The Proliferation of Fiscal Incentives and the Nicaraguan State as a Manager of Rents: A Political Economy Perspective on Nicaraguan Industrial Policy Since 1990

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Abstract:
This paper finds that the proliferation of fiscal incentives in the form of tax exemptions in Nicaragua since 1990 represents the indiscriminate allocation of monopoly rents to interest groups. While theory suggests some rents can encourage productive investments, Nicaragua's tax incentives are merely "assistentialist" and lack effectiveness. For a dynamic industrial policy, opportunity costs would need to be taken into account and rents would need to be performance contingent, which requires selectivity and increased transparency.

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This essay will investigate the political economy of industrial development in Nicaragua since 1990. After highly interventionist policies under the Sandinistas resulted in economic crisis, the following years were characterised by Washington Consensus type stabilisation and liberalisation policies. However, after 16 years the results with regard to industrialisation have been disappointing. This essay will argue that the Nicaraguan state was unable to create adequate learning rents which could have off-set market imperfections and created productive investment opportunities. Here the proliferation of tax incentives was crucial, which allowed for rents to be captured by interest groups. This made rent-management impossible and condemned the state to the role of a passive administrator of detrimental rents.

The essay is structured as follows. Section 1 introduces the debate surrounding state intervention and identifies several types of rents. Secondly, the proliferation of tax exemptions in Nicaragua and its relation to the liberalisation process after 1990 is discussed. In this context, I also briefly investigate the issue of uncertainty and its implications for investment. In the fourth section some aspects of Nicaragua's system of fiscal incentives regarding Free Zone manufacturing, banking, and tourism, as well as industries benefiting from tariff protection, is investigated. Section 5 then analyses flaws and logical fallacies of the incentive system as a whole from a rent-management perspective. Finally, I will look at the role of the political system and draw some conclusions.

Market vs. State

The discipline of economics has often been characterised by the division between those advocating certain state interventions in the economy and those believing in free markets. It was Alexander Hamilton who first set out the infant industry argument in his 1791 Reports of the Secretary of the Treasury on the Subject of Manufactures (Chang 2002, p. 25). On the other hand, Ricardo emphasised the efficiency gains of trade. While the former ideas were dominant during Latin America's Import Substitution Industrialisation (ISI) period, the latter came to dominate after the 1970s. With the debt crises, ISI was seen as failed. Infant industries did not grow up, while distortions weakened the functioning of the market as an instrument of efficient resource allocation. Moreover, in a seminal paper Anne Krueger (1974) argued that indeed, government intervention not only created distortions but induced economic agents to engage in unproductive behaviour, such as lobbying and even corruption. Government intervention would thus do more harm than good. The best policy would be to eliminate the possibility of rents and to rely on competitive markets, leading to the set of policies that became known as the Washington Consensus. This approach has been criticised by Khan who argues that rents cannot simply be abolished by decree. Khan furthermore, differentiates between positive and negative rents and distinguishes between the costs of the rent-seeking process and its outcomes. While rent-seeking activities are always negative, some rents can be positive and these account for the differences in economic performance between different economies (Khan in Jomo & Khan 2000). That perfect markets are often unattainable was also emphasised in the 1990s by economists, for instance those focusing on information-theoretic approaches, who shifted the focus back from state to market failure. They provided the rationale for selective and strategic state intervention. Some issues include inter-temporal externalities, such as learning by doing, which mean that increasing production today can allow lower marginal costs in the future (Chang & Cheema 2001, p. 18). Furthermore, in industries with increasing returns, potentially successful new entrants may be priced out by incumbents. Also, if the success of a business depends on complementary investments by other agents, coordination failure may occur, where neither investment takes place. In the presence of imperfect financial markets, necessary investments may not take place. In short, some government intervention, if executed effectively, would be beneficial for functioning of markets. Moreover, Chang and Cheema point to another issue that goes beyond the functioning of markets. Since "[…] improvements in production techniques are likely to be clustered around factor combinations already in use […]", "[…] if a particular type of technological change is associated with a higher rate of productivity growth, the distance between economies choosing such technologies and other economies will increase over time" (Chang & Cheema 2001, p. 18). Thus, while retraction by the state may reduce some distortions in the short-term this is a balancing act since long-term, dynamic productivity improvements may require some of these temporary distortions (Blankenburg & Khan, p 2).

Rents

Since rents can often not be abolished by decree, it may be more important to manage rents effectively rather than to seek to abolish them. Khan (in Jomo & Khan 2000) identifies several types of rents, with very different economic impacts. An unambiguously negative case is that of monopoly rents. This kind of rent limits output through increases in prices and disincentivises productive behaviour. However, in the case of natural resource depletion, a type of monopoly rent may be positive in the long-term, if individual and social returns of resource consumption are not equal due to externalities.

The most clearly positive rent is a Schumpeterian rent. Entrepreneurs are rewarded for innovation by enjoying a temporary advantage. This can be a temporary de-facto monopoly over a new product or cost reductions through enhanced production processes with competitors unable to cut prices. This ex-post rent rewards past innovation and thus incentivises future innovation. Patenting is a widely accepted form to protect such rents and governments are involved actively in the protection of intellectual property rights. Thus most governments actively engage in rent management.

Other rents include information rents (Stiglitz 1996), which incentivise improved monitoring, for instance in the finance sector. Even efficiency wages can be considered rents with positive implications, as employee performance is enhanced. Rents having both positive and negative aspects are transfer rents, which involve resource transfers from one agent to another. Their impact in terms of incentives is negative. However, if allocated appropriately, they can be used to support social stability and may at times represent the lesser evil. However, inadequately designed transfer rents can be problematic in encouraging rent-seeking. Also, if the recipient’s propensity to invest is lower than that of the emitter, the impact on overall welfare is likely to be more strongly negative. Thus, whether a transfer rent is channelled into public or private investment, which could include “investment” in education by the poor, or spent on “conspicuous consumption” à la Veblen can make a great difference.

Khan identifies a further type of rent, learning rents. Missing information markets, externalities and economies of scale (Lall 1994 quoted in Dijkstra 1996b, p. 536) can entail a socially suboptimal level of investment in certain areas. While externalities can be internalised through static taxation or subsidisation measures, issues such as the presence of economies of scale may require dynamic measures. With high risks involved the adoption of new technologies and with imperfect capital and virtually non-existent insurance markets in developing countries, entrepreneurs may not find it feasible to invest in such advancements. The assignation of a rent in conjunction with conditionalities may incentivise socially desirable behaviour and overcome market failures. However, since learning rents are ex-ante rents, there is the danger of misuse. For learning rents to work, an agreed and relatively short time horizon, relatively minor distortions, easily quantifiable performance indicators and a clear set of sanctions in case of underperformance are required. If the government is not able to discipline the respective firm, the learning rent will be "lost" and transformed into a monopoly rent, which represents a static distortion without dynamic effects. As Chang and Cheema put it, "[…] the crucial condition for successful use of learning rents is that the state is able and committed to monitor relative firm performance at low costs and to impose penalties in the event of non-performance […]"(Chang & Cheema 2001, p. 24). This disposition has been lacking in Nicaragua, as will be explained below. In this paper I shall thus argue that detrimental monopoly rents have been wide-spread in Nicaragua since 1990. Particular rents became monopoly rents rather than learning rents because no dynamic change was induced. The static inefficiency that rents represent was thus not offset by a dynamic gain, as required for a rent to have an overall productive impact.

