

## Chapter 3

### Strengthening the role of the personal income tax in Costa Rica

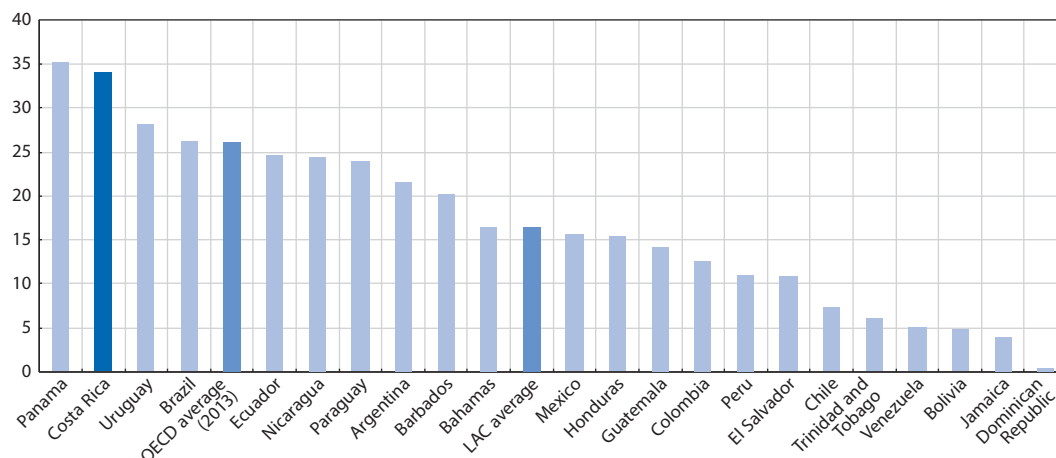
*This chapter discusses the design of the personal income tax (PIT) in Costa Rica, including the tax rate schedule and the income threshold where taxpayers start paying tax, the progressivity of the PIT, the PIT withholding system, the schedular PIT design under which different types of labour income are taxed separately and the PIT evasion by liberal professions. The chapter also discusses the design of the social security contributions (SSCs), focusing on the level of the rates and the minimum contribution threshold, as well as their impact on the incentives to work in the formal economy. The chapter discusses the impact of the lack of integration between the PIT and SSC systems. Average and marginal labour income tax wedges show the combined impact of PITs and SSCs on work incentives.*

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## Costa Rica relies heavily on SSCs while the PIT plays a limited role

**Revenues from social security contributions account for a very large share of total tax revenues.** As mentioned in Chapter 1, SSCs accounted for about 34% of Costa Rica's total tax revenues in 2014, which was significantly above the Latin-America and the Caribbean (LAC) average of 16.4% (Figure 3.1). Panama is the only LAC country where SSCs account for a greater share of total tax revenues. The share of SSCs in total tax revenues in Costa Rica is also higher than the OECD average, where SSCs constitute a major source of tax revenues and account on average for around a quarter of total tax revenues.

Figure 3.1. SSCs as a share of total tax revenues in 2014

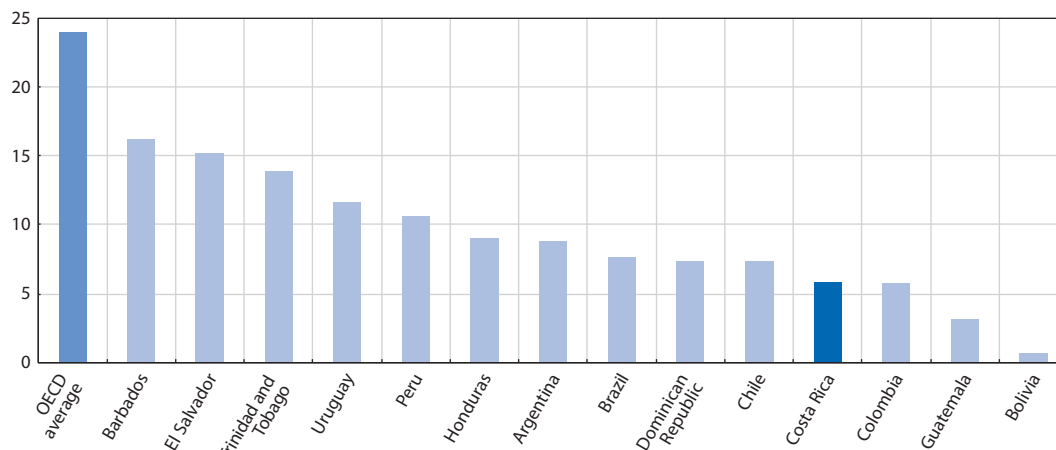


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Source: OECD/IDB/CIAT (2016), *Taxing Wages in Latin America and the Caribbean 2016*, OECD Publishing, Paris.

**PIT, on the other hand, accounts for a very small share of total tax revenues in Costa Rica.** In 2014, PIT revenues amounted to only about 5.8% of total tax revenues. This share is very low in comparison to OECD countries where PIT accounted on average for 24% of total tax revenues in 2014. Costa Rica's revenues from PIT are also low

Figure 3.2. PIT as a share of total tax revenues in 2014



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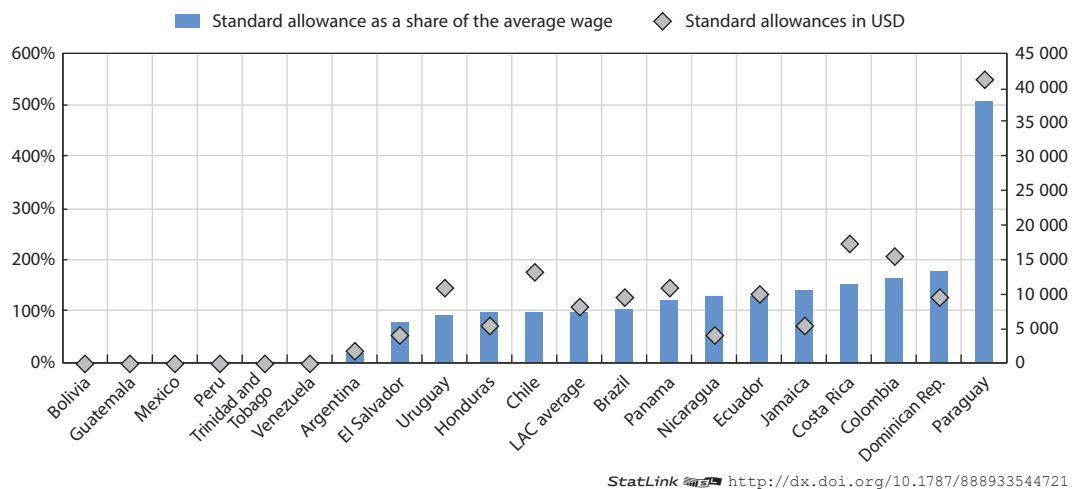
Note: No data was available for Ecuador, Jamaica, Mexico, Nicaragua, Panama, Paraguay and Venezuela.

Source: OECD/IDB/CIAT (2016), *Taxing Wages in Latin America and the Caribbean 2016*, OECD Publishing, Paris.

compared to LAC countries, although low shares of revenues from PIT are a more common characteristic in the region. Many LAC countries collect less than 10% of their total tax revenues from PIT (Figure 3.2).

**A large amount of employment income is exempt from PIT, which means that only very few people pay PIT.** Costa Rican employees only start paying PIT on earnings exceeding more than 150% of the average wage. Costa Rica’s tax-free threshold is high in comparison with LAC countries, where, on average, taxpayers start paying PIT on earnings above a threshold equivalent to 0.99 times the average wage (Figure 3.3). Costa Rica’s tax-free threshold is also high compared to common practice in OECD countries where, on average, taxpayers start paying income tax on earnings around one third of the average wage, although considerable differences exist across countries (OECD, 2012). Because of this very high income threshold, only 88 684 people (or close to 2% of the population) were subject to PIT in 2015, significantly eroding potential tax revenues.

