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# Uniform Tax Incentives Legislation in Central America

## Introduction

Central America in recent years has proved to be a popular place for American investment in manufacturing activities. A variety of U.S. firms have established manufacturing or assembly facilities in one of the five Central American nations<sup>1</sup> or concluded licensing arrangements with local entrepreneurs. Most of these regional operations have been established since 1958, when the first of the several treaties establishing the Central American Common Market (CACM) was signed.<sup>2</sup> Since 1963, the CACM has provided most regional manufacturers with duty free access to the entire market region (1968 population, 15,000,000), and adequate protection from extra-regional competition through a common external tariff.<sup>3</sup>

The attractiveness of the area for American investors has been further enhanced by the availability of various tax incentives. Until recently, these incentives were offered under separate, though similar, legislation in each of the five countries. The laws and the available benefits differed in some respects, but most offered tariff exemptions for imported materials, supplies and equipment; tax exemptions; and other incentives such as reinvestment credits and investment guarantees.

On March 23, 1969, national industrial encouragement legislation was largely superceded by the Central American Convention on Fiscal In-

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<sup>1</sup>Panama, for historical reasons, is not considered politically a part of Central America.

<sup>2</sup>Multilateral Treaty on Free Trade and Central American Economic Integration, signed June 10, 1958.

<sup>3</sup>Free trade was established for most products of regional origin under the General Treaty for Central American Economic Integration (signed December 13, 1960). The common external tariff began with the Central American Convention on the Equalization of Import Duties (signed September 1, 1959), and has been expanded to cover more than 96 per cent of all product groups through additional protocols. Among the products still not subject to free trade and/or a common tariff are wheat and wheat flour, electronics, motor vehicles, petroleum and some petroleum products, sugar and unprocessed coffee.

centives for Industrial Development. The Convention, signed in 1962, is based on the premise that the industrial development of the region can be best encouraged through the application of uniform fiscal incentives legislation throughout the region. With minor exceptions, it will be applicable to all new applications for fiscal benefits filed with any of the member governments.<sup>4</sup> The Convention has been applied in Central America since the late summer of 1969, although as of January 1, 1970, the implementing regulations had not been completed.

This article is a brief summary of the most important provisions of the Convention and its Protocol.<sup>5</sup> The implications for potential American investors in Central America are also discussed.

## **Features of the Convention**

### *A. Applicability*

Like the national laws it replaced, the Convention on Fiscal Incentives is broadly applicable; benefits may be granted for "the establishment or amplification of manufacturing industries which contribute effectively to the economic development of Central America."<sup>6</sup> The Convention is exclusive insofar as it prohibits member states from granting other "fiscal privileges" to *manufacturing* industries except as provided for in the Convention and Protocol. It does not necessarily replace national legislation insofar as the latter is applicable to extractive, service and certain other "industries."<sup>7</sup> Nor in most respects will the Convention affect firms which currently enjoy fiscal benefits under national legislation.<sup>8</sup>

<sup>4</sup>Under the draft regulations, applications which had already been approved at the time the Convention went into effect (March 23, 1969) are to be granted benefits according to the old laws. (Transitional Article 1, Draft Regulations).

<sup>5</sup>Honduras' demand for special treatment as the least developed member of the CACM led, in 1966, to the signing of a special Protocol to the Fiscal Incentives Convention, which gave Honduras authority to grant somewhat more extensive benefits than those to be granted by the other four nations. Both Convention and Protocol went into force simultaneously on March 23, 1969.

<sup>6</sup>Convention Article 2. English translations of the Convention, Protocol and other major instruments of Central American economic integration may be found in Inter-American Institute of International Legal Studies, *INSTRUMENTS RELATING TO THE ECONOMIC INTEGRATION OF LATIN AMERICA* 3-199, esp. at 117-42 (Oceana, Dobbs Ferry, N.Y., 1968).

