DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

NICARAGUA

MODERNIZATION OF THE STATE AND FISCAL REFORM

(NI-0172)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Stephen Doherty, Project Team Leader; Susana Sitja Rubio, RE2/SC2; Manuel Agosín, Economic Advisor (RE2); Manuel Márquez and Alberto Barreix (INT/ITD); Luis Amado Sánchez (COF/CNI); Cristina Landázuri-Levey (LEG/OPR); and Ladislao Brachowicz (RE2/OD3); peer evaluator Francisco Mejía (RE1/SC1). The following individuals participated in the preparation of the document: Juan Carlos Gómez Sabaini and Julio Francisco Báez Cortes, consultants, and Cristina Pando and Hilia Gensheimer (RE2/SC2).

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Annex II	Indicators of the fiscal reform's collection impact, broken down by tax

BASIC SOCIOECONOMIC DATA

For basic socioeconomic data, including public debt information, please refer to the following address:

http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata

INFORMATION AVAILABLE IN THE RE2/SC2 TECHNICAL FILES

Preparation:

* Government's request and policy letter
* IDB-Nicaragua: challenges for tax system modernization
* Fiscal Equity Act. Law 453
* Fiscal Equity Act. Changes in the law and comments on the impact thereof
* Fiscal Equity Act. 2003 tax reform. Synopsis and changes
* Decree 46-2003. Implementing regulations of Law 453. Fiscal Equity Act
* Preliminary notes and comments on the draft implementing regulations of the Fiscal Equity Act
*Everything about Taxes in Nicaragua. Official Edition 2001

Nicaragua Country Financial Accountability Assessment. (Draft) June 2003

* Law Establishing the Customs Directorate and Amendment of the Law Establishing the Revenue Directorate (Nicaragua, 6 April 2000)

* Fiscal Equity Act. Presentation by the Ministry of Finance. May 2003

* Public Sector Reform in Nicaragua. Presentation by the Royal Embassy of Denmark. April 2003

World Bank. Nicaragua. Public Expenditure Review. December 2001

* Draft Civil Service and Career Service Act, Managua, 23 August 2003
* Comptroller General of the Republic. Government Auditing Rules of Nicaragua (NAGUN), April 2002

EXECUTION:

* Preliminary draft of the tax code of the Republic of Nicaragua. February 2000
* Support for Tax Reform technical cooperation operation (ATN/SF-8464-NI). Plan of operations and terms of reference

* Available in Spanish.

ABBREVIATIONS

BCN	Central Bank of Nicaragua
CABEI	Central American Bank for Economic Integration
CAUCA	Código Aduanero Uniforme Centroamericano [Uniform Central American Customs Code]
CENIs	Certificados Negociables de Inversión [negotiable investment certificates]
CESI	Committee on Environmental Social Impact
CFAA	Country Financial Accountability Assessment
CGR	Comptroller General of the Republic
DGI	Dirección General de Ingresos [Revenue Directorate]
DGSA	Dirección General de Servicios Aduaneros [Customs Directorate]
FTAA	Free Trade Area of the Americas
GDP	Gross domestic product
HIPC	Highly Indebted Poor Countries
IMF	International Monetary Fund
INT/ITD	Integration, Trade and Hemispheric Issues Division
MHCP	Ministry of Finance
NAGUN	Normas de Auditoría Gubernamentales de Nicaragua [government auditing rules of Nicaragua]
PBL	Policy Based Loan
RE2	Regional Operations Department 2
SIDUNEA	Sistema Aduanero Automatizado [automated customs system]
SIGFA	Sistema Integrado de Gestión Financiera Administrativa y Auditoría [Integrated Administrative Financial Management and Auditing System]
UNCTAD	United Nations Conference on Trade and Development
VAT	Value added tax
WTO	World Trade Organization

Inter-American Development Bank
Regional Operations Support Office
Operational Information Unit

Nicaragua

Tentative Lending Program

2003

Project Number	Project Name	IDB US$ Millions	Status
NI0167	Multisectoral Global Program	30.0	APPROVED
NI0172	Modernization of the State and Fiscal Reform	25.0	
NI0182	Improvement of Plant, Animal and Forestry Health and Sanitary Services	7.3	
NI0170	PPP Road Program for Competitiveness	40.0	
NI0181	Institutional Support to the Coordination and Strategy Secretariat	6.0	
	Total - A : 5 Projects	**108.3**	
	TOTAL 2003 : 5 Projects	**108.3**	

2004

Project Number	Project Name	IDB US$ Millions	Status
NI0171	Basic Education for the Young and the Adults	10.0	
NI0180	VIII population and IV housing census	10.0	
NI0168	Citizenship Security Prog.	7.0	
NI0183	Social Reform Program II	15.0	
NI1001	Health Program II	30.0	
NI0113	Multiphase Program Secondary Roads	40.0	
	Total - A : 6 Projects	**112.0**	
NI0155	Integral Attention to poor neighborhoods	20.0	
NI0152	Masaya Basin and Municipality Env Prog	10.0	
NI0177	Administrative Probity and Anti-Corruption Plan	15.0	
	Total - B : 3 Projects	**45.0**	
	TOTAL - 2004 : 9 Projects	**157.0**	

Total Private Sector 2003 - 2004	**0.0**
Total Regular Program 2003 - 2004	**265.3**

*** Private Sector Project**

NICARAGUA

IDB LOANS

APPROVED AS OF AUGUST 31, 2003

	US$Thousand	Percent
TOTAL APPROVED	2,049,007	
DISBURSED	1,567,201	76.48 %
UNDISBURSED BALANCE	481,806	23.51 %
CANCELATIONS	41,909	2.04 %
PRINCIPAL COLLECTED	336,286	16.41 %
APPROVED BY FUND		
ORDINARY CAPITAL	262,221	12.79 %
FUND FOR SPECIAL OPERATIONS	1,717,828	83.83 %
OTHER FUNDS	68,957	3.36 %
OUSTANDING DEBT BALANCE	1,230,914	
ORDINARY CAPITAL	140,937	11.44 %
FUND FOR SPECIAL OPERATIONS	1,085,128	88.15 %
OTHER FUNDS	4,849	0.39 %
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	365,474	17.83 %
INDUSTRY, TOURISM, SCIENCE AND TECHNOLOGY	108,187	5.27 %
ENERGY	205,845	10.04 %
TRANSPORTATION AND COMMUNICATIONS	268,366	13.09 %
EDUCATION	22,240	1.08 %
HEALTH AND SANITATION	176,051	8.59 %
ENVIRONMENT	64,580	3.15 %
URBAN DEVELOPMENT	57,014	2.78 %
SOCIAL INVESTMENT AND MICROENTERPRISE	284,788	13.89 %
REFORM AND PUBLIC SECTOR MODERNIZATION	465,758	22.73 %
EXPORT FINANCING	1,826	0.08 %
PREINVESTMENT AND OTHER	28,877	1.40 %

* Net of cancellations with monetary adjustments and export financing loan collections.

NICARAGUA

STATUS OF LOANS IN EXECUTION

AS OF AUGUST 31, 2003

(Amount in US$ thousands)

APPROVAL PERIOD	NUMBER OF PROYECTS	AMOUNT APPROVED*	AMOUNT DISBURSED	% DISBURSED
REGULAR PROGRAM				
Before 1997	1	15,000	5,970	39.80 %
1997 - 1998	3	134,730	91,590	67.98 %
1999 - 2000	14	201,455	81,072	40.24 %
2001 - 2002	15	339,950	62,427	18.36 %
2003	1	30,000	0	0.00 %
TOTAL	34	$721,135	$241,059	33.43 %

* Net of cancellations. Excludes export financing loans.

MODERNIZATION OF THE STATE AND FISCAL REFORM

(NI-0172)

EXECUTIVE SUMMARY

Borrower:	Republic of Nicaragua	
Executing agency:	Ministry of Finance (MHCP)	
Amount and source:	IDB (FSO):	US$25 million
	Total:	US$25 million
Financial terms and conditions:	Amortization period:	40 years
	Grace period:	10 years
	Disbursement period:	Minimum: 1.5 years; maximum 4 years
	Interest rate:	1% per year during grace period; 2% thereafter
	Inspection and supervision:	1% of the loan
	Credit fee:	0.5% per year on undisbursed balance
	Currency:	U.S. dollars or equivalent in other convertible currencies except that of Nicaragua

Objectives: The overall objective is to improve the country's fiscal situation. On the revenue side, it is anticipated that domestic tax and customs collection will increase through the establishment of a stronger legal framework, improved regulations, a fiscal code, and more efficient, fairer, and less arbitrary collection institutions; exports will be promoted; and the cost of collection will be lowered. On the spending side, government resources will be managed more efficiently and transparently, through the establishment of guidelines to prepare properly defined budgets.

Description: The proposed operation is a policy-based loan (PBL) that is consistent with the State reform process undertaken by the Government of Nicaragua in the area of fiscal reform. In the fiscal area, the loan will cover areas of reform with regard to revenues, specifically the deepening of tax reform and modernization of customs, and some priority areas on the spending side, such as budget restructuring and the Fiscal Responsibility Act (paragraph 2.2).