Figure 3.3. **Income thresholds at which single individuals start paying income tax, measured as a multiple of the average wage in USD, in 2013**



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Source: Barreix et al. (2017).

**Moreover, personal income tax rates are low.** The 2017 PIT rate schedule consists of three tax brackets. The tax rates on employment income range from 0% up to monthly income of CRC 793 000 (EUR 1 320), 10% and 15% on monthly employment income exceeding CRC 1 190 000 (EUR 1 980).

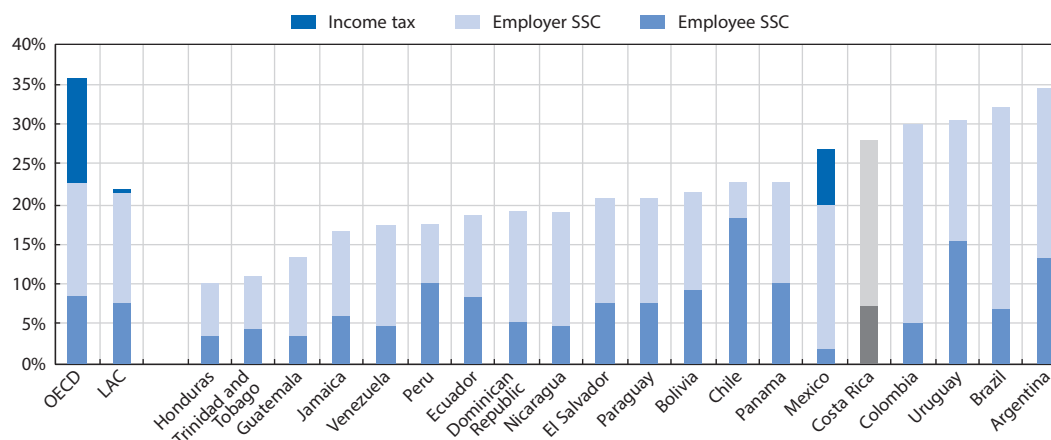
**On the other hand, social security contribution rates are high.** Costa Rican employees must contribute at a total rate of 9.34% of their monthly gross income. Their contributions are withheld by their employers but, in contrast to most OECD countries, those contributions are not deductible from taxable employment income,<sup>1</sup> which effectively increases the tax burden on employees. In addition, employers’ must make contributions equal to 26.33% of the salaries of their employees which they can deduct as costs. Those SSCs cover health and pension contributions paid to the *Caja Costarricense de Seguridad Social* (CCSS), unemployment insurance, family allowances, and contributions for complementary pensions as well as a few additional contributions. Finally, unlike OECD countries, the state also pays for a small share of SSCs (Table 3.1).

Table 3.1. Social security contribution rates

	Employee	Employer	State
Old-age pensions	2.84%	5.08%	0.57%
Healthcare	5.50%	9.25%	0.25%
Unemployment insurance		3.00%	
Family allowances (FODESAF)		5.00%	
Popular Bank fee	1.00%	0.50%	
Complementary pensions		1.50%	
National Learning Institute (INA)		1.50%	
Mixed Institute for Social Support (IMAS)		0.50%	
<b>Total</b>	<b>9.34%</b>	<b>26.33%</b>	<b>0.82%</b>

**High SSCs – in particular employer SSCs – result in a high average tax burden on labour income.** Figure 3.4 compares the tax burden on single workers earning the average wage across LAC countries. The average tax burden on workers is measured as the average tax wedge, which expresses all taxes (PITs, employee and employer SSCs) as a percentage of total labour costs (gross wage earnings plus employer SSCs). The tax wedge for the average employee in Costa Rica reached 28% in 2013 which is high compared to the average tax wedge in LAC countries (21.7%). Costa Rica's average tax wedge remains lower than the average tax wedge in the OECD but that is mainly because workers earning the average wage in Costa Rica do not pay PIT, as opposed to OECD countries where PIT accounts for a significant share of average workers' tax wedges. Employers' SSCs account for almost three quarters of an average worker's total tax wedge in Costa Rica.

Figure 3.4. Average tax wedges for single individuals earning the average wage in LAC countries in 2013



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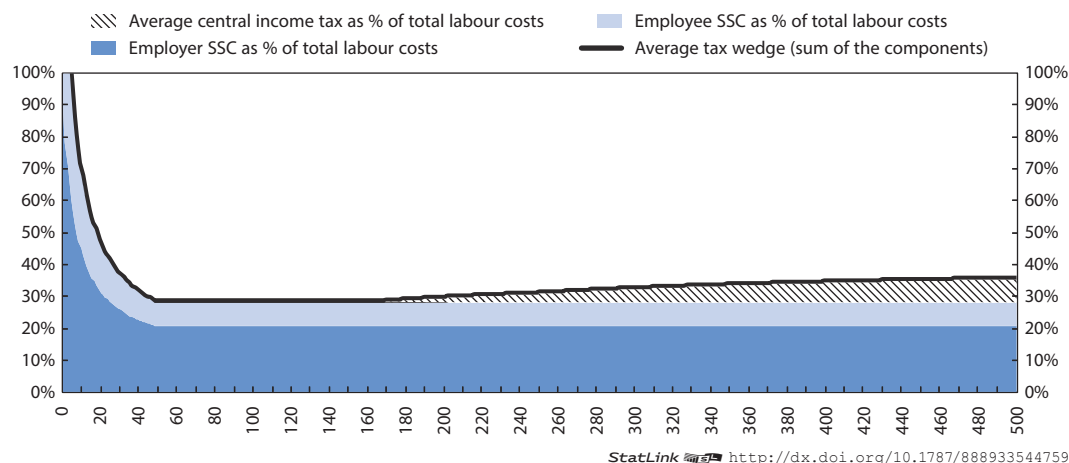
Source: OECD/IDB/CIAT (2016), *Taxing Wages in Latin America and the Caribbean 2016*, OECD Publishing, Paris.

### The tax wedge is overall relatively flat but highly regressive at the bottom of the income distribution, which reduces incentives for formalisation

**The average tax wedge on labour income is relatively flat.** The average tax wedge is about 28% for income between 50% and 170% of the average wage. PIT is paid on income

exceeding 170% of the AW. Because of the low PIT rates, the average tax wedge gradually increases to 35% for taxpayers earning five times the average wage (Figure 3.5).

Figure 3.5. Average tax wedge across earnings levels expressed as a % of the average wage in 2016



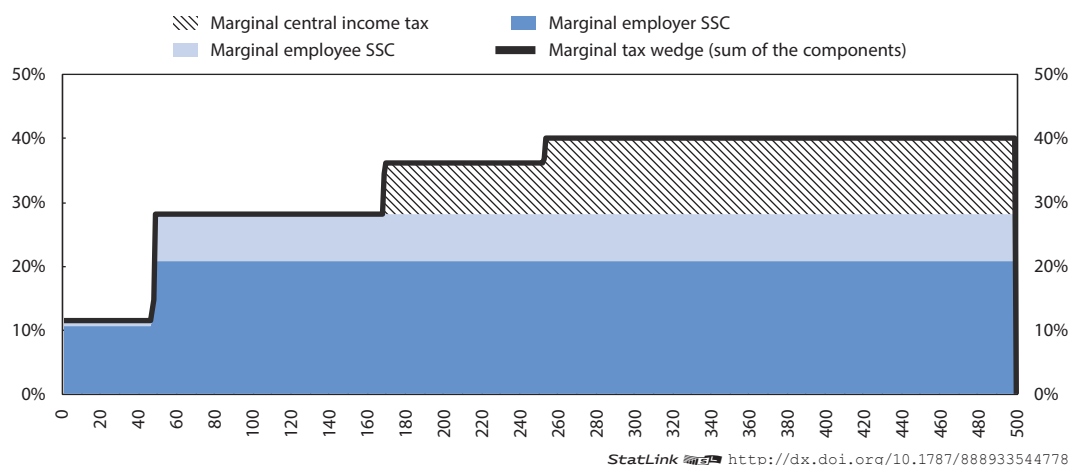
Source: Authors' calculations.

