ADVANCING THE CENTRAL AMERICAN CUSTOMS UNION

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ABBREVIATIONS

CA	Central America
CAFTA	Central America Free Trade Agreement
CACU	Central American Customs Union
CET	Common External Tariff
CM	Common Market
CU	Customs Union
DSA	Digital Signature Algorithm
EMU	Economic Monetary Union
EU	European Union
FIPS	Federal Information Processing Standard
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GPS	Global Positioning System
IMF	International Monetary Fund
ITC	Information Technology and Telecommunications
MFN	Most Favored Nation
NAFTA	North American Free Trade Agreement
RIA	Regional Integration Arrengements
SIECA	Central American Secretariat for Economic Integration
VAT	Value Added Tax
WCO	World Customs Organization
WTO	World Trade Organization

SUMMARY

The purpose of this paper is to put forward specific actions to advance the implementation of the Central American Customs Union (CACU) in the area of Tax and Customs Administration (TCA). The CACU Agreement signed in 2008 by Guatemala, El Salvador, Honduras, Nicaragua, and Costa Rica can become a driving force for economic growth and poverty reduction in a region of low income economies.

Central America (CA) has been considered a strong case for integration due to the potential economic impacts on trade creation and the area's relatively low potential for trade deviation, as well as for the similarities in economic, social, and cultural background in the region.

The investments, economic dynamism, technical and administrative actions, regional coordination, political cooperation and institutional building required to implement the Customs Union could result not only in the expected free trade and economic benefits but also in democratic, social and political strengthening that will contribute to good governance and poverty reduction.

A successful implementation of the CACU could also lead to an increased relative weight of Central America when negotiating, as a sub region, with its main trading partners and attracting more interest for investment and trade from other economic blocs. This in turn, may contribute to the CA countries in their aim for more balanced political and strategic relationships with other States.

During the past five years, the CA countries have made significant progress in their integration process generating results such as: (1) product diversification towards more value added exports; (2) intraregional free trade in force for more than 92 percent of tariffs; (3) intraregional trade representing a third of total commerce; (4) the common external tariff (CET)

currently 95 percent harmonized, with few exemptions, including those negotiated with its main trading partner (the United States) in their FTA; (5) joint customs posts at the most important regional borders; (6) improvements in the degree of banking, financial, and fiscal coordination; and (7) a new common customs code, norms, and regulations. The signing of the CACU Agreement was the most recent milestone.

Despite these important steps, the region faces a long-term process of complex challenges, decisions, negotiations, and execution of plans and strategies to make the CU a reality.

The expected benefits and incentives of the CACU to all of its private and public partners are considerable, but implementation is a complex and long-term process requiring political commitment, leadership, and technical competence from the member countries.

No estimates of benefits and costs derived from the implementation of the CACU have been made public, but according to the experience of other Custom Unions and concerns raised by fiscal authorities in the region, the implementation of FTAs and CUs may generate tax revenue losses due to the intrinsic decrease in tariff collections. In the Central American case, the tariffs have already lost their importance as a source of collection but if no preventive actions are taken, the CU will probably decrease value added tax (VAT) revenues and increase opportunities for contraband and evasion.

It is clear that the matter of potential revenue losses needs to be further and seriously studied to determine its extent and specific sources; but strategically considered, gains and incentives for fiscal institutions have to be in place if proactive involvement and strong leadership from the Tax and Customs Administrations are to be expected for the CACU implementation.

Technicians from the different government agencies involved in the implementation of the CACU as well as experts from international institutions such as the International Monetary Fund (IMF) have made important contributions to identify relevant information, successful cases, and possible strategies, requirements, and actions to implement the Union.

Complementing those initiatives, the proposal in this document presents concrete, specific projects with strategic implications to generate incentives for TCAs in terms of capacity-building and increased control for law enforcement; to create incentives for the private sector regarding trade facilitation at the border; to build positive experiences of collective regional management and to offset potential tax revenue losses.

The specific proposals are: a) a Central American Authorized Economic Operator Program –CA/AEO; b) exchange of information on mismatch of import/export operations with main trade partners; c) a regional and international transit control system; d) a regional system of electronic invoice; e) a regional electronic system for non-tariff control at the border; f) implementation of a regional data base of electronic cargo manifests and documentation for customs release of goods; and g) implementation of a regional certification of institutional and operational standards for customs.

INTRODUCTION

The purpose of this paper is to propose specific actions to advance the implementation of the CACU in the area of Tax and Customs Administration. The CACU Agreement signed in 2008 by Guatemala,, El Salvador, Honduras, Nicaragua, and Costa Rica can become a driving force for economic growth and poverty reduction.

CA[1] is potentially a strong case for integration. Evidence shows that the process has resulted in trade creation, while trade deviation[2] was limited once the protectionist policies and inward-oriented approaches from the initial phases of integration were reoriented during the 1990s.[3] The region is also a case of small trading countries unable to influence international terms of trade or to cease trading entirely with non-member countries. They also have common trading partners, no remarkable differences in economic size and present similar economic, political, and cultural backgrounds and characteristics.[4]

In practice, the last two decades of free trade policies and progress in integration have been welcomed by the private and public sectors, since the reality of globalization and the pro-competitiveness policy approach have created a new framework for intraregional commerce, finance, and investment. During the last few years, the integration process has produced new regional partnerships, and more businesses with regional operations and investments, as well as

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[1]See appendix A for selected indicators.

[2]Increased trade of non-competitive regional goods replacing competitive imported goods from extraregional markets.

[3]During the research period, no evidence was found of empirical or analytical studies, publicly available, on trade deviation or trade creation of the CA integration process or of the potential impact of the Customs Union (CU) model.

[4]In the last decade Costa Rica has been differentiating itself from the rest of the region by increasing its industrial exports. It also has better social indicators than its neighbors.

new opportunities for the expansion of intraregional trade. In summary, for the first time in decades, improved policies and economic environments have created new business opportunities and renewed interest in regional integration.

On the public sector side, a high level of political willingness to advance regionalism but a slow pace of implementation of policies and legislation have characterized the process. In the last few years, even though the regional institutional framework is weak, renewed technical exchanges, new ministerial fora and progress in the strengthening of national institutions dealing with integration are enhancing the potential for implementation. A broader cooperation environment has also developed, including a higher degree of coordination of the financial, monetary, fiscal and tax areas, as well as some progress in joint projects for regional infrastructure.

One of the issues raised by fiscal authorities as an important cause for not moving forward at a more rapid pace in the integration process is the fact that, despite other important economic benefits, implementation of integration and free trade policies has had and could continue reducing tax collections, as it has occurred in other CU experiences.

The convergence of political willingness to integrate and economic interests from both the public and a critical mass of private sector players, has reached a level that has not been present in previous phases of integration. Hence, identifying policies, projects and measures to prevent further revenue loss and proposing actions to innovate the ways the CACU members have put integration into practice can contribute to the regional objectives and take advantage of the current pro-integration atmosphere.

During previous steps of integration, significant attention and effort have been placed on the negotiation of tariffs and legal and regulatory instruments. Building institutions and working on standardized procedures, systems, and practices have been left behind and mostly in the hands of customs and tax managers, with little involvement of high-level economic authorities.

One of the key areas to make this new phase of integration become real is the field of tax and customs. Trade operations and investment opportunities are significantly determined by the way the legislation, processes, administration, conflict resolution, and judiciary cases actually work in that matter.

To accomplish the intention of this study, the first chapter, on policy background, includes relevant information on regionalism and free trade taken from the literature related to CUs. In the next chapter, on the CACU, a brief summary of the integration process and the regional economic outlook is presented. Chapter 3 examines means of advancing the implementation of the CACU in the area of tax and customs, while Chapter 4 presents specific proposals of regional projects.

CHAPTER 1

POLICY BACKGROUND

Most economists and politicians believe free trade to be a crucial factor in fostering economic growth and development. Multilateral negotiations and regional agreements have been the instruments used to pursue this objective at a global level.

The most important achievements of multilateral trade negotiations have been the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), with their mechanisms and agreements. Multilateralism has been considered the “first best” approach to advance free trade, because it is based on the most-favored nation (MFN) principle which, in theory, leads to fair, efficient, general, competitive, and non-discriminatory trade.

In practice, the high degree of complexity, endless rounds of negotiations, limited influence over other countries’ viewpoints, and frequent frustration with the meager results have diminished the willingness of many nations around the world to actively and continuously engage in multilateral trade negotiations aimed at removing important trade barriers and preferential treatments that still in place in developed and developing countries.

This situation and the common interests of particular groups of nations have led to regional agreements that are considered the “second best” approach to promote free trade, since goods, services, investments, and other matters originating in non-regional countries are not granted the same treatment as those originating in the countries covered by the regional agreement, thus creating subsets of trade rules for different regions.

