PD-ABI-521

PROJECT ASSISTANCE COMPLETION REPORT
December, 1993

I. BACKGROUND DATA

A. Project Title: Fiscal Administration Development Project

B. Project Number: 518-0042 Loan 518-W-061

C. PACD - Original: July 31, 1989
Revised: June 30, 1993

D. Implementing Agency: Ministry of Finance's General Directorate of Revenues (GDR)

II. PROJECT STATUS

A. Financial Summary

	USAID	GOE	ESF
Grant	4,800,000		
Loan	2,250,000		
Total	7,050,000	2,500,000	200,000

The Fiscal Administration Development Project was authorized by the Acting Assistant Administrator of LAC on January 13, 1985 and was scheduled to end July 31, 1989. The authorized LOP funding was \$4.8 million Grant and \$2.0 million Loan. On March 29, 1985, the Government of Ecuador (GOE) and AID executed a Project Loan and Grant Agreement to assist the General Directorate of Revenues (GDR) in increasing central government fiscal revenues, especially from income and sales taxes, through activities directed at improving the organization and administration of the GDR.

On August 29, 1986, the Mission Director authorized an increase in the LOP Loan amount to \$2,250,000, to develop a computerized system by procuring the necessary computer equipment and related furniture, and training the GDR staff in charge of processing income and business license tax returns. Subsequently, the support to the tax reform was the factor in extending the Project to July 31, 1991 and again to July 31, 1992. This second phase of the Project was initiated in 1990. Finally, a final extension to June 30, 1993 was approved to perform a final project evaluation.

In sum, the total Project financing, as determined by the Project Authorizations amounted to \$2,250,000 in Loan funds and \$4,800,000 in Grant funds. The GOE contribution was set at \$2,250,000, and the equivalent of \$200,000 in ESF local currency funds were provided to the Ministry of Finance (MOF) to help meet counterpart funding requirements.

Technical Assistance for implementation of the first phase of the project was provided under an AID direct contract with Omnimax International, Inc., and for the second phase, under a Host Country Contract with Centro Interamericano de Administradores Tributarios (CIAT).

By the end of the project, the deobligation of $444,000 in loan and $298,000 in grant funds was processed.

B. Progress Toward Achievement of Project Purpose

The goal of the project as stated in the Project Paper, was to strengthen GOE capacity to finance equitable development on a sustained basis. The key indicator of Goal achievement is an increase in public sector investment to approximately 10 percent of GDP by 1990.

The project Purpose was to increase Central Government fiscal revenues, especially from the income and sales taxes. The target for purpose achievement is a net increase in non-petroleum revenues over the life of the project of 25 billion sucres (principally income and sales in constant 1983 terms) above and beyond what would have been expected in absence of the project.

The Subpurpose of the project was to strengthen the fiscal revenue administration capacity of the GOE. As stated in the Project Paper, the success of this effort would depend on minimal personnel turnover in the MOF's revenue units and on the effectiveness of project-financed technical assistance and training in changing attitudes and improving skills of those personnel responsible for institutionalizing the new administration mechanisms.

The project strategy was based on two major components: revenue administration and organizational improvements. The first attempted to reduce taxpayer noncompliance in the three major functional areas: delinquent accounts, nonfiling and under-reporting. The second component, other than its central activity of reorganization of the GDR, dealt with returns processing, professional inspection (internal audit), and public relations.

A third and smaller component addressed four topics related to the MOF's fiscal administration responsibilities. These are: a study to examine deficiencies in the procedural laws and regulations, with recommendations for changes. A second study was to analyze the possible effects of the existing tax rate structure on taxpayer incentives. Third, an analysis of the GOE's revenue-sharing program to improve the development impact of those resources. And fourth, a study to develop recommendations for improved customs revenue administration.

The Project experienced implementation delays during its first three years. The reorganization of the GDR which was central to the project, was held up for one year before finally being approved by the MOF, which put project implementation a year behind schedule. When that problem was resolved, the GOE refused to provide duty-free customs clearance for equipment brought in under the project so that the other central project-element, computerization of tax collection, control and follow-up, was delayed indefinitely. This problem persisted until the change of government in August 1988.

A mid-term evaluation of the project conducted by Development Associates, Inc. in August 1987 concluded that, while the project had proved successful in terms of increasing revenue collections and exceeding established goals, significant delays were evidenced in meeting the objectives of the two major components, namely, revenue administration and organizational improvements.

With the advent of a new GOE administration in August 1988, the Mission requested a stronger GOE demonstration of commitment to the Project for the one year remaining until the original PACD (July 31, 1989). Immediately upon assuming office, the new administration demonstrated such commitment and began to take actions. It not only promulgated a new tax law and initiated a lightning-like program of procedural changes, it also addressed some of the project's long-standing problems. Within six weeks it administratively resolved the duty-free customs clearance for project equipment and promptly honored a project obligation to put 20 collection agents on the GDR payroll who were being temporarily carried with project funds. Later, in May 1989, the law was changed to accommodate duty-free entry of project equipment.