**However, the average tax wedge is highly regressive at the bottom of the income distribution.** Costa Rica imposes a minimum amount of SSCs if earnings are below a minimum threshold. For workers with earnings below CRC 228 530 per month (about 50% of the average wage in 2016), SSCs that are paid to the CCSS are calculated on the basis of that income threshold irrespective of workers' actual earnings. For other types of contributions, they are calculated on the basis of actual earnings. This minimum contribution makes SSCs under the minimum income threshold regressive – meaning that the average contribution rate is higher for low-income workers. Part-time workers in particular can be subject to very high contribution burdens relative to their earnings. For instance, workers earning 10% of the average wage face an average tax wedge of 68%, which means that they only take home as net pay 32% of what they cost to their employer (Figure 3.5). This minimum contribution is highly distortive as it strongly discourages low-income workers, in particular those working part-time, from joining or remaining in the formal sector.

**The minimum contribution base, which makes the average tax wedge regressive at the bottom of the income distribution, has been raised in recent years.** Since 2014, the minimum contribution base has been set as a percentage of the minimum wage, increasing over time, and to reach 100% of the minimum wage by October 2019. Raising the minimum contribution base without strengthening compliance with minimum wage legislation and without allowing the minimum base to vary with working hours will further reduce incentives for formal employment, with adverse consequences on both workers and public finances (OECD, forthcoming).

**Marginal tax wedges are relatively high due to the combined effect of PITs and SSCs.** The marginal tax wedge shows the additional taxes (PIT, employee and employer SSCs) that have to be paid when total labour costs increase with an additional CRC. Taxpayers earning income exceeding 250% of the AW face a marginal tax wedge of about 40%, meaning that 40% of the increase in labour costs is paid to government in the form of taxes and SSCs and only 60% is received by the taxpayer as net-income (Figure 3.6).

Figure 3.6. **Marginal tax wedge across earnings levels expressed as a % of the average wage in 2016**



Source: Authors' calculations.

**However, marginal tax wedges at the bottom of the income distribution are lower.** Figure 3.6 shows that marginal tax wedges at income levels below the SSC minimum earnings threshold are relatively low. If workers earn less than CRC 228 530 per month, the only additional contributions they have to make when they earn an extra CRC amount to 11.6%, because most of their SSCs have already been paid in the form of a lump-sum amount. So, while the minimum SSC threshold discourages workers for participating in the formal labour market, they create an incentive to work more hours for workers who are already in the formal sector because most of their SSCs have already been paid anyway.

**In general, high SSCs encourage informality.** High labour taxes in the formal sector may push low-productivity workers into the informal sector or unemployment. SSCs increase the cost of employing workers and reduce workers' after-tax earnings. The larger the difference between total labour costs in the formal sector and the return on labour after taxes are deducted, the greater the incentive for both employers and employees to avoid taxes by remaining or joining the informal economy. High levels of informality may in turn negatively affect productivity, growth and trust in government institutions (Box 3.1).

### Box 3.1. Main consequences of informality

**High levels of informality can have significant negative consequences for the economy.** First, workers employed in the informal sector have limited access to social protection, inadequate contracts, comparatively lower wages, and are highly vulnerable when they lose their job or when they retire. High levels of informality may also reduce workers' access to training, exacerbating skills shortages. This ultimately generates greater inequalities. This is of particular concern in Latin American countries where inequality is already very high.

**The informal sector also affects productivity and growth.** Production in the informal sector often generates inefficiencies, either because firms limit their size below their optimal efficiency scale to avoid being detected or because they use outdated production technologies (Andrews et al., 2011). The relative cost advantages enjoyed by informal firms may allow them to stay in business even if they are not productive (Andrews et al., 2011). Firms operating in the informal sector also have a more limited access to finance which constrains investment and to qualified labour.

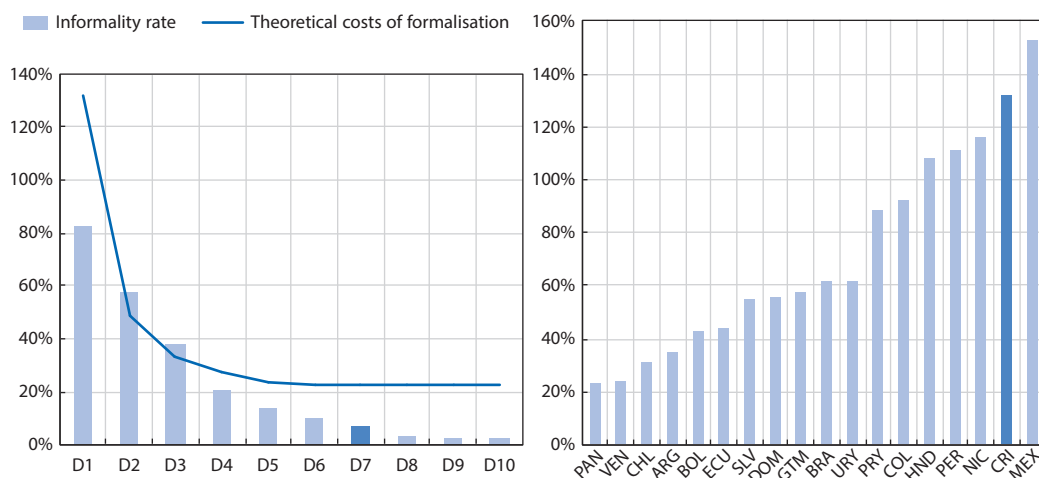
### Box 3.1. Main consequences of informality (continued)


**A significant level of informal economic activity also has significant negative fiscal consequences.** High levels of informality reduce the amount of tax revenue received by the government. Many informal workers may also be in receipt of social benefits, adding to the unnecessary fiscal burden on the state. (This is not so clear-cut: it can be argued that taxing the informal sector has limited revenue potential because informal workers and businesses tend to be poor and would entail heavy collection costs).

**Finally, high levels of informality, when observed by formal workers, can result in an erosion of trust in public institutions** and result in lower tax morale, which may lower revenues through other channels. Importantly, the larger the informal sector, the more incentives people have to remain or become informal (less fear of being sanctioned, view that the informal sector is tolerated).

**Recent analysis confirms that taxation, especially through SSCs, has an impact on labour market outcomes.** Figure 3.7 (Panel A) shows the relationship across the income distribution between informality and “formalisation costs”, proxied by the employee SSCs workers would have to pay to remain or become formal in Costa Rica. This measure can be taken as a lower bound, given that formalisation generally entails additional monetary and non-monetary costs. The white bar identifies the approximate location of the minimum wage. For workers earning above the minimum SSC threshold, this cost is defined as the amount of employee SSCs payable on wages. However, for workers currently excluded from social security programmes, the cost of becoming formal is the amount of SSCs payable at the minimum SSC threshold. As a result, the cost of formalisation will be greater if the shortfall between a worker’s income and the established minimum threshold is large. Costa Rica’s theoretical costs of formalisation for workers in the lowest income decile (Panel B) are the second highest in LAC after Mexico (OECD, 2016).