The proliferation of tax incentives and the context of liberalisation

The Proliferation of Tax Exemptions

In analysing Nicaragua's policy towards its industrial sector, the almost exclusive reliance on tax incentives calls attention. In this section I shall thus analyse the tax system from a rent-management perspective.

As Gasparini and Artana argue, Nicaragua's tax system has been "[…] far from the ideal […]" (Gasparini & Artana, p. 4). They point to several sales tax rates and exonerations of the same tax for certain goods and certain buyers. Similarly, Agosin et al. mention "[…] discretionary exemptions for various categories of taxpayer such as non-governmental organizations (NGOs) municipalities, non-profit institutions – and for the agriculture sector and enterprises established in free zones" (Agosin et al.

2005, p. 89). Excise taxes are applied to numerous products even though negative externalities are not always present. For excise taxes and import duties, again, exonerations were applicable "[…] based solely on the influence of buyers […]" (Gasparini & Artana, p. 4).

In order to illustrate the proliferation of tax exemptions, Medal (2002, p. 16) presents a table, which is reproduced and translated here.

Table 1

	Zona Franca	Tourism	Agriculture	Fishing and Aquiculture	Small handicrafts industry	Exports under Temporal Admission Law	Other exports	Hospital investments	Public Transport Cooperatives	Commerce	Industry
DAI (Tariffs)	Exempt	Exempt	Art. 35 exemption	Art. 35 exemption	Art. 35 exemption	Exempt	Not exempt	Exempt	Exempt	Not exempt	Some exemptions
IEC (Excise Tax)	Exempt	Exempt	Art. 35 exemption	Art. 35 exemption	Art. 35 exemption	-	-	Exempt	Exempt	Not exempt	Some exemptions
IVA (Sales Tax)	Exempt	Exempt	Art. 35 exemption	Art. 35 exemption	Art. 35 exemption	Exempt	Not exempt	Exempt	Exempt	Not exempt	Some exemptions
IR (Income Tax)	Exempt	Exempt	Not exempt	Not exempt	Not exempt	Not exempt	Not exempt	Some exemptions	Exempt	Not exempt	Not exempt
IBI (Municipal real estate tax)	Exempt	Exempt	Not exempt	Not exempt	Not exempt	Not exempt	Not exempt	Some exemptions	-	Not exempt	Not exempt

As tax exemptions are fiscal cost, they represent implicit subsidies. These subsidies are indeed very substantive. Artana calculates that the state contributions to projects via tax exemptions amount to 60% for the tourism sector, 38 % to Zona Franca, 35% to cooperatives, 31% to hydroelectric energy projects and 27% for the forestry sector (El Nuevo Diario, December 2nd 2005). Even the press benefits from a 38 % implicit subsidy, Artana finds (Núñez Soto 2005). As a result, the state acts as a sort of "socio tonto", or inferior, "slightly stupid" associate, as all benefits accrue to the private company (Artana in Olivares 2005). In terms of fiscal cost, Medal (2003, p. 17) provides the following estimates.

Table 2

	Tax Collection (% of GDP)	Exemptions (% of GDP)
IGV (Sales Tax)	9.9	5.9
IEC (Excise Tax)	7.4	2.8
DAI (Tariff)	1.7	1.1
ATP (Temporary Protection Tariff)	0.4	0.6
Total	19.4	10.5

These numbers imply that an enormous amount of fiscal revenue is foregone due to exemptions. In fact, revenue could increase by over 50% or tax rates could be reduced by a third, if all exemptions were abolished. Of course, this would politically not be feasible. Indeed, it may socially not even be desirable, given the distributional impact of some tax exemptions. Nevertheless, given the low ratio of tax revenue over gross domestic product –when compared to industrialised country standards-, it becomes clear how significant rents in the form of tax exemptions –monopoly rents, transfer rents and learning rents- are[1].

As a great part of tax exemptions lacks a clear distributional rationale (Gasparini & Artana, p. 22), the described features point to widespread rent-seeking behaviour (Medal 2002, p. 17). The interpretation of tax exemptions as rents becomes even clearer when looking at what is referred to as horizontal inequality (Gasparini & Artana, p. 20). The definition of horizontal inequality as "unequal treatment of individuals or 'agents' who are in similar economic situations" (Gasparini & Artana, p. 20) remarkably resembles the definition of rents, which are incomes beyond the

[1] In fact the ratio is likely to be even lower, as Nicaragua's GDP is probably underestimated, given the size of its informal sector.

“competitive” income from a perfect market. This suggests that tax holidays and other measures can be interpreted as rents.

If rents have been widely distributed, has the manufacturing sector benefited? Medal disagrees in that in fact part of the anti-export bias is due to these tax incentives aimed at sectors involved in domestic production (Medal 2002, p. 2). There is no free lunch and the general economy pays the price for some sectors’ privileges.

Liberalisation

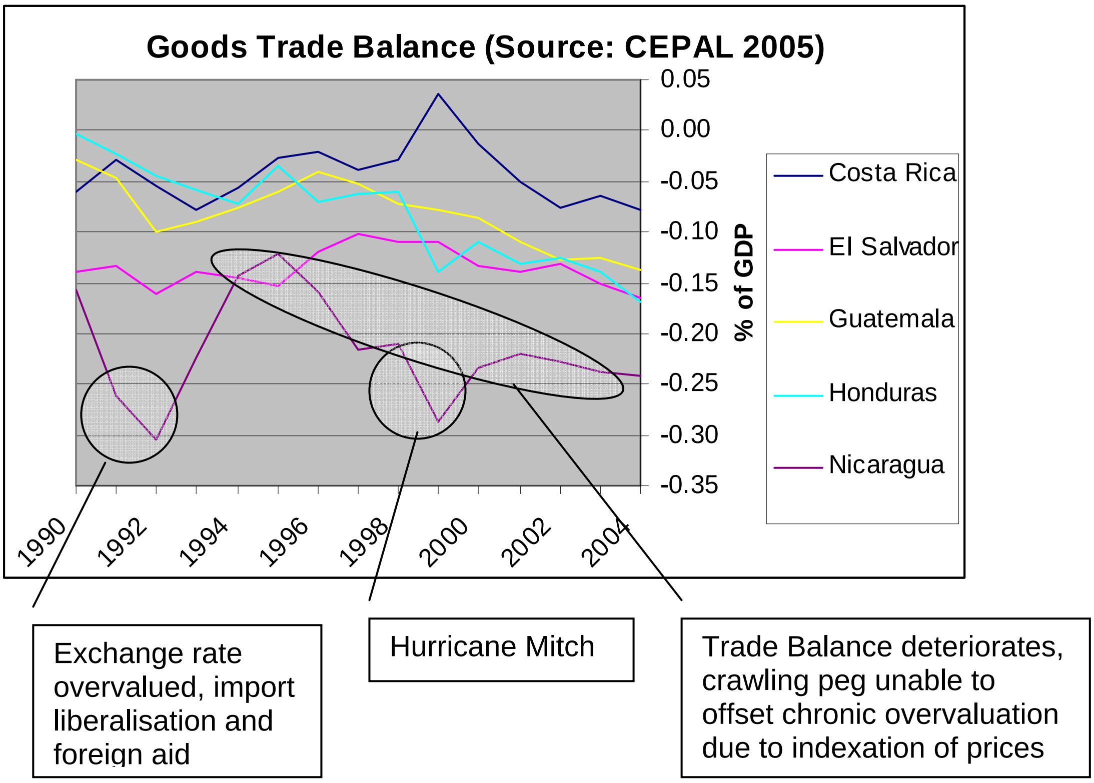
In order to analyse why the Nicaraguan state adopted these measures, the political and economic trends need to be taken into account. In this context, Nicaragua’s process of stabilisation and liberalisation is crucial. Under the Sandinista government during the 1980s, economic policies had led to macroeconomic imbalances of such magnitude that first stabilisation measures were already undertaken in the last years of that decade. During the early 1990s, the Barrios de Chamorro government undertook measures to end hyperinflation, deregulate the economy, liberalise Nicaragua’s trade regime, return confiscated properties and privatise state-owned firms. Yet the reforms were undertaken at such pace that government often seemed overwhelmed and unable to control the situation. This is why Catalán concludes that “[…] the velocity and phasing of the market liberalisation process were determined not by technical feasibility but by the political aim to abolish interventionist policies and the belief that the elimination of intervention would be sufficient for perfect markets to emerge automatically” (Catalán 2001, p. 56). In this context, critics have argued that a more gradual and selective approach to structural adjustment could have been more advantageous. “[… Less] demand restriction, selective expenditure cuts maintaining a minimum level of public investment, selective credit restrictions in order to protect productive activities vis-à-vis commercial activities and speculation, and a more gradual and more selective trade liberalisation” (Dijkstra 1996b, p. 536) could have allowed certain industries to enhance their competitiveness by technological upgrading. For this, however, the Nicaraguan state would have required the ability to monitor and discipline industrialists. It is very questionable whether it had that ability in the early 1990s. Moreover, others argue that a certain shock-therapy was necessary given the high degree of distortions.