The Bank's country and sector strategy: In the Bank's strategy with Nicaragua (GN-2230-1 of 5 February 2003), the first strategic approach is economic growth as a necessary condition for poverty reduction; the first instrument for promoting growth is strengthening fiscal policy, i.e., cutting the fiscal deficit and therefore reducing domestic debt. The second instrument involves promoting competitiveness and production, which includes the establishment of a tax system that will spur investment and minimize tax distortions in the market. As has been described, this operation is key to the country's and Bank's strategy (see paragraph 1.48).

The second strategic approach is to establish an efficient, effective, and honest government with the capacity to attain the goals of the Economic Growth and Poverty Reduction Strategy (EGPRS) (see paragraph 1.49).

Environmental and social review: In view of the type of operation involved, the project team does not anticipate adverse environmental or social impacts (paragraphs 4.1 and 4.2).

Benefits: The government estimated that the Fiscal Equity Act would lead to an annual increase in tax revenues of about 760 million córdobas, the equivalent of US$50 million or 1.2% of GDP (paragraph 4.4). (See Annex II for details on each tax.)

Risks: The main risk is a possible lack of consensus in the National Assembly. The recent approval of various reform laws in the National Assembly indicates, however, that the government stands ready to proceed with reform (paragraph 4.6). The enactment of the Fiscal Equity Act (Law 453) and the preparation of the draft tax code have required a national consensus that emanates from an extensive process of consultation and dissemination, supported by loans currently in execution and a number of dissemination activities.

A sensitivity analysis indicated the need for careful monitoring to ensure that the increase in collection can be sustained. To make sure that such monitoring takes place, it was agreed that a study and analysis would be performed of the fiscal sacrifice and fiscal macro impact of integration, to be financed with resources from the technical cooperation operation (paragraph 4.7).

There is a technical risk, given the reform's concentration on resources expected to be obtained through the application of a minimum income tax and the reduction in the number of goods affected by the VAT zero rate (52% of the estimated total) (paragraph 4.8).

Special contractual clauses:	The program will be executed pursuant to the terms and conditions set out in the loan contract. These contractual clauses are summarized in Annex I (Conditionality Matrix).
Poverty-targeting and social sector classification:	This operation does not qualify as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704) (paragraph 4.3).
Exceptions to Bank policy:	None.
Coordination with other donors:	The IDB, the World Bank, and the IMF have followed a coordinated program in which the IMF has developed the macroeconomic framework, the World Bank has focused its efforts on public sector reform, including the civil service, and the IDB has focused on fiscal reform. Under this framework, the three institutions have worked closely to ensure consistency among their programs and avoid duplication in the allocation of resources (paragraph 1.51). In the fiscal sector, the Bank participated with the Governments of Sweden and Norway in the financing of a tax study, the preparation and discussion of the reform, the diagnostic assessment of the problem, and the design of viable solutions (paragraph 1.52).

I. FRAME OF REFERENCE

A. Macroeconomic situation

1.1 In 2002, the first year of the Bolaños administration, economic activity was affected by the adverse international economic climate, deterioration in the terms of trade, the lingering international recession, cuts in public spending and therefore in public investment, and confrontation between the Executive Branch and the National Assembly, which delayed the private sector's investment decisions. In this context, the main economic indicators signal gross domestic product (GDP) growth of 1% (3% in 2001), a consolidated public sector deficit (includes the deficit of the Central Bank of Nicaragua—BCN), after grants, equivalent to 9.1% of GDP, a balance-of-payments deficit on current account of 35% of GDP, and a cumulative inflation level of 4%.

1.2 In December 2002, the country was able to sign an agreement with the International monetary Fund (IMF) for a poverty reduction and growth facility (PRGF) in the amount of US$129 million. This program lays the foundation for economic policy management for the 2002-2005 period. Preliminary estimates indicate that, as a result of the economic program in force, gross domestic product (GDP) would grow at about 2.5% in 2003, the consolidated fiscal deficit would narrow to 3.8% of GDP, with cumulative inflation on the order of 6%. Nevertheless, economic performance will depend on a more favorable international economic climate and a sustained economic recovery in the United States. Domestically, the main challenge is managing the fiscal deficit.

B. Fiscal situation

1.3 Fiscal policy implementation has been the overarching factor in the Bolaños administration's economic policy. The excessive fiscal spending of the previous years had generated an unsustainable fiscal situation, where the government's revenues were insufficient to cover its needs. It had to turn to the BCN for financing, which worsened the serious public debt problem. To mitigate the crisis arising from the failure of four banks[1] in the preceding years, and to control the liquidity surplus in the economy, the BCN adhered to an aggressive domestic debt policy (see point C), which in turn limited credit availability for the private sector.

1.4 From 1998, when the total fiscal deficit rose to 6.7% of GDP, the situation has gradually worsened (Table 1), having reached 13.8% of GDP in 2001. It was necessary to take on a significant level of indebtedness and narrow the gap through external grants, which on average have represented 5% of GDP. This situation, caused in part by Hurricane Mitch, continued to have aftereffects in subsequent

[1] In 2000 and 2001, BANIC, BAMER, BANCAFE, and INTERBANK all went under.

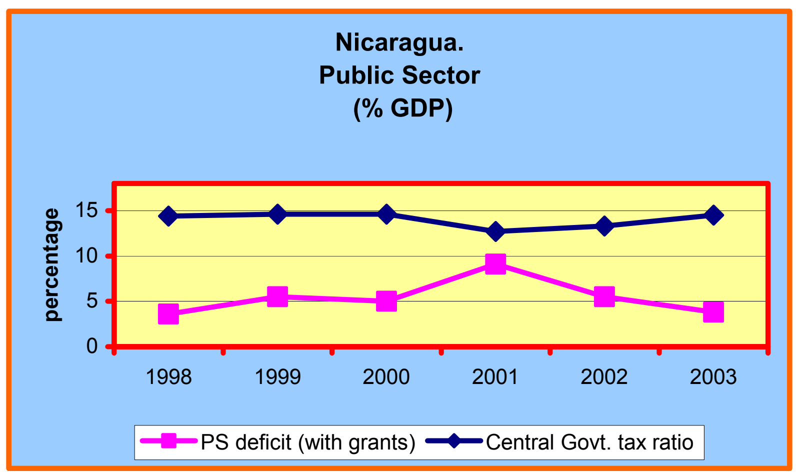
years because of the growing interest burden that the debt generated, which forced the authorities to adopt deficit control measures in 2002.

Table 1. NICARAGUA

Tax Burden and Fiscal Deficit (%GDP)					
	Tax Burden Central Govt. 1/	Tax Burden Central Govt.2/	Public Sector Fiscal Deficit (excl. grants) 2/	Grants	Public Sector Fiscal Deficit (incl. grants) 2/
1998	24.6	14.4	6.7	3.1	3.6
1999	24.8	14.6	12.5	7.0	5.5
2000	24.8	14.6	9.4	4.5	5.0
2001	21.5	12.7	13.8	4.7	9.1
2002	22.6	13.3	10.5	5.0	5.5
2003	24.7	14.5	8.9	5.0	3.8

Notes: (1) Calculated on the basis of GDP of national accounts based on 1980. (2). On the basis of GDP of new national accounts published in May 2003.
Source: BCN, IMF, OD3 estimates

1.5 As a result of the measures adopted, the total public deficit for 2002 dropped to 5.5% of GDP (10.5% without grants). These measures and others to be taken with support from this moderniza-tion of the State and fiscal reform loan are expected to make it possible to cut the deficit to manageable levels in 2003 and 2004. Nevertheless, the fiscal accounts situation remains critical and highlights the urgent need to adopt measures to restructure public spending and make it more efficient, and effect a stable increase in public revenues.



1.6 It should be noted that, as a result of the national accounts update and given that the GDP increased by approximately 70% in nominal terms,[2] the central government's tax ratio (tax revenues as a proportion of GDP) has been at a more realistic level of around 15% in the last six years, placing Nicaragua with countries at a similar level

[2] In May 2003, the Central Bank of Nicaragua updated national accounts with 1994 as the baseline year instead of the one used previously (1980).

of development. This also implies, however, that the tax burden is not as excessive as was thought and, in fact, there is a wide margin for improving collection (see Table 1).

C. The public debt

1.7 Total public debt at December 2002 came to US$7.942 billion. Domestic debt (Table 2) totaled US$1.583 billion (39% of GDP), while foreign debt (Table 3) came to US$6.362 billion (159% of GDP).

1.8 Domestic debt was comprised of Bonos de Pago por Indemnización [indemnity bonds] (BPIs) issued for confiscated property, in the amount of US$850 million, plus BCN certificates in the amount of US$671 million, of which US$585 million are in the form of Certificados Negociables de Inversión [negotiable investment certificates] (CENIs), and the remainder open market operations through the management of monetary policy. Because of the high amount of interest and short-term maturity, between 2003 and 2005 the government will have to meet an annual average amount of about US$450 million in principal and interest. In addition, BPI redemption, which begins in 2004, will become significant in 2007.

