

PROJECT ASSISTANCE COMPLETION REPORT

FISCAL ADMINISTRATION PROJECT (FAP)

Project Number: 520-0371 Grant

FUNDING: Grant authorized LOP \$12,400,000
Grant obligated \$12,400,000
Grant expenditures \$12,106,700
Amount for deobligation \$ To be Determined*

*Based on most recent figures from USAID/Guatemala

COUNTERPART CONTRIBUTION: \$10,000,000**

**Originally counterpart was established at \$6,000,000

PROJECT ASSISTANCE COMPLETION DATE : Original 07/01/92, Amendment
03/31/94

IMPLEMENTING AGENCY: MINISTRY OF FINANCE (MOF)

PROJECT PURPOSE:

The purpose of the project was to assist the Government of Guatemala (GOG) in a comprehensive modernization of its fiscal administration system.

SPECIFIC OBJECTIVES:

The project had four specific objectives: 1. improvement in the allocation of resources; 2. greater fairness in the distribution of tax burdens and expenditure benefits; 3. mobilization of resources to cover the cost of public services; and 4. improved government ability to plan and monitor its fiscal decisions.

PROJECT OUTPUTS	PROJECTED	ACTUAL	PERCENTAGE
1. Specific fiscal analyses performed	10	10	100%
2. Analytical Models developed & applied	6	6	100%
3. Fiscal Policy Analysis Unit institutionalized in MOF	1	1	100%
4. New modern fiscal legislative framework:			
-Income tax	1	1	100%
-Value added tax	1	1	100%
-Customs	1	1	100%
-budget planning execution	1	1	100%

BACKGROUND

Throughout the decade of the 1980s, the macroeconomic situation in Guatemala was one of relative disequilibrium and instability, with low rates of real economic growth, periods of high rates of inflation by Guatemalan standards, devaluation of the quetzal, chronic deficits in the balance of payments and decreased international reserves, continually growing difficulties in servicing external debt, and the inability of the central government to command enough resources to provide an adequate level of basic services such as health and education.

The situation deteriorated markedly between 1990 and 1992 and fiscal imbalance became a severe problem.

The fiscal deficit exceeded 2.5 percent of gross domestic product (GDP) in 1990, and tax collections were lower in 1991 than in 1988 by 1.3 percent of GDP. Real per capita government spending levels were falling in the early 90s, and potential sources of foreign borrowing were all but exhausted.

During 1991, the Government attempted to shore up its fiscal position with a number of temporary measures. There was a tax amnesty, a one-time charge on the gross income of companies, and a surcharge on petroleum products. Current expenditures were also reduced significantly. These temporary measures did succeed in reducing the fiscal deficit but failed to achieve progress towards creating a more equitable and efficient tax system capable of generating resources required to finance public sector operations and needed social investment. The need for a fiscal reform was evident.

Raising additional revenues to deal with a budget deficit was only one of the three major issues that would have to be addressed by such a program. The others were an excessively complex and economically inefficient tax structure and inadequate tax administration. The results of these structural and administrative shortcomings were a slow growth in government revenues; unfairness in the distribution of tax burdens among families at different income levels, and among those with similar incomes; unequal treatment of businesses in different sectors of the economy; and interference with economic choices. Up to that moment it was recognized that the solution to Guatemala's short-term fiscal crises would have to include a tax rate increase, but it was also recognized that in the longer run, the more chronic problems could not be resolved without a comprehensive reform of the tax structure and the tax administration.

PROJECT DESCRIPTION

The goal of the FAP was to support the Government of Guatemala's efforts to stimulate robust economic growth, with a structure reflecting broad participation and optimal utilization of Guatemala's particular resource endowments, given cost-price relationships in world markets.

The purpose of the project was to assist the Government of Guatemala in a comprehensive modernization of its system of fiscal administration.

The project had four specific objectives:

- a. Improved resource allocation through: 1. improving fiscal policy; 2. strengthening tax administration; and 3. providing better information to assist government officials in making fiscal decisions.
- b. Greater fairness in the distribution of tax burdens and expenditure benefits.
- c. Mobilization of resources to cover the cost of public services through improved tax administration and the system for delivering public services.

- d. Improved Government ability to plan and monitor its fiscal decisions through greater institutional capacity to monitor fiscal decisions.

The purpose of these components was to leave in place within the MOF, the capability to evaluate the implications for future revenue and expenditures, and for income distribution and growth, of changes in public policy or external economic conditions.