Even though each regional arrangement has its own characteristics, they can be classified as follows:

- Free trade areas (FTAs) or Free trade zones (FTZs): Tariffs and quotas are eliminated for goods originating in the FTA members, but they continue in place for non-member countries.
- Customs unions (CUs): Besides free trade among members, a common external tariff and a common trade policy are adopted for trading with non-members (including tariffs, non-tariff barriers, customs procedures, legislation, and coordination of trade and economic policy).
- Common markets (CMs): In addition to the characteristics already in place for a CU, this integration level will allow trade with no restrictions among the member countries as well as free movement of capital and labor. The degree of policy coordination is expected to be higher than in previous stages.
- Economic and monetary unions (EMUs): A high degree of common economic, trade and monetary policies is present. It can evolve to a monetary union, common laws, and strong regional institutions in the economic, labor, social, even the political arenas.

A more recent and widespread instrument for promoting free trade has been regional FTAs. Under these setups, the member countries immediately or gradually eliminate tariffs and non-tariff barriers to trade and agree on specific rules of origin. They may also agree on national treatment of investments and freer capital and labor movement, but they do not include a common external tariff.

There are more than 50 regional integration arrangements of different types in the world today. The largest two are the European Union (EU) and the North America Free Trade

Agreement (NAFTA). Most accords include developed and developing countries. The pace and ease of negotiations of these instruments and their implementation are determined by two main factors: their perceived and actual impact on the countries' economies and the quality of the institutions in charge of policy and operations in areas such as taxes, customs, agriculture, health, intellectual property rights, the environment, and other services.

An interesting document commissioned by the International Trade Division of the World Bank in 1998 titled "Integration Arrangements: Static Economic Theory, Quantitative Findings, and Policy Guidelines" (written by Dean A. De Rosa, principal economist of ADR International, Ltd., as a background paper for the World Bank Policy Research Report "Regionalism and Development") discusses the economic impact of regional integration.

The paper reviews the static theory of regional integration arrangements—starting with contributions to the CU issue by Viner (1950) and Meade (1955)—and considers the relevant findings of recent quantitative (analytical and empirical) studies of new and "revitalized" regional integration arrangements, identifying and analyzing the expected or actual impacts of regional integration agreements on trade and welfare of member countries, non-member countries, and the world at large. The paper also derives policy guidelines for advanced and less-developed countries considering joining either large or small regional trading blocs (De Rosa 1998: 84).

The policy guidelines and their potential effective and negative changes in the trade blocs summarized in Table 7 of that paper are included as Appendix A.

The comprehensive book *Regional Integration and Development* by Maurice Schiff and L. Alan Winters (World Bank, 2003) is one of the most important works for policy design in this matter. It covers regionalism as trade policy and how to take advantage of it; it analyzes regionalism and investment, growth and location, domestic policies, politics and their implications for the rest of the world. Lessons are derived from the interesting analysis presented in this book.

The following quote summarizes Winters' "Rules of Thumb for Regionalism":

> …Regionalism is too complex and sui generis to generate universal operational rules. We believe, however, that there are consistent lessons from the analyses that apply in most circumstances. These are collected as rules of thumb that are not inviolable, but should not be violated lightly. The rules are grouped into eight main messages:

- Use RIAs as a way of fostering competition. If an RIA is necessary, it should be used as a procompetitive instrument, with a focus on incorporating provisions that will foster greater competition in domestic markets.

- North-South dominates South-South. Not all partners are equal. RIAs with high-income countries are more likely to generate significant economic gains than are those with poorer ones.

- Credibility gains require explicitness. RIAs can enhance the credibility of economic and political reform programs, but generally only if they explicitly include provisions and mechanisms that directly affect the policies of interest.

- Only efficient RIAs are likely to help politically. RIAs can help solve political problems, but if they are economically wasteful or divisive, they could have opposite effects.

- Regional cooperation does not generally require trade preferences. The existence of widespread intercountry spillovers calls for cooperation between developing countries in areas other than trade policy, such as regulatory reform and provision of infrastructure. Usually, however, these goals should be pursued independent of trade discrimination.

- Beware of transaction costs in operating RIAs. Governments should consider carefully the transactions and implementation costs associated with different types of RIAs.

- RIAs may have positive or negative fiscal implications. The fiscal dimensions of RIAs are important for countries in which trade taxes generate a significant share of government revenue.

- Do not rely on the WTO to ensure that RIAs are beneficial. Countries should not rely on the WTO to ensure that RIAs are beneficial to members and to outsiders. The WTO forbids some destructive forms of regionalism, but its main contribution toward constraining the potential negative implications of

> regionalism for non-members is as an instrument for pursuing global liberalization on an MFN basis (Schiff and Winters, 2003: 25).

Another key issue in regional integration is the relationship between the degree of actual integration (implementation of agreements) and institutional development. This topic is analyzed in one of the few papers addressing this particular issue, “The Link Between Institutional and Economic Integration: Insights for Latin America from the European Experience” by Ettore Dorrucci, Stefano Firpo, Marcel Fratzscher, and Francesco Paolo Mongelli (European Central Bank, *Open Economies Review,* Volume 15, Number 3: July 2004).

The paper examines how economic and institutional integration are interrelated and whether there is a causal link between them. The authors found that: “Latin America is currently less economically integrated, not only, than the European Union today, but, for certain economic variables, even than the European Union in the 1960s. A VAR analysis illustrates that the link between institutional and economic integration has worked both ways throughout the European experience. There is also evidence that stronger institutional integration has indeed led to deeper economic integration.”

The paper concludes that:

> What the European experience … tells us is that the process of regional integration is a long one that can take many decades to complete and requires a strong political will and commitment from its participants. This process may also not be a continuous one, but may be characterized even by extended periods with little or no apparent progress, such as much of the 1970s in Europe. Another important implication of the European experience, as presented in the paper, is that strong efforts to strengthen institutional integration can indeed play a crucial role in furthering and deepening the degree of economic integration. Finally, over time the EU has experienced a dynamic interaction between the process of institutional integration and the fulfillment of certain criteria of economic integration. There is indeed no “automatic pilot” ensuring that a strengthening in institutional integration will bring about, for instance, higher intraregional trade, more synchronized business cycles, financial market integration, and nominal convergence. Rather, it means that, if the analysis becomes dynamic and forward-

looking, a virtuous circle may be identified between institutional and economic integration at the regional level. (Dorrucci et al., 2004: 258).

CHAPTER 2

THE CENTRAL AMERICAN CUSTOMS UNION (CACU)

The Integration Process

During the past five decades, Guatemala, El Salvador, Honduras, Nicaragua, and Costa Rica have been involved in a process of building ground for economic integration. Although during different periods the political will for integration has been strong, the reality has always been behind the written declarations and agreements. Tables 1 and 2 summarize the key aspects of the process leading to the recent CU agreement.

Table 1
Central America Integration: Major Agreements and Treaties

1950s	1060s	1970s	1980s	1990	2000
Organization of Central American States Multilateral Treaty for Free Trade and Economic Integration	General Integration Treaty Central American Monetary Agreement Central American Organization of States ODECA Central American Bank for Economic Integration	Dissolution of ODECA (Political and Military Alliance)	Agreement on Central America Tariffs and Customs Union Regime	Tegucigalpa and Guatemala Protocols to the General Integration Treaty CA Monetary Agreement	Treaty on Investments and Trade Services Amendment to the Tegucigalpa Protocol **Customs Union Agreement** Central American Free Trade Agreement with the USA

Table 2
Central America Integration Process

	60s	90s	Last five years
International economic policy context	• , protection to infant industries, high tariffs	• A global, practical and open approach to integration • Free trade multilateral negotiations and WTO • Privatization, free market economic policies	• Slow progress in multilateral negotiations (WTO) • FTAs with major trade partners in place: USA, EU • Current signs suggest that with the present economic crisis some protectionism may be back
Geopolitics	• High importance to US and to some extent to EU	• Cold war ended, lost importance	• Limited importance
Political context	• Guerrilla wars in 3 of the 5 countries, military governments in 4 countries	• Conflicts ended, political negotiations, fiscal pacts, renewed democratic commitments	• Formal democracy has consolidated, middle class is growing
Legal framework Integration	• MCCA (not a real common market) • In practice: Free trade zone with limitations	• Legal framework for the System for CA Integration (economic integration) • Slow implementation	• CU Protocol • Implementing Customs Union • Guatemala and El Salvador CU • Dominican Republic becomes an Associated State • Panama joins the Integration Treaty but not the CACU. Its process for adhering to the process is ongoing.
Private Sector interests	• Enlargement of consumption of very small middle and upper class in the five countries • No regional perspective in most industries • Mono exporters • Most regional investments were transnational • Traditional exporters and importers not highly interested in the regional market • Industries were based on protectionist policies	• Diversification of exports • Regional market growing • Global competition forces for new markets •	• FTAs negotiations • Regional investment groups in partnership with multinationals developing new projects • Medium size and small companies exporting • Financial, service, and commercial sector investing in the region
Countries and groups taking advantage of integration	• Costa Rica and Guatemala • Large scale industries • Some opportunities for medium sized businesses • No regional operations in the service sector	• Guatemala, Costa Rica, and El Salvador • industries • Some opportunities for medium-size businesses • No regional operations in the service sector	• El Salvador and Guatemala (55%) • 75% of exporters to intraregional market are small businesses • Regional service sector operations expanding

Evaluating this process, Rafael Sanchez in his article “Rebuilding the Central American Bloc in the 1990s” (2004) wrote:

> The new regionalism is an arrangement to promote the competitiveness of the economies of the region. In the face of an increasingly globalized economy, enlarging the markets through integration has become a condition of survival especially for small economies...
>
> Although the governments have presented integration as a new regionalism in the sense that it goes beyond trade to include other issues, the centrality of trade and concerns with external integration have undermined regional cohesion…the system reflects the preferences and interest of the governments and works as a compromise, where some governments press for cohesion and deepening integration, while Costa Rica looks outwards … favoring its external integration.