Figure 3.7. **Theoretical formality costs as a % of workers’ actual wages and informality rates for dependent workers in 2013 (Panel A) and theoretical formality costs for workers in the lowest income decile (Panel B)**



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Source: OECD/IDB/CIAT (2016), *Taxing Wages in Latin America and the Caribbean 2016*, OECD Publishing, Paris.



**In addition, incentives to pay SSCs are reduced by the universal coverage of core public services, such as health care.** Some SSCs are earmarked for benefits associated with the labour market status, in particular pension and unemployment benefits, which can be seen as part of labour compensation. Others, however, finance benefits that are available to all citizens, whether they contribute or not (e.g. training services and child care). Because of this weak link between payments and benefits, incentives to pay into the system and be formal are low.

**Reducing SSCs for low-income workers could raise incentives for employers to hire and declare workers and for employees to operate in the formal economy.** Lehmann and Muravyev (2012) find evidence, based on a panel of Latin American countries, that a larger tax wedge increases informality and suggest that lowering the tax wedge might be one of the most effective instruments to fight against informality. Such an approach was already adopted to promote formalisation among female domestic workers in Costa Rica. In July 2016, the minimum base which is used as the reference to calculate and charge SSCs was cut in half. Until then, employers who employed part-time domestic workers had a very strong incentive not to declare them to avoid paying a disproportionate amount of SSCs required to ensure their workers.

**A better option would be to levy SSCs as a percentage of actual income, which is the common practice in OECD countries.** This means that part-time workers would contribute and receive social benefits by making contributions proportional to part-time incomes. Such a measure would avoid penalising low-income workers, would no longer discourage part-time work and would strengthen workers' incentives to work in the formal sector. Levying all SSCs on actual income would also enhance the overall progressivity of the tax and benefit system as low-income workers would contribute less for the benefits that they receive.

**Levying SSCs on actual earnings instead of on a minimum threshold or reducing SSCs for low-income workers would nevertheless most likely come at a budgetary cost, which would need to be compensated.** To continue ensuring the adequate funding of the social security system, some social benefits – in particular those where there is no clear link between the level of contributions and the level of benefits such as family allowances or health insurance – could be financed through taxes that bear on tax bases other than labour income, including corporate income, consumption or property. Some OECD countries (e.g. France through the *contribution sociale généralisée* – CSG) partly finance their social security systems through such taxes. Shifting part of the financing of social benefits onto general taxes would require close co-operation between the Ministry of Hacienda and social security funds.

**To address informality among small firms, the government is currently discussing a Bill which proposes that micro-companies joining the formal sector would be partially exempt from SSCs for four years.** The programme would lower employer's contribution rate to health insurance and anti-poverty programmes, resulting in a total reduction of SSCs of 12.5 percentage points, almost cutting in half the rate payable by employers (OECD, forthcoming). Because the SSC cut is limited to four years, after which employers would pay the full amount of SSCs, the programme would minimise the budgetary cost associated with the measure.

**An earned income tax credit (EITC) could also be a useful tool to reduce informality and poverty.** EITCs – or work-contingent tax credits – are an important tax policy tool used in many OECD countries to address concerns regarding unemployment and inactivity traps. These measures have the dual goal of alleviating poverty and increasing



incentives to work, which they achieve by targeting low-income workers (often with children) and imposing some form of work-contingent eligibility rule (Box 3.2). An EITC could be very relevant in the Costa Rican context as it would provide incentives for people to register with the tax authorities to receive the credit and encourage individuals working in informality to put pressure on their employers to become formal (Perry et al., 2007).

### Box 3.2. In-work tax credits

**Work-contingent tax credits or benefits are one of the main measures used in many OECD countries to address concerns regarding unemployment traps and inactivity traps.** These measures have the dual motivation of poverty alleviation, and increasing incentives to work. They achieve this by targeting low-income workers (often with children), and imposing some form of work-contingent eligibility rule.

**In-work credit schemes are a long established component of the tax-benefit systems in some countries including the UK, US, and have had overall positive effects on employment.** Theoretically, in-work credits can have conflicting effects on employment, increasing the incentive to enter employment, but reducing work incentives for those already in employment. However, empirical evidence (based particularly on the US and UK schemes) shows that the overall impact of these schemes on employment is positive.

**There are large variations in design across countries, particularly regarding eligibility rules and targeting, credit levels, withdrawal rates and payment methods.** Regarding eligibility criteria, countries either require a certain number of hours to be worked each week, or a minimum amount of income to be earned from employment. Additionally, seven countries require the presence of children for eligibility (while the number of children in a family increases the value of credits in six countries). Most countries also target the credit by income level. This is generally achieved by withdrawing the credit as income increases above a certain level. Rates of withdrawal, however, vary significantly. The size of the credit, which is to some extent linked to the withdrawal rate (e.g. large credits tend to be phased out more quickly to limit the fiscal cost), also varies greatly.

#### **Countries have tended to adopt one of three broad approaches:**

- High withdrawal rates and generous credits: To maximise the effectiveness of credits at increasing employment (as well as at reducing in-work poverty) a number of countries provide credits at relatively high rates. This is particularly the case in Ireland, the UK, the US, New Zealand, and Belgium where maximum credit payments are all greater than five per cent of the average wage. Ireland in particular is very generous with a maximum credit greater than 20 per cent of the average wage. To reduce fiscal costs, these countries all withdraw these credits at relatively high rates (20 per cent or greater), thereby accepting relatively high marginal effective tax rates (METRs) as a consequence. Ireland is the extreme case with an effective phase-out rate of 60 per cent, emphasising the predominant focus of the Irish FIS on poverty reduction rather than employment goals.
- Low withdrawal rates and smaller credits: Some countries that are more concerned about the negative consequences of high METRs choose to phase out credits over a wider income range, thereby reducing the size of METR increases (but extending the income range facing the increases). However, when limited funding is available this necessarily results in lower credits, which may pose concerns for the effectiveness of the credits at increasing employment and reducing in-work poverty. That said, the lower phase-out rate means they are available to a wider range of workers, potentially providing incentives for some middle-income earners also to move into work or to increase hours worked in order to meet eligibility requirements for the

### Box 3.2. In-work tax credits (continued)

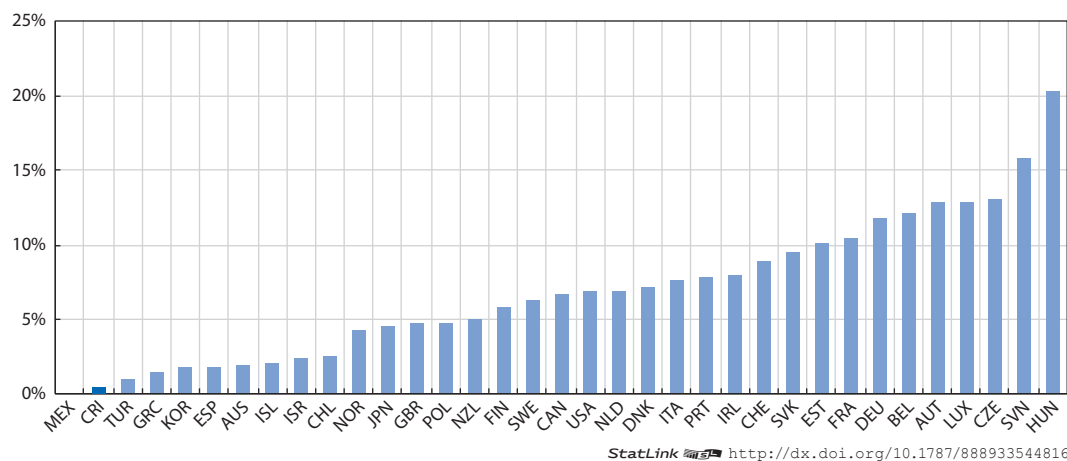
credit. Conversely, this also means that higher METRs are faced by a greater income range, potentially resulting in some workers reducing the number of hours they work. Countries in this category include Canada, France, and Spain (earned income credit).