Certain general principles guided this project:

- a. The first general principal was that successful tax administration depends on a sound tax policy framework. There are urgent administrative reforms that can and should go forward prior to policy changes. However, changes in the tax policy structure must be implemented to achieve an equitable and efficient tax system.
- b. The second general principle was that fiscal administration and structural changes were formulated to be consistent with the Government's broader economic policy package.
- c. The third principle made institution building a primary objective in all activities of the project. The purpose was to leave behind a capability to maintain and update the reforms and operational changes in the future. Formal and on-the-job training, computerization of tax administration, data base development, and the development of analytic models were all an important part of the work.

USAID/Guatemala approved the FAP project paper in July, 1989 and the purpose was to assist the MOF to improve the administration of the fiscal system. Peat Marwick (KPMG) was contracted to provide technical assistance to the MOF and to implement the FAP.

PROJECT INPUTS

Following is a summary of the resources provided to implement the FAP:

INPUT	ORIGINAL BUDGET (I-II Phase)	DISBURSED BUDGET (I-II Phase)
Technical Assistance	\$11,003,818	11,704,823
Training	\$ 0	67,357
Commodities	\$ 118,500	0
Audits & evaluations	\$ 190,000	163,736
Inflation	\$ 249,288	0
Contingencies	\$ 838,395	0
Related studies	\$ 0	170,784
TOTAL PROJECT	\$12,400,000	12,106,700

The total counterpart financing requested from the MOF to support project implementation was \$6,000,000. These funds financed MOF salaries, training, indirect costs, travel and transportation and equipment. Reflecting both GOG interest and financed commitment to the project and higher than expected cost of support activities, at project completion, the GOG had contributed over US\$10,000,000 in counterpart expenditures for the FAP.

CONSTRAINTS TO REACHING PROJECT GOALS

1. Lack of GOG political commitment to tax reform.
2. Institutionalization of tax reforms not achieved. Another of the greatest problems for the Ministry was personnel policy. Salaries in the MOF are set by the Civil Service Law, and their steadily diminishing real levels over the past 15 years have generated a migration to the private sector of the most qualified personnel. Sustainability of FAP achievements depends on a Ministry commitment to assign qualified and motivated people to permanent positions, to work with the FAP inspired improvements, and to attract these people to pursue careers in the Ministry thereafter.

The MOF has gotten around the civil service pay scale by relying heavily upon contracting for the personal services of qualified people. Indeed, entire departments (informática, DAF, VAT Program) are now staffed by contract employees.

The tax code in Guatemala is a major constraint to what can be gained by applying the administrative improvements offered by the FAP. The Tax Code defines the procedures facilities, appeals, penalties and other important key issues for tax enforcement. The design of the Tax Code (known as "unified project") can create more problems that it solves. This tax code specifies a series of repetitive and unnecessary procedural rituals that do not necessarily provide the taxpayer with protection against an unjust settlement, but it does provide many opportunities for taxpayers to paralyze the process or delay its resolution inordinately.

3. Improvements in tax administration were not achieved as expected, and this undercut potential for fiscal improvement resulting from tax policy reform. One of the main principles of the project was that any tax structure must be complemented by the way it is administered. Tax policy is established via tax administration. The tax reform package implemented on July 1, 1992, provided Guatemala with a more rational tax structure, but with a very small element on administrative reform. Structure itself has little meaning without simultaneous administrative reform.

The constant updating of data bases and the immediate data entry of information from tax returns are prerequisites to any

continuous effort of tax administration. The FAP improved the tax database, and data entry backlogs have been reduced. Nevertheless, superfluous data are generated, as there exists a lack of coordination between what the data users need and what is actually generated.

There are also administrative problems in the Customs Department. The different areas and departments into which the presently constituted Customs Department is divided make little functional sense. The FAP designed a structural reorganization plan which has been accepted in principle by the Custom Director. This effort must be accompanied by serious and sustained efforts to improve the quality of the human resources. The Customs Department must be able and willing to take concrete steps toward establishing career-path employment for its employees.

Due to time and money constraints not all divisions of the MOF received attention from the FAP. The attention in the project was centered towards the revenue side and the expenditure side (budget and control unit) was left behind causing problems to the implementation and execution of the activities designed by the FAP.

ACCOMPLISHMENTS

The FAP team fulfilled almost all components included in the terms of reference. Omissions have been few (eg. limited activity in budgeting). The FAP team played a key role in the design and implementation of the tax modernization program, the centerpiece of which was the fiscal package signed by the President in May 1992. The FAP was the mechanism used by the government to implement a new fiscal package. In addition, the FAP team completed numerous important additional tasks not included in the original terms of reference.