The international context, policy trends, and the reality of globalization and international competition have created a new setting favorable to integration. It is in that context, that the CA states signed the CU agreement in 2008.

The Regional Market

Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, Belize and Panama are current signatories of the Central America ***General*** Integration Treaty. The Dominican Republic is an associated state. Only the first five countries conform the ***economic*** integration system.

CA exports almost doubled between 2003 and 2008. Excluding drawback regime products, they rose from U.S. $11 billion to U.S. $21 billion. Imports also increased from U.S. $23 billion to U.S. $48 billion, leading to a secular trade deficit that more than double the amount of exports. This trade deficit has been more than offset by capital inflows, direct investment, and remittances, increasing the international reserves position of the region and most of its countries.

After decades of exporting only coffee, fruits, vegetables, cattle, and other agricultural products, in the 90s CA started a process of export diversification with agro-industrial products, and apparel under the drawback scheme of that time. In the last decade mainly Costa Rica, Guatemala, and Honduras have attracted foreign investment and new export businesses. In 2007, the top five export products (42 percent of the total) were in order of importance electronic circuits, mechanical parts, medical instruments, fruits, and coffee. Other items their participation are heavy petroleum products, gold, and crustaceans.

The main export markets are the United States (31 percent), the intraregional market (29 percent), the EU (13 percent), and China (9 percent). Petroleum products represent approximately a third of imports, the rest being machinery, equipment, and industrial products.

The intraregional market has been growing at a rapid pace in the last 10 years, particularly between 2005 and 2008 when most of the intraregional traders have been small businesses, mainly from the industrial and agricultural sectors. According to the February 2009 report by the Central American Secretariat for Economic Integration (SIECA), in 2008, diversification of goods is one of the CA trade characteristics. Pharmaceuticals is the only item accounting for more than 10 percent of total exports; the remaining tariff schedule headings do not reach that figure. All headings related to food and beverages accounted for more than a third of goods traded in the intraregional market; the remaining comprised industrial products such as pharmaceuticals, plastic and paper products, cable and wires.

Except for intraregional trade, CA imports represent less than 1 percent of its other trading partners exports**,** placing the region in a clearly asymmetric position. Around 70 percent of exports and 60 percent of imports are under free trade agreements, including CAFTA with the United States. Negotiations with the EU, Canada, Panama, and the Caribbean Community are ongoing.

In terms of the extension of regional integration, CA has developed a comprehensive legal and regulatory framework dealing with almost all matters and trade institutions: tariffs, origin, taxes, customs, sanitary and phyto-sanitary restrictions, transportation, commercial protection, services, investment, and government procurement. The financial, fiscal, tax, service, and investment harmonization has had very limited progress, except for recent advances in the financial sector.

The CET is based on the International Harmonized System. The following tariffs apply:

- Capital goods and raw materials from countries other than the CACU: 0 percent
- Regional raw materials: 5 percent
- Regional Intermediate goods: 10 percent
- Final consumption goods: 15 percent

According to SIECA, more than 95 percent of the CET is presently harmonized.

Sugar, coffee, alcoholic beverages, and petroleum products subject to future agreement for free trade among the CA countries.

The weighted average of collected import duty rates (in percent of total imports) was 10.1 percent in 1990-1995, 6.4 percent in 1996-2000, and 4.2 percent in 2001-2006 (Desruel and Shipke, 2008: 17) In most countries, more than 80 percent of the tariff positions are “0” after the conclusion of the FTA with the United States. Table 3 and Figures 1-4 present key intraregional trade figures.[5]

Recently the private sector has benefited from the new wave of integration in the financial sector, investments, and the new dynamism of intraregional trade compared to the non-

[5] Presented after the Conclusion.

regional exports, mainly in the case of the industrial sector. This has proven beneficial during the 2008-2009 economic downturn, since part of the reduction in exports to markets outside the region has been offset by the increase in the intraregional market, although only some countries have benefited from the situation.

Taxes and Customs

According to IMF staff estimates, based on data from national authorities, in 2006, the structure of tax revenue for the CA countries was as follows

Table 3
Central America Evolution and Structure of Tax Revenue
In Percent of GDP

	Total Revenue		Total Tax Revenue									
			Total[1]		Income Taxes		VAT/Sales		Excises		Trade Taxes	
	2003	2006	2003	2006	2003	2006	2003	2006	2003	2006	2003	2006
Costa Rica	13.9	13.8	13.6	13.6	4.0	4.0	4.7	5.1	2.7	2.7	1.5	1.5
El Salvador	12.7	13.8	11.5	12.9	3.3	4.1	6.1	6.7	0.6	0.6	1.2	1.1
Guatemala	12.5	12.6	11.7	11.7	1.5	2.3	5.9	5.4	1.2	1.1	1.4	1.1
Honduras	18.4	19.7	16.3	18.1	3.5	4.9	6.0	6.6	1.4	1.0	1.5	1.4
Nicaragua	16.4	18.8	15.2	17.5	3.8	5.1	6.2	7.3	4.1	4.0	1.0	1.0
Central America	**14.8**	**15.7**	**13.7**	**14.8**	**3.2**	**4.1**	**5.8**	**6.3**	**2.0**	**1.9**	**1.3**	**1.2**

1 Other taxes are excluded from the table, so the sum of income, VAT, excise and trade taxes is not equal to total

Total tax revenue of the CACU members in 2006 averaged 14.8 percent of the GDP, ranging from 11.7 percent for Guatemala to 18.1 percent for Honduras. The average is relatively aligned to the Latin American average (13.5 percent), but significantly lower than the average rate for OECD countries (21 percent).

VAT on internal taxed transactions accounted for 6.3 percent of the GDP, income taxes 4.1 percent, excises 1.9 percent, and trade taxes 1.2 percent, VAT clearly being the most important source of collections.

Although progress has been reported, with some variations, the CA countries have a complex and high compliance cost tax and customs legislation with loopholes, significant exemptions, and relatively narrow tax bases. Most legislation has not been the product of macro and micro economic analysis and most planning departments lack up-to-date models and analytical tools. It is common that legislation is extremely detailed and specific.

In terms of tax administration, all countries have programs aimed at modernizing and strengthening their institutions and important progress has been reported in most cases. There is a long way to go, however, in adapting the institutional framework to the challenges of the highly demanding globalized context and the new capacities required to implement the CACU.

Among the most important areas of reform are as follows:

- Eliminating political interference in the technical, financial, and administrative decision-making of these agencies.
- Establishing strategic planning systems (as compared to plans), including performance indicators and management.
- Applying good practices in professional human resources management, including a solid, transparent hiring system, well-designed technical and management training programs, performance evaluation and incentives systems, and professional careers in these areas.
- Developing strategic and long-term Information Technology and Telecommunications, including platform, security, good design and development of software, training and compatibility.

- Re-engineering the operational and administrative process in both customs and internal tax revenue. The new design should respond to a holistic view to integrate facilitation of taxpayer services, reduction of discretionary practices, control, and reliability, as well as application of international standards and concepts such as risk management and tax intelligence.
- Establishing across-the-board transparency, anti-corruption, and ethics policies and programs.
- Involving stakeholders in the reform process to increase sustainability and support.

In addition to the constant challenge of elevating the tax burden in real terms and implementing a vast and holistic institutional reform, the CA administrations have been facing the loss of revenue derived from the application of CAFTA and many other bilateral trade agreements, and, more recently, the need to adapt to the CACU operational and institutional requirements and potential further revenue loss.

VAT, not tariffs, is the source of the potential loss in collections that worry tax authorities. The weight of tariffs in the total collections is already relatively low.