<sup>7</sup>Specific exceptions are made for mineral, petroleum or natural gas extraction, forestry, fishing and service industries, agricultural activities, and the construction of low cost housing. The exceptions are not, however, to include the "typically manufacturing processing of the products obtained, which will be controlled by the provisions of this agreement." Article 3, Convention. Independent provisions of national legislation, such as those governing price regulation, accounting and inspection, are presumably not affected by the Convention.

<sup>8</sup>Firms which have received benefits under national industrial encouragement laws are not eligible for benefits under the Convention once those original benefits have expired.

## B. Classification

Applicants for benefits under the Convention are placed in three categories. Group "A" firms are those which produce raw materials or capital goods, or other goods whose materials are at least 50 per cent of regional origin. Group "B" firms are those which produce semi-finished and consumer goods, or containers, with a "high" production value added.<sup>9</sup> Group "C" encompasses all other firms, specifically including those which "simply assemble, pack, cut up or dilute products," or are involved in the manufacture of beverages, tobacco products and most cosmetics.<sup>10</sup> Groups "A" and "B" are further divided into "new" and "existing" categories. "New" industries are those which manufacture products not yet made in the *country* or, if manufactured, are made only under rudimentary methods, if in the latter instance there is still substantial unfilled demand. All other industries in groups "A" and "B" are considered "existing."<sup>11</sup> It is important to note that the application of these classification distinctions is to be on a country-by-country basis for the first seven years during which the Convention's provisions are in effect. Only after that period will classification be on the basis of what manufacturing is currently carried on in the *region*.<sup>12</sup>

## C. Benefits Available

The benefits offered under the Convention are similar in nature to those previously offered under the national laws: customs exemptions for machinery, raw materials, semi-manufactured products, containers and fuels (excluding gasoline), and exemptions from income, profits and capital taxes. The latter direct tax exemptions do not apply if they would be made ineffective by tax policies in the investor's home country.<sup>13</sup> The ex-

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However, they may opt to receive instead benefits under the Convention during the remainder of their contract periods under national legislation. Transitory Article 1, Convention. Since the benefits available under the Convention are in general less extensive than those under national legislation, most firms can be expected to elect to remain under the latter. Firms which would be classified in Group "C" under the Convention, as noted below, are required to opt for reclassification under the Convention, or face trade restrictions. Transitory Article 2, Convention.

<sup>9</sup>Convention Article 5.

<sup>10</sup>*Id.*, Article 5, Annex 1. Other assembly type industries are to be covered by a subsequent special protocol to the Convention. Transitory Article 7. There is apparently little agreement among the five countries as to the treatment to be given to assembly industries.

<sup>11</sup>*Id.*, Article 7.

<sup>12</sup>*Id.*, Articles 24, 25.

<sup>13</sup>*Id.*, Article 8.

emptions available under the Convention are generally of shorter duration and of lower percentage than the maximum permitted under the national laws. The difference is especially important for assembly type industries which, under national industrial encouragement laws, often enjoyed a full slate of benefits. Under the Convention, a Group "C" firm would receive only tariff exemptions for machinery imports for a period of three years.<sup>14</sup> Neither Group "C" firms nor any "existing" firms would receive the important customs exemptions for the importation of raw materials, semi-manufactured products or containers.

According to the Convention and Protocol, Costa Rica, El Salvador, and Guatemala are required to grant identical benefits. Nicaragua must grant the same benefits except with respect to direct taxes, where an extra year of exemption is permitted.<sup>15</sup> Under the modifications dictated by the Protocol, Honduras is permitted to grant benefits of somewhat longer duration and higher percentage of exemption than are the other four; in a few instances extra benefits are permitted.<sup>16</sup> Comparison of benefits permitted is complicated by the number of variables involved: (a) the type of benefits granted to a particular category of applicant, (b) the percentage of exemption for each benefit, (c) the duration of each benefit, and (d) the country in which the firm is to be located. In addition, the degree of special treatment permitted firms classified by Honduras varies with the number of years the Convention has been in force.<sup>17</sup>