Leaving aside these counterfactuals, the aforementioned tax incentive policy and the liberalisation have to be seen as complementary. As for their creation, firstly tax incentives were the industrial policy measure most compatible with the free market

view since the intervention was via taxation only and hence perceived as “mild” compared to Sandinista policies. Secondly, tax holidays and the resulting reduction in tax revenues were compatible with a reduced role of the state in other sectors, which was integral to structural adjustment. Thirdly, Nicaragua’s elite –still influenced by “hacienda life” (Interview: Gloria Carrión)– lacked the transformationalist determination of countries such as South Korea or Taiwan. Little industrialisation beyond some agro-industry was perceived to be feasible (ibid). Fourthly, tax incentives could be used as bargaining chips and to appease various interest groups. Dependent on a multi-party coalition and with a relatively weak political base, especially the Barrios administration was subject to such pressures.
As a result, the different tax incentives cannot be considered one coherent policy but rather a set of different, not necessarily harmonious policies. These rents were allocated according to political rather than economic calculations and most other instruments were excluded from consideration a priori. The outcomes, in terms of industrialisation, have been disappointing.

While the technology of most companies was obsolete after a decade of under-investment, Nicaragua’s industry hardly became competitive as the economy opened. Exports first dropped and only started increasing after 1993. Even then, however, the trade balance deteriorated, with imports increasing dramatically. Over the next decade, aid inflows and remittances contributed to a consistently overvalued real exchange rate. Due to the de-facto dollarisation of large parts of the economy and indexed prices, the crawling peg regime could not provide relief either. As of 2004, no Latin American nation fared worse, when it comes to the trade balance in goods (CEPAL, Statistical Yearbook 2005).

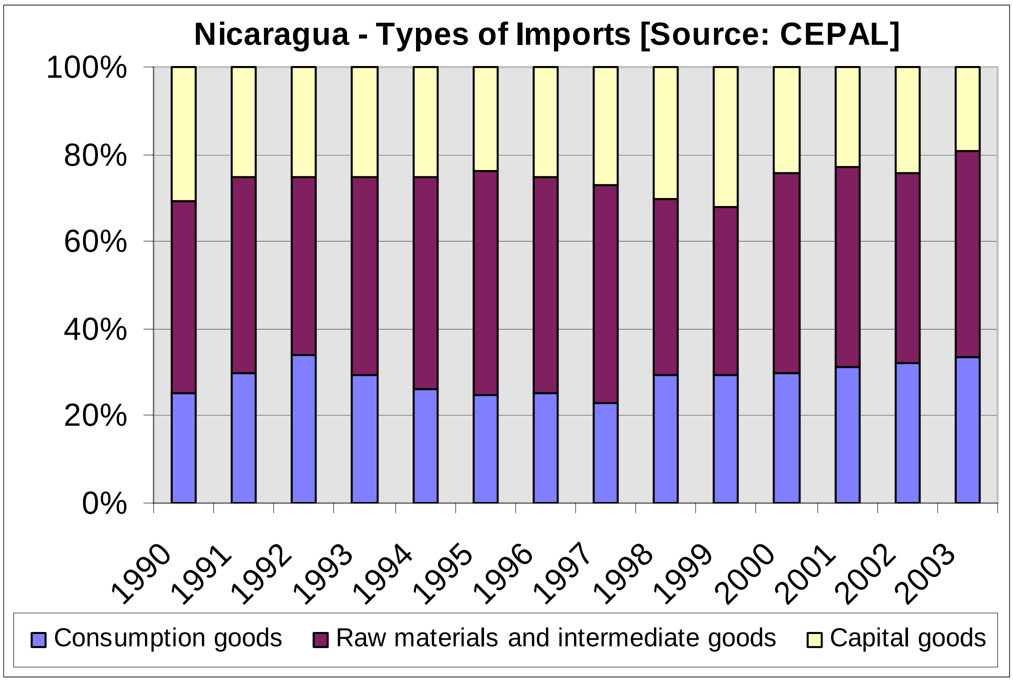
Figure 1



While developments in the trade balance during the Barrios de Chamorro administration can be understood as a result of a hectic period of stabilisation and liberalisation, the Alemán and Bolaños administrations cannot invoke such justification, apart from the temporary effects of Hurricane Mitch. Although there is a regional trend towards deteriorating trade balances, Nicaragua is an extreme case. Exports simply did not grow fast enough to at least partly offset imports. To illustrate the issue further, the export coefficient -the ratio of exports to GDP- declined from 31.6% in 1990 to 25.9% in 2000 (Sobrino 2004 p. 12-13).

As for imports, an increasing proportion of these were consumer goods. While increasing in absolute terms, the share of capital goods decreased. This implies that the prime beneficiaries of trade liberalisation were consumers, not exporters or manufacturers. Thus, evidence does not support the view that trade liberalisation contributed to an export-led growth strategy. While one-off efficiency improvements took place, this growth was not sustainable and capital goods imports were not sufficient to contribute to significantly improved productivity (Blankenburg & Khan, p. 16). From a political perspective, it could be argued that after the 1980s rationings, the new government needed to gain popular support by making cheaper consumption goods available, at the cost of a deteriorating trade balance.

Figure 2



It thus seems that the manufacturing sector has been abandoned, as the Chamber of Industry and ONUDI find (CADIN et al. 2001, p. 25). As Dijkstra puts it, “[…] medium and large industrial enterprises were simply expected to achieve competitiveness somehow, or else, to close” (Dijkstra 1996b, p. 540).

Manufacturing not only failed to reap the benefits of imports. Among other issues, Albalá, for instance, points to the “tertiarisation” of bank credit (Albalá 1998, p. 37, see also Dijkstra 1996a). Over the 1990s, an increasing share of credits was allocated to the services sector, especially commerce, while agricultural and industrial credits’ share declined. It seems that banks preferred low-risk import businesses to high-risk manufacturing. Part of the reason why industrial development failed was the relative abandon towards the manufacturing sector in the process of liberalisation. However, the tertiarisation of bank credit points to another issue, the issue of risk and uncertainty.