Neither SIECA nor the CA governments have made public any official estimates of revenue loss for all FTAs and the CACU. Just as an illustration, though, the following estimate of CA lost tariffs revenue derived from the ALCA/FTAA (Free Trade Area of the Americas) then, expected negotiations were found in “Los Desafíos de Política Tributaria Relacionados con la Integración Económica Regional” (Tax Policy and Regional Economic Integration Challenges by Alberto Barreix and Luiz Villela, International Development Bank: 2003).

Table 4
Tariffs revenue Loss
Impact of ALCA (1999)

	% Of tax revenue	% Of GDP
MERCOSUR	2.4	0.4
CAN (Andean Community)	8.2	1.0
MCCA (CA Common Market)	9.5	1.1
CARICOM (Caribbean Community	14.2	2.9
LAC (Latin America)	8.6	1.3

Table 5
Tariffs Revenue Loss
Impact of ALCA (1999)
Central American Common Market
% Of GDP

	USA	ALCA
Costa Rica	0.1	0.7
El Salvador	0.1	0.1
Guatemala	0.5	0.9
Honduras	1.6	2.1
Nicaragua	0.6	1.6
MCCA	0.6	1.1

Source: Authors' calculations with DOTS/IMF (2001)

The negotiations for ALCA did not take place, but along with other Latin America countries, the Central American states and the United States signed a Free Trade Agreement few years ago. The tariff revenue losses expected from that Agreement have already taken place and will continue for the next 10 years, but the effects will not be significant in terms of tariffs revenue (less than 0.10 percent of intraregional trade). The strongest impact was in the early years of implementation, particularly in 2007. The same situation applies for the FTAs with Mexico, Taiwan, and other trading partners.

As previously mentioned, however, the Tax and Customs Administrations have presented their concerns about the impact of the CACU on VAT revenues. Three situations that will be, in practice, extremely difficult to control by the TCAs have been mentioned:

- The transfer of extraregional goods that have already paid the import VAT in a country, to another member of the union. Depending on the final mechanism to be adopted, this may be a source of losses due to highly possible evasion practices.
- The potential increase of evasion and contraband of the few non-harmonized goods, particularly if the present, already weak controls are removed within the union. This element must be taken into consideration for the design of the "trade facilitation centers" forseen in the CACU Agreement.
- Increase of domestic VAT fraud within the CACU borders. Even in Europe, with a high degree of compliance, a positive tax culture, strong Tax and Customs Administrations and a heavy load of information obligations carried out by enterprises sending their products to other members of the union, the fraud scheme known as "VAT carrousel" has seriously affected tax collection. In the case of CA, current conditions arising from different VAT rates, non-standardized procedures for tax compliance, weak control systems, and slow administrative and judicial procedures will further deteriorate with the potential elimination or reduction of border controls and the increased complexity of transaction control and fiscalization involving different countries and TCAs. In the context of a CU, the "Zonas Francas" (extra national customs territory) regime can easily be utilized for tax fraud, if operated with this intention and no effective, enhanced controls are in place.

In summary, the remaining CAFTA tariff reduction schedule and the implementation of the CU will imply further, but not significant, loss of tax revenue (less than 0.10 percent of the value of intraregional exports), while the TCAs authorities worry that the potential losses of VAT may be significant, but cannot be estimated due to the lack of information on contraband and other unlawful practices. If no reliable information on the contrary is available, measures need to be taken to prevent the decline in tax collection that has been present in other CUs —a state of affairs that promises to worsen a fiscal situation that has been one of the most important challenges for CA. —

A comprehensive study to determine the ex-ante fiscal impact of the CACU is advisable to facilitate the dialogue between Ministers of Finance, TCAs, Ministries of Economy and regional authorities in the Region

CHAPTER 3

ADVANCING THE IMPLEMENTATION OF THE CACU IN THE AREA OF TAX AND CUSTOMS

The CA governments have been working at the ministerial, directorial and technical levels in most areas involving economic integration. The results have been mixed. In some areas, key steps and specific plans are better laid out than in others. In the case of tax revenues and customs, the administrations face a CACU agreement that is vague about the role of customs in the new integration phase as well as the functions of a potential regional authority that may perform some of the main tasks carried out by national administrations today (collecting tariffs and taxes at the regional borders, for example).

Despite their concerns about the impact of the regional pro-free trade agreements on fiscal revenue, the CA governments have implemented actions towards the CACU. The most recent and important are summarized as follows (SIECA 2009 and 2008):

- Free trade for goods of CA origin, except for certain sensitive products (sugar and coffee for all five countries, and petroleum and alcoholic beverages in specific bilateral cases).
- Common trade norms and regulations for most relevant matters (value origin, protective measures, non-tariff requirements, and conflict resolution).
- Harmonization of more than 95 percent of the CET.
- Recent adoption of a new version of the Customs Code and Regulations.
- Investment and services treaties, either under legislative approval (three countries) or implementation (two countries).
- Mutual assistance agreements among TCAs under approval.

- Agreement for harmonization of taxes applied to trade (pending approval in some counries.)
- Adoption of technical regulations for new sectors.
- Progress in various common transportation regulations approved.
- Multi-country customs posts at main seaports for regional entry.

Those in progress include:

- Communication among the TCAs for electronic transmission of the CA Unified Customs Format (for regional purposes) and the International Transit Declaration.
- Implementation of the Unified Customs Information System.
- Implementation of the Electronic Unified External Tariff.
- Data base for tariff and non-tariff requirements.

The CA technical groups have identified the following key actions to advance the CU

Regulations and key commercial issues pending:

- Complete negotiations for the last few products pending for full free trade among CACU members.
- Finalize negotiations on the few headings remaining to complete the External Tariff.
- Definition of procedure and destination of VAT and tariffs when transferring goods, imported to one of the member countries, to a second member country.
- Negotiate convergence schedule to align VAT differential treatments negotiated by the CA countries in the U.S.-CA FTA.

Tax and customs issues:

- Comprehensive plan of developing the CACU.

- Coordination of customs and tax procedures.
- Coordination of processes, operations control and ITC systems.
- Review of previous regulations to conform to the CACU.

Another source of guidelines for advancing the CACU is Chapter V of the IMF report "¨Central America: Economic Progress and Reform," edited by Dominique Desruelle and Alfred Shipke. Based on the basic requirements of a CU, Andrea Lemgruber-Vol identifies the following key steps for implementation of the CACU.

1) Strategy

- Strategic plan for modernizing the CTAs[6] and closing the gaps between good international practices and the present CACU situation.
- Increase of regional institutional coordination.
- Implementation of the CACU with a gradual, progressive, and consistent approach to local administrative capacity.
- Blueprint exercise providing a framework to assess and compare progress of the operational capacity and institutional development of the national CTAs.

2) Normative and Institutional Convergence

- Seek rapid ratification of the framework agreement in each member country, and of other regulations needed to govern its implementation.

[6] CTA refers to Tax and Customs Administrations in the report.

- Define the institutional arrangements for administration of the CACU (with key attention to CTAs needs, in terms of infrastructure platform, human resources development, and political independence).
- Establish rules of operation for the structural and investment fund (which could support some necessary investments in the CTAs)
- Review and harmonize the CET, taking into account the need to review bilateral trade agreements and to formulate a clear policy in this area.
- Work toward the gradual convergence of the various free trade treaties, in particular the bilateral agreements signed by each of the countries with non-member countries.
- A new version of the common customs code in line with the CACU
- Review and harmonize regional regulations in the areas covered by the framework agreement, especially specific rules of origin, customs transit, sanitary and phyto-sanitary measures, security measures, technical barriers to trade, trade defense, trade in services and investments, rules of public procurement, intellectual property, competition policy, and public procurement.
- Analyze and review documents and agreements related to the coordination of domestic taxes (a key aspect is convergence with respect to exemptions and incentives).
- Adopt the agreement on good investment practices aimed at adopting a common policy on tax concessions for free trade zones in the region and establishing a level playing field for the countries competing for foreign investment.
- Implement the agreements on information-sharing, mutual assistance, and technical cooperation; start building knowledge on advanced issues, such as transfer-pricing rules, thin capitalization, and treaties to avoid double taxation (these issues have initially been addressed in some meetings of the regional ministers of finance).

- Strengthen the Central American Customs and Tax Training School.

3) Administrative and Operational Requirements

- Establish good practices and identify minimum standards for the CTAs in the region.
- Define and implement IT systems with minimum functionalities, flexible responses, and high communicability (in particular, attention should be given at the outset to the operating status of the customs systems: unified customs information systems, electronic sharing of customs data forms, electronic transmission of international transit declarations, etc.).
- Strengthen external customs posts.
- Harmonize procedures and risk analysis criteria for customs control, with clear channel selectivity, as well as separation of the prior, immediate, and ex-post audits.
- Streamline and clean up the taxpayer registries, managing reliable data, the crucial backbone of all information exchanged in the region.
- Expand e-filing and e-payment for all types of taxpayers throughout the region.
- Strengthen taxpayer services, including online assistance (Web sites and e-mails), focused on providing clear and targeted information for economic operators doing business in the CACU area.
- Start a coordinated program of tax education to reach taxpayers in the region, focusing on the CACU requirements and encouraging better compliance in the entire region.
- Apply massive controls and crosschecking methods to all taxpayers, but focus audit efforts (external audits) on targeted, high-value cases (selected through risk analysis).