In January, 1989 the GOE passed Legislation (Control Tributario y Financiero) to expand the tax base, simplify tax collection procedures, and facilitate tax payment through the private banking system. In July of 1989, the Mission approved a PACD extension to December 31, 1989 in order to conduct a final project evaluation. This evaluation concluded that while only a few of the project's original objectives had been achieved, most of them continued to be valid and important to pursue. Based on analysis of the new tax legislation and the benefits of assisting the GOE to implement them, the Mission approved an additional extension of the PACD to March 31, 1990 to permit study of project redesign and extension requests from the MOF.

Meanwhile, in September of 1989, the GOE signed an agreement for technical cooperation through July 31, 1992 with the Inter-American Development Bank (IDB). The IDB project was also aimed at improving tax administration and used the same source of technical assistance (CIAT) as contracted for the second phase of the project, and the same project director.

In December 1989, the GOE passed a comprehensive tax reform law which went into effect on January 1, 1990 (Ley de Regimen Tributario Interno). Under this new law, individuals with an annual income of up 2,000,000 sucres ($3,340 at 1990 value) are exempt from paying taxes; individual income tax rates are set from a minimum of 10% to a maximum of 25%; tax rates are established at 36% for profits repatriated by foreign investors and at 25% for reinvested profits; inflation adjustment mechanisms, based on the Consumer Price Index, are contemplated; a 10% Value-Added Tax (IVA) is to be implemented; and taxes are to be collected through banks, the MOF and all other national financial entities, such as credit unions and housing finance corporations. These reforms were subsequently modified as explained below. The Capital Markets law approved by Congress in mid 1993, reduces the tax rate for foreign investors from 36% to 25%.

In response to MOF requests for assistance for the development of a proposal to use funds remaining under the project to support reform efforts, project funds were used in November-December 1989 to provide technical assistance to the MOF for this purpose. This proposal was approved by AID on March 20, 1990.

The primary purpose of Phase II was to support the institutionalization of the 1988 and 1989 tax reforms, in addition to the goal and purposes of the original agreement. Specifically, the following actions were planned targets for this second phase of the Project:

- Undertake an extensive program to train GDR personnel in the administration of the new tax law (in addition to training already initiated under Phase I) and to increase labor and management productivity. The program was to become a permanent activity in the GDR.

- Undertake a countrywide public communications drive to educate taxpayers in the filing and accounting requirements of the new law, and increase public awareness of the need for tax compliance.

- Implement tax filing and collection through the commercial banking system.

- Increase the quantity and quality of audits to identify tax evaders, nonfilers, and stopfilers.

- Increase effectiveness in collecting delinquent accounts.

- Implement the Objective Global Assessment System (SEOG), a presumptive system for determining income and value-added-tax liabilities.

The effort was to be supported by an efficient data processing organization, the donation of personal computers, printers, accessories, and the refurbishing of classrooms.

Final evaluation for the second phase of the project took place in June 1993, through an IQC contract with Nathan Associates. The following comments have been extracted from the evaluation findings as presented by the contractor.

The training program itself was completed successfully. From June 1990 to July 1992, a total of 4,635 GDR employees were trained through 200 courses and seminars, an average of 2 courses per employee. Nevertheless, the training strategy was not completely adequate in that a significant number of personnel were trained in skills unrelated to either the short- or medium-term requirements of the GDR. Rather, they were trained in areas that had no direct application back in the office since little or no computer equipment is available for staff use. In spite of the wide coverage of the training program, productivity has not increased and in critical areas such as audit productivity it has actually declined. Also, there are no incentives for the staff to improve in terms of either increased salaries or job recognition. The only incentive for training derives from the possibility of increased income from activities outside the government.

The training program lost much of its impact with the subsequent dismissal of 30 percent of the personnel who had worked in the GDR during the intensive training period. Some of the personnel were involved in tax collection and were no longer needed when the system began to be implemented by the private banks. Regarding the continuity of the training program, it has floundered for lack of financial support from the GOE. Job-related attitudes of GDR personnel have not improved.

The public relations effort was successful to the extent that it provided the public with basic instructions and information on the tax reform's new rates and filing requirements. However, it was not successful in improving taxpayers' attitudes toward tax evasion, which remains at very high levels according to the evaluation team's rough estimates, the IDB, and the contractor's opinion.

Implementation of tax filing and collection activities through the banking system was successful. Today, close to 100 percent of the collection is done through this system. There are now 370 tax collection points, up from 20 before the reform. One of the main benefits of this system is a reduction in collection costs, which should result from privatization.