Investments and Uncertainty

In explaining why productive investments did not take place sufficiently, the issue of political and judicial risk needs to be addressed. As Violeta Barrios de Chamorro assumed the presidency, the conflict with institutions still dominated by the Sandinistas led to a high sense of uncertainty. This issue was addressed by Borner, Brunetti and Weder (1995) who defined property rights more broadly than just the resolution of concrete conflicts in court. In their view the perception of entrepreneurs does more to influence their investment decisions than the actual practise of the courts. 77% of entrepreneurs surveyed in their study, did not feel secure from future state expropriation (p. 52). Borner et al. argue that these perceptions reduced the amount of productive investment, and consequently affected growth. Given entrepreneurs' exposure to political uncertainty, they may prefer to hold resources in a liquid form, engaging in a "'wait and see' strategy" (p. 47). Furthermore, if investors risk their resources, they will ask for the institutional risk to be compensated in the form of higher interest rates. This explains why Nicaragua, despite its "text book stabilization program" (p. 49) has not managed to achieve the levels of investment necessary for long-term growth.

Many government measures were not based on broad social consensus, due to the polarisation of Nicaraguan society and its political system. As a result, changes of government could have been expected to lead to significant changes in economic policies. Ironically, this fear may have led to less productive investment, as investors were unwilling to risk funds by locking them in long-term investments. Thus, political stability may at times have been more important than efficiency in its neoclassical sense. Transfer rents, such as the hand-over of some state-owned firms to its workers by the Barrios government helped the government to appease social unrest. Whether these transfer rents created productive companies is of course a different question.

As for judicial risk, 86% of entrepreneurs in the previously mentioned survey had little confidence in the judicial system's reliability (p. 56). Still today, the judicial system is widely recognised to be partidised. Most observers agree that it is controlled by FSLN and PLC party affiliates, with the FSLN having the upper hand. Dye however argues that party interference in judicial sentences seems to be sporadic and decentralised, via multiple loyalty networks. For day-to-day arbitrary judicial decisions this means that they may in a majority stem from simple bribes and corruption among magistrates, rather than from direct instructions from party leaders (Dye 2004, p. 55). Theory suggests however that centrally controlled systems of corruption may be preferable to ones with a wide proliferation of this type of illegal rent-seeking, since some costs of corruption are internalised (Khan in Jomo & Khan 2000, p. 132). Yet in Nicaragua, corrupt officials, be it in the judicial system or in other institutions, feel protected by their respective parties. Caudillos -Nicaraguan party strongmen- have tolerated corruption in exchange for support. Indeed, officials who are widely perceived to be corrupt are their most loyal supporters, given their need for political protection. Thus, there is little reason to expect a significant change in judicial insecurity in the short to medium-term. With risk and uncertainty affecting the private sector and the government unable to act against corruption, it appears that the tax incentives were an inappropriate substitute for the deep reform that would have been required but was politically not feasible.

Some examples from selected sectors

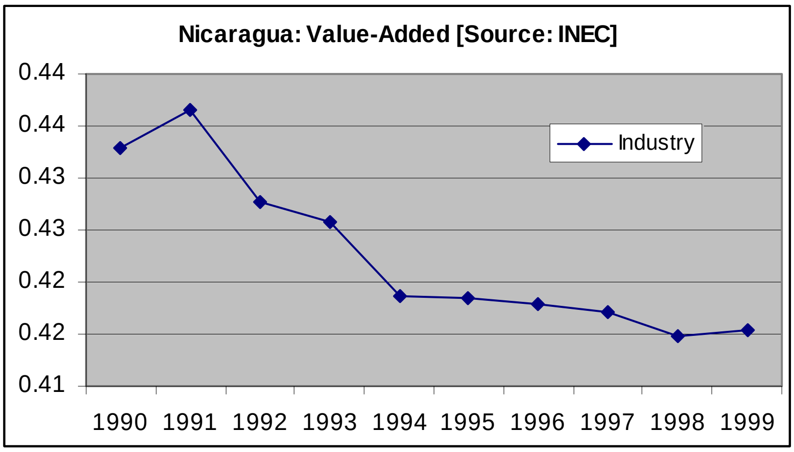
Zona Franca

To illustrate fiscal incentives' problematic impact in Nicaragua, let me know turn to a few sectors that have benefited most. The so-called Maquila has been the manufacturing sector with the highest privileges. Nicaragua's Free Zone regime relies on quasi-extraterritorial industrial parks, catering mainly to foreign companies of the textile and garment sector. Companies benefit from tax and tariff exemptions on an unprecedented scale, as seen in Table 1. In the past, the sector benefited from quotas allocated to Nicaragua for the US market. In fact, benefits go further, as the state provides infrastructure at low prices. Such implicit subsidies do not cause much concern, as debt relief was granted by the Central American Bank for Economic Integration for a credit, which implicitly subsidised the Free Zone by financing infrastructure.

Zona Franca activity provides employment opportunities for an otherwise disadvantaged segment of population, as companies employ a young, unqualified, mainly female workforce[2]. However, other benefits are hard to find. The sector is a prime example for the lack of horizontal networking and vertical linkages. After benefiting from incentives for years it continues as an "enclave" (Nuñez Soto 2003), with hardly any spill-over effects, neither in terms of technology, nor local inputs, nor human resources (Interview: Vidaurre). This goes contrary to declared intentions. The 2003 National Development Plan, for instance, points to a strategy of increased value added to Nicaraguan products. Yet Zona Franca activities have not contributed to this. As Figure 2 shows for the 1990s[3], value added in the industrial sector has decreased, rather than increased in the recent past, when the Free Zone sector became more significant.

Figure 2

[2] In fact, the Free Zone Corporation has advertised to investors with unemployment rates, presenting them as locational advantages (Corporación de Zonas Francas 1997). It is not surprising then that the employments created are at subsistence level.
[3] Unfortunately, data is not available for 2000 onwards.



While lip service is paid to Porter's clustering approach (Porter 1996), the practise suggests that little horizontal networking and little vertical linkages are promoted (Mendoza & Kuhnekath 2004). Why is this so? Due to regional competition for this type of investment, Nicaraguan policy-makers feel unable to adopt adequate measures that could encourage the integration of this sector with the national economy. Regional neighbours find themselves in a Prisoners' Dilemma situation. As Free Zone companies easily move to different locations, governments feel they have little leverage, as Tanzi and Zee (IMF Survey 2000, p 217) argue. This leads to a vicious circle where the lack of linkages entails high mobility of Free Zone firms. High mobility in turn hinders political moves that aim at ensuring a level playing field that would favour linkages. This underscores the need for dynamic rather than static incentives. Yet although the regime was intended to be transitionary with firms receiving benefits for a period of ten years, Nicaraguan authorities have acquiesced, allowing firms to simply rename after that period, thus receiving the same benefits for the next ten years (Interview: Baez).

A further flaw in the granting of incentives has been that these have often merely implied a resource transfer from the Nicaraguan state to developed states, especially the US. Companies have to pay corporate income tax on repatriated dividends in the US. Due to US legislation against double taxation, Nicaraguan income tax (IR) could be credited towards this (Agosin et al. 2005, p. 86). Yet, Nicaragua grants tax exemptions for income tax. Part of the incentive regime can therefore be considered ineffective, even on its own terms.