- Strengthen key areas in the fight against smuggling and fraud and in customs and domestic tax intelligence, audit, and control; increase cooperation within such areas.

If the CACU is to succeed, a sustainable process of implementation has to include these sound proposals by the technical bodies and international experts. According to past experiences, progressive political and legal agreements can be signed but, unless the entrepreneurial sector and public institutions find gains and incentives for themselves in the process, there will not be true commitment and willingness to advance integration.

Despite TCAs' understanding of the potential and general economic benefits of trade liberalization policies, their commitment to a regional process bound to complicate their institutional task will inevitably weaken and may even be seriously compromised.

If a faster and smoother pace of implementation of the CACU is desired, tax and customs officials and authorities must be seriously engaged in and committed to the process. This will not occur unless regional leaders address and solve the TCAs concerns regarding loss of revenues and control and identify ways to allow gains in the fiscal area along with other expected trade, economic, social and political benefits from further regional integration.

CHAPTER 4

PROPOSAL

The objective of this section is to propose specific actions with the intention of triggering a discussion on what administrative or policy instruments, practices, or actions may concretely address the problems faced by the Tax and Customs Administrations (TCAs) in order to unleash their creativity and proactive nature in favor of the implementation of the CACU.

Recognizing the importance of advancing in all fields in a CU, this proposal is focused on implementation of policy and legislation of the tax and customs component, which is among the more demanding and critical areas. The two main issues in this area are institutional strengthening and streamlining of operations to facilitate trade.

The implementation strategy would comprise the selection of key, high impact interventions and a gradual and building blocks approach; allowing collective learning and building trust among TCAs, governments, businesses, private sector organizations and their international clients, partners and allies.

Some of the proposed projects are advanced, systemic versions of programs or procedures already in place. In other cases, the projects are expanded and renewed designs of pilot projects that have been started by one or more CTAs. In all cases, they constitute innovative practices and respond to a new, regional vision and scope that would enhance the possibilities of better service for importers and exporters, effective operations and control including cross checks, exchange of information and coordination among the CTAs in Central América.

The following measures and projects can be considered as part of the integrated strategy to implement the Union

- Develop a common Regional Strategic Plan for the CACU implementation.
- Exchange of information on mismatch of import/export operations between the customs authorities of CA and the United States, and CA and the EU under the World Customs Organization (WCO) framework.
- Implementation of a regional authorized economic operator program AEO (Customs-Trade Partnership Against Terrorism Program in the United States –USC-CTPAT-).
- Implementation of a regional and international transit control program with electronic detection systems of registered "transit operations" at the border to facilitate controlled regional transport of goods.
- Implementation of a regional network of non-intrusive inspections at selected customs and trade facilitation centers at regional and national borders, applying a regional risk management tool for inspection selection.
- Implementation of a regional system of electronic invoicing.
- Implementation of a regional electronic system of non-tariff controls, including those related to intellectual property rights.
- Implementation of a regional data base of electronic cargo manifests and documentation of goods release for both intraregional imports and exports and those entering the CACU.
- Implementation of a regional certification of institutional standards for customs.

These projects would improve present controls at borders, facilitate legitimate trade, increase transparency and VAT and tariff revenues at ports of entry and CACU internal points of control.

Expected benefits would include:

- Improved collections of VAT and tariffs.
- Incentives for tax and customs authorities (increased revenues, improved international indicators and image); incentives for governments (more resources for investment); incentives for businesses and service providers (less red tape and release procedures at borders and increasingly fair regional competition).
- Higher probabilities of agreement among TCAs on the implementation of these projects, since, barring few exceptions, pilot or partial implementation of these initiatives are in place in one or more countries, as in the case of non-intrusive inspection, electronic invoice, and transit control. New projects that do not imply substitution of systems or replacement of existing processes are potentially easier to agree upon than those requiring them.
- Facilitation of border controls, reducing the time of clearance for transport and cargo agents, custom agents, and exporters and importers.
- Increase of electronic procedures, reducing contact between customs officials and private agents dealing with authorizations or registration. This implies fewer discretionary practices and opportunities for corruption.

The investments, economic dynamism, technical and administrative actions, regional coordination, political cooperation and institutional building required to implement the Customs Union could result not only in the expected free trade and economic benefits but also in democratic, social and political strengthening that will contribute to good governance and poverty reduction.

A successful implementation of the CACU could also lead to an increased relative weight of Central America when negotiating, as a subregion, with its main trading partners and attracting more interest for investment and trade from other economic blocs. This in turn, may contribute to the CA countries in their aim for more balanced political and strategic relationships with other States.

Description of Projects

- *Exchange of Information on Mismatch of Import/Export Operations*

A simple crosscheck of information between customs data bases can have a very important and productive impact on accurate customs declarations of description, classification, quantity, value, and origin of goods. In recent years, Mexico and Guatemala have taken advantage of information verification services using private international companies when customs officials have doubts or are suspicious of specific operations. The results have identified systematic mismatches between what some exporters and importers declare to their corresponding customs authority. These discrepancies in the declaration of value, origin, quantity, or description of goods affect not only tariffs and taxes to pay, but also the risk perception and customs control by importers, exporters, and supply-chain service providers.

The exchange of information among customs entities, beyond statistics or investigation of specific cases, has been very limited, mainly due to the concern of customs authorities in sharing their private business and individual information on a regular basis. To overcome these limitations and concerns, the proposal is that the United States, Canada, and the EU, each one implements a electronic system to compare their own customs declarations for exports to/from the CA countries with the information provided by the CA TCAs. The system would report only discrepancies in value, origin, amount, or classification of goods. In those specific cases, both customs authorities would provide each other with names and other relevant information to initiate administrative procedures for verification of information and, according to their findings, potential cases of administrative sanctions or criminal prosecution. Currently, mostly for security purposes, the United States and the EU have programs for customs pre-inspection at other port facilities such as the U.S. Container Security Initiative, under which customs-to-customs agreements are expected to be signed and to allow for exchange of information. The present proposal will only expand the scope of the exchange to all imports and exports (compared to only maritime trade).

The system described here must be designed in accordance with high IT security standards, customs technical practices, and legal frameworks. According to WCO provisions, it is legally and technically viable. Political will on the part of the different administrations is the key issue to advance its implementation.

- *Central American Authorized Economic Operator Program—CA/AEO*[7]

The WCO, the World Bank, Canada Borders, and other institutions are disseminating information about these types of programs allowing frequent and certified operators throughout the supply chain (meeting the prerequisites, standards, and criteria) to clear customs procedures quickly and efficiently, creating a self- and mutual- control environment with supervision by customs officials, based on risk management techniques. Those failing to fully comply with the standards or caught in an unlawful practice are expelled from the program and sent back to the normal procedure line.

[7] **US C-TPAT** in the United States.

According to customs-to-customs agreements, AEO programs certified by a national customs service can be recognized by the customs administrations of second or third countries, in order to benefit from a similarly efficient fast track for clearing procedures.

In order to implement national AEO programs, some CA countries have been training customs officials and private sector technicians and service providers, designing the programs and fostering collaboration between private and public sector institutions.

A regional program can benefit all involved in these initiatives. The operators interested in the attractive benefits of clearing customs in an efficient and responsible way could apply only to one regional program, instead of various national programs with different sets of rules. Each country could invest fewer resources in implementation. Efficiency gains, fewer discretionary practices, more transparency, and less numerous opportunities for corruption can be expected during implementation and operation of a regional program. The establishment of the program, negotiations, and technical cooperation can also be dealt with regionally, thus reducing the level of resources and technical cooperation efforts on the part of the international community.

The results of this program will be: a) an increase of customs control over an important portion (at least 40 percent) of import/export operations, holding the importer accountable for discrepancies, all payments and legal and procedural obligations; b) a potential increase of revenues due to accurate declarations; c) a reduction of release times for frequent and good importers/exporters; d) a self- and mutual-control framework with official supervision; e) experience in dealing with international standards; and f) building confidence among customs services at a regional level.

- *Regional and International Transit Control System*

One of the most common forms of smuggling in certain CA countries is importing goods under the transit regime and not complying in taking the goods outside the national borders or taking goods out of a port, customs area, or Zona Franca destined to another of these facilities, but never delivering them. In these cases the imported goods enter the national customs territory illegally and without paying the corresponding duties and taxes. Such practices exist because national and international transit controls are obsolete, weak, or simply nonexistent, not to mention bureaucratic red tape and discretionary practices applied to those importing, declaring, transporting, and exporting goods under this type of operation, very common and widely used in international trade.