- Low-to-moderate withdrawal rates and generous credits: Another group of countries also have lower withdrawal rates due to concerns regarding high METRs, but still desire substantial credit amounts in order to achieve a significant work incentive. These countries accept higher fiscal costs in order to achieve this. Denmark, Sweden and the Netherlands are particularly strong examples of this. Concerns in these countries about high withdrawal rates are particularly great for two reasons: first, labour is already taxed at high rates so METRs are already high; and second, the income distributions are particularly narrow, especially those of Denmark and Sweden. As a result, high withdrawal rates over even a small income range would affect a very large number of workers.

## Consider making child tax credits more generous to lower the tax burden on families with children

**Labour taxes and cash benefits do not vary much with family size and composition.** SSCs, which account for the bulk of taxes on labour income, do not differentiate across different family types, and family cash transfers are small and targeted at households in extreme poverty (OECD, forthcoming). Figure 3.8 shows that there is almost no difference between the net take-home pay (income after taxes and transfers) of similar households with and without children, reflecting that the tax and benefit system is rather insensitive to

Figure 3.8. Net take-home pay ratios between a household with and without children (%) in 2015



*Note:* The ratios are calculated as the difference between the net take-home pay (i.e. income after taxes and benefits) between a household with two children and another without any children as a percentage of the net take-home pay of a family without children. Both households are composed of married couples with one spouse earning the average wage in the country and the other spouse earning a third of that amount.

*Source:* OECD (2016) *Taxing Wages 2016*, and OECD/IDB/CIAT (2016), *Taxing Wages in Latin America and the Caribbean 2016*, OECD Publishing, Paris.

the presence of children in the households (OECD, forthcoming). This contrasts with many OECD countries where the disposable income of households with children is significantly greater than that of similar households without children.

**Given that child poverty is high in Costa Rica, making greater use of family tax credits to lower the tax burden on families could be considered.** Costa Rica offers a tax credit per child amounting to CRC 16 080 (approximately EUR 27). This level is low compared to similar provisions in OECD countries. If Costa Rica managed to raise additional revenues through the planned tax reforms, it could enhance the generosity of its child tax credit, in particular given the country's poor performance on child poverty indicators (OECD, forthcoming). Increasing child tax credits could also be a way to compensate households for the possible regressive effects of VAT base broadening if the VAT reform is approved.

### **The “final” withholding of PIT on employment makes it difficult to provide targeted tax support through the PIT system**

**Generally, the withholding of PIT on employment and other types of income helps to raise tax compliance.** Except for Switzerland, PIT levied on employment income is administered in all other OECD countries through a withholding tax system. In Switzerland, PIT is administered at the cantonal level; as cantons are relatively small and individuals may work in a different canton than the canton where they live, PIT withholding becomes more difficult to implement in Switzerland. PIT withholding systems also exist in most major non-OECD countries including Brazil, China, India, and Russia.

**Where both withholding taxes and third party information apply, compliance reaches around 99 percent in advanced countries (IMF, 2015).** Imposing the obligation on independent third parties such as employers and financial institutions to withhold an amount of tax from payments of income to taxpayers brings three major advantages. It enhances tax compliance; the timely remittance of amounts withheld by third parties to the revenue body ensures a regular flow of revenue to government and assists budgetary management; it is a more cost efficient way for both taxpayers and the revenue body to transact the payment of taxes (i.e. lower compliance and administrative costs).

**Costa Rica implements an imperfect “cumulative” withholding regime for employment income.** The cumulative withholding regime aims to ensure that for the majority of employees the total amount of taxes withheld over the course of a fiscal year matches their full (fiscal) year tax liability. To the extent this is achieved, employees are then freed of the obligation to prepare and file an annual tax return, but they are allowed to do so if exceptional circumstances would have resulted in too many taxes having been withheld. Under this approach, employees are required to provide employers with details of relevant entitlements to assist them determine the amount of tax to be deducted from their earnings. In some countries (e.g. Ireland and UK), employees provide this information to the revenue body which in turn advises the employer of a code that determines the amount of tax to be deducted from earnings. Employers withhold tax from income paid, as required, determining amounts to be withheld on a progressive/cumulative basis over the course of the fiscal year. Under the cumulative approach, employees tend to have few entitlements (that reduce tax payable) as this enables greater accuracy in calculating the amount of taxes withheld over the course of a fiscal year vis-à-vis their end-of year tax liabilities. When employees change jobs or have been previously unemployed, the new employer would have to take those changes in income into account in order to again

withhold the appropriate amount of taxes such that the total amount of withheld taxes during the year math the full-year tax liability. However, this is not the case in Costa Rica.

**Inequities arise as PIT is withheld irrespective of previously earned income.** In Costa Rica, PITs are withheld on a monthly basis not taking into account previously earned income during the fiscal year. Taxpayers that face a steady stream of employment income will therefore pay a different amount of tax than employees who earn the same total amount of income over the year, but earn high income in some months and less or no income in other months of the fiscal year. This clearly undermines the fairness of the tax system.

**The more common alternative is the “non-cumulative” PIT withholding approach.** The “non-cumulative” PIT withholding system operates on a “pay period” basis for each employee. Employers withhold taxes for each pay period having regard to their gross income, taking some but not necessarily all entitlements into account (that may reduce the amount to be withheld) and the rate of withholding to be applied. Where an employee changes jobs, the new employer simply commences the withholding process on the employee’s future income without regard to his/her previous employment withholdings. However, as this approach involves a less precise form of withholding, the amount deducted for each employee over the course of a fiscal year represents only an approximation of their full fiscal year’s tax liability. In these circumstances, employees are normally required to file annual tax returns to ensure that the correct overall amount of tax is paid (and to obtain a refund of any overpaid tax), taking account of all categories of assessable income and entitlements (e.g. tax deductions and credits).

**“Final” withholding of PITs on monthly employment income, as is the case in Costa Rica, makes it difficult to provide targeted tax support through the PIT system.** Costa Rica implements two limited tax credits: a monthly tax credit for each dependent child (CRC 1 490) and a monthly tax credit for a spouse in a married couple (CRC 2 230); both tax credits have only a minor impact on the overall tax burden on employment income. Indeed, the fact that taxes on employment income are withheld by the employer on a monthly basis and that these withheld taxes are the final taxes that have to be paid, irrespective of employment income earned in the rest of the year, makes it difficult to provide more targeted support to particular families through the PIT system.

## **Labour taxes introduce distortions between employees and self-employed and professional workers**

**In contrast to common practice in OECD countries, the PIT system in Costa Rica taxes employment and personal business income separately.** Personal business income has to be declared by the taxpayer on a yearly basis. PIT on employment income, on the other hand, is withheld by the employer on a monthly basis. The tax rates on employment income range from 0% up to monthly income of CRC 793 000 (EUR 1 320), 10% and 15% on monthly employment income exceeding CRC 1 190 000 (EUR 1 980) while personal business income is taxed under a 5-bracket rate schedule with tax rates ranging from 0% to 25% (Table 3.2).

**SSCs levied on employment income are significantly higher than SSCs paid by the self-employed.** As mentioned before, employee SSCs are levied on employment income at a flat rate of 9.34% in 2015 and employers pay SSCs at a rate of 26.33%. By contrast, the self-employed pay SSCs on their personal business income at rates which are increasing with income and vary between 8.25% and 19.59%. Nevertheless, the total contribution

rate is the same for all self-employed workers, irrespective of their income, because, unlike any OECD country, the central government contributes for self-employed workers' health, maternity and first-tier pension (with the government contribution rate decreasing with income). Another major difference between the tax treatment of employees and self-employed workers is that, contrary to employees who are required to pay a minimum amount of SSCs if their earnings are below a certain threshold, independent workers earning below that minimum contribution base are exempt from contributions.