In terms of achieving project outputs, the FAP has been a relatively successful project. Some of the most important contributions of the FAP are:

- Significant input to the GOG's tax modernization program. New tax laws, covering Guatemala's most important taxes (Value Added Tax (VAT), Income Tax), and implementing regulations were designed and written primarily by the FAP team.
- Computerized systems in the MOF have been modernized. Data management is now much improved over the old mainframe environment.
- Control systems have been put in place to assist the MOF in managing tax related matters.

- Training has occurred in almost all functions of the Internal Revenue Directorate (DGRI) and Customs Directorate (DGA). This is particularly the case in computerized operations and auditing.
- The Financial Analysis Unit (FAU) has been established and its staff trained and equipped by the FAP to provide assistance to the Minister in the formation and management of fiscal policy.
- The tax modernization program of 1992 significantly improved the Guatemalan tax structure. The new system is simpler, easier to administer and comply with, more investor friendly and more fair.
- The Guatemalan tax reform was directed mostly at a structural reform, and it achieved its goal. A primary objective was to broaden the tax base and therefore remove distortions in relative prices that effected economic choices. Significant improvements were introduced in five areas:
 1. The removal of all tax incentives (except for those for export promotion) will put more businesses on an equal footing.
 2. The taxation of interest, which reduces incentives for debt finance and reduces the possibility of negative real tax rates that characterize the previous system.
- The provisions of refunds, the full and immediate credit for capital purchases and the allowing of credit for all inputs removes the existence of cascading (fiscal term that defines tax over tax), an important distortion in the VAT.
- The extension of zero rating (mechanism used by the GOG to reimburse VAT to exporters) traditional exports puts investment in all types of export activities on the same footing, and enhances the competitive world position of Guatemalan traditional exports.
- The elimination of the average-marginal rates under the income taxes removes a significant incentive to understate income and to engage in some form of transfer pricing to avoid a substantial tax penalty from changing tax brackets

This reform program was not revenue neutral, it did focus more on tax structure than on revenue raising.

PROJECT EVALUATION/MONITORING

During the life of the project, two evaluations were completed. Both evaluations were performed by IMCC; the Interim Evaluation in December 1991 and the Final Evaluation was in

November 1993. Both evaluations mentioned the importance of FAP as the design and implementing tool of the fiscal package designed by the GOG and Peat Marwick. The main problems that were found related to a lack of planning for the implementation of the enforcement laws to help the package be as effective as it was designed. Also a lack of political will and lack of a program of institutionalization of the FAP were identified on the evaluations.

The FAP was audited in the United States.

On monitoring results, the project suffered from a lack of clarity of end-of-project status and how to measure results. This resulted in the MOF implementing measures and training people that didn't help to evaluate the real impact of the fiscal package and to measure the real tax collection versus what was estimated in the design.

RECOMMENDATIONS AND LESSONS LEARNED

There are several lessons that can be learned from this project.

- The FAP's modernization effort should have had a broader coverage of MOF divisions. FAP attention was aimed mainly at the Internal Revenue Office and Customs Office. Some divisions still operate in antiquated and counterproductive ways, and act as constraints on tax collections. All the divisions that conform the revenue area should have been included.
- Tools are not everything. The FAP has had more-than-expected success in installing computerized information systems at the MOF. Nevertheless, the will to use the tools does not seem to have increased simultaneously.
- Day to day ministry work should not be the responsibility of project advisors. It should be clear from the outset that advisors are not to be used to make up for staff deficiencies.

The main problems and decisions that the MOF must resolve in order to implement an effective fiscal system are:

- The implementation of a new tax code.
- Increase the value added tax rate. An increase from 7 to 10 percent on the reformed VAT base would raise an amount equivalent to about 1.3 percent of GDP (based upon 1992 fiscal reform)
- Increase the compliance rate through better enforcement. Even under the reformed structure of taxes, there is significant room to increase revenues through improved compliance.

- Imprecision in the MOF's administration. The way that the MOF administers its tax laws, does not help the MOF to take advantage of the potential for increased equity contained in the law. This makes it unlikely that any significant changes in equity have occurred in fact.
- Tax audits are still very weak. Audits are still by individual tax rather than being comprehensive. Additional support for it is required.

Women's participation

Women's participation in the project can be analyzed in two ways. If the participation is viewed as the permanent staff of the MOF, many women participated in the implementation of the FAP and had the opportunity to improve their knowledge by working with the FAP advisors. Women participation as taxpayers is elevated and the percentage of women as households and income generators is very high in Guatemala. The long-run benefits that they will receive by the creation of the new tax laws through transparency and rational structure is very important and will help women to be more participative in the tax payment process.

Drafted by:

AVPocasangre: R. 06/08/95

Clearances:

KDelaney, TRI: KD 6/8/95
 RPeterson, TRI: RP 6/9/95

U:\spriepub\doc\PSIFAP