Despite its widely acknowledged limitations, if not outright flaws, the maintenance of the Zona Franca regime in its current form is defended by some on the grounds that the extraterritorial status implies no harm to the domestic economy. Yet this is argument clearly fails to acknowledge fiscal and opportunity costs. After all, if the regime was reformed to incentivise spill-overs and linkages or if additional tax revenue was obtained, the national economy would benefit directly, not only through a more integrated Zona Franca sector but also through the possibility of a lower general tax rate.

Banking

Another sector that has benefited from tax exemptions has been the banking sector. Indeed, Nicaragua's banking sector is highly profitable. Net utility of capital is at 26% twice as high as the Central American average (Acevedo 2003, p. 97). However, banks do not pay corporate income tax. While this measure has helped the emergence of private banks after the Sandinista period, it has clearly long become unnecessary. These tax exemptions must thus be considered static rents. In fact these rents can be considered monopoly rents. Relatively high prerequisites by the bank supervision authority (SIBOF) have limited entry into this sector. As a result, microfinance institutions have not been able to raise deposits, limiting the amount of credit they can give, which helps maintaining interest rates at very high levels (Parrilli 2001, p. 10). It is in this context that Jorge Vidaurre (Interview: Vidaurre) argues for more competition from international banks, which could reduce interest rate margins and fees.

Acevedo (2003, p. 102) points to a further source of profits, the so-called CENIS. These government bonds were allocated to banks acquiring their bankrupt competitors after various bank collapses in the late 1990s and early 2000s. Interest rates were so high that the government felt obliged to renegotiate those rates subsequently. Presumably, banks understood that insisting on the bond payments as originally agreed would have put them at risk of losing these assets entirely, either because of a default by the state or due to public outrage. Acevedo also considers that in guaranteeing all deposits, even the highest, the Central Bank president emitted a "blank cheque" that allowed for the "gains to be privatised, while the losses were socialised" (Acevedo 2003, p. 110).

Tariffs

Turning to other powerful sectors, some tariffs are still very substantial, despite trade liberalisation. The profits resulting from these import restrictions are classic examples of monopoly rents. For example, it is doubtful that the special protection for sugar, rice and poultry can be justified as an instance of a learning rent, necessary temporarily in order to allow these sectors to adjust. Rather, it seems that the special protection may be more related to rent-seeking (Medal 2002, p. 35). The sugar sector is dominated by the Pellas group, generous supporter of electoral campaigns, as Lacayo remarks (Interview: Lacayo). The rice sector is dominated by a single company, Agricorp (Olivares 2003, Confidencial 2003). As for the poultry sector, this oligopolistic sector is strongly organised, with its own chamber of industry, and can thus engage in effective lobbying (Interview: Medal). It is remarkable that all three sectors have monopolistic or oligopolistic structures, which suggests that tariffs could be an instrument to avoid competition from abroad where there is none at home. This seems to be the political economy problem pointed out by Olson (1982), where the concentration of benefits among a few agents and dispersion of the costs among the many lead to socially inefficient rents. In addition to the absence of any incentives for productivity increases, these rents cannot be justified on distributional grounds. The poorest quintile of the population spends 13% of incomes on rice (Confidencial 2003). Here lower prices could prove very beneficial indeed.

Retail oligopolies and PYMEs

However, even where trade liberalisation through the reduction of tariffs has taken place, this has not necessarily led to competitive markets with lower prices. Dijkstra (1996b, p. 542) argues that

> "[…] the revival of the old import houses, the concentrated ownership of the (seven) former state supermarkets, and the ownership linkages between new private banks and commercial enterprises led to new monopolies and oligopolies in wholesale and retail trade in the small Nicaraguan economy. These monopolies and oligopolies represent powerful interests that are likely to obstruct measures to stimulate production".

She thus concludes that even among the officials of the Barrios de Chamorro administration, which most perceived as technocratic, private interests were powerful (Dijkstra 1996a).

Parrilli argues that the sector of small and medium-sized industrial enterprises, specialising in leather, shoes, handicrafts and furniture, has been affected by such lobbying. Parrilli contends that importers of international brands, who are among the strongest lobbies in Nicaragua, can be considered regressive coalitions. Their lobbying led to 'tariff perversion', where inputs faced higher tariffs than the respective final goods, thus discouraging local production (Parrilli 2001, p. 10). At the same time, the small and medium enterprise sector itself was discouraged from increasing competitiveness, as legislation disincentivises the acquisition of technology. With automatised industries being excluded from the incentive regime[4] small firms had no incentive to invest in technological upgrading (Lacayo, J. 1998, p. 80).

Tourism

As for the tourism sector, this sector has been benefiting from tax exemptions for some time, as Table 2 shows. Yet recently, Nicaragua has seen the initiative to extend the regime of incentives even further. The state would allow companies to issue bonds over what would otherwise have been payments of income tax, and to use the revenue of these bond sales for up to 70% of their respective investments in the tourism sector. The incentive scheme, classified by Julio Francisco Báez as an "unconstitutional privatisation of taxes" (Interview: Báez), not only appears to be tailored towards the interests of one particular major international hotel firm. It moreover fails to fulfil the very function of an incentive, as it appears that the investment decision of this concrete case for which incentives are sought, has already been taken (Báez in Olivares 2006). The rent would thus acquire a merely "assistentialist" character with no power of compulsion, as will be argued below.

After pointing out these concrete instances of detrimental, yet completely legal rents, I shall now turn to more general flaws and fallacies surrounding Nicaragua's tax incentives and their administration by the state.

[4] "Ley de incentivos fiscales a la pequeña industria artesanal"

Flaws and fallacies of Nicaragua's fiscal incentives

Fallacy of intangibility

In analysing Nicaragua's economic policies, it becomes clear that apart from macroeconomic policies and public investments in infrastructure, industrial policy has been very limited. How can the reliance on tax exemptions be explained? As argued earlier, this form of rent is attractive for policy-makers due to its intangible nature. After all, "it is always easier to let go money one doesn't (yet) have". From the technical point of view, they nevertheless represent fiscal losses just like explicit subsidies. The fact that the funds acting as incentives have not yet entered the treasury makes it easier to defend measures of doubtful effectiveness. Thus, Free Zone and other exemptions are falsely argued not to affect the national economy, as without these incentives "investments would not have been undertaken anyways".

Perverse costs

A further flaw lies in the perverse costs of exemptions. Medal draws attention to the fact that a policy to exempt a "winning sector" from taxes would have perverse consequences, in that "[…] in the hypothetical case that the supposedly winning sectors result being the most dynamic […]", the costs of the incentive would be the highest (Medal 2003). This problem is inherent in rents that are not clearly temporary, with specific obstacles to be overcome. Furthermore, this issue reveals a flaw in thinking where economically successful sectors are perceived as an aim in themselves, rather than as an instrument to enhance productivity and push forward industrialisation.

Flaws in rent-design

As mentioned above, incentives can have perverse effects, as in the context of small and medium enterprises and automatisation. Another instance pointed out in the literature is the impact the Export Promotion Law had with regards to long-term investment in the early 1990s. Indeed, that law stimulated "[…] short-term projects, such as natural resource exploitation, with relatively low value-added and low technological impact (Larios & Cordero 1992, p. 68). With regard to the banking sector, Medal points to the problems stemming from the absence of the concept of global income. As a result, capital outflows are implicitly subsidised (Medal 2002, p. 7, Medal 2003, p. 15).