Table 2. Nicaragua. Domestic debt: balances and projections 1999-2005
(Millions of U.S. dollars)

	2002	**2003**	**2004**	**2005**
Instruments				
BPIs (1)	850	850	840	808
CENIs:	585	578	448	363
Auction	178	280	440	355
Bank failures	398	290	0	0
Coffee program	9	8	8	8
BOMEX (2)	24	0	0	0
TEIs (3)	16	0	0	0
TELs (4)	46	0	0	0
Bonds SS (5)	18	17	17	16
Other	44	42	57	74
Total	**1,583**	**1,487**	**1,361**	**1,261**
% GDP	39	35	30	26

(1) Indemnity bonds; (2) Bonds in foreign currency; (3) Special investment bonds; (4) Special liquidity bonds; (5) Social Security Institute bonds.

Source: BCN, IMF

1.9 Faced with the fiscal impossibility of covering those maturities and given that these liabilities imply enormous fiscal as well as monetary pressures, the government has been making an enormous effort to reschedule the debt contracted through CENIs, under more advantageous terms. In August 2003, the BCN was able to restructure the maturities and terms of the CENIs with the main holder of those certificates. The rescheduling includes a calendar of longer-term maturities and the issuing of new certificates with yields below 9% (previously 15% on average).[3] The rescheduling constitutes significant fiscal and monetary relief but does not completely resolve the problem, whose resolution is postponed for the medium and long terms. This demonstrates the need to improve tax revenues significantly.

1.10 Foreign debt by far outdistances domestic debt but the fact that Nicaragua has been admitted to the Highly Indebted Poor Countries (HIPC) Initiative enables it to reduce its debt by about 72% in present value when it reaches the HIPC completion point, which should occur in the near future (beginning of 2004). In the meantime, the country is benefiting from interim relief since it qualified for the decision point of the initiative in December 2000. In terms of bilateral debt, the amount owed to Costa Rica—US$561 million—stands out. Medium- and long-term debt accounts for 90% of total foreign debt.

Table 3.
Nicaragua: Foreign Debt Balance 2002
(Millions of U.S. dollars)

Creditor	Amount	%
Multilateral	2563	40
IDB	1100	17
World Bank	812	13
CABEI	391	6
IMF	174	3
Other	86	1
Bilateral	3555	55
Paris Club	1638	25
Other bilaterals	1917	30
Commercial banks and suppliers	244	5.0
TOTAL	**6,362**	**100**

Source: Central Bank of Nicaragua. International Department.

D. The tax situation

1.11 The report on Nicaragua's tax situation[4] prepared by the Bank (RE2) in 2002 emphasizes that: (i) significant challenges will have to be faced over the next few years to achieve sustained growth with equity and to reverse the current trend of many indicators (drop in the growth rate, increase in the public deficit, and lower tax burden, among others); (ii) the country's tax revenues are in full decline; in 1999 they grew 7.1% in real terms over the previous year, then dropped to 2.3% in 2000, and abruptly to –3.4% in 2001; and (iii) this trend presents a serious

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[3] The main holder of the CENIs is the Banco de la Producción (BANPRO), with over 60%.

[4] Inter-American Development Bank, *Nicaragua: Desafíos para la Modernización del Sistema Tributario [Nicaragua: Challenges for Tax System Modernization]*, mimeo, Washington D.C., August 2002, financed by the Governments of Sweden (SIDA) and Norway (NORAD) under the regional technical-cooperation operation *"Tax Reform for Human Development in Central America."*

challenge for the authorities if the goal is to reduce the country's vulnerability caused by external financing, cut the growing public sector deficit, generate resources to fight poverty, and face the financial challenges stemming from the new social security system.

1.12 In slightly less than one year, the authorities adopted various fiscal measures aimed at reversing the situation described above. While they have not all had the result anticipated by the Executive Branch, they do signal the latter's firm commitment to moving forward with clearly defined policies to solve this delicate situation. Some of these measures are indicated below:

a. The set of tax reforms that the Executive Branch sent to the Assembly in March 2002, which were approved the following September (Tax Base Expansion Act) and constitute the first phase of this process (see Box 1);

Box 1
Tax Base Expansion Act (Law 439 of September 2002)
Main Measures

Goods and services tax reforms

Increase in the international air transportation tax rate to 15% beginning in January 2003.

Gradual increase in tax on cement to 7% beginning in 2003 and subsequent annual increases until 15% is reached in 2006.

Increase in the exemption on electric power supply for consumption below 300 kW per month (previously up to 150 kW per month).

Repeal of the sale of invoices mechanism in the case of goods the transfer of which is subject to zero tax.

Expansion of the number of goods in the consumer basket subject to zero tax.

Income tax reforms
Increase in the tax rate for juristic persons from 25% to 30%.

Elimination of the exemption on interest from savings account deposits and term certificates of deposit, when earned by juristic persons.

Repeal of tax exemption for NGOs with financial activities.

Elimination of the exemption on National Lottery prizes when they exceed 50,000 córdobas, which will now be subject to 10% withholding.

Reform of the accelerated depreciation system, partially limiting its use.

Establishment of a presumptive payment of the income tax for casinos, slot machines, bingos, etc.

Specific consumption tax reforms
Expansion of the taxable base to sodas, extending the application of the tax including retailer markup.

Expansion of the tax on marketing of juices and soft drinks.

Elimination of exemptions and waivers
Elimination of any tax holiday or exemption benefit on imports, except where expressly

indicated by law, thereby repealing the benefits attached to State imports and a list of close to 1,500 products.

Extension of the withholding at source system
Increase in the withholding at source rate for the payment of professional services and fees from 5% to 10%.

Increase in the withholding at source rate on occasional earnings from 1% to 4%.

Increase in the withholding at source rate from 1% to 2% for the purchase of goods and services.

Application of a withholding at source rate of 7.5% for wood harvesting, and of 10% for income tax on importers, except for exempted goods or sectors.

Application of an income tax withholding system for payments abroad.

b. A 556 million córdobas reduction in the amount of expenses approved by the Assembly in 2001 for the 2002 budget;

c. Ratification of Law 447 in February 2003, increasing the rates applied to some taxes (vehicles and cigarettes) and tax of 0.2% on national private bank deposits (see Box 2).

Box 2
Changes in Laws 447 and 448 of February 2003

Specific consumer taxes increase on the importation of vehicles, to a range of 10% to 30% depending on the number of cylinders. Prior to this change the taxes ranged from 0% to 25% (Law 447).

The specific consumption taxes applied to the importation of cigars, small cigars, and cigarettes increased from 39% to 43% (Law 447).

Creation of a special tax to be paid by commercial banks operating in the country, equivalent to 0.20% of each entity's average monthly deposit balance (Law 448).

E. Situation prior to the reform (Fiscal Equity Act)

1.13 Nicaragua's collection structure was heavily concentrated on the following taxes: (i) the goods and services tax, which was collected on sales and the delivery of services in the domestic market as well as on imports of goods, represented 42% of total tax revenues in 2001; (ii) the selective tax on petroleum byproducts (18%); and (iii) income tax. These three sources accounted for 77% of total tax revenues. The high concentration on these sources had economic impact on the neutrality of the economic system and consequences on distributional equity, and limited the management capacity of the tax administration to expand its sphere of action.

1.14 In 2001, income tax accounted for 17% of total tax revenues, having maintained a constant share over the last few years, despite reforms introduced in 1997 and 1999. The collection of this tax came primarily from large businesses, in particular from those in the so-called “fiscal industry”, and from withholding at source.

1.15 In 1997, pursuant to IMF recommendations, a 1.5% tax was introduced on the value of tangible fixed assets and inventories as a minimum payment on the account of income tax. However, since the application of the rule was limited to enterprises that did not keep legally authorized accounting books, the effect of the measure was all but cancelled. Nicaragua’s tax system contained the same instruments as any tax system but its formal structure differed from what would be desirable when the characteristics of each tax was examined. The system became extremely complex because of the large number of exemptions, arbitrary treatment, and applicability criteria that undermined its transparency. The taxes that comprised it are listed below:

a. The income tax was assessed on a five-level scale and a maximum marginal rate of 25% on income earned by natural persons. Businesses or juristic persons were taxed at a proportional rate of 25%. The tax was not personal and comprehensive since it did not take in to account the personal characteristics of the taxpayer—since no deductions were provided for based on the size of the taxpayer’s family unit—but did allow for the progressive disappearance of capital income in its taxable base since dividends and shares distributed by juristic persons were not included in the taxable base of natural persons and exempted almost all income generated from deposits in financial instruments, issued by public and private financial institutions.

b. Property tax, the management and collection of which has been transferred to the municipios;

c. The value added tax, previously called the value tax, which had a general rate of 15% and differential rates of 5% and 6% for air transport and cement, respectively. This tax had two main problems. The use of the zero tax rate on imports or transfers related to a long list of goods and sectors such as: free zones, certain encouraged activities such as tourism, machinery, and equipment. There was also a list of goods and services that were exempted at sale or importation.

d. A set of selective taxes that, in addition to covering petroleum byproducts, assessed alcoholic beverages, sodas, and tobacco products with varying rates.

e. The country applied a customs tariff established on ad valorem bases, with rate levels that had been dropping over the course of the years; and

f. There was an additional group of small taxes that accounted for a small portion of total tax revenues.