Consequently, this discussion is limited to a few representative examples.<sup>18</sup> A "new" Group "A" applicant classified in Costa Rica, El Salvador or Guatemala would receive (a) customs exemptions on imports of raw materials, semi-manufactured products and containers at the rate of 80 per cent of the applicable tariffs for five years, and 50 per cent for five more years; (b) customs exemptions on machinery, 100 per cent for ten years; (c) customs exemption for fuel, 100 per cent for five years; (d) income and profits tax exemptions, 100 per cent for eight years; and (e) exemption from assets taxes, 100 per cent for 10 years. The same firm, classified in Nicaragua, would receive identical benefits, except that the exemptions for

<sup>14</sup>*Id.*, Article 15.

<sup>15</sup>*Id.*, Transitory Article 5.

<sup>16</sup>Protocol, *supra*, Articles 3-7. Honduras may also grant the free use of state-owned buildings to certain applicants; an investment credit applicable to income taxes may be granted for any plant expansion, regardless of whether the firm involved has been classified under the Convention and Protocol. *Id.*, Articles 8, 9, 10.

<sup>17</sup>Protocol Appendices 1, 2.

<sup>18</sup>See Inter-American Institute, *supra* note 10, at 122-142, Table, 142, for complete details.

income and profits taxes, and assets taxes, would be nine and 11 years, respectively.

The same firm classified in Honduras would receive, during the first year the Convention is in force (a) customs exemptions on raw materials, etc., 100 per cent for five years, 70 per cent for the next five years; (b) customs exemption for machinery, 100 per cent for 12 years; (c) customs exemption for fuel, 100 per cent for five years; (d) exemptions from income and profits taxes, 100 per cent for ten years; and (e) exemption from assets taxes, 100 per cent for 12 years.<sup>19</sup>

At the other extreme, a firm classified as Group "C" in Costa Rica, El Salvador, Guatemala and Nicaragua would receive only the customs exemption for machinery imports of 100 per cent for three years. The same firm classified in Honduras would receive the customs exemption for machinery, 100 per cent for five years, and exemption from capital, profits and assets taxes, 100 per cent for two years.<sup>20</sup>

#### D. Procedures

Administrative procedures under the provisions of the Convention will for the most part be similar to those previously used by the national governments. The administrative authorities formerly charged with implementation of the national laws will implement the provisions of the Convention, Protocol, and regulations.<sup>21</sup> In a few instances more specific standards will make local administrative decision-making somewhat more predictable. The most important departures from old procedures are in the provisions for review by the Executive Council—the major executive body of the CACM—of national administrative rulings in several important areas. Once the Council, which is also the general coordinating body for the application of the Convention, finds that one of the national authorities has rejected an application for benefits for a specific industrial project, it is to see to it that "no enterprise shall be classified in any of the other States with respect to the same investment project."<sup>22</sup> This means that potential investors will have to be more careful as they investigate alternative country locations within the CACM; once a formal application is rejected in one country, it will be quite difficult to obtain benefits elsewhere.

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<sup>19</sup>Articles 11-15, Convention; Articles 3-7, Protocol. The San Jose Protocol to the General Treaty would reduce customs exemptions for raw material imports to a maximum of 50 per cent of the applicable tariff, except for Honduras. See note 35, *infra*.

<sup>20</sup>Convention Article 15. Protocol Article 7.

<sup>21</sup>Convention Article 22.

<sup>22</sup>*Id.*, Article 27.

The Executive Council is also arbiter when one country feels that another has improperly classified an applicant.<sup>23</sup> The provision is designed to keep individual country administrators "honest," and to prevent the granting of excessively generous or discriminatory benefits. On the other hand, a dispute over classification could easily result in delays for a prospective manufacturer until the issue is ultimately resolved by the Executive Council. If such protests become commonplace—an improbable but conceivable development—the time required between the submission of an application and its final approval or denial could be substantially increased.