Fallacy of indiscriminate rent allocation

As for the proliferation of tax policy measures, Dijkstra remarks that as of 1996, "[…] if we take together all branches receiving priority in either export promotion or industrial rehabilitation, almost all branches are included. This is obviously impossible, and testifies to a lack of selectivity in searching for priority sectors" (Dijkstra 1996b, p. 544).

On the one hand, there seems to be very limited consciousness of the costs that rents impose, especially for non-exempted tax payers who could otherwise benefit from lower taxation. Since higher prices for non-exempted goods limit demand, those goods that are exempt can be considered to benefit from monopoly rents.

On the other hand, there is little regard for the "cancelling-out effect". In the extreme case, if investment was assumed to be fixed in absolute terms, unconditional tax incentives would merely transfer investment from one sector to the next. In the context of tax incentive proliferation, tax incentives may simply cancel each other out. Allowing for foreign capital inflows, however, inter-sectoral measures are inadequate. Under this assumption measures that achieve generally lower taxation would be required (Artana in Olivares 2005). In this sense, rents in the form of tax incentives are highly inefficient.[5]

Urgently needed revenue

On the other hand, at times public spending rather than tax incentives may be required. In the case of tourism, for instance, the provision of public goods and goods subject to positive externalities is important. Thus for this sector, the exemption from the municipal real estate tax may be counterproductive, as the municipal tax base is eroded, thus limiting necessary investments (Medal 2003, p. 7). Here, public investments could result in crowding in, rather than crowding out (see Streeten, 1993, p. 1285). Recently, the Inter-American Development Bank (Agosin et al. 2005) has

[5] Chang and Cheema point to another problem of indiscriminate rents. They argue that sector-wide incentives may not be adequate for "search" activities that evaluate routines in the production process, since rents can be dissipated too quickly by new entrants. As a result, given the risk and the fact that these expenditures have sunk cost characteristics, entrepreneurs may not invest sufficiently (Chang & Cheema 2001, p. 21). As tax incentives are not allowed to be discriminatory, they are inadequate for this type of incentive. However, given the low degree of Research and Development activities in Nicaragua, this most likely does not represent a problem at this point.

emphasised the need for a reduction of tax exemptions in order to increase revenue to be directed towards human development. A consensus seems to be emerging that at times more, rather than less public spending –on a sustainable basis– is required. However, Nicaragua's government appears to be moving into a different direction. The National Development Plan, for instance, advocates the extension of the Zona Franca regime to the tourism sector (Nicaraguan Government 2003, p. 95), a move that would not only seriously undermine Nicaragua's fiscal sustainability but might also fail to produce the expected positive effects, due to the sector's infrastructure needs, which have public goods characteristics or are subject to externalities. For the industrial sector, the situation seems to be similar, as the industrial sector's most urgent needs are constituted by infrastructure investments and improved governance, rather than tax exemptions as Ana Cecilia Vega and Sonia Diaz of the Nicaraguan Chamber of Industries (Interview) argue.

Insufficient focus on outcomes

The system is flawed in another manner, in that incentives made little impact on business decisions. In fact, one successful entrepreneur welcomed tax measures, such as accelerated depreciation, yet he rejected that such incentives influence business decisions (Interview: Salvo). It thus seems that tax incentives were not aimed at overcoming particular market failures. As some innovative entrepreneurs have benefited, so have less innovative businesses. Without incentives, the same investment decisions would have been taken. As a result, the allocation of rents in the form of tax incentives did not have any power to transform the economy. As argued before, they were of a merely assistentialist type. The rationale of these rents, however, was to compel entrepreneurs to overcome particular obstacles and to invest in technology in order to increase productivity where this would not have been possible otherwise.

A case in point is the aforementioned recent proposal regarding the tourism sector. While much of public outrage is due to the measure being tailored to one particular investment project, the problem rather stems from the fact that the incentives do not have an impact on the business decision itself, which has already been taken (Interview: Báez)[6].

[6] According to Báez (Interview), a contract has already been signed for the project.

It thus seems that as long as the entry into certain sectors is incentivised but not particular behaviour, tax incentives merely represent a distortion. While the government's strategy has been to promote investment via the maintenance of tax exemptions, a truly dynamic incentive system would compel entrepreneurs to overcome market imperfections once and for all, so that the temporary cost of the incentives would no longer have to be incurred. Thus, in sectors with increasing returns to scale, government incentives would allow entrepreneurs to increase production until average costs are low enough for successful competition. Similarly, companies could be compelled to invest in technology, even in the presence of externalities, and learning-by-doing could increase productivity. In this sense, incentives would cease to have a merely "assistentialist" character and take advantage of entrepreneur's "Schumpeterian" quality, thus creating an effective system of compulsion with strategic ends. Rather than subsidising inefficient industries or industries that would be efficient in any case, such a policy would abolish monopoly rents and create learning rents. However, to the present date, government appears to have been a passive recipient of pleas.

Transparency

If incentives were subject to such critical flaws, why have corrective measures not been undertaken? Firstly, it seems that the proliferation of tax exemptions was self-reinforcing. Government came under pressure from more and more sectors (see also FIAS, 2003, p. 55). To use a metaphor, rather than renewing the tyre, the government put patch after patch. Secondly, the lack of transparency made rent-seeking easier in that cost-benefit considerations were avoided and accountability towards the tax payer reduced. In the presence of a relatively weak bureaucracy, rent-monitoring became more and more difficult.

On another note, one reason for the lack of transparency lies within government itself. For instance, by exempting its own spending from Sales Tax, it introduced hidden subsidies to some of its activities, thus camouflaging the fiscal cost of such spending. A change towards a system where the government pays the relevant taxes would allow those departments more efficient spending according to market prices and a much easier scrutiny of government spending overall, too (Medal 2003, p. 23). To overcome resistance, the sum of the additional tax revenues could be allocated to the relevant departments, in order to avoid resistance. Agosin et al. also point out that "[…] it is essential to start quantifying the loss that each incentive regime inflicts on the Treasury and hence the opportunity costs it involves" (Agosin et al. 2005, p. 92). If incentives are justified and effective, there should be no reason to expect opposition. After all, as a Nicaraguan saying goes, "el que no la debe, no la teme" – loosely translated, "he who doesn't owe anything to anybody, shouldn't fear anybody". However, it is well possible that many implicit subsidies may not pass the test of scrutiny. Thus, some resistance to a more transparent rent allocation is to be expected from previous beneficiaries. Furthermore, the opaque tax system lent itself to corruption. Thus, a few agents in both public and private sector may resist. Baez and Baez point out that in the past the tax system was used for political and other ends. "The capsizing of the tax system is due to the extreme discretion used in allocating exemptions of dubious justification" (Báez & Báez, 1994, p. 36). Similarly, Báez and Báez refer to the IMF's findings that in 1994 "[…] the rules of the game [were] modified frequently to resolve particular cases" and "[…] the granting of partial or total relief of tax debts by officials of different levels is a common practice in the DGI" (quoted in Báez & Báez 1994, p. 38). On the one hand, such excess of discretion and often corruption undermined the credibility of the state as an administrator of rents. After all, if it is known that conditions for the receipt of certain benefits are flexible, a situation of moral hazard is created, lowering companies' incentives to invest productively in return for rents. On the other hand, the flip side of discretion was the abuse of the tax administration for political ends. Manuel Ignacio Lacayo (Interview), for instance points to "fiscal terrorism", where excessive measures by tax authorities against particular companies are used to extract bribes or political favours. Due to his vocal opposition to corruption, Lacayo (Interview) was subject to such pressures. Indeed, this businessman argues that his decision to sell his companies was due to the fact that in order to play a high profile role in politics, his business role would have to be low profile, as he would have been economically too vulnerable otherwise (Interview: Lacayo). This is a clear instance of rent-seeking and corruption affecting entrepreneurship. While the situation has definitely improved since, this clearly demonstrates that there are problems with regard to the control of private and public rent-seeking.