1.16 The overall view of the tax system brought up the need to introduce reforms to make it more transparent, simplify the technical options applied, eliminate discretionary powers in the setting of tax bases, expanding them in a manner consistent with their impact on horizontal and vertical equity, and simplify procedures to make the tax administration's work easier. If the tax administration's management capacity were not strengthened, the set of provisions indicated would only help to stimulate evasion and noncompliance.

F. Main changes contained in the Fiscal Equity Act (Law 453)

1.17 In May 2003, the authorities adopted a critical fiscal measure with the enactment of the Fiscal Equity Act (Law 453), which includes minor changes to some taxes and administrative provisions, and material changes such as the creation of taxes and tax figures that were not in the legislation. (See Annex II for the estimated fiscal impact with the body of new measures.)

1.18 The preambular paragraphs of the law indicate the need to eliminate biases and distortions that undermine the operation of the economic system of the country's tax structure, aim towards a fairer tax system, expand the taxpayer assessment base, and develop mechanisms that stimulate and guide the economic process towards boosting exports. In this regard, it is worth highlighting the overlap between these objectives and those indicated in the document prepared by Regional Operations Department 2 (RE2) in August 2002.

1.19 The new law allocates an amount equivalent to 3% of annual gross collections to the tax and customs administrations. This is justified by the need to implement the law and make collection more efficient. It is worth noting that the budget allocation, which is permanent, must be renewed annually. This procedure takes into account a collection base of 1.7% of GDP; the respective administrations will need to increase annual collection by 0.6% of GDP. In other words, the budget allocation would only take place if the overall output of the law exceeds 2.3% of GDP. This standard is a difficult condition to verify and could only begin to be executed in the 2005 budget year, after the 2004 collection has been compared against the previous fiscal year's effort.

1.20 Among the changes introduced is a new **income tax** law that levels out the rate paid by juristic persons at 30% instead of 25%, limits the use of accelerated depreciation to exporters, eliminates the interest exemption on deposits in current and savings accounts and certificates for natural and juristic persons, and restores a minimum payment of 1% on account of the income tax determined on the monthly average of the year's total assets for both natural and juristic persons. Enterprises with assets below US$150 are exempt from this minimum tax as are those with fewer than three years of operation. The reform implemented has the right approach in that it moves towards expanding the assessment base, reduces exemptions and treatments that limit the tax's potential, evens out the rates between physical and juristic persons, and imposes a minimum payment requirement (1% of the value of assets) that will help enhance the fiscal impact of the reform, until the tax administration achieves the level of efficiency necessary to improve tax control.

1.21 The **value added tax (VAT)** was created and replaces the goods and services tax. Although the general rate of 15% is being maintained, it will drop to 14% beginning in May 2004, provided collection on an annual basis attained under the law and estimated at 1.7% of GDP is greater than 0.6% of GDP, i.e., that the increase is higher than 2.3% of GDP. The rate applied for the importation or transfer of cement gradually increases, beginning at a level of 7% in 2003 and rising to the same level as the general rate in 2006, thereby unifying the tax rates. The 0% rate is limited exclusively to exports and eliminated for domestic market operations. This last measure is one of the most significant ones structurally. The zero rate is repealed for domestic operations and replaced with the concept of exempted transfers, under which in many cases the benefit only applies to the VAT in the final stage of consumption. In other cases the benefit extends to the raw materials necessary to produce the goods (for example, printed matter and medication), and in others the exemption is limited to the national origin of the good (such as personal hygiene articles and butane gas, among others). There is an extension of the taxable events for the tax on financial services delivered by insurance companies, notaries, credit cards, leasing, overdrafts, check certification, and others.

1.22 Some of the other changes introduced by the law include:

a. New revenue stamp law;

b. Framework of offenses, penalties, and limitations, modifying administrative offenses, creating new penalties, and generating changes in the prescription system;

c. Changes in the **tax concession and incentive system** covering various domestic and import activities;

d. **Control of exemptions**, transparency, and fiscal stability, repealing a significant number of fiscal exemptions;

e. Transitory provisions establishing a number of special exemptions, ranking the currency of some rates (cement, for example) and applying guidelines for minimum collection for budget allocations for the Dirección General de Ingresos [Revenue Directorate] (DGI) and the Dirección General de Servicios Aduaneros [Customs Directorate] (DGSA);

f. Under Article 126, imports and transfers of intermediate and capital goods for the agriculture sector are exempted from duties and taxes until 2005; and

g. Article 127 exempts coffee producers whose asset level is “above” US$150,000 from the payment of the minimum tax for the first three years, as long as the price of coffee does not exceed US$80 per hundredweight.

1.23 The law changed the designation of the **General Sales Tax** adopting one more consistent with the nature of the tax; it has also changed its structure fundamentally, in accordance with the recommendations made in the aforementioned report on the Nicaraguan tax reform (RE2). In this regard, some procedures involving gradual advances have been established for purposes of generalizing the tax rate and limiting the use of the zero rate almost exclusively to exports, and expanding the assessment base thereof by extending its scope to a large portion of the transfer of goods in the stages preceding the end consumer stage in the case of goods in the consumer basket, and to the delivery of financial services that do not involve credit operations. A series of technical problems in the Tax Base Expansion Act of 2002 are also corrected, such as the sale of used assets, which are once again exempt.

1.24 It should be noted that, while the reforms are going in the right direction, some important areas are still in need of reform in the future, primarily the listing of fuels as VAT taxable goods. This measure, which implies changing the conglobated tax nature of these goods, will contribute to boosting the country’s international competitiveness without having to offer tax credits to exporters to offset the bias from the use of goods. In this way, similar effects would be achieved with greater administrative simplicity since the exporter will have a right to automatically request tax rebate payments.

1.25 **Selective consumer tax:** Reform of this tax has consisted in general of a change in designation with regard to the majority of goods, except in the case of cane sugar, which will be taxed at a rate of 2%. With regard to taxes on petroleum byproducts, the reform has a very significant reach, since it changes the taxation criterion; instead of being established as a percentage applied on the differential of the retail price less costs and profit margin, it will now be set as a fixed amount in dollars per gallon, which varies depending on the product taxed, making it much simpler than the current system. The VAT is also extended to certain fuel byproducts, especially oil for agricultural use and other goods at varying percentages, as provided in the law.

1.26 **Export-friendly treatment:** The new export-promotion system contained in the Temporary Admission Act establishes the granting of a “tax credit” of 1.5% of the exported FOB value, which may be credited against payment of the tax on exporters’ annual income. This benefit will be extended for seven years but will not apply to exports of goods from free zones. Exporters operating under the Temporary Admission Act may credit 25% of the tax on fuel used as input for the export product against the payment of annual income tax. A digressive scale for credit of the fuel tax will apply to exporters of fishery, industrial, and handicraft products, beginning at 75% with entry into force of the law, then down to 25% by 2007.

1.27 **Changes in the area of promotional schemes:** Law 453 attempts to solve the problem of the large number of deductions, reductions, and special treatments. Some positive aspects include the elimination of the tax credit certificate mechanism, under which any private individual was allowed to provide tourism investment capital funds and benefit from a tax credit of up to 70% of the total annual income tax liability. In addition, the benefit that allowed banks to consider interest from tourism sector loans exempt from income tax was eliminated.

1.28 Given the large number of special regimes in existence, Law 453 deepens the criterion followed by the previous Tax Base Expansion Act, establishing that all legal provisions granting tax deductions that are not contained in the positive list indicated in Article 123 of the law are repealed. This position serves to clarify the situation and highlights the large number of regimes that remain in force.

1.29 **Other provisions.** Law 453 legalizes the royalties for the issuing fishing licenses and aquaculture concessions, establishes rights for the development of traditional, small-scale, and large-scale fisheries, and expands the administration's authority in terms of streamlining the processes for collecting taxes, making it possible to apply presumptive criteria. In addition, it regulates the prescription regime, unifying the timeline for the tax authority and for taxpayer rights to four years, and establishes administrative and penalty infractions that will be part of the Tax Code.

1.30 **Main criteria established in the regulations under Law 453.** Because the law in some cases (income tax, VAT, and selective consumer tax) has replaced all tax provisions, the authorities have had to ratify new regulations for each of these tax instruments. The Executive Branch issued Decree 46-2003 on 6 June to implement the May tax reform.

