

Guatemala is characterized by a small public sector with limited resource mobilisation. Consequently, public spending on its own, has been an ineffective policy tool to tackle development challenges. Through improvements to revenue mobilisation from the 1990s onwards, the government's intake increased from 7 to 12 percent of GDP. However, revenue mobilisation has trended downwards in recent years. Tax revenues dropped to 10 percent in 2013 and stayed around those levels through 2020. This level of revenue collection is significantly below the Latin America and Caribbean (LAC) average of 16.9 percent. Low levels of tax revenues have significantly constrained social and infrastructure spending, which is already low compared to international standards. In fact, low DRM is one of the key factors affecting the country's credit rating despite its traditionally prudent macroeconomic stance. Moreover, corruption perception deteriorates the confidence of citizens towards government.

Two main weaknesses explain low revenue collection levels. First, compliance levels for most taxes are low. For instance, Value Added Tax (VAT) and the Personal Income Tax (PIT) compliance is estimated at only 74 and 20 percent, respectively (in 2019). The second weaknesses is the inadequate tax policy framework that has been designed not just to render a low tax burden, but also to steadily reduce the tax burden over time through sunset provisions for specific taxes and excises rates.

In addition, the regressive nature of the tax system in Guatemala, has caused a slight increase of poverty (IMF, 2018). In Guatemala, the first decile, in rural areas, has an 86.7% reduction of income after taxes, compared to the richest 10%; in urban areas, this value reaches 79% (Commitment to Equity Institute, 2017). Fiscal policy has a slight impact on reducing inequality through efficient public spending, expenditures on education and health, as well as transfers have the highest impact on reducing inequality (Commitment to Equity Institute, 2017).

The EU can support Guatemala's efforts to obtain additional resources to finance critically needed social investments. It proposes to do so under the MIP 2021 – 2027. Specifically, in the Annual Action Plan (AAP) 2021, this action has been included to enhance DRM by strengthening and modernizing the SAT. It contributes to Priority Area 3) Good Governance and Human Development of the MIP. In particular, to the Government and Civil Society-General sector (DAC code 151), which among others seeks to help improve PFM and DRM. As well as to strengthen the application of fiscal legislation and improve the efficiency of the tax collection system, aiming to move toward a simpler and more equitable model. Specifically, the proposed action will contribute to reaching Specific Objective 1 under Priority Area 3 of the MIP 2021-2027: Strong, accountable and transparent national, regional and local administrations are able to efficiently design and implement sustainability-oriented national policies and mobilise sufficient national resources to finance them. Regarding expected results per specific objective, it will contribute to achieving Result 1.2: Public and private resources mobilisation for sustainable development is increased in the context of sounder and greener economic, fiscal and PFM policies.

Furthermore, the action is framed within the SAT's medium-term strategy, which is aligned with the National Development Plan, the Peace Agreements and the Government's General Policy 2020 – 2024 and follows recommendations from the IMF and the Tax Administration Diagnostic Assessment Tool (TADAT). It directly contributes to: SDG 17 "Partnerships for the goals" (especially goal 17.1 Strengthen domestic resource mobilisation, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection). As well as to SDG 1 "End Poverty", SDG 8 "Decent Work and Economic Growth", SDG 5 "Gender Equality", SDG 2 "Zero Hunger" and SDG 10 "Reduced inequalities".

The transformational impact of this action for Guatemala is that enhancing DRM by promoting a tax compliance culture and improving the efficiency of the tax collection system will increase fiscal margins to finance public policies in order to address structural social challenges particularly widespread poverty, food insecurity, chronic malnutrition and limited access to health and inclusive education, especially for women and children, including those living with disabilities, older persons and others living in vulnerable situations. Moreover, it contributes to the Team Europe Initiative (TEI) "Alliance for Sustainable Growth and Jobs". This TEI seeks to support Guatemala in its efforts to establish a new sustainable and inclusive economic model that guarantees the protection of workers and mobilises sufficient domestic revenues to finance the country's social development. This action advances to this purpose by addressing critical issues, such as tax avoidance/evasion, risk-based tax enforcement, improvement of taxpayer services, and tax institutional governance promoting transparency and accountability as a means to underpin economic equality. The implementation of this TEI will be coordinated with Member States, notably Germany, which also supports strengthening Guatemala's tax administration.