust peer-review process, the Global Forum ensures that countries meet high standards regarding transparency and exchange of information (exchange of information, availability of information and access to information, see Box 2.5) to combat fraud and tax evasion.[31] By implementing these international standards, the DGII will be able to access the information it needs to conduct its monitoring and auditing activities nationwide.[32]

Box 2.5. **International standards on transparency and exchange of information**

International standards on transparency and exchange of information (hereinafter referred to as "the standards") are contained in the Terms of Reference approved by the Global Forum in 2009. The standards provide for the exchange on request of information that is foreseeably relevant for the administration or enforcement of the domestic tax laws of a requesting party

Exchange of information for tax purposes is effective when reliable information, foreseeably relevant to the tax requirements of a requesting jurisdiction is available, or can be made available, in a timely manner and there are legal mechanisms that enable the information to be obtained and exchanged in practice. The relationships between these three essential elements that form the cornerstone of the standards can be illustrated in a pyramid:

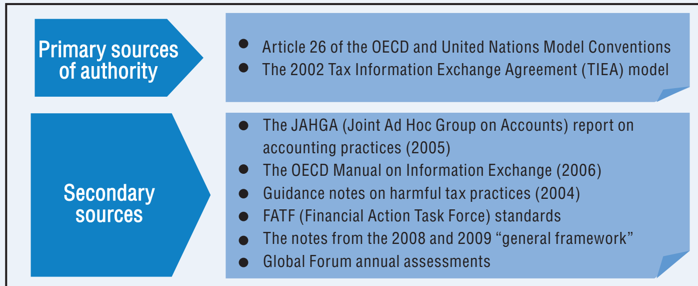


The main instrument used by the Global Forum to ensure that its members effectively implement the internationally agreed standard is a peer review process, which is split into two phases:

- *Phase 1 focuses on the legal and regulatory frameworks*: it determines whether these frameworks are implemented (ten elements) and makes recommendations on how to improve them.
- *Phase 2 focuses on the practical implementation* of the standards on exchange of information.

The standards are based on the following primary and secondary sources, which allow the Peer Review Group and the Global Forum to implement the standards in the monitoring and peer-review processes:

Box 2.5. (cont.)



For more information on the Global Forum, see www.oecd.org/tax/transparency.

In order to combat tax evasion and tax avoidance, countries are advised to sign the multilateral Convention on Mutual Administrative Assistance in Tax Matters[33] (recommendation of the 2012 G20 meeting in Los Cabos 2012).[34] This multilateral agreement provides many different means of administrative co operation relating to tax assessment and collection, including: *i)* exchange of information (on request, automatic or spontaneous); *ii)* simultaneous tax examinations; *iii)* tax examinations abroad; *iv)* assistance in recovery and measures of conservancy and the service of documents; and *v)* facilitation of joint audits. Also, in the area of confidentiality and protection of personal data, the Convention provides that information shall be treated as secret and protected in the receiving State in the same manner as information obtained under its domestic laws. If personal data are provided, the Party receiving them shall treat them in compliance not only with its own domestic law, but also with the safeguards that may be required to ensure data protection under the domestic law of the supplying Party.

Finally, it is important to underline the importance of the culture of change within the DGII, which will undoubtedly enable rapid progress in its modernisation. This culture of change has enabled the DGII to adapt easily and creatively to new situations and will continue to do so. It is this ability and its other strengths mentioned above, coupled with a strong political leadership, that have contributed to the success of the reforms and have given the DGII the maturity of one of the most important institutions in the region.

Notes

1. The figures released only include contributions made under the old pay-as-you-go scheme, which was replaced in the 2001 healthcare reform by a system of individually funded accounts (admissions to the old scheme have now been closed). Contributions under the new system are computed separately.
2. In some countries in the region, higher international prices of raw materials, and particularly higher income from oil and mining, have also helped to raise the relative contribution of direct taxes to total tax revenues.
3. Tax expenditures can be defined as regulatory provisions or practices that reduce or postpone tax payments for a group of taxpayers (OECD, 2010b).
4. The benefits experienced by the Dominican Republic and its neighbours thanks to trade agreements have diminished considerably since the Multi Fibre Arrangement (MFA) ended and since China, Viet Nam and other competitors joined the World Trade Organisation (WTO), giving them tariff-free access to markets, especially the United States (Coelho, 2011).
5. The same trend occurred in neighbouring countries such as Costa Rica, El Salvador, Guatemala and Honduras, partly because new countries – such as China and Viet Nam – gained access to the same markets (especially the US market) after joining the WTO and because of the US cut customs duties.
6. Mexico responded to this problem by setting very specific criteria that firms must meet to be considered textile producers and thus qualify for the preferential regime. The purpose of these criteria was to prevent national companies from moving into the textiles sector (see the Decree passed on 24 December 2010).
7. Historically, free zones were purely export-oriented, and this focus was guaranteed by legislation establishing a minimum amount of exports. However, in compliance with the DR-CAFTA agreement and the Dominican Republic's commitment to the WTO (to be implemented from 2013 and completed in 2015), the government lifted this export requirement. The changes to the legislation have not altered the export focus of firms based in the free zones, but they do open up the possibility of tax planning, since operations with the local market are not normally with independent firms. The forms of tax planning include, in particular, manipulation of transfer pricing and undercapitalisation operations.