1.31 Lastly, there are three provisions that require the Executive Branch to present for the Assembly's approval a series of new provisions, such as the Fiscal Responsibility Act, the Tax Career Service Act, and the Tax Code, within 180 days of the entry into force of Law 453, which are included as conditions for disbursement of the second tranche of this loan. These three provisions will help with the introduction and execution of the reform.

G. Achievements in reform-related operations

1.32 The Ministry of Finance (MHCP) has been executing loan 1045/SF-NI—modernization of the tax administration—the objective of which is to support the strengthening and modernization of the tax and customs administrations, through the implementation of an organizational model featuring high capabilities for planning and supervision at the central level plus decentralized operations. The institutional strengthening process has been supported by the adoption of the Law Establishing the Customs Directorate and amendment of the Law Establishing the Revenue Directorate, of April 2000. Implementing the reform of these administrations and leading them toward a current and modern model of tax and customs administration are essential tasks of the program under way. Both institutions seek to have a professional staff that is technically skilled and permanent.

1.33 Both directorates have experienced problems with political interference. Under the reform considered under this operation, the budget of both directorates will depend on the level of receipts, which is why they need flexibility and the legal capacity to determine who will work for them. For this reason, both the DGI and the DGSA have undertaken an assessment of their staff, although they have not yet been able to make the cuts considered at the start of the operation (1045/SF-NI). The adjustments are expected to be implemented beginning in 2003 in the context of a **Career Service Act**, the legislative approval of which will be supported by the NI-0172 program. This law will be consistent with a new Omnibus Civil Service and Career Service Act (currently under consideration by the National Assembly), which is part of a civil service reform program in the context of the public sector modernization program under the HIPC Initiative. If the Omnibus Civil Service Act is not approved before the end of 2003, the Career Service Act for the DGI and the DGSA will be comprehensive, as currently is the case with the laws applicable to teachers, the police and the foreign service. If the Omnibus Act is approved in time, the law for the DGI and DGSA will be specific to the special issues involved in customs and revenue.

1.34 At the DGI, the collection and receipts processes were transformed through the approval of regulations to support the process, staff training, adaptation of the tax information system, and implementation of a single file at the revenue administrations in Managua. The professional and technical level of DGI staff continues to be raised, through training in the collections area, and DGI staff has been evaluated using functions profiles and manuals developed for the reform of substantive processes. The verification strategy has been defined as well as the action plan to implement the adjustments and reforms to the verification system in 2003-2004. The verification work began with the establishment of a team to renew verification activities, the update of sector economic and fiscal studies, and the execution of the renewed verification programs, including a small taxpayer regime to replace the fixed-quota system. The review of the consensus-based **Tax Code** proposal is expected to be completed for approval by the National Assembly, as the linchpin of the verification process and as part of the fiscal reforms under way. The revenue administrations in Managua and five departmental revenue offices have been connected to the Integrated Administrative Financial Management and Auditing System (SIGFA) network and five departmental revenue offices are in the process of connecting to the Empresa Nicaragüense de Telecomunicaciones

(ENITEL) network. Tax information system changes and updates have been recommended, which are being reviewed and analyzed.

1.35 The Customs Directorate (DGSA) has made progress in preparing procedures manuals for the areas of customs surveillance, express mail, cargo and warehouse control, exports, customs transit, and imports. The management, middle-management and supervisory staff were evaluated and staffing changes have begun as well as the reassessment and redistribution of staff for the surface customhouse. The customs legislation compendium was completed in order to homogenize and facilitate the application of customs legislation; and draft amendments to key laws have been prepared, which will be incorporated into the **Omnibus Customs Act**, approval of which is expected to be supported through this program. With the restructuring of the Verification Division, progress was made with the introduction of the documents review and in the business audits, in accordance with the model designed. The staffing plan was implemented to set up the division, and a customs laboratory has been set up to support the classification of hard-to-identify goods. Risk analysis methodology the courier procedures manual were prepared with support from the MIF-financed regional project.

1.36 The DGSA continues to implement UNCTAD's SIDUNEA 2.7 computerized system and has decided to modernize the system. Studies of the region's customs information systems were completed under technical coordination by the Bank and the IMF. The DGSA needs a long-term contract and plan and a flexible system for maintaining and updating its hardware and software. It is currently dependent on an annual budget. In May 2003, steps were agreed upon to continue implementation of the change to the new technology system related to modernization of information systems and provision of hardware and communications, but the final decision needs to be made and communicated to the MHCP. The national customs system currently lacks information technology modules critical to having a system compatible with its trading partners: (i) control of entering and departing cargo; (ii) national customs transit; (iii) importation for consumption; (iv) export for consumption; and (v) control of in-bond processing. This policy-based loan will assist in the basic decision-making for moving forward with the institutional strengthening process.

1.37 Other customs areas to be affected by this operation involve the drafting and introduction of the **Customs Act** complementing the Uniform Central American Customs Code (CAUCA) and the implementation of the career service, both of which are needed to improve the organizational and operational aspects and those related to human resources management.

1.38 The aforementioned activities financed under loan 1045/SF-NI have supported the preparation of the reform and the related consultation and consensus-building processes; the loan will continue to be executed to support the introduction of the reforms and provide administrative capacity for execution. In addition, the set of legal reforms in the tax area and the institutional development will provide the DGI and the DGSA with political, administrative, legal, financial, and technical autonomy.

1.39 In the context of its strategy to enhance transparency and accountability, the IDB is providing support to the Comptroller General of the Republic (CGR) through loan 1100/SF-NI, which was declared eligible for disbursements on 29 January 2003. The electronic interconnection between the CGR and SIGFA (completed in August 2003 with support from Germany) establishes the technical foundation for conducting a complete audit of the Government of Nicaragua's accounts. The loan establishes an efficient and effective organizational and managerial structure, with appropriate mechanisms for control and with the capacity to train auditors and bring them up to speed. Despite the existence of Nicaragua's government auditing rules (NAGUN) and a legal framework for auditing, until now the Government of Nicaragua has not been in a position to fulfill the requirement of conducting a financial audit of all its accounts. The introduction of the SIGFA system and the connection between the MHCP and the CGR are expected to enable the government to present its audited annual financial statements in late 2004. That is why a condition for the second tranche is "that **the MHCP present consolidated accounts of budgeted central government entities to the Comptroller General of the Republic within 90 days after the end of fiscal 2004**" for financial audit by the CGR in accordance with NAGUN.

1.40 The IDB has ample experience in the design and implementation of modernization of the State programs in Nicaragua with the following programs: modernization of the Judiciary (pipeline NI-0081, loan 1047/SF-NI, 3.6% disbursed); financial sector (pipeline NI-0104, loan 1014/SF-NI, 100% disbursed); and efficiency and transparency in government procurement and contracting (pipeline NI-0143, loan 1046/SSF-NI, 15% disbursed).

1.41 The sector loan for a social policy reform program to support the poverty reduction strategy (NI-0169) demonstrates the responsibility assumed by the Government of Nicaragua to follow up on and meet the very precise budget item targets and indicators and has highlighted the commitment to carry out this type of activity seriously. It is part of the agreements concluded with the IMF in the context of the sector loan, which strengthen the objectives of the proposed operation.

1.42 The IDB's Multilateral Investment Fund is executing an operation with the Institute of Accountants to promote international accounting standards for the private sector; several of the program participants are government employees. In addition, the IDB is implementing a regional project on transparency in public accounts (ATN/SF-7661-RG) with Argentina, Bolivia, Chile, Peru, Uruguay, and Brazil, which will provide lessons for adopting measures to globalize public-sector accounting standards.

1.43 The IDB and the World Bank have prepared a Country Financial Accountability Assessment (CFAA) that was presented and discussed with the Government of Nicaragua in late August 2003. The CFAA noted that public financial administration has improved, having become more efficient through the integration of budget, accounting, treasury, public debt, and procurement, activities that are very important if broad-based financial reform is to be achieved. The foundations of a system of public participation in the scrutiny of public spending have been laid, but implementation will require overcoming the obstacles arising from the lack of public consultation, the difficulty of obtaining information on public finances, and the lack of public access to information. The capacity to manage and provide detailed information on the external public debt has been developed, but modernization of domestic debt management and the collection of data on debt accruals, and better coordination among the various entities involved with the public debt are still a priority.

1.44 The CFAA concluded that: (i) the traditional single-year budget system inhibits adequate public expenditure planning and there is incrementalism in its preparation; (ii) budget planning does not fully encompass all State funds and public expenditure is not closely tied to program outputs, making it difficult to measure performance; (iii) weak internal control and internal audit capacity in institutional spending prevent checking the legality and efficiency of expenditures; (iv) deficient monitoring and evaluation systems perpetuate the existence of obsolete and inefficient programs; (v) although modernization of the Office of the Comptroller General is under way, the lack of external audit reports on all government financial statements hinders transparency in public finances; and (vi) the public sector does not use international accounting standards. The government prepares annual budgets (for legal reasons), despite the fact that it has the capacity to budget in a multiyear framework, which affects continuity and investment planning.