The serious problem of maintaining competitive conditions in the area, when various competing firms enjoy non-concurrent industrial encouragement benefits under the national laws, will also be entrusted to the Executive Council for solution. The Council will decide when a member state shall be permitted to grant customs exemptions necessary for the maintenance of competitive relationships within the area.<sup>24</sup> After the Convention has been in force for seven years, and classifications are on a regional basis, the Executive Council will review their validity.<sup>25</sup>

Most large American firms doing business in Central America have had some contact with the Permanent Secretariat and Executive Council of the CACM. Under the Convention, the frequency of that contact is likely to increase for firms seeking or enjoying benefits. Yet there will be little reduction in the volume of dealings with local administrative entities, especially in such areas as taxation and price or quality regulation, to which the Convention, Protocol and regulations do not apply.

## Implications

### *A. Reduced Benefits*

The benefits available under the Convention and Protocol are generally fewer in number at lower percentages of exemption and for shorter periods of time than under national legislation, except—with respect to time—for "new" Group "A" firms. If certain "emergency" revenue measures now approved in four of the five CACM member nations are eventually ratified as well by Costa Rica, the percentages of customs exemption will be further reduced by 30 per cent of the applicable tariff.<sup>26</sup> Several countries

<sup>23</sup>*Id.*, Article 28.

<sup>24</sup>Convention Article 26; Protocol Article 13.

<sup>25</sup>Convention Articles 24, 25.

<sup>26</sup>The San Jose Protocol to the General Treaty (*La Gaceta* (Costa Rica)), No. 151 of July

are advocating a further reduction of benefits available under the Convention. They would substitute broad accelerated depreciation provisions for the tariff exemptions on raw materials and semi-finished goods which have placed such a fiscal strain on the local economies.<sup>27</sup>

Assembly type industries, especially, will receive only minimal benefits under the Convention; neither they nor any existing industries will receive the often crucial tariff exemption for materials and semi-manufactured products used in manufacturing. For them, the availability of tax incentives is likely to become a much less important factor in investment decisions.

### *B. Procedures*

On the local level, one of the most important differences under the Convention is the automatic nature of the benefits, once classification had been made and an application improved. Local administrative entities have less discretion, and their decisions on classification are subject to review by the regional entities. Both of these factors should make the local entities easier to deal with, although the volume of dealings will not be significantly reduced. The local authorities are likely to retain their present characteristics to a considerable degree, especially during the first few years the Convention is in force. Shopping around for tax incentives is likely to be less rewarding because of the reduced discretion and the danger of the rejection of a formal application by one member country.

In spite of the delays and longer periods of uncertainties likely to result from review of certain local administrative decisions by the regional entities, the advantages of these procedures for foreign investors should outweigh the disadvantages. As noted above, improvement of the local administrative function can be expected because of regional review. The danger of a subsequent entrant-competitor receiving greater benefits from another member government should be correspondingly reduced. Eventually (after 1976), the Executive Council will assure the application of classification procedures on a regional basis, a practice which will discourage uneconomical duplication of production facilities within the area.

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4, 1968) provided for an across the board tariff increase of 30 per cent, based on the then applicable common tariff. (Article 7) Only a few "necessary" products are excepted. (Annex 1.) Although the San Jose Protocol was specifically made applicable to the imports under national fiscal incentives legislation and the Fiscal Incentives Convention, its application to such imports could be suspended until after all five CACM member nations had ratified the Protocol. (Transitory Article) The four other nations have suspended the applicability of the San Jose Protocol in this respect, pending Costa Rican ratification of the instrument.

<sup>27</sup>Oficina de Planificación PLAN OPERATIVO INDUSTRIAL PARA EL AÑO 1969-69 (Government of Costa Rica, San José, 1968).



And the general authority of the regional entities over the application of the Convention should prove helpful to local businessmen with problems involving more than one member country.