Rent-monitoring

Would setting performance criteria for all tax incentives resolve the problem? It would appear that if attempted, the administration would simply not be able to undertake such task. Where attempts for performance-contingent rents have been made, it was proved difficult to monitor performance, since entire sectors of the economy had to be monitored. Medal for instance mentions the disposition in the Decree 34-91 where non-traditional exports require a generation of foreign exchange of at least 35% of the exports' value in order to benefit from incentives (Medal 2002, p. 33). Authorities were unable to monitor performance, given the sheer number of firms. With the Temporal Admission Law this disposition was subsequently withdrawn, however, other dispositions difficult to monitor remained. Thus rent capture by entire sectors made rent monitoring next to impossible.

However, even ex-post evaluations of overall efficiency of tax incentives, which should be expected to be well within an administration's capacity, have been neglected. Over the last decade and a half, no studies were undertaken to monitor the effectiveness of incentives, as César Suazo (Interview) mentions. On a similar note, Medal regrets that there has been no attempt to prove the impact of the tourism sector, in terms of foreign exchange generation and employment creation (Medal 2002, p. 19).

Suazo (Interview) suggests that the Nicaraguan Finance Ministry is aware of the flawed regime of tax incentives. Yet respective sector ministries have a more narrow vision. For instance, Nicaragua's Tourism Institute is judged not by the tax revenue collected but by the amount of investments undertaken in this particular sector. In this form of so-called "bureaucratic politics" –competition for power among government agencies- sector ministries have the upper hand, as the Finance Ministry is obliged to rubber stamp incentives that are proscribed by law (Interview: Suazo). While there are issues regarding the bureaucracy, the main issue is clearly political.

Rent-Seeking Costs

After having identified that rent-seeking behaviour led to the extent of tax exemption proliferation, is the cost to the Nicaraguan economy a rent-seeking cost? Khan importantly distinguishes between rent-seeking costs and rent outcomes (Khan 2002a). For Asia, he finds that rent-outcomes are more significant and rent-seeking costs less significant than expected.

It is very difficult to estimate the cost of rent-seeking, since expenditure on lobbying activities are notoriously opaque. Also -for obvious reasons- corruption figures are not reliable. Although corruption is undoubtedly high, it seems that Nicaraguan corruption is only slightly higher than one would expect for a country of its level of development. This is confirmed by a comparison of its Corruption Perception Index

(CPI) ranking and its GDP per capita ranking. Nicaragua's level of perceived corruption is 9 ranks higher than would be expected given its level of development, which is not much in a sample of more than 150 countries[7]. Relative to its level of development, perceived corruption is similar to that of South Korea and Japan. In absolute terms, Nicaragua's CPI score is similar to two high growth economies, Vietnam and China. Thus, it seems that the general level of corruption or rent-seeking costs are not what distinguishes Nicaragua from these East Asian late developers.

In a country as small as Nicaragua, influence is often based on personal relations[8]. Vilas (1995), for instance, investigates elite families since colonial times to find that they form relatively cohesive groups. The costs of conventional lobbying can thus be expected to be comparatively low. After all, rent-seeking behaviour cannot influence whether an agent forms part of a particular family or business group, or not. Interviewees argued that in Nicaragua under the Bolaños administration, influence was based on campaign contributions and a corresponding feeling of obligation, rather than outright corruption.

This judgement seems reasonable, as it is supported by the argument that due to more secure returns –in terms of rent allocation- given the personal relation, factions may push harder to get their associates into office. This can explain the fierce power struggles in Nicaragua. Even then, however, it seems that most damage was done not through the rent-seeking process but rather through the resulting rent outcomes, which were almost exclusively negative. These results would be in line with Khan's findings for Asia who argues that it is rent outcomes that account for the difference in economic performance, for instance between South, Southeast and East Asia (Khan 2002a, p. 77).

[7] This was obtained by using the subset of countries both part of the 2005 CPI surveys and 2005 UN Human Development Indicators (HDI). The 2003 GDP per capita rank was subtracted from the relevant country's 2005 CPI rank. The use of this new indicator is however limited. Firstly, corruption is likely to have a higher perception in countries with low growth, and, in the case of Nicaragua, GDP per capita is likely to be underestimated, as national accounts do not take into account sufficiently the informal economy. Secondly, these indicators cannot give any indication as to causality.

[8] Anecdotal evidence for this is the relatively limited use by the private sector of official participatory bodies, such as CONPES. Instead, the "linea directa", the "direct line" between big firms and government (Interview: Violeta Granera) is used. Vega (Interview) similarly mentions that the Chamber of Industries mostly deals with the problems of its smaller members, as big firms have other channels of influence.

Selection vs. Creation of Winners

Although it is not acknowledged openly, as state interventionism has not been en vogue recently, the Nicaraguan state is engaged in the selection of winners, as the proliferation of tax incentives shows. In fact, the Nicaraguan government‘s instincts seem not to be completely wrong. As Martínez and Cortés (2004, p. 37) find, a fair share of Nicaragua’s exports can be considered “rising star” sectors. However, the government is missing crucial point here. Industrial policies should be about creating winners, rather than merely selecting them (Streeten 1993, p. 1285). After all, if a sector promised higher returns, investment would automatically flow towards it. In this case, there would be no rationale for government intervention. It is doubtful whether the Zona Franca and tourism sectors’ special treatment is adequate. While both sectors could be considered winners, the relevant tax incentives do not address the problems they face.

The insulated low-technology manufacturing presently prevalent in the Free Zones does not require much state help. If, however, the Free Zones were to upgrade their technology and integrate their chains of production, the kind of state help required would be that of a coordinator of different investments, rather than tax exemptions. In fact, the Zona Franca regime is the opposite of a functioning system of compulsion, as entrepreneurs are incentivised not to integrate. Thus, rather than merely promoting market entry for the Zona Franca, the sector must be transformed into a winner –with productivity growth, linkages, etc.– by the right incentives.

Similarly, the tourism industry has been identified as a winner by the Nicaraguan government. Tax exemptions are aimed at compensating businesses for the lack of infrastructure and other negative factors. Yet, again, simply encouraging market entry with tax exemptions is not sufficient. Such an approach does not address problems, such as public goods characteristics of some necessary investments. For instance, the international promotion of Nicaragua as a tourist destination is not being undertaken by private firms due to its public goods characteristics. While tax exemptions are granted, Nicaragua’s promotion budget is dwarfed by competing nations. Thus, the obstacle of Nicaragua’s image problem persists and represents a constant cost to the state, which tries to compensate by implicitly subsidising sectors. This approach also does not take advantage of entrepreneurs who do not need subsidies to be profitable if only market imperfections are overcome.