H. Other support actions related to the operation

1.45 In 1999, the World Bank approved an economic management technical assistance loan in the amount of US$20.9 million to improve budget procedures, treasury functions, and the management of public debt and information technology. The loan is 87% disbursed. As a result of the operation, SIGFA should be operating in all central government entities for budget planning, preparation, follow-up, and execution by the end of 2003. In the specific case of the CGR, the staff has received training on electronic auditing methods; but SIGFA has not been used for the audit. The *nómina fiscal* system, through which public employees are paid with the respective budget control, has been integrated into SIGFA. In addition, SIGFA has supported the preparation and monitoring of the program with the IMF and the poverty reduction strategy.

1.46 The Civil Service and Career Service Act could be approved by the end of October, laying the foundation for guaranteeing a professional bureaucracy and giving government employees job stability. The legislative proposal, which would be implemented by the current government, went through at least 16 drafts, of which three were presented by the coordination unit of the public sector reform and modernization program to the National Assembly. More than a gesture of support for the administration, the law is considered a priority for reaching the final phase of the HIPC Initiative and giving rise to job stability in the government. The law that guarantees job stability for nonpolitical technical staff is applicable to any government. Its approval would give a positive signal as to the feasibility of the other reforms proposed in this operation.

1.47 The World Bank is preparing new loans in 2003 for modernization of the public sector and poverty reduction in Nicaragua.

I. The Bank's sector and country strategy

1.48 In the Bank's strategy with Nicaragua (GN-2230-1 of 5 February 2003), the first strategic approach is economic growth as a necessary condition for poverty reduction; the first instrument for promoting growth is strengthening of fiscal policy, i.e. cutting the fiscal deficit, and therefore reducing domestic debt. The second instrument involves promoting competitiveness and production, which includes the establishment of a tax system that will spur investment and minimize tax distortions in the market. As has been described, this operation is key to the country's and Bank's strategy.

1.49 The second strategic approach is to establish an efficient, effective, and honest government with the capacity to attain the goals of the Economic Growth and Poverty Reduction Strategy (EGPRS).

J. Coordination with other donors and consultation with stakeholders

1.50 The 1991-2001 country program evaluation prepared by the Office of Evaluation and Oversight (OVE) in 2002 emphasized the need for coordination among donors. Accordingly, the team has worked in partnership with the World Bank in preparing the CFAA, about which the donor community was consulted, including the European Commission, which is drafting its own "evidence of conformity."

1.51 The IDB, the World Bank, and the IMF have followed a coordinated program in which the IMF has developed the macroeconomic framework, the World Bank has focused its efforts on public sector reform, including the civil service, and the IDB has concentrated on fiscal reform. Under this framework, the three institutions have worked closely to ensure consistency among their programs and avoid duplication in the allocation of resources.

1.52 In the fiscal sector, the Bank participated with the Governments of Sweden and Norway in the financing of a tax study, the preparation and discussion of the reform, the diagnostic assessment of the problem, and the design of viable solutions.

1.53 Lastly, both the enactment of the Fiscal Equity Act (Law 453) and the preparation of the draft Tax Code have required a national consensus-building effort that is the result of a broad process of consultation and dissemination, supported by loans being executed and by dissemination activities such as high-level fiscal policy meetings and workshops.

II. PROGRAM DESCRIPTION

A. Objective

2.1 The operation's overall objective is to improve Nicaragua's fiscal situation:

a. On the revenue side, the collection of domestic taxes and customs duties is expected to increase through the application of a sounder legal framework, better regulations, a fiscal code, and more effective, fairer, and less arbitrary collection institutions. In addition, exports will be promoted and the cost of collection cut.

b. On the expenditure side, government resources will be managed more efficiently and transparently, through the establishment of guidelines to prepare properly defined budgets.

B. Program structure

2.2 The proposed operation is a policy-based loan (PBL) that is consistent with the process of State reform undertaken by the Government of Nicaragua in the area of fiscal reform. The loan will cover areas of reform with regard to revenues, specifically the strengthening of tax reform and modernization of customs, and some priority issues on the spending side, such as the Fiscal Responsibility and Budget Restructuring Act. The program has three main thrusts: (i) to strengthen the legal framework for tax collection; (ii) to strengthen the institutional framework for tax collection; and (iii) to improve budget management.

a. The main measures to strengthen the legal framework for tax collection include approval of the Social Equity Act and its implementing regulations, entry into force of a tax code, and entry into force of a customs act;

b. With regard to strengthening the institutional framework for tax collection, it was agreed that a Career Service Act for the Revenue and Customs Directorates would be brought into force and that the administrative actions described in paragraphs 2.11 and following would be taken in the DGSA;

c. Improving budget management includes approval and entry into force of a Fiscal Responsibility and Budget Restructuring Act and implementing regulations.

2.3 The loan is in the amount of US$25 million, to be disbursed in two tranches. The first tranche, in the amount of US$15 million, will be disbursed after the Board approves the loan, since the government has already fulfilled the conditions. These include approval of the Fiscal Equity Act (which the government approved taking into account the Bank's policies in the sector and country), and approval of the regulations of the Fiscal Equity Act (Decree 46-2003 of 13 June). Moreover, the conditionality matrix calls for the Customs Directorate to make certain decisions and implement actions, with support from loan 1045/SF-NI. The first tranche is characterized by its legal nature, which establishes the laws of a tax system that is efficient in administrative and economic terms, and is equitable, fair, and transparent.

2.4 The second tranche, in the amount of US$10 million, will be eligible for disbursement when the established conditions have been fulfilled. The disbursement will be made at least 18 months after the entry into force of the loan contract. The second tranche emphasizes execution, implementation, and institutionalization of reforms. The size of the first tranche is justified because approving the Fiscal Equity Act and issuing its implementing regulations constitute the most difficult steps in the reform.

2.5 The PBL will require a parallel technical-cooperation operation (for US$289,000), the objective of which is to support the Government of Nicaragua in the performance of specific activities needed to meet the conditions of the disbursements, financed with resources from the net income of the Fund for Special Operations (FSO) on a nonreimbursable basis (see technical-cooperation plan of operations ATN/SF-8464-NI. Other studies and activities to prepare for meeting the conditions, including the development of an information system for customs administration, will be financed with resources from loan 1045/SF-NI.

C. Conditions precedent to both disbursements

2.6 The measures included in the program are to be implemented within a macroeconomic context consistent with its objectives. Having a macroeconomic climate that is conducive to achieving the program's objectives will be a condition precedent to disbursement of each of the two tranches of the loan. The conditionalities for each disbursement are described below.

D. Strengthening of the legal framework for tax collection

2.7 As described in paragraphs 1.17 to 1.28, a Fiscal Equity Act (Law 453) has been approved and entered into force. The law regulates the following: (i) minimum tax on income and/or total assets; (ii) expansion of the income tax base including interest; (iii) elimination of the 0% VAT basic rate (except for exporters); and (iv) reduction of exemptions. The implementing regulations for the Fiscal Equity Act have been approved and are in force.

2.8 The Customs Directorate will contract the consulting services needed to begin preparing a Customs Act that complements the Uniform Central American Customs Code (CAUCA) and includes, among other things, the customs infraction system.

2.9 For disbursement of the second tranche, a tax code will have had to be approved and entered into force. The tax code is currently being revised in light of best international practices. It will clearly define each party's rights and obligations and will contain the following points: (i) the definition of a fair and progressive system of sanctions and fines in proportion to the infraction, with the aim of promoting voluntary compliance, including determination of criminal penalties for evasion; (ii) the power to close establishments for violations; and (iii) definition of the powers of the administration to require information from third parties. To support the Government of Nicaragua in preparing this law, the parallel technical-cooperation operation ATN/SF-8464-NI (support for tax reform) will provide funds for an international specialist on tax code best practices.[5]

2.10 To strengthen the DGSA's legal framework, the Customs Act and its implementing regulations, which are to be consistent with the domestic tax code and the CAUCA, are to be approved and in force for the second tranche.

E. Strengthening of the institutional framework for tax collection

2.11 For the first tranche, consultants will be hired to prepare a draft revenue and customs career service act. The latter's entry into force is included as a condition for the second tranche. Also included is adoption of a decision communicated by the MHCP on the customs management information system model and the associated procedures based on the systems study conducted by the DGA with IDB and IMF support.

2.12 Conditions for the second tranche include entry into force of the Revenue and Customs Directorates' Career Service Act and implementing regulations consistent with Law 453 (see paragraph 1.31) and international best practices, which: (i) strengthens the technical and legal autonomy of the institutions as provided for in the Law Establishing the DGA and the amendment of the Law Establishing the DGI (No. 339 of 6 April 2000); (ii) provides each institution with the capacity to determine their payroll based on their work and budget, taking into account the new system for allocation of resources as a percentage of revenues; (iii) establishes a transparent, competitive, and merit-based recruitment system; (iv) promotes an ongoing professional training system; (v) promotes a professional, permanent career; (vi) promotes high public service standards; and (vii) requires a professional code of ethical conduct. This Law is expected to be consistent with the draft civil service and career service legislation currently being considered by the National Assembly. To support the Nicaraguan government in the preparation of this law, the aforementioned parallel technical-cooperation operation ATN/SF-8464-NI, support for tax reform) provides funding for a specialist in this area.