The design and implementation of a common and secure transit control system is required to advance regional trade facilitation. The system would consist of a regional ITC solution to trace all transit operations in the area. This implies a) use of global positioning system (GPS) devices (or any other solution with similar functions), seals, and any other means to guarantee the inviolability and detection of containers; and b) installation of secure tracking devices to detect GPS devices located at easy-pass lines at the borders and other locations, with the least slow-down possible, and an ITC system to record and close all tracking points of cargo from beginning to end.

The Guatemalan Customs Administration received cooperation from the U.S. Trade Development Assistance Agency (USTDA) to design and develop software for a national transit control system. This software development is in progress and the ITC proposal has been presented. A review of this experience and those of other CA countries would allow this initiative to progress in the short run.

- *Regional Network of Non-Intrusive Inspections*

Among the risk management applications to customs operations, risk analysis programs of different levels of sophistication as well as electronic information at different degrees of extension, accuracy, and relevance have been used by customs administrations in some of the CA countries to determine whether or not a container or cargo will be physically inspected at seaports and airports. Most terrestrial borders do not have systematic and electronic procedures to determine when an inspection should take place.

Along with the unreliability of ex-post input of basic information on import/export operations, most of the present inspection selection mechanism create grounds for discretionary practices, potential corruption, red tape, and inefficient release of goods at terrestrial borders. In the context of the implementation of the CACU, this situation would contribute to consolidating the arguments about mistrust, non-standardized procedures, and loss of revenue.

Therefore, it is necessary to complete, at the regional level, a terrestrial electronic cargo manifest, include this operation in the national customs operations systems, apply a standard set of criteria for risk management, and implement a reliable network of non-intrusive inspections as the front line for control. Physical inspections, based on risk analysis and potential non-intrusive findings, will still be conducted to control aspects that x-ray or gamma technology cannot detect.

In summary, a pre-arrival to border information analysis, risk management tools, as well as Information Technology and Tele Communications (ITC) need to be applied in order to create a modern, effective, fast and reliable control system, not only at CACU borders, but also at "trade facilitation centers."

- *Regional System of Electronic Invoicing*

An electronic invoice system (EIS) is operational today in Guatemala,[8] under design in El Salvador and Costa Rica has already basic regulation on the matter.

In an oversimplified description, an EIS is created to allow customers to issue and/or store information on all selling transactions of taxpayers in the data center of a certified public or private service provider. The tax administration has access to the data for control, auditing purposes, and, most importantly, easy invoice cross-checking among taxpayers. The system is designed to progressively eliminate physical documents and storage, reduce costs, and increase security and reliability of information both for taxpayers and TCAs.

Communication protocols and standard formats, including EDIFACT, UNCEFACT and UBL, are applicable to EISs.[9]

A regional, standardized, and mandatory system of electronic invoicing for all taxpayers with regional operations can increase efficiency for businesses and effectiveness of VAT control, and, if linked to the customs operations system, the EIS can transform and facilitate trade among CACU members and lower transaction costs.

Implementing this project would require, a comprehensive study of different models of electronic invoicing and the design of a regional system allowing customers to comply more easily with TCAs, reduce reporting, and facilitate electronic commerce. In terms of integration of

[8] Regulation has been approved and service providers have been already certified but only few large-scale taxpayers are seriously using it because this option is voluntary at the moment.

[9] The Guatemalan system uses an electronic algorithm to validate invoice documents, following the procedure of an XML signature, which is based on a digital signature algorithm (DSA) used by the U.S. National Institute of Norms and Technology as part of the Federal Information Processing Standard (FIPS 186-1).

tax and customs provision of information compliance, the system should at least be capable of integrating the issuance and remittance of commercial invoices required by customs, the electronic manifest and customs declarations based on the information created during electronic invoice issuing required by all countries' VAT legislation.

- *Regional Electronic System for Non-tariff Controls at the Border*

One of the most important functions of customs administrations in a CU environment is the identification and coordination of compliance control of agricultural, health, security, and property rights requirements and provisions, both at the CU and national borders.

Presently, CA legislation, regulations, and procedures are different in each country. It is imperative to harmonize these elements. With no tools and mechanisms to enforce their compliance, however, regional norms will have little impact on the reality of trade.

A basic tool to control compliance with non-tariff norms is an electronic system capable of: registering norms and procedures and electronically issuing, delivering, and storing permits, authorizations, certificates, and other authentic documentation from national and international public and private institutions or entities PRIOR to arrival at the border and integrating them into the customs systems to keep records of compliance in each transaction electronic file. Another function would be to run the algorithms and include these areas of risk within the determination of physical inspections by specialized agencies under the customs administration at the border. Once the norms are standard at the regional level, importers and exporters could present only one single regional document to comply with non-tariff norms, with the system registering them in the regional data bases.

The system would facilitate compliance and law enforcement, reduce transaction and compliance costs to importers and exporters, and create an environment of closer relationships among regional and national institutions.

- *Implementation of a Regional Data Base of Electronic Cargo Manifests and Documentation Required for Release of Goods for Both Intra regional and Extra regional Imports and Exports.*

Most countries have already implemented their operational ITC systems. They are not usually operational at terrestrial borders, however, because administrations prioritize sea and airport customs posts, due to their relative importance in collections. The systems are not compatible, and specific procedures for goods release are different from country to country.

A new common regional data base of electronic cargo manifests and electronic documentation for releasing cargo could become the first building block in developing a common system in the future. This would allow for progressive exchange of information with the United States, the EU, and Canada as proposed earlier.

- *Implementation of a Regional Certification of Institutional and Operational Standards for Customs*

This initiative would require design, development, and implementation of a regional certification institution specializing in customs institutional development. It would require technical cooperation from the WCO and other international trade-related institutions.

The system would be a new model for measuring intraregional cooperation, monitoring, and performance.

Project Implementation

All projects would require regional agreement on the design, implementation strategy, and management.

To help SIECA and the TCAs to overcome bureaucratic, inflexible environments and regulations in which they have to operate, one interesting option to explore for efficient implementation of the proposals would be the creation of a single purpose corporation incorporated by the five TCAs that will operate according to private sector legislation which board of directors would be integrated by representatives of the TCAs and run according to good management, transparency and ethical practices. This corporation may execute other regional integration projects.

CONCLUSION

Central America has been considered a strong case for integration due to the potential economic impacts on trade creation and the area's relatively low potential for trade deviation, as well as for the similarities in economic, social, and cultural background in the region.

A successful implementation of the CACU recently agreed upon by these countries is a desirable political and economic outcome that would require political, technical, and private sector commitment, as shown by the recent implementation of the FTA with the CA main trading partner, the United States. The overall economic benefits and incentives expected of the CACU by all of its private and public partners are high. Implementation is a complex and long-term endeavor, however, requiring leadership and technical competence from member countries.

The investments, economic dynamism, technical and administrative actions, regional coordination, political cooperation and institutional building required to implement the Customs Union could result not only in the expected free trade and economic benefits but also in democratic, social and political strengthening that will contribute to good governance and poverty reduction.

A successful implementation of the CACU could also lead to an increased relative weight of Central America when negotiating, as a sub region, with its main trading partners and attracting more interest for investment and trade from other economic blocs. This in turn, may contribute to the CA countries in their aim for more balanced political and strategic relationships with other States.

No estimates of benefits and costs derived from the implementation of the CACU have been made public, but according to the experience of other Custom Unions and concerns raised by fiscal authorities in the region, the implementation of FTAs and CUs may generate tax revenue losses due to the intrinsic decrease in tariff collections. In the Central American case, the tariffs have already lost their importance as a source of collection but if no preventive actions are taken, the CU will probably decrease value added tax (VAT) revenues and increase opportunities for contraband and evasion.

Strategically considered, gains and incentives for fiscal institutions have to be in place if proactive involvement and strong leadership from the Tax and Customs Administrations are to be expected for the CACU implementation.

Technicians from different government agencies involved in the implementation of the CACU, as well as experts from international institutions such as the IMF, have made important contributions to identify relevant information, successful cases, and possible strategies, requirements, and actions to implement the union.

CA has the advantage of acquiring knowledge and experience from other complete (EU) and incomplete (MERCOSUR, South African CU) CUs around the world and using new information and communications technology to build integrated solutions to facilitate compliance and intelligent control.

The projects proposed in this document are strategic to the process, since they have the potential for: a) generating income to compensate for losses; b) building new processes and systems that are useful to administrations for their national operations; c) creating new, up-to-date and useful ITC applications and systems for processes that are key to customs and tax operations in the new CU environment; and d) constituting positive experiences in collective regional management, being that the projects are new to most administrations, thus allowing them to learn together.

The implementation of projects, regional coordination, political cooperation and institutional building required to implement the Customs Union could result not only in the expected free trade and economic benefits but also in democratic, social and political strengthening that will contribute to good governance and poverty reduction.