8. However, Law 139-11 (2011) partly eliminated discriminatory taxation between the domestic and foreign markets. Under the new legislation, when goods or services are sold domestically, businesses in free zones are subject to an income tax of 2.5% on the gross value of domestic sales and must pay customs duties on those sales.

9. Originally conceived as areas for processing export products, free zones are usually precisely defined areas with strict customs controls upon entry and (until recently) restricted access to the domestic market. These zones are afforded privileges, including exemption from all customs duties and from indirect taxes on exports, with the aim of making the national economy more competitive. This exemption could be justified on the basis of competitiveness and complies with international trade rules. But the situation is different for the exemption on taxes on profits, which are levied not on trade flows but on the net profit made by the exporter's business.

10. Note that estimates available for other countries show that evasion of income tax is much higher than evasion of value-added tax in the region (Gómez Sabaini and Jiménez, 2011).

11. Around 3.6 million people are in employment in the Dominican Republic, an estimated 57% of whom are believed to be working in the informal sector (according to data from the National Workforce Survey published in Guzman [2011]).

12. See Jaque García (2006), Gutiérrez Santana (2007) and Ministerio de Hacienda (2011).

13. Dominican corporate income tax has been increased to 29% for 2011-13, after which it will return to its previous rate of 25%.

14. An incentive is efficient in so far as it can attract additional investment, i.e. investment that would not have occurred otherwise.

15. This is what is known as the "upside-down subsidy" effect (Surrey and McDaniel, 1980).

16. One of the incentives awarded through the tax system that is considered most effective is "in-work benefits" or "make-work-pay policies" – benefits provided to those who are working (OECD, 2006). The purpose of these incentives is to reduce the disincentives to joining the labour market and to reduce inequalities, since they focus on unskilled people with low incomes.

17. These refundable credits for social purposes are the closest thing to benefits through direct spending.

18. Self-employed workers who do not have organised accounts can deduct 40% of their income as assumed expenses, and then deduct the non-taxable part of their income.

19. We should, however, remind ourselves that the effective rate of corporate income tax is much lower because of the many exemptions and deductions available in the Dominican Republic.

20. Foreign residents are exempt from tax on income from debt securities traded on the Dominican stock exchange. Similarly, interests on Dominican public debt are exempt from personal and corporate income tax for domestic and foreign investors alike.

21. OECD countries show different trends in the integration of personal and corporate income tax. Some countries have opted for flat taxes, which typically combine a single tax with broader tax bases. The systems are progressive thanks to an income-tax threshold (such as in the Slovak Republic). Other countries, meanwhile, such as Finland, Norway and Sweden, have introduced a dual income-tax system, with a flat tax on capital income and a progressive tax (usually with a wide tax base) on labour income. Finally, most countries use progressive rates on all types of income, but allow more deductions than in the cases just mentioned. Each of these systems has implications for the simplicity, efficiency and equity of the tax system.

22. The good wage structure helps to attract and retain these skilled members of staff. The DGII is the only tax administration in the region that bases wages on both personal performance and overall performance (the latter represents 20%-30% of total pay). It also offers salaries that can compete with those offered by the private sector.

23. Improvements in the quality and quantity of information exchanged with the customs authorities (DGA) on export and import operations make it easier to cross-check data for domestic operations.

24. The DGII has also made important progress in conducting economic studies. Thanks to these studies, the DGII can perform complex calculations to gauge the amount of tax evasion, measure tax expenditures and explain the behaviour of revenue in accordance with variations in micro- and macroeconomic variables. The DGII would benefit from further analysis of special regimes in co ordination with the Ministry of Finance, especially with regard to the impact that the regimes have on tax evasion and on the DGII's administrative costs.

25. Links to these and other studies can be found at: www.oecd.org/site/ctpfta/listofftapublications-bytopic.htm

26. The DGII compared public data from the internet on rates for package hotel stays with the rates paid to the DR hotel itself. This analysis demonstrated that a sizable spread was retained in offshore intermediaries that performed few functions. This analysis allowed the DGII to present several cases in the court to argue that the payment to the local hotels were too low and the spread retained in the intermediaries too high. This evidence also helped the DGII to negotiate favorable agreements with a hotel trade association regarding the minimum payments to be made to the hotel based on a percentage of the package prices

in internet pricing data. This amounted to a sort of resale minus pricing for hotel space based on available public data.

27. The 2011 legislation includes some progress in this regard.

28. A major step forward was the creation of the Department of Transfer Pricing Control in 2011.

29. See www.oecd.org/tax/transparency

30. Membership of the Global Forum is expanding among developing countries, with 20 countries having recently been invited to join.

31. In its process of transparency and exchange of information, the Global Forum takes into account both the need to protect information confidentiality and the international instruments for the protection of data flows (see www.oecd.org/ctp/exchangeofinformation/deontheprotectionofconfidentialityofinformationexchangedfortaxpurposes.htm)

32. The Global Forum also offers a unique environment for exchanging information to promote multilateral negotiations and regional instruments and a unique platform for co ordinating technical assistance. The main purpose of the Global Forum is to help developing countries to achieve the Millennium Development Goals by maximising the financial resources available for their development.

33. The convention is a free-standing multilateral agreement designed to promote international co operation for a better operation of national tax laws, while respecting the fundamental rights of taxpayers.

34. www.oecd.org/ctp/eoi/mutual.

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FISCAL POLICY FOR DEVELOPMENT IN THE DOMINICAN REPUBLIC

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