The dual goals of higher efficiency in audit and collection of delinquent accounts were not achieved. In some instances, these forces were beyond the contractor's reach. Enforcement of the audit process requires government commitment and an appropriate legal and regulatory framework in order to enforce notifications and collections.

The Objective Global Assessment System (SEOG) created by the tax reform was partly implemented. In 1991, only 1,326 payments were registered from this system out of a total of 13,432 potential taxpayers. The system is not practical, provides a low yield, and is difficult and costly to administer. But the main disadvantage of the system is that it is an open door for tax evasion by taxpayers who should keep accounting records and do not qualify for the system (such as the fuel transportation association).

The data processing organization received constructive technical assistance during the first 16 months of the project, but they were not satisfied with the assistance received during the last year.

Computer equipment was provided by several donors, but there was no coordination among donors to ensure compatibility. Some equipment was either not used at all or not to full capacity. There has been no government commitment to basic maintenance or supplies such as paper. The MOF mainframe, on which the GDR heavily relies to process tax data, is operational only 8 hours a day 5 days a week, in spite of heavy demand. In addition, there are several unused microcomputers, mid-sized computers, and printers throughout GDR.

With regard to the project's stated purpose of increased revenues, the small increase to GDP, indicated in the table below, seems to have resulted more from changes introduced within the system by the tax reform and other measures unrelated to the project than from increases revenues. At the end of the project, the goal of increasing revenues through a better-run, better-equipped, more efficient institution has not been achieved.

Based on information from the GDR and Central Bank of Ecuador, Income tax (including corporate tax but excluding taxes paid by oil companies Texaco and Cities) and Value-Added Tax (VAT) (which does not include VAT paid directly by oil companies), as percentages of GDP, are as follows:

Year	Income tax (percentage of GDP)	VAT (percentage of GDP)
1985	1.38	1.62
1986	1.64	2.73
1987	1.65	2.68
1988	1.36	2.74
1989	1.96	2.77

1990	1.53	2.91
1991	1.79	3.15
1992	1.78	3.22

The project had a target of increasing public sector investment to 10 percent of GDP by 1990. This target was not achieved either at that time or during the last phase of the project. The highest ratio achieved during the life of the project was 8 percent in 1991; the ratio declined to 7.7 in 1992. The projected ratios for 1993 and 1994 are 7.5 percent for each year according to World Bank figures.

One positive aspect of the project, however, has been to make the GDR more aware of and receptive to the needs for reform. It was also successful in implementing tax collection through the banking system, and the public instruction drive effectively covered a large segment of the taxpayer population. The failures resulted from a combination of internal resistance to change within the GDR, a lack of leadearship at high levels of the GDR, highly variable government commitment, deficient technical assistance from the contractors, and a lack of project flexibility in order to adjust to changing circumstances.

C. Changes in Project Design

As detailed above, in February of 1990, the Ministry of Finance submitted a proposal to AID which outlined its plan to institutionalize tax reform through this Project. Based upon this proposal, the Mission extended the LOP to July 31, 1991, and amended the project agreement to include a Phase II to the project, and reprogrammed the budget to include a new component aimed at helping the MOF to implement the 1989 legislation. The new component consisted of $1,125,000 in unused grant funds and $1,461,000 in unused loan funds and was complemented by $1,059,000 of remaining counterpart funding. The component was comprised of three activities: 1) information dissemination, public education and training; 2) technical assistance, training and equipment to improve the MOF's administration of the reform legislation; 3) studies to examine the macroeconomic impact of the reform.

III. POST-PROJECT CONSIDERATIONS

A. Recommendations for Final Adjustments

No final adjustments in project design are required.

B. Post-Project A.I.D. Monitoring Responsibilities

None.

C. Data Collection and Evaluations

No further data collection and evaluation of the project is considered necessary.

D. Summary of Lessons Learned

- Until the president of Ecuador and his administration place a high priority on tax collection and enforcement, donor funds for tax administration and reform will likely be underused by the GOE.

- Project implementation should take place in stages, with continuation subject to successive and gradual achievement of specific goals, and continuous government support.

- Focused training programs should be developed for key areas, but only with the GOE's commitment of increased salaries for tax administration personnel.

- When participating in joint ventures with other donor agencies, there should be a clear delineation of target areas and achievements to be produced under each contract.

- The project should include its own measuring and monitoring capability. In this case the project should have developed a tax computation model for fiscal analysis, a model based on disaggregation of information contained in tax returns records. This point is not applicable in countries where such models already exist. The model is badly needed in Ecuador and would be very useful for serious tax reform proposals.

SIGNED: ______________________ DATE: 12/31/93
Michael R. Jordan,
Acting USAID Director

CLEARANCES:

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