2.13 As a condition for the second tranche, the DGSA will have at least three of the five following modules of the new customs management information system in place

[5] The terms of reference for the specialists financed under ATN/SF-8464-NI can be found in the files for that operation.

and in operation: (i) control of entering and departing cargo; (ii) national customs transit; (iii) importation for consumption; (iv) export for consumption; and (v) control of in-bond processing. The customs service will be required to have information and communications systems in full operation, outsourced to the private sector. To support the Nicaraguan government in meeting this condition, the aforementioned parallel technical-cooperation operation (ATN/SF-8464-NI) provides funding for a customs specialist and for the tender processes, a team of seven specialists with experience in information technology, tenders, communications, and maintenance.

F. Improvement of budget management

2.14 To improve government resource management, as a condition for the second tranche it was agreed that the Fiscal Responsibility and Budget Restructuring Act and implementing regulations would be adopted and consistent with the reform approved, as required under the Fiscal Equity Act (see paragraph 1.31). The component of the Fiscal Responsibility Act provides for: (i) the prevention of excessive and repeated deficits, through a balance between society's aspirations and the revenues it places at the government's disposal; (ii) a ceiling on public debt at a prudent level compatible with tax revenues and public assets, providing a safety margin to absorb the effects of unforeseen events; (iii) adoption of predictable and stable tax policy; (iv) presentation of a multiyear planning framework for each annual budget, beginning with budget preparation for 2006; and (v) adoption of international accounting standards for the public sector. To support the Nicaraguan government in the preparation of this law, the aforementioned parallel technical-cooperation operation (ATN/SF-8464-NI) provides funding for a budget specialist.

2.15 In the interest transparency, a condition agreed upon for the second tranche is that the MHCP would present consolidated accounts of the budgeted central government entities[6] to the CGR within 90 days after the end of fiscal year 2004 on the year prior to the year in which the disbursement is made, for financial audit by the CGR, in accordance with Nicaragua's government auditing rules (NAGUN) of April 2002.

G. Lessons taken into account from other operations

2.16 Lessons considered important from the experience of other policy-based loans have been incorporated into this operation. The first is to pay attention to the introduction

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[6] The institutions included in the central government are: National Assembly, Supreme Court, Supreme Electoral Council, Comptroller General of the Republic, Office of the President of the Republic, Ministry of the Interior, Ministry of Foreign Relations, Ministry of Defense, Ministry of Finance, Ministry of Development, Industry, and Trade, Ministry of Education, Culture, and Sports, Ministry of Agriculture and Forestry, Ministry of Transportation and Infrastructure, Ministry of Health, Ministry of Labor, Ministry of Environment and Natural Resources, Ministry of Family, Nicaraguan Institute for Municipal Development, Office of the Attorney General.

and execution of a legal reform through preparatory and subsequent activities. With IDB operations under way in the DGI/DGSA and the CGR, and World Bank operations in the area of modernization of the State, the government has maintained momentum and a growing interest in acquiring modern skills and know-how. To support the sustainability of the reforms, a second tranche promotes actions in support of legal reforms. The government is executing several institutional development operations.

2.17 The second lesson is that this type of reform should begin early in the political life of an administration. The current government took office in November 2001 and has enough time and a high level of interest and motivation to enforce its mandate.

2.18 The third lesson is to take advantage of other related required actions that complement and support the reforms; in Nicaragua, the HIPC Initiative and associated reforms, the poverty reduction and economic growth strategy, the fight against corruption, the macroeconomic stability program with the IMF, and the interest of the friendly countries of Nicaragua create a climate conducive to fiscal reform.

2.19 Responsibility for execution of a reform should remain within a single institution and at a single level of government, to avoid the obstacles that can arise from conflicts between institutions. Accordingly, it is recommended that responsibility for execution of this operation remain with the MHCP and two of its directorates, the DGI and the DGSA. It is also suggested that the institution that executes the reforms also benefit from them.

2.20 Lastly, an important lesson has been that consensus on the part of all stakeholders and civil society on the subject of the reforms is needed. The Government of Nicaragua has placed significant emphasis on the consensus-building process. For example, in the development of the draft tax code, the government had an extensive discussion with the Chambers of Commerce and Industry of Nicaragua.

III. PROGRAM EXECUTION

A. Borrower and executing agency

3.1 The borrower will be the Republic of Nicaragua, which has designated the Ministry of Finance (MHCP) as program executing agency. The MHCP will have the following responsibilities: to deliver reports and evidence of fulfillment of the operation's conditions; and to receive funds.

B. Project execution and administration

3.2 The components and actions pertaining to the customs system will be executed by the DGSA.

C. Procurement of goods and services

3.3 There is no procurement to consider inasmuch as this is a policy-based loan. The quick-disbursing resources of the sector loan will be used, among other things, to support the borrower's balance of payments. In this case, the sector loan procedures established in document GN-2001-2 will apply; accordingly, international competitive bidding will not be required. The funds will be disbursed when the borrower presents evidence that all the contractual conditions have been fulfilled to the Bank's satisfaction.

D. Execution and disbursement timetable

3.4 The disbursement period will be at least 18 months, as required by the Board of Governors for policy-based loans (AG-1/02). Execution of the parallel technical support activities (ATN/SF-8464-NI) coincides with the disbursement of the second tranche.

E. Technical supervision

3.5 Technical supervision will be the responsibility of State and Civil Society Programs Division 2 (RE2/SC2) with support from the Integration, Trade, and Hemispheric Issues Division (INT/ITD).

F. Reports and monitoring

3.6 The borrower, through the executing agency, will submit annual reports on progress in the implementation of the reform program to the Bank within the first three months of each calendar year during program execution. Depending on the progress reports, it will meet with the Bank to share views regarding progress achieved in program implementation. If the Bank deems it necessary, within 30 days following the Bank's notification, the borrower will submit reports or plans containing any measures needed to adjust program execution.

G. Evaluation

3.7 The anticipated results of the program and impact indicators are listed in Annex II; these indicators will be updated annually to measure the scope of the reform. The set of indicators will be examined in the final evaluation, to be conducted in accordance with terms of reference agreed upon by the borrower and the Bank, which will serve as a basis for the preparation of the project completion report (PCR). The borrower undertakes to cover all the costs related to gathering the necessary data and to guarantee that they will be available, though for the time being, it does not undertake to commit additional resources for the evaluation.

3.8 The parallel technical-cooperation operation ATN/SF-8464-NI includes resources to finance consulting services the main objectives of which are to: (i) identify the most appropriate GDP and collection data to serve as baseline for the impact evaluation; (ii) quantify the impact of the reform in terms of tax revenues, economic efficiency, distributional equity, and administrative efficiency, as a result of the Fiscal Equity Act (Law 453); (iii) analyze any deficiencies in the implementation of the tax reform contained in Law 453; (iv) propose corrective measures; (v) analyze the effects on collection of the loss of fiscal resources (tariffs, VAT base, and selective) due to the possible entry into force of bilateral and subregional free trade agreements (through the bilateral and multilateral FTAA and WTO processes); and (vi) present alternatives.

IV. VIABILITY AND RISKS

A. Environmental viability

4.1 In view of the nature of this operation, the project team does not anticipate environmental impacts.

B. Social impact

4.2 The program may have a positive social impact as it contributes to the long-term sustainable financing of the country's development programs. In addition, it indirectly helps to increase the number of taxpayers while at the same time the burden on current taxpayers is reduced.

C. Social equity classification

4.3 This operation does not qualify as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704)

D. Benefits

4.4 The government estimated that the Fiscal Equity Act would lead to an annual increase in tax revenues of about 760 million córdobas, the equivalent of US$50 million. (See Table III and Annex II for details on each tax.)

Table 3.
Concentration of the collection impact of Law 453 on "managed collection"
(in millions of córdobas and as % of total)

Measure	*Millions of C$*	*As %*
Minimum income tax	190	24.9
Elimination of accelerated depreciation[7]	56	7.4
Elimination of VAT zero rate	208	27.4
Reduction of exemptions	96	12.6
Increase in luxury taxes	72	9.4
Remaining measures	139	18.2
TOTAL	**761**	**100.0**

[7] The net increase in collections stemming from the limitation of the accelerated depreciation criterion is neutral, inasmuch as this measure only implies a temporary change at the time the tax is paid, which could lead to questioning the rationale for considering its impact on the aforementioned data.