Table 3.2. **Personal income tax rates: employment income (Panel A) and business income (Panel B), 2016**

A. Employment income Monthly PIT rate schedule		B. Business income Annual PIT rate schedule	
up to 792 000	exempt	up to 3 517 000	exempt
792 001 – 1 188 000	10	3 517 001 – 5 251 000	10
over 1 188 000	15	5 251 001 – 8 760 000	15
		8 760 001 – 17 556 000	20
		over 17 556 000	25

Source: IBFD Database.

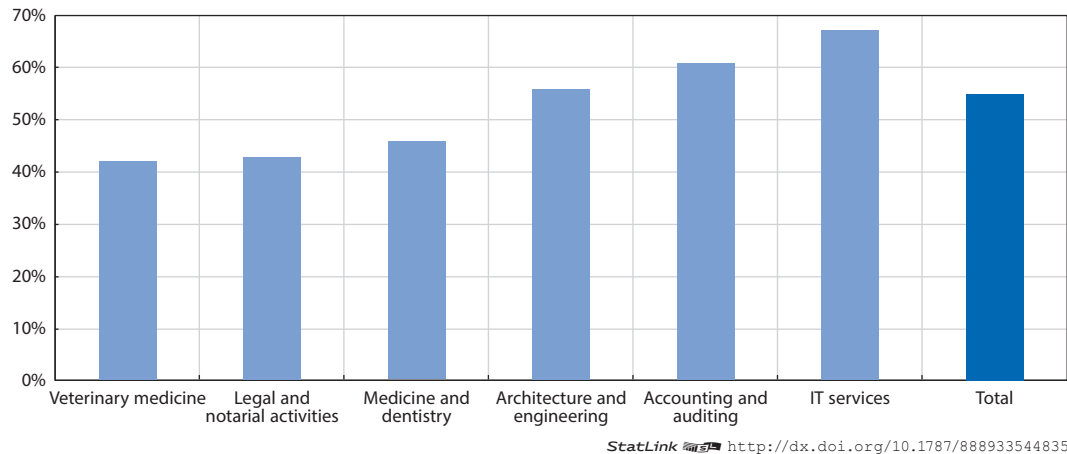
**Differences in the tax treatment between employees and self-employed workers create significant incentives to work as independent workers as well as tax avoidance opportunities.** The much lower SSC burden on self-employed workers as well as the absence of a minimum level of contributions provides incentives for formal workers to work as independent workers. In addition, in order to lower their overall tax burden on labour income, formal workers may have an incentive to work part-time as employees and the rest of the time as self-employed workers. This allows workers to benefit from the exempt amount of income under both tax rate schedules and to spread their total income into two separate taxable sources which implies that less income will be taxed at top PIT rates. This tax treatment violates the horizontal equity tax principle, as taxpayers earning the same amount of income but receiving it through different sources are taxed differently. It also violates vertical equity as higher income earners do not necessarily pay higher taxes than lower income workers. The different tax withholding approaches and the lower SSCs for self-employed workers have also provided incentives for employers to hire “dependent workers” in the form of self-employed labour. A better alignment between the SSCs paid by self-employed workers and employees could help address this issue.

### Costa Rica also suffers from widespread tax avoidance in liberal professions

**Tax avoidance is widespread among liberal professions.** Income earned by professionals such as lawyers, architects, doctors, dentists and accountants through the rendering of independent professional services, is taxed in the same manner as personal business income. For professionals who do not maintain accounting records or do not issue receipts, they pay taxes over a presumed income. The presumption is either 250 or 335 times the basis salary depending on the profession. However, tax avoidance by those professions was reported as a critical issue. A report found that in 2015, about 55% of the physical and legal persons rendering profitable professional service activities declared zero income tax (Figure 3.9). On average, this share remained relatively constant over the 2011-15 period at an average of 56% (report *Contraloría General de la República*). The share of professionals who reported zero

income tax is particularly high in accounting and auditing and information and technology (IT) services (Figure 3.9). The report also found that a total of 53 005 taxpayers (86% of the total), accounted for about 48% of assets and 30% of gross earnings of the total group; while accounting for only 9% of total taxes paid (Table 3.3).

Figure 3.9. Share of taxpayers declaring zero income tax in different liberal professions in 2015



Source: CGR (2016).

Table 3.3. Income tax declared by liberal professionals in 2015

Income tax declared (in CRC)	Number of taxpayers	% of taxpayers	% of taxes paid	% of gross earnings	% of assets
Equal to zero	33 527	54.8%	0.0%	9.6%	21.9%
[1 – 500 001]	19 478	31.8%	9.1%	20.2%	26.5%
[500 – 1 000 001]	3 042	5.0%	7.1%	7.9%	7.0%
[1 000 001 – 1 500 001]	1 430	2.3%	5.8%	5.2%	5.0%
[1 500 001 – 2 000 001]	850	1.4%	4.8%	4.3%	3.5%
[2 000 001 – 2 500 001]	599	1.0%	4.4%	3.5%	2.7%
[2 500 001 – 3 000 001]	323	0.5%	2.9%	2.3%	1.8%
[3 000 001 – 10 000 001]	1 489	2.4%	25.9%	17.1%	13.2%
Over 10 000 001	471	0.8%	39.8%	29.8%	18.4%
Total	61 209	100%	100%	100%	100%

Source: CGR (2016).

**Liberal professions can easily underreport their income or overstate deductible expenses.** Many professionals do not receive payments for their services via debit or credit cards and do not issue receipts for payments in cash, which allows them to underreport their income. Liberal professions can also easily over-report deductible expenses or claim expenses that should not be claimed (e.g. inclusion of personal expenses or partners' expenses such as luxury vehicles, high-value property, the construction and/or interest payments on housing, land acquisition, school payments for children).



**Widespread tax evasion among liberal professions undermines the integrity of the tax system.** Tax evasion by liberal professions significantly erodes tax revenues. It also undermines the integrity and the fairness of the tax system and ultimately negatively affects tax morale. Finally, this form of evasion is likely to reduce the overall progressivity of the tax system as professionals tend to earn high incomes.

**Further efforts are needed to reduce tax avoidance among liberal professions.** Establishing rules requiring all professionals to maintain accounting records and issue receipts would increase tax compliance. In addition, mandatory electronic invoicing should be speeded up to address the underreporting of income. This process has been delayed several times; the government is now developing a system to use digital invoices which is expected to be launched in June 2017. A stricter definition of deductible expenses should also be considered. For instance, deductions from taxable income of expenses paid in cash above a low minimum threshold could be disallowed. The tax administration should also be granted more authority to control deductible expenses. In theory, the tax administration may disallow the deduction of payments deemed excessive but the Administrative Court ruled in Decision 122-07 that the tax administration cannot disallow expenses only through the application of the economic reality principle and that all documentation (usually invoices and accounting records) provided by the taxpayer as proof must be taken into consideration. Finally, more targeted audits focusing on riskier professions are needed to fight tax avoidance and evasion by professionals.

**The planned VAT reform could indirectly strengthen PIT compliance among liberal professions.** The reform plans to apply VAT broadly to services (with a few remaining exceptions). Thus, businesses would have to be registered to be able to deduct input VAT on their business to business (B2B) transactions. Costa Rica could also consider providing a PIT credit for the VAT paid on certain services.