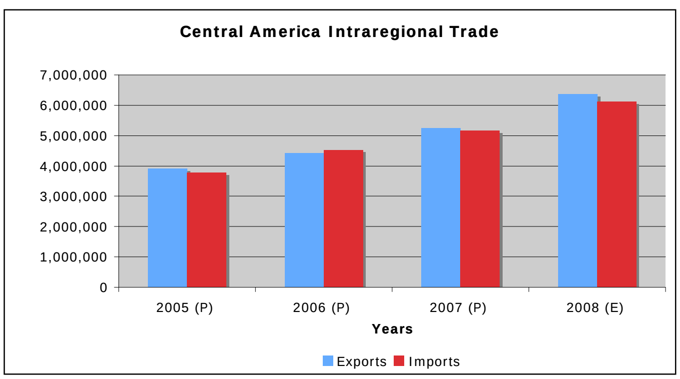
A successful implementation of the CACU could also lead to modifications in the current balance of economic power in the continent, increasing the relative weight of Central America when negotiating as a region with its main trading partners and attracting more interest for investment and trade from other economic blocks. This in turn may contribute to a more balanced political and strategic relationships with other States.

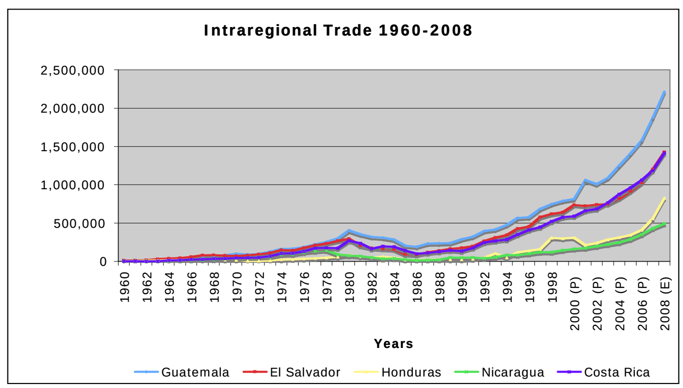
Central America Intraregional Trade 2004-2008
-In thousands of US$-

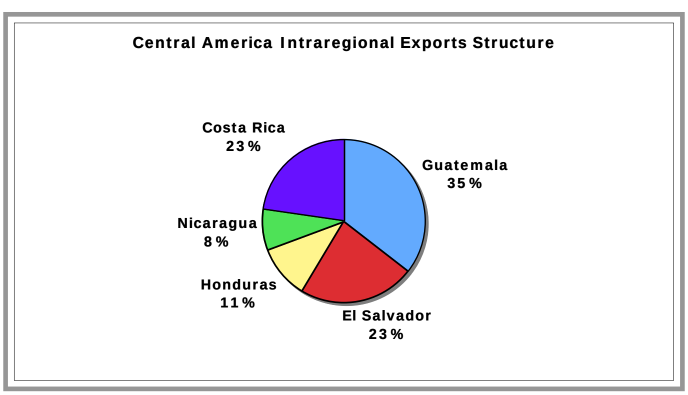
	TOTAL	GUATEMALA	EL SALVADOR	HONDURAS	NICARAGUA	COSTA RICA
			FOB EXPORTS			
2004 (P)	3,506,105	1,248,116	822,126	313,001	248,310	874,553
2005 (P)	3,911,732	1,404,120	913,593	345,403	290,264	958,352
2006 (P)	4,428,803	1,577,584	1,027,327	410,712	351,239	1,061,940
2007 (P)	5,259,436	1,875,525	1,202,742	561,492	432,404	1,187,273
2008 (E)	6,373,270	2,212,645	1,425,707	828,116	493,121	1,413,682
			CIF IMPORTS			
2004 (P)	3,350,904	908,500	946,080	660,806	501,335	334,181
2005 (P)	3,776,084	986,467	1,015,058	830,471	572,024	372,064
2006 (P)	4,536,108	1,083,473	1,154,082	1,215,938	656,970	425,645
2007 (P)	5,169,499	1,304,245	1,329,873	1,215,593	770,619	549,168
2008 (E)	6,122,053	1,455,108	1,478,850	1,689,818	896,186	602,091

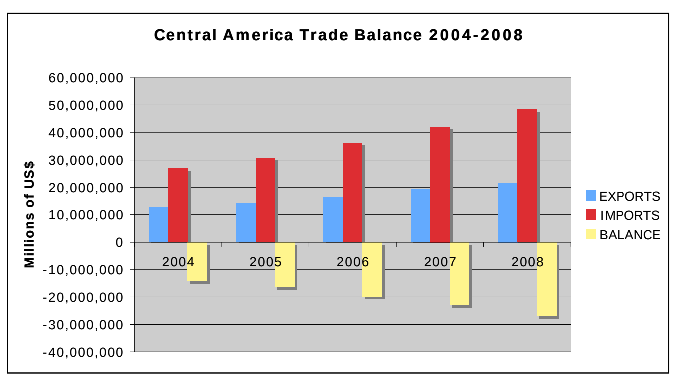
NOTES: (P) Preliminary Draw back regime excluded

*/ Data until November 2008. SIECA estimates for December
Sources: Direcci—n General de Inform‡tica/SIECA based on the following primary sources: Guatemala: Banco de Guatemala, El Salvador: Banco Central de Reserva, Honduras: INE, Nicaragua: MIFIC, Costa Rica: Banco Central de Reserva y Procomer









Data source: SIECA Trade Statistics

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Appendix A

Source: Central America: Economic Progress and Reforms; Desruelle and Shipke; FMI, pp3

Table 1.1. Main Economic Indicators												
	Output Growth (Annual Rate in percent)				**Inflation (e.o.p. Rate in percent)**[2]				**Private Credit Growth (Change in percent of GDP)**			
	1995-2000 Avg.	**2001-2005 Avg.**	**2006**	**2007**	**1995-2000 Avg.**	**2001-2005 Avg.**	**2006**	**2007**	**1995-2000 Avg.**	**2001-2005 Avg.**	**2006**	**2007**
Central America[1]	**4.9**	**3.5**	**7.4**	**6.9**	**8.4**	**10.0**	**6.0**	**9.0**	**2.0**	**0.1**	**1.3**	**3.5**
CA simple average	**4.6**	**3.6**	**6.8**	**6.7**	**8.7**	**8.2**	**6.0**	**9.3**	**2.2**	**0**	**2.0**	**3.8**
Costa Rica	4.8	4.1	8.8	6.8	13.4	11.5	9.4	10.8	1.7	2.3	2.2	6.4
Dominican Republic	7.1	3.5	10.7	8.5	7.2	18.7	5.0	8.9	1.5	-1.0	-1.3	2.0
El Salvador	3.6	2.3	4.2	4.7	4.7	3.3	4.9	4.9	2.4	-0.4	-0.3	-0.5
Guatemala	3.7	3.0	5.2	5.7	7.3	7.8	5.8	8.7	1.0	1.4	2.0	4.0
Honduras	3.2	4.7	6.3	6.3	16.9	8.1	5.3	8.9	2.0	0.8	6.1	7.1
Nicaragua	5.2	3.2	3.9	3.7	10.0	6.8	9.4	16.9	1.8	-0.3	4.3	5.3
Panama	4.9	4.3	8.7	11.2	1.0	1.3	2.2	6.4	5.3	-3.0	1.3	2.4
Memorandum												
Latin America and Caribbean	**2.8**	**2.8**	**5.4**	**5.6**	**13.6**	**7.6**	**5.0**	**6.2**	**-2.4**	**-0.4**	**2.9**	**4.5**
United States	**3.8**	**2.3**	**2.9**	**2.2**	**2.6**	**2.6**	**2.6**	**4.1**	**0.9**	**1.4**	**1.9**	**2.6**
	Ext. Current Account (In percent of GDP)				**Export Growth (US$ in percent)**				**Reserves (In percent of M2)**			
	1995-2000 Avg.	**2001-2005 Avg.**	**2006**	**2007**	**1995-2000 Avg.**	**2001-2005 Avg.**	**2006**	**2007**	**1995-2000 Avg.**	**2001-2005 Avg.**	**2006**	**2007**
Central America[1]	**-5.0**	**-4.1**	**-4.9**	**-6.7**	**12.4**	**4.8**	**11.4**	**11.9**	**21.5**	**25.6**	**30.5**	**32.0**
CA simple average	**-6.5**	**-5.3**	**-5.5**	**-7.8**	**13.8**	**6.1**	**11.9**	**12.3**	**24.7**	**30.6**	**35.3**	**36.3**
Costa Rica	-3.4	-4.6	-4.7	-5.8	13.4	4.6	12.7	15.6	20.9	21.6	28.3	31.2
Dominican Republic	-2.3	0.7	-3.5	-5.6	8.9	1.6	7.1	4.4	11.8	11.1	21.2	25.0
El Salvador[3]	-1.8	-3.5	-3.8	-4.8	11.7	3.9	21.8	13.8				
Guatemala	-4.5	-5.2	-5.0	-5.0	11.0	4.0	9.3	18.0	24.3	34.3	30.5	28.7
Honduras	-4.2	-5.5	-4.7	-10.0	33.3	8.8	2.9	7.7	33.7	52.0	52.0	45.5
Nicaragua	-22.8	-15.4	-13.2	-17.3	18.0	14.0	19.6	17.0	32.7	33.9	44.5	51.2
Panama[3]	-6.4	-3.8	-3.2	-6.0	0.5	5.8	9.7	9.4				
Memorandum												
Latin America and Caribbean	**-2.9**	**-0.1**	**1.6**	**0.5**	**11.0**	**9.9**	**19.0**	**12.8**	**29.0**	**33.4**	**33.1**	**42.8**
	Public Sector Balance (In percent of GDP)				**Public Sector Debt (In percent of GDP)**				**Foreign Currency PSD (In percent of total PSD)**			
	1995-2000 Avg.	**2001-2005 Avg.**	**2006**	**2007**	**1995-2000 Avg.**	**2001-2005 Avg.**	**2006**	**2007**	**1995-2000 Avg.**	**2001-2005 Avg.**	**2006**	**2007**
Central America [1]	**-2.1**	**-3.6**	**-1.7**	**-0.9**	**63.6**	**55.1**	**46.1**	**37.4**	**76.1**	**73.2**	**63.0**	**59.7**
CA simple average	**-2.2**	**-3.6**	**-1.3**	**-0.8**	**89.3**	**68.1**	**51.2**	**38.6**	**76.1**	**77.1**	**69.6**	**65.0**
Costa Rica	-3.4	-4.2	-0.5	0.6	51.0	58.1	51.0	44.2	38.0	40.8	43.5	40.0
Dominican Republic	-1.6	-4.4	-3.5	-1.7	30.8	41.3	44.0	39.0		67.0	54.8	53.3
El Salvador[3]	-2.2	-3.7	-2.9	-2.4	29.7	40.2	41.9	41.1				
Guatemala	-1.3	-1.5	-1.4	-1.0	16.3	18.9	21.9	21.0	94.1	94.8	68.5	66.7
Honduras	-3.1	-3.2	-1.7	-2.3	88.3	73.3	35.6	24.4	86.8	85.9	81.2	65.2
Nicaragua	-3.6	-4.6	0.2	1.2	341.9	180.7	106.5	50.2		96.9	100.0	100.0
Panama[3]	-0.6	-3.6	0.5	0.4	66.9	63.8	57.6	50.1				
Memorandum												
LA and Caribbean	**-4.1**	**-2.9**	**-1.0**	**-1.3**	**49.2**	**61.8**	**51.4**	**50.4**	**32.4**	**51.5**	**30.9**	**27.0**