In this context it is important to consider the role of the entrepreneur, in the Schumpeterian sense. It is his task to create innovative processes and products and thus enhance productivity. As argued by Schumpeter, competition is a dynamic process, rather than a static equilibrium. The entrepreneur innovates responding to sticks and carrots. The threat of bankruptcy and the availability of rents –in the competitive market this would be the producer's surplus– constitute a system of compulsion. In the case of Nicaragua, however, the kind of compulsion that rents gave has often been everything but innovative. Cruz argues that this is a legacy of Sandinista policies, as part of the private sector has adopted a passive attitude as recipient of initiatives and favours from the government (Cruz 2000). Another recent study points to the same problem. The authors consider that

> "[…] a significant part of Nicaragua's entrepreneurs are of low quality, in Schumpeterian terms. The great majority looks for simple accumulation, minimised risks, state protection and barriers to the entry of competitors. Nicaragua urgently needs entrepreneurs of a modern fashion, as understood by Schumpeter, who risk capital and reinvest profits instead of bringing them off-shore. […] To accelerate this conversion, the government needs to modify incentives that currently stimulate these behaviours among Nicaraguan businessmen and replace them with different incentives and rules of the game which lead to modern and desirable behaviours" (ASDI 2004, p. 86).

As Rocha 1999 puts it for the small and medium enterprise sector, instead of "private initiative", agents were often "deprived of initiative" (Rocha 1999, p. 120). Thus rents need to stimulate initiative, rather than helping companies to barely subsist. Learning rents in their different manifestations have an important role to play. Rather than subsidising entire sectors, the learning curve of non-traditional exporters needs to be subsidised, to use Gitli's words (Gitli 1996, p. 108). Unlike old-fashioned advocacy of state intervention in the form of ISI or similar policies, it is necessary to take into account the state's ability to administer learning rents. Only then can the transformation of learning into monopoly rents be avoided. In order to investigate this, I shall now finally turn to some political factors.

The political limitations to effective policy

Political Representation

It seems that the problems surrounding Nicaragua's system of fiscal incentives can be overcome via rational and benign policy-making. For this to be possible politicians need to be able to put forward dynamic incentive regimes that are not captured by economic interests. The bureaucracy in turn needs to be able to administer these. Unfortunately, as Navarro argues, "In Nicaragua the parties have ceased to interpret society's demands adequately and thus do not constitute an adequate communication nexus between the social subsystem and the political class" (Navarro 2004, p. 28). In this way, socially suboptimal regimes can persist. Furthermore, there is a lack of democracy within the parties with personal loyalties prevailing over political convictions. Ultimately, this reduces congressmen's roles to "[…] handing out scholarships and building basket ball playgrounds […]" (Navarro 2004, p. 36). With initiative among law-makers stifled, there is not much room for the development of smart incentive systems. The low degree of accountability of Nicaragua's clientelistic political system is further exacerbated by the lack of transparency in campaign contributions. This is problematic, as monopoly rents are often enshrined via legislative processes. However, there is hope that the newly elected parliament may prove more independent and competitive, which could encourage members to scrutinise policies more strongly in the pursuit of public recognition.

Business Groups

As for the private sector, concentrated power in Nicaragua's already small economy has not benefited innovation either. Strachan, for instance, has investigated Nicaraguan business groups in the 1970s. He characterised them as defensive in nature, given their competition with firms close to Nicaraguan dictator Somoza. They were thus not detrimental to development in the 1970s. However, Strachan considered business groups to be transitional institutions whose concentration of power may at one point become detrimental (Strachan 1976, p. 98). It seems that despite the interruption of the Sandinista years, the latter point was reached with the liberalisation process of the 1990s with their organised power now serving rent-seeking objectives, as clearly illustrated above with regards to tariffs.

> “One hushed-up truth is that the most subsidized sector in Nicaragua is a huge business group that uses its power to lobby for new and continuing tax exonerations with the arrival of all new parliamentary benches, and it always gets them. This can be easily demonstrated with data and figures, as well as laws endorsing the subsidies” (Báez 2006).

Bureaucracy

As for the bureaucracy, unfortunately the changes of government have often done more harm than good. Just as the 1979 revolution meant an exodus of qualified bureaucrats, the transition from Sandinistas to the Barrios de Chamorro government meant that again many efficient public officials left, while inefficient ones remained (Ramirez 1993, p. 97). Furthermore, Neira Cuadra (1998, p. 143) argues that the purge of top level Sandinistas in the administration also led to a fragmentation of the chain of command, with old and new bureaucrats engaging in conflicts to control their “turfs”. With the election of Arnoldo Alemán, the positioning of party cadres in the bureaucracy even antagonised international donors. Only with the Bolaños administration a relatively smooth transition took place. Thus, only in recent years has the bureaucracy recovered some capacity that could be used for the efficient monitoring of a limited number of rents. It remains to be seen whether the newly elected Sandinista government will repeat the mistakes of past governments or whether it will smartly use the administrative capabilities that have been built up.

Recommendations

With a political system largely captured by economic interests, what could lead to a more efficient industrial policy? It seems that several components would be crucial. Firstly, more accountable law-makers would be incentivised to ensure legislation contributes to the creation of learning, rather than monopoly rents. Secondly, Nicaragua’s private sector needs more innovative entrepreneurs, or “fewer who are deprived of initiative and more private initiative”. Thirdly, Nicaragua’s bureaucracy should help politicians to make wise choices. While Nicaragua’s bureaucracy would not be able to implement a Korean or Taiwanese style industrial policy, a clearer vision for Nicaragua’s industrial development –and about what is and what is not feasible– is certainly required. Ortega’s new government will need to be very selective with regard to its interventions and merely “assistentialist” tax exemptions will have to be discontinued unless justified by externalities or on distributional grounds. Dynamic measures that use performance-contingent rents to overcome temporary obstacles to industrial development need to be realistic, transparent and credible, which could be achieved by making such de-facto subsidisation more explicit and easier to withdraw[9], unlike the indiscriminate, sector-wide implicit subsidies enshrined in law. The high visibility would help making the political legitimacy of such measures dependent on the good performance that Nicaragua so desperately needs.

Conclusion

In conclusion, during Nicaragua's liberalisation process, tax incentives emerged as the preferred measure of industrial policy. While not all rents have to be necessarily negative, Nicaraguan tax incentives were not allocated strategically, according to economic criteria. Rather, measures benefited various interest groups and were assistentialist, not transformational in character. This failure was due to various flaws in individual incentives, flaws in the system as a whole and the inadequacies and fallacies related to the instrument used, tax incentives. Innovation and the overcoming of market imperfections were not incentivised and monitored sufficiently and the fiscal cost of misguided measures implied that necessary public investments could not be undertaken. At times they were openly counterproductive. For an effective industrial policy, rent-management needs to become more selective and independent. It remains to be seen whether Nicaragua's clientelistic political system is capable of achieving this.

[9] Blankenburg and Khan argue that in Latin America, "[…] rent-management strategies rarely involved export or other subsidies that are easily withdrawn, because they target individual producers […]" (Blankenburg and Khan, p. 18).

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- Báez Cortés, Julio Francisco, Fiscal Law Expert & Executive President, Nicaraguan Institute of Fiscal Studies (Instituto Nicaragüense de Investigaciones y Estudios Tributarios), 2 August 2006
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- Granera, Violeta, Executive Secretary, Nicaraguan Council for Social and Economic Planning (Consejo Nacional de Planificación Económica y Social), 20 July 2006
- Lacayo Gil, Manuel Ignacio, Businessman, 26 July 2006
- Lopez Vigil, Maria, Editor-in-chief, Envío, Nitlapán-UCA, 12 July 2006
- Medal, José Luís, Professor of Economics, Ave Maria College Carazo, 16 August 2006
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