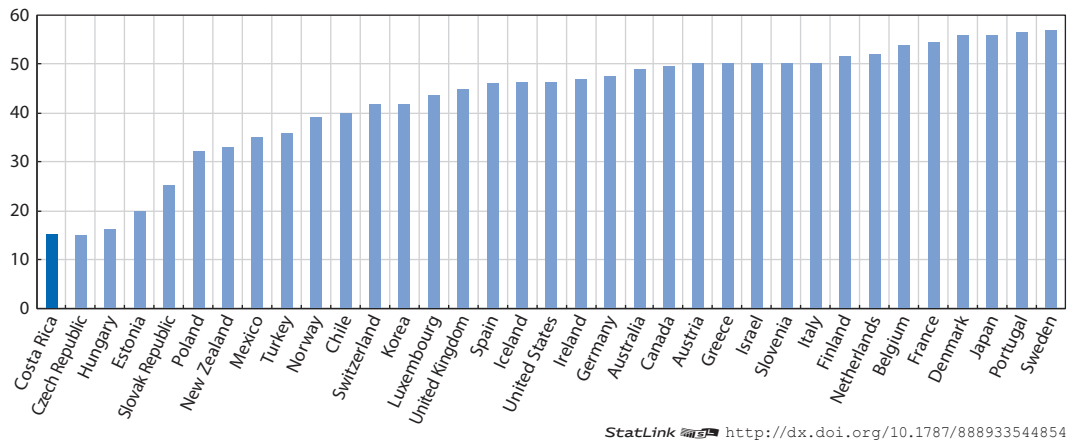
### **PIT does not contribute to income redistribution**

**The top PIT rate for employees is low in comparison with OECD and LAC countries.** The current top PIT rate of 15% on income exceeding CRC 1 181 000 is much lower than the average top PIT rate in OECD countries which reached 43.6% in 2015 (Figure 3.10). The only country in the OECD that has a similar statutory top PIT rate is the Czech Republic, which is an uncommon case as Czech Republic has a flat PIT rate and the taxable base is labour costs as opposed to gross earnings (meaning that employee and employer SSCs are taxable). Costa Rica's top PIT rate is also low compared to LAC countries (Figure 3.11). Costa Rica's relatively low top statutory PIT rate may be partly explained by the fact that it starts being levied at relatively low income levels (Figure 3.12).

**The 2017 tax reform proposal includes an increase in the top PIT rate with the inclusion of two additional tax brackets and rates.** Employment income would become subject to two additional tax brackets: incomes exceeding CRC 2 225 000 and income above CRC 4 450 000 would respectively be taxed at the rates of 20% and 25%. This would increase PIT progressivity and bring Costa Rica closer to top PIT rates in OECD and other LAC countries. This would also be in line with recent trends of top PIT rate increases in OECD countries (OECD, 2016).



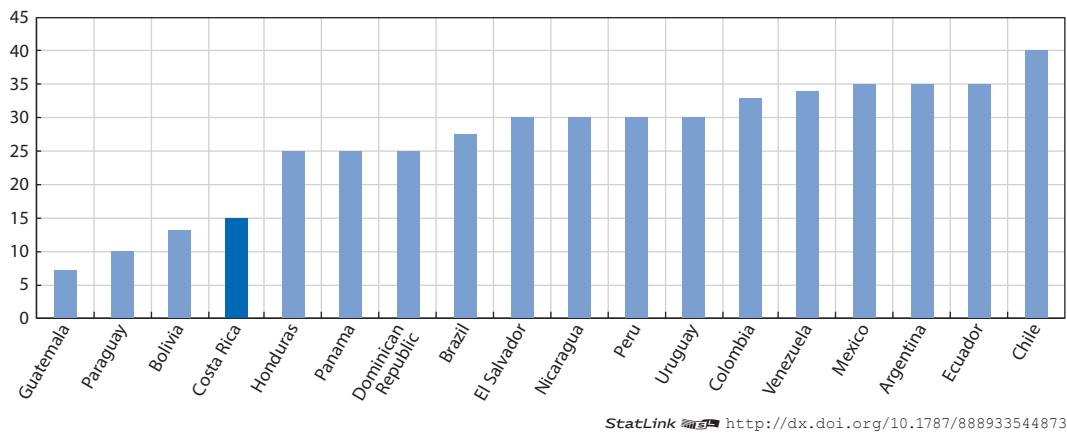
Figure 3.10. Top statutory PIT rates in Costa Rica and OECD countries in 2015



Note: Information on data for Israel: <http://dx.doi.org/10.1787/888932315602>.

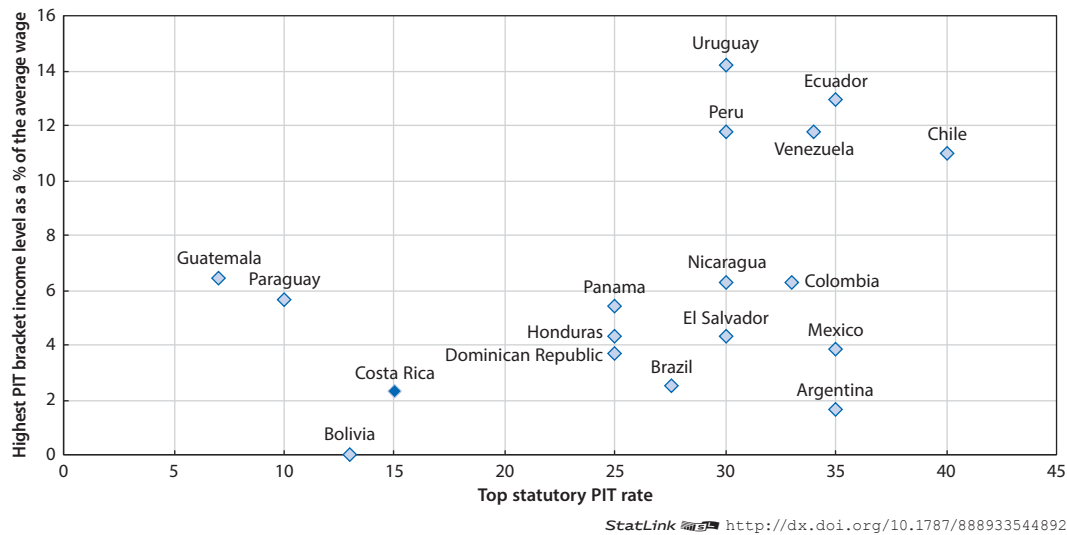
Source: OECD Tax Database.

Figure 3.11. Top statutory PIT rates in LAC countries in 2016



Source: IBFD Database.

Figure 3.12. Top statutory PIT rates and income levels levied in LAC countries



Source: Based on Barreix et al. (2017).

**Effective PIT rates show that PIT is progressive in Costa Rica but that effective PIT burdens are very low, including for high-income earners.** Table 3.4 shows what proportion of gross income has been effectively paid as income tax across income deciles. In Costa Rica, PIT payments as a share of income increase with income, which means that PIT is effectively progressive. However, average PIT rates are very low, including for taxpayers in the top income decile. Indeed, average PIT rates in the top income decile amount to about 4.5%, far below the statutory tax rate of 15%. This rate is also low in comparison to effective PIT rates on top income earners in many other LAC countries. Additional PIT brackets and rates would contribute to further increasing progressivity and raising the tax burden on high-income earners but those measures would also have to be accompanied by base broadening measures and stricter tax enforcement.