E. Beneficiaries

4.5 It is not possible to identify direct beneficiaries since this is a policy-based program.

F. Risks

4.6 The main risk is a possible lack of consensus in the National Assembly. The recent approval of various reform laws by that body indicates, however, that the government stands ready to proceed with reform. Moreover, in June 2003 the International Monetary Fund announced approval of the first and second revisions of the agreement in force with Nicaragua, and authorized disbursement of two installments in the amount of US$19.8 million, indicating its faith in the Government of Nicaragua's will to fulfill all the agreed reform targets. The Bank's recent experience with the sector loan for a social policy reform program to support the poverty reduction strategy (NI-0169) inspires confidence in the feasibility of achieving consensus for the remainder of the measures to support reform.

4.7 A sensitivity analysis was conducted of the main reform variables, which indicates the need for careful monitoring to ensure that the increase in collections is sustained. To make sure that such monitoring takes place, it was agreed that a study and analysis would be performed of the fiscal sacrifice and fiscal macro impact of integration, to be financed with resources from the technical cooperation operation. The study and analysis will not only make it possible to evaluate the preliminary impact on fiscal collection, but also to make progress in considering its impact on the economic structure and on the equity of the group of activities undertaken over the last three years, since tax expenditures have produced a substantial variation in the way the tax burden is allocated among the various economic sectors. The impact of exogenous economic events on domestic collection is demonstrated. In addition, a methodology and capacity within the MHCP are being developed for ongoing evaluation of that impact. With these data, the Government of Nicaragua will be able to guide and direct the administrative and legal capacity to achieve the collection targets, not only in financial terms but also with regard to economic impact and equity.

4.8 The sensitivity analysis identified a specific technical risk, which is the reform's concentration on resources expected to be obtained through the application of a minimum income tax and the reduction in the number of goods affected by the VAT zero rate (52% of the estimated total). This concentration requires paying special attention to the regulatory aspects of the law, in order to avoid risks that could affect the application of these measures, such as appeals that could limit their scope. This possibility will be included in the study on the tax burden being financed under the parallel technical-cooperation operation.

NICARAGUA. Modernization of the State and Fiscal Reform (NI-0172)
Conditionality Matrix (See Annex II for Fiscal Performance Indicators)

Objective	Related actions to support the project	First Tranche Expected results	Second Tranche Expected results
I. Macroeconomic policy framework			
1. Economic stability	1-a) Signed letter of intent with the IMF (December 2002).	1-b) Macroeconomic policy framework is consistent with program objectives.	1-c) Macroeconomic policy framework remains consistent with program objectives.
II. Strengthening of the legal framework for tax collection			
2. Increase in tax revenues (and reduction of fiscal deficit) and equity of tax system.	2-a) Tax Base Expansion Act (approved September 2002). 2-b) Loan 1045/SF-NI Modernization of the Tax Administration—strengthening and modernization of the tax and customs administrations (INT/ITD). 2c) Study and high-level meeting: "Nicaragua: Challenges for tax modernization" (RE2/MGR).	2-d) Adoption and entry into force of the Fiscal Equity Law, which governs: – minimum income tax and total assets; – expansion of the income tax base to include interest; – elimination of the 0% tax base in VAT (except for exporters); – reduction in exemptions. (Approved) 2-e) Adoption and entry into force of Fiscal Equity Act implementing regulations. (Approved) 2-f) Customs Directorate actions: – Has hired consulting services needed to begin drafting a comprehensive Customs Act that complements the Uniform Central American Customs Code (CAUCA), which includes, among other things, the customs infraction system.	2-g) Adoption and entry into force of a tax code that: – defines a fair and progressive system of fines in proportion to the infraction, with the aim of promoting voluntary compliance, including determination of criminal penalties for evasion; – establishes the power to close establishments for violations; and – broadly and precisely defines the administration's power to require information from third parties. 2-h) Approval and entry into force of Customs Act and implementing regulations, which are consistent with the domestic Tax Code and the CAUCA and include: – in a single legal body, customs rules that are not included in CAUCA; – the guidelines necessary to efficiently organize the DGSA's activities and staff, in the context of fiscal control, without neglecting the facilitation aspects required by the new economic situation.

Objective	Related actions to support the project	First Tranche Expected results	Second Tranche Expected results
III. Strengthening of the institutional framework for tax collection			
3. Improve the capacity and effectiveness of collection institutions.	3-a) Law Establishing the Customs Directorate and amendment of the Law Establishing the Revenue Directorate (April 2002). 3-b) Loan 1045/SF-NI Modernization of the Tax Administration—strengthening and modernization of the tax and customs administrations (INT/ITD. 3-c) Draft Civil Service and Career Service Acts (September 2003).	3-d) Customs Directorate actions: – Has hired consultants to prepare the draft Tax and Customs Career Service Act. – Adoption of a decision communicated to the Ministry of Finance on the information system model for customs management and associated procedures based on the systems study performed by the DGA with support from the IDB and the IMF	3-e) Approval and entry into force of the Revenue and Customs Directorates' Career Service Act and implementing regulations consistent with the new Civil Service and Career Service Act, that: – strengthens the technical and legal autonomy of the institutions as provided for in the Law Establishing the DGA and the amendment of the Law Establishing the DGI (No. 339) of 6 April 2000; – provides each institution with the capacity to determine their payroll based on their work; – establishes a transparent, competitive, and merit-based recruitment system; – promotes an ongoing professional training system; – promotes an ongoing professional training system; – promotes high public service standards; and – requires a professional code of ethical conduct. 3-f) At least 3 of the following 5 modules of the new customs information system in place and in operation – control of entering and departing cargo; – national customs transit; – importation for consumption; – export for consumption; and – control of in-bond processing.

Objective	**Related actions to support the project**	**First Tranche Expected results**	**Second Tranche Expected results**
			3-g) Have information and communications systems, allocated through outsourcing, in full operation at customs.
IV. Improvement of budget management			
4. Establish guidelines for preparing budgets that are properly defined and allow for efficient and transparent management of government resources.	4-a) SIGFA in place at all central government departments and most of the functional decentralized public sector. Modernization of budget procedures program (with World Bank support). 4-b) Country Financial Accountability Assessment (CFAA) prepared by the IDB and the World Bank. 4-c) A MIF operation with the Institute of Accountants to promote international accounting standards.		4-d) Approval and entry into force of the Fiscal Responsibility and Budget Restructuring Act and implementing regulations, which call for: – the prevention of excessive and repeated deficits, by seeking a balance between society's aspirations and the revenues it places at the governments' disposal; – ceiling on public debt at prudent level compatible with tax revenues and public assets, providing a safety margin to absorb the effects of unforeseen events; – adoption of predictable and stable tax policy; – presentation of the budget in a context of multiyear planning, beginning in 2006; and – adoption of international accounting standards by the public sector.

Objective	Related actions to support the project	First Tranche Expected results	Second Tranche Expected results
5. Improvement in public finance transparency and foundation laid for audit of all government accounts.	5-a) IDB—support for the CGR (with loan 1100/SF-NI) and electronic connection between the CGR and SIGFA, establishes a technical base for conducting full audit of Government of Nicaragua's accounts. 5-b) CFAA presented and discussed with MHCP, IDB, and World Bank.		5-c) The MHCP will present consolidated accounts of budgeted central government entities to the Comptroller General of the Republic within 90 days after the end of fiscal 2004 or the year prior to the year in which the disbursement is made, for financial audit by the CGR pursuant to April 2002 government auditing rules of Nicaragua (NAGUN).

Modernization of the State and Fiscal Reform
NI-0172
Indicators by Tax of the Collection Impact of Fiscal Reform

I. Estimates of Additional Managed Collection by Tax
(First year of the reform in full operation)

Measures	Annual Impact (millions of C$)	Annual Impact (millions of $)	Structure (as % of collection)	Increase/collection 2003 (in %)	Impact % GDP 2003 base 1994
Total revenues	732.9	48.5	96.3	7.9	1.2
Income tax	**337.6**	**22.4**	**44.4**	**16.0**	**0.5**
Minimum payment of 1% on gross assets	189.7	12.6	24.9		0.3
Accelerated depreciation only for exporters under the Temporary Admission Act	56.2	3.7	7.4		0.1
Withholding on transactions in the Agricultural Exchange	41.6	2.8	5.5		0.1
Other	50.1	3.3	6.6		0.1
Value added tax	**303.9**	**20.1**	**39.9**	**7.9**	**0.5**
Elimination of zero rate in domestic market (basic basket exempt)	208.3	13.8	27.4		0.3
Waivers and exemptions on domestic sales	49.9	3.3	8.6		0.1
Waivers on imports	45.6	3.0	6.0		0.1
Selective consumer tax	**78.7**	**5.2**	**10.3**	**3.9**	**0.1**
Reduction in range of rates on imports of luxury goods	71.7	4.7	9.4		0.1
Other	7.0	0.5	0.9		0.0
Import tariffs	**6.9**	**0.5**	**0.9**	**1.1**	**0.0**
Waivers, exemptions, and special treatment	6.9	0.5	0.9		0.0
Other revenues	**5.8**	**0.4**	**0.8**	**0.9**	**0.0**
Cost reduction measures	27.8	1.8	3.7		0.0
TOTAL	760.7	50.4	100.0		1.2
Nominal GDP (millions of C$)					61,926.6