Sources: IMF World Economic Outlook; and IMF staff estimates.
[1] Weighted average. Weighted by PPP GDP
[2] End-of-period rates i.e., December on December.
[3] Fully dollarized. The concept of reserve: coverage and foreign-currency-denominated public sector debt (i.e., currency risk) is not relevant.

Appendix B

In 1998 the International Trade Division of the World Bank commissioned the preparation of "Integration Arrangements: Static Economic Theory. Quantitative Findings, and Policy Guidelines" to Dean A De Rosa, Principal Economist of ADR International, Ltd. as a background paper for a World Bank Policy Research Report entitled "Regionalism and Development." The following quote is directly relevant to policy background for the Central American case.

"The policy guidelines on regional integration arrangements in Table 7 are applicable mainly to small trading countries unable to influence international terms of trade or to cease trading entirely with non-member countries, under increasing (domestic) cost conditions, homogenous traded goods, and perfect competition. That is, they apply appropriately to many advanced countries and particularly to less developed countries.

The prevalence of policy guidelines derived from the highly stylized Vinerian static framework is somewhat off-putting, given that the Vinerian framework is a partial equilibrium framework and largely neglects possibly significant spillover and feedback effects of regionalism.

Nonetheless, the policy guidelines based on the Vinerian framework are instructive and might still be deemed appropriate for judging the impact of regional integration arrangements involving small countries whose combined trade usually accounts for only a small fraction of world trade." (De Rosa 1998, pp 85)

The following eight policy guidelines were taken from Table 7, De Rosa, 1998, pp124-125:

Policy guideline 1

Under constant cost conditions, a customs union or free trade area established among "small" countries unable to influence their external terms of trade will be predominantly trade-creating and welfare-improving for the trading bloc and its individual member countries, if member countries are predominantly least-cost producers of exportables by international standards. If one or more member countries are inefficient producers of exportables, causing substantial diversion of trade with non-member countries, the inefficient member countries will gain from the regional integration arrangement. Efficient member countries, on the other hand, will not necessarily gain because welfare gains resulting from trade creation might not be sufficient to offset welfare and tariff revenue losses resulting from trade diversion. It is also uncertain in such circumstances whether the trading bloc as a whole will gain.

Policy Guideline 2

A customs union or free trade area that results in welfare losses for one or more member countries might still be successfully implemented if welfare gains for other member countries are sufficiently large to provide a net welfare gain for the trading bloc as a whole and if a facility for compensatory intra-bloc payments, typically involving apportionment of tariff revenues among member countries, can be successfully implemented such that member countries that gain from the regional integration arrangement compensate member countries that lose.

Policy Guideline 3

Under increasing cost conditions, a customs union or free trade area established among small countries unable to influence their external terms of trade will be predominantly trade diverting, so long as non-member countries continue to supply imports to member countries. Although member country producers whose exports to other member countries are increased under the regional integration arrangement will enjoy welfare gains, the welfare of member countries will typically decline because they give up substantial tariff revenues and enjoy no overall increase in their imports. Welfare of the trading bloc and (equivalently) the world economy will also typically decline, because they give up substantial tariff revenues and enjoy no overall increase in their imports. Welfare of the trading bloc and (equivalently) the world economy will also typically decline, owing to the greater resources necessary to expand exports by member countries than necessary to supply the same exports by non-member countries. The certainty of welfare losses occurring under increasing cost conditions is greater, the less highly protectionist are, initially, the countries forming the regional integration arrangement

Policy Guideline 4

In a general equilibrium setting under increasing cost conditions in both member and non-member countries, a customs union or free trade area established among countries unable to influence their external terms of trade individually or as a trading bloc will be welfare-improving for individual member countries and the trading bloc, if the regional integration arrangement increases imports by member countries from all trading partners. To ensure this outcome, member countries of a new trading bloc should simultaneously reduce their barriers to trade with non-member countries.

Barring this strategy, a regional integration arrangement formed by a relatively small number of countries will result in at least one member country being made better off and the possibility of one or more member countries being made worse off, raising the advisability of establishing a facility for compensatory intra-bloc payments to ensure that all member countries enjoy economic gains when the trading bloc as a whole is welfare-improving.

Policy Guideline 5

Under increasing cost conditions, a small country unable to affect its international terms of trade will increase its welfare by joining a "large" regional integration arrangement whose intra-bloc relative prices will not be affected by accession of a small country to the arrangement. Conversely, a small country will reduce its welfare by joining a "small" regional integration arrangement that cannot supply a greater volume of imports to the small country except at higher intra-bloc prices, in which case welfare of the trading bloc itself will also be reduced.

Policy Guideline 6

Under increasing cost conditions, "natural" trading partners that are unable to affect their international terms of trade will not experience substantial trade diversion on forming a regional integration arrangement among them. However, on forming a regional integration arrangement, natural trading partners will also not enjoy substantial gains in welfare because forgone tariff revenues will be nearly equal to, if not greater than, welfare gains from consumption and production effects.

Policy Guideline 7

Under increasing cost conditions, two or more neighboring countries facing substantial foreign trade barriers, transport costs, or other "hindrances" to their exports to third-countries might form a regional integration arrangement that will be welfare-improving to individual member countries, and possibly the trading bloc as a whole, if the benefits of "capturing" the costs of the hindrances to exports to third-countries through formation of the regional integration arrangement outweigh the tariff revenue losses and other possible welfare costs of forming the trading bloc.

Policy Guideline 8

Under imperfect competition and increasing returns to scale, a regional integration arrangement will be welfare-improving in member countries only so long as pro-competitive effects, including reduction in possible price discrimination between markets by firms, dominate tariff revenue losses and other possible welfare-reducing effects, and result in substantially lower prices for domestic and imported goods, as regional firms expand their output in response to increased demand and cost reductions from achieving greater economies of scale. Whether the regional integration arrangement will be beneficial to the world economy as a whole will depend on the relative magnitude of cost reduction effects in member countries versus possible trade suppression effects in non-member countries, the latter arising from trade diversion and reduced economies of scale in production by firms in non-member countries.