### *C. The Soccer War*

The industrial encouragement program does not operate in a vacuum. Thus, any contemporary attempt to appraise the implications of uniform Central American treatment of fiscal incentives for industrial development must implicitly or explicitly reckon with a major "external" factor, the "Soccer War" waged between Honduras and El Salvador in June, 1969. The war caused and continues to cause major disruptions in the affairs of the CACM, and has slowed the progress of the CACM to an as yet undetermined degree. Needless to say, the regional industrial encouragement program has been seriously affected.

As of January 1, 1970, the Executive Council of the CACM had not yet resumed meetings, due to the unwillingness of the representatives of El Salvador and Honduras to be present simultaneously.<sup>28</sup> Trade between El Salvador and Honduras was at a standstill, and there was considerable public pressure within each of the belligerents to avoid the purchase of the other's goods. Honduras still refused to permit goods from El Salvador destined for Nicaragua or Costa Rica to pass through Honduran territory. Consequently, trade between El Salvador and either Nicaragua or Costa Rica was limited to what could be carried by plane or ship.

Although goods are flowing freely again among Guatemala, Nicaragua and Costa Rica, the total volume of intra-regional trade remains well below *ante bellum* levels. The hiatus is likely to have long-term effects on regional trade patterns.

Current new investment is down, even in the non-belligerent nations. Many foreign investors are apparently waiting until they are convinced that the CACM will continue as a viable entity before committing themselves,

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<sup>28</sup>The meeting scheduled for September 16 was cancelled when Honduras refused to attend. *La Republica* (Costa Rica), September 14, 1969, p. 1. While pressing Honduras to relent, other Council members discussed another possibility. Under the "4-4" scheme, El Salvador and Honduras would alternate attendance at the monthly meetings. Since most of the Council's operations are by majority vote, without a quorum requirement, it would still be possible to transact business. The November meeting of the Inter-American Conference on Human Rights (San Jose), at which El Salvador and Honduran representation sat together for the first time since the war, gave some cause for believing that "normal" Executive Council meetings would be resumed in the near future.

as several of the national investment promotion centers have reported. Given the lack of any progress in the settlement negotiations between the belligerents, it will undoubtedly be mid-1970 before the future of the integration movement can be predicted with any assurance.

Among the measures delayed by the war is the set of regulations to the Fiscal Incentive Convention, which had been nearly completed by June, 1969. Although the Convention itself is being applied sporadically, the incompleteness of the regulations adds a measure of uncertainty which will not be removed until the regulations have been approved in their final form by the Executive Council. This is not likely to occur until late spring of 1970 at the earliest.

Predictably, the war has settled none of the underlying issues which caused it, and there is no assurance that it would not break out again were the OAS to depart. In the long run, present investment and less tangible commitments to regional integration point toward survival of some sort of regional trading arrangements. At best, the perfecting of the common market has been seriously delayed. If unrestricted regional trade is not fully restored within the not-too-distant future, there is considerable danger of a division of the area into two distinct blocs. The possibility of strengthening and expanding the ties among Nicaragua, Costa Rica and Panama is apparently receiving increasingly serious thought in those countries.

The regional industrial encouragement program presupposes effective application of the Fiscal Incentives Convention and regulations by the Executive Council, as well as unrestricted intra-regional trade. These pre-conditions depend in turn upon the final resolution of the conflict between Honduras and El Salvador.

## **Conclusion**

In the past, there has been some question of how important tax incentives were in decisions to establish manufacturing facilities in Central America, given the great importance of the common tariff and free trade within the region, and related aspects of the investment climate. Under the Convention, tax benefits *per se* are likely to become an even less critical factor.

In spite of possible short run complications, uniform regional treatment of tax incentives under the supervision of regional entities should ultimately produce a system more efficient and equitable for both foreign investors and the countries themselves. Rather than being viewed as a package of tax

benefits alone, the Convention is best seen as another program for furthering the trade, industrial development and general economic viability of the region. Like other such regional efforts, its success presupposes the existence of conditions conducive to orderly industrial development, including unrestricted intra-regional trade and operating regional administrative authorities.