Table 3.4. **Personal income tax: observed average rates by income decile**

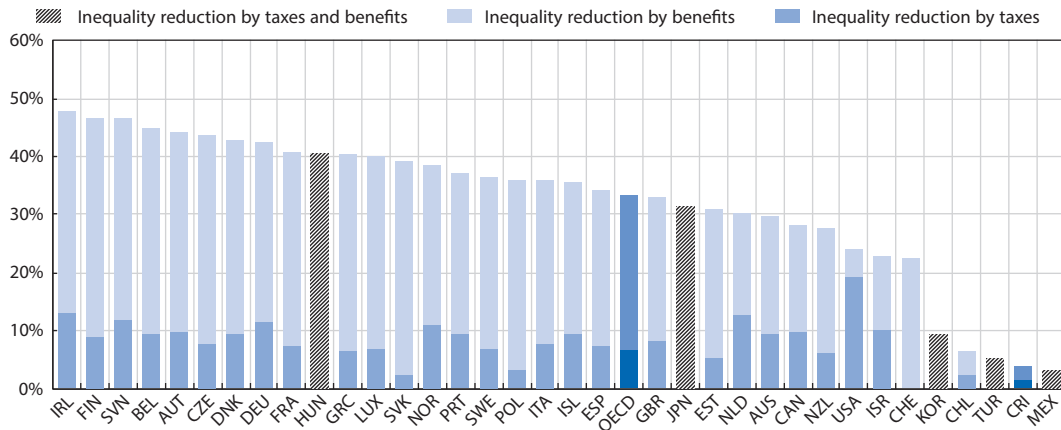

Deciles	I	II	III	IV	V	VI	VII	VIII	IX	X	Average
Argentina	2.6	3.1	3.9	6	7.7	8.6	10.1	11.9	14.3	20.5	8.9
Bolivia	0	0	0.6	2.6	4.1	5.4	6.7	7.7	8.8	11.3	4.7
Chile	0	0	0	0	0	0.1	0.1	0.3	0.8	10.4	1.2
Costa Rica	0	0	0.1	0.1	0.1	0.3	0.4	1.2	1.9	4.5	0.9
Honduras	0	0	0	0	0	0	0	0	0	5.8	0.6
Ecuador	0	0	0	0	0	0	0	0.3	0.9	2.6	0.4
Mexico	-0.2	0	0.3	0.9	1.1	1.6	2.8	3.3	5.8	6.8	2.2
Paraguay	0	0	0	0	0	0	0	0	0	0.03	0
Peru	0.2	0.3	0.4	0.4	0.3	0.3	0.5	0.7	2.8	13.2	1.9
Dominican Republic	0	0	0	0	0	0	0	0	0.9	12.6	1.4
Uruguay	0	0	0	0	0	0.1	1.5	4.5	8.3	14	2.8
Average	0.2	0.3	0.5	0.9	1.2	1.5	2	2.7	4	9.2	2.3

*Note:* The rates derive from the ratio between the tax or resulting benefit, in the case of refunds, in the tax year and the gross income of each income decile according to the returns received by the tax administrations. The rates indicate what proportion of gross income has been effectively paid as income tax.

*Source:* Barreix et al. (2017).

**Despite being progressive, the very limited revenues from PIT constrain the income tax's redistributive effect.** In OECD countries, even if transfers typically play a much greater role in narrowing income gaps, taxes – in particular PIT – have an important effect on income redistribution. On average, three quarters of the reduction in inequality between market and disposable incomes are due to transfers while taxes account for the remaining quarter of income redistribution (Figure 3.13). In Costa Rica, however, PIT does not contribute to reducing income inequality. Even if the PIT is designed to be progressive, in practice it raises far too little revenue to have an effect on the distribution of income. Limited revenues from PIT is one of the factors accounting for the very small difference between Gini coefficients before and after taxes and transfers in Costa Rica compared to other countries (Figure 3.13).

Figure 3.13. Reduction in income inequality due to direct taxes and cash benefits in 2013

StatLink  <http://dx.doi.org/10.1787/888933544911>

Notes: Data refers to 2009 for Japan; 2011 for Canada; 2013 for Chile; 2015 for Costa Rica. OECD refers to the simple (unweighted) average of the OECD countries.

Source: OECD (forthcoming), OECD Reviews of Labour Market and Social Policies: Costa Rica, based on OECD Income Distribution Database, <http://oe.cd/idd>.

### The lack of integration between the PIT and SSC systems limits the efficiency and redistributive potential of labour taxes

**There is a lack of integration between the PIT and SSC systems in Costa Rica.** The Costa Rican social security system is divided into different institutions including the *Caja Costarricense de Seguridad Social* (CCSS), the *Fondo de Desarrollo Social y Asignaciones Familiares* (FODESAF), IMAS and INA. The CCSS is by far the largest one and constitutes a separate distribution mechanism which needs to balance its own budget. This is particularly challenging as certain welfare provisions, such as health care, are “universally” available also to households which did not pay matching social security contributions. This is the case, for instance, for workers in the informal sector. In order to prevent extreme poverty among the elderly, workers in the informal economy are also entitled to an, albeit very low, minimum pension. In addition, the CCSS is entitled to raise SSC rates without the Parliament’s approval, which creates uncertainty for workers and employers.

**The lack of integration between the PIT and SSC system lies at the heart of the labour market challenges which Costa Rica is facing.** Because they have to finance their own expenditure, social security funds including the CCSS end up levying very high tax rates, without taking into consideration the economic impact of SSCs on work incentives and on the cost of employment. It results also in large incentives for workers and their employers to continue working in the informal economy.

**In addition to funding social security programmes, Costa Rican SSCs are used to fund programmes other than social security programmes.** This raises the tax wedge on labour income even further, which in turn deters the creation and formalisation of employment, and reduces the progressivity of the tax system (see above). The government should avoid using SSCs to fund public banks and antipoverty programmes and should rely, for those purposes, on other more progressive taxes such as PIT. However, this shift in financing would require a greater integration across the different institutions in the social security system as well as between the PIT and the SSC systems.

**A better integration between the PIT and SSC systems could be achieved in different ways.** Countries' experiences differ in that regard. Of the 32 OECD countries with SSC regimes, 13 have integrated their collection with tax administration operations while the rest administer their collection through separate social security bodies (although integration has also been considered as a possibility in the future or is being studied in Czech Republic, Greece, Portugal and Slovak Republic). In those countries where separate arrangements exist for tax and SSC collection, the overlapping nature of the revenue collection responsibilities of the different bodies and their client base present opportunities for co-operation and mutual assistance. This occurs in various ways, e.g. through the use of common audit programmes, information exchange between agencies, assistance with enforced collection of unpaid SSCs and collaboration to streamline information exchange procedures (OECD, 2015). In general, this highlights the importance of digitisation and exchange of information. In that sense, Costa Rica should move towards adopting a system where fiscal and SSC information can be linked together.

The tax policy recommendations that can be drawn from this analysis are as follows:

### Recommendations

- Lower the PIT threshold under which no PIT has to be paid.
- Make employee SSCs deductible for personal income tax purposes.
- Levy all SSCs as a share of actual income.
- Consider lowering the tax burden on low-income workers by lowering SSCs or introducing an earned income tax credit.
- Consider funding some social benefits, in particular non-contributory programmes such as FODESAF and IMAS, through general taxes.
- Possibly enhance the generosity of family tax credits to lower the tax burden on families with children.
- Tax employment and personal business income under the same PIT rate schedule.
- Introduce additional PIT brackets and, in particular, raise the top PIT rate over time.
- Move from a monthly assessment basis towards an annual assessment of PITs levied on employment income and allow taxpayers who earn employment income to file a tax return at the end of the year.
- Increase efforts to address tax evasion by liberal professions.
- Better integrate the PIT and SSC system, in particular through enhanced exchange of information.

### Note

1. Table III.1 in the OECD Tax Database provides more information on the deductibility of employee SSCs from the personal income tax base: see [www.oecd.org/ctp/tax-policy/Table%20III.1-Mar-2015.xlsx](http://www.oecd.org/ctp/tax-policy/Table%20III.1-Mar-2015.xlsx).

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