Quarterly Report

August – October 2005

TAX POLICY & ADMINISTRATION REFORM (TPAR) PROJECT
El SALVADOR

November 2005

This publication was produced for review by the United States Agency for International Development. It was prepared by Development Alternatives, Inc.

Quarterly Report

August – October 2005

TAX POLICY & ADMINISTRATION REFORM (TPAR) PROJECT
EL SALVADOR

DAI Development Alternatives, Inc.

TABLE OF CONTENTS

1. Executive Summary

USAID signed a Task Order with Development Alternatives Inc. (DAI) on July 23, 2005 to design and implement a program for modernizing and improving tax policy and administration in El Salvador.

Highlights for the quarter are listed below:

Start of the Project

- Life-of Activity (LOA) Work Plan development
- Annual Work Plan development

Activities Performed

- Benchmarking study
- Study of potential performance under current structure
- Training assessment and planning
- Tax administration administrative structure assessment
- Information technology system assessment

Quarterly Results

- Established operations in the Ministry of Finance
- Earned approval of the LOA Work Plan
- Drafted the First Year Work Plan
- Established institutional relationships with USAID, Directorate General of Internal Revenues (DGII), and the US Treasury
- Completed an assessment of the tax administration
- Conducted a benchmarking study
- Conducted an analysis of potential performance under current structure
- Developed a Training Plan for the LOA
- Target-setting for the Life of Activity of the project

2. Introduction

USAID commissioned Development Alternatives, Inc. (DAI) and its TPAR team to design and implement a program for modernizing and improving tax policy and administration in El Salvador. The project goals are to maximize tax collection and minimize evasion without increasing the tax rates.

USAID and the Directorate General of Internal Revenues (DGII) have prioritized several key areas for the TPAR team to target in our efforts to help modernize the tax administration, including: improving audit skills and procedures; collecting higher quality information on taxpayer wealth/income and financial/ commercial transactions; improving information technology infrastructure to manage taxpayer information, cross-reference taxpayer data, automate tax administration processes, and improve online taxpayer services; training; creating and/or strengthening offices of Tax Analysis, Taxpayer Current Account, Stopfilers and Delinquents, Tax Investigation, and Excise Duties; establishing a Call Center to assist taxpayers; and advising on analysis and drafting of new regulations and legislation.

The TPAR project is working with the DGII to help them achieve their targets for the tax administration:

- Increase tax revenues equivalent to 2.5-3.0% of GDP by 2009.
- Achieve a 50% reduction in tax evasion and avoidance in VAT, income tax, and excise tax.
- Successfully implement the current tax reforms recently enacted.

To assist the DGII in their progress towards these targets, DAI and USAID have set the following goals for the TPAR project:

- Build the capacity and systems required to achieve the MOF's ambitious revenue targets;
- Establish the impartial, transparent, and rigorous procedures necessary to reduce tax evasion; and
- Strengthen the analytical abilities necessary for the DGIR to gauge the fiscal impact of current law and proposed reforms and to serve as an ongoing source of expert advice to senior policy makers.

<u>The TPAR team is keenly aware that the first quarter of project activity sets the tone for the life of the project. With this in mind, we have made an early effort to build relationships with our counterparts at DGII and USAID, to produce high-quality reports and assessments that inform our project activities; and to design appropriate activities that will leave a lasting impact on El Salvador's tax administration.</u>

<u>One of our primary goals for this first quarter was to minimize administrative and logistics obstacles of project start-up, so that the TPAR team could immediately focus</u>

on the technical aspects of the project. With the highly capable assistance of our Administrative and Financial Manager, Rosa Maria de Valiente, our COP and TPAR team were able to do just that. Within the first six weeks of the project, we had already produced several critical reports: the *Life-of-Activity Work Plan*, the *Benchmarking Study*, the *Assessment of Potential Performance under the Current Structure*, and the *Training Assessment and Plan*.

We have been very pleased with the progress made in these initial three months—and we look forward to continued cooperation and productive working relationships with our counterparts at DGII and USAID.

The following sections detail TPAR's first quarter activities; our results; DGII's performance against its own targets; TPAR's project performance, and TPAR's financial report for the quarter.

3. Activities Performed

During the first quarter, the project has made a quick start. The COP started working on the project the 1st of August and traveled to San Salvador the 14th of August to manage the project's start-up, and to begin building relationships with all the TPAR project counterparts.

The TPAR project requested that the DGII provide a counterpart team to support activities throughout the 4-year duration of the project. The DGII Directorate graciously agreed to our request. By the 22nd of August the counterpart team was in place and working. By August 29th the first consultant arrived in the country.

The activities performed during the quarter included:

1. Life of the Project Work Plan

A 4-year Work Plan was prepared for the Life of the Project. This included a Benchmarking Study, Training Assessment and Plan, and an Assessment of the Potential Performance under the Current Structure.

This document was produced by the Chief of Party and Christina Erickson, with the input of USAID CTO and the General Director and the Deputy Director of the DGII.

2. Annual Work Plan

The work plan for the first year of the project was developed. The document was produced by the Chief of Party and Christina Erickson.

3. Work Plan revision

During the month of October a Work Plan revision was done in conjunction with USAID CTO and the board of directors of the DGII, in order to achieve a comprehensive and agreed document as the work plan for the following four years and of the first year.

The benchmarks and indicators for the project were settled in conjunction with USAID and the DGII.

4. Benchmarking Study

In order to have a system of indicators and targets to track the project achievements, a benchmarking study was developed. The TPAR staff drew upon best practice tax benchmarking experience in Guatemala (see Gallagher, 2005) to develop a set of indicators that were used as a reference for the study. The consultant worked in close collaboration with the counterpart team to gather data on the condition and performance of El Salvador's tax administration. The Benchmarking Study includes an analysis of these data against international comparators, and against the goals of the Salvadoran tax administration. The study provided an important starting point for analyzing tax administration performance throughout the life of the project. These benchmarks will be updated on an annual basis, and the skills for conducting a benchmarking study will be transferred to DGII and MOF staff.

The task was performed by Arturo Jacobs who arrive in the country on August 29th. He performed the activity over two weeks, until September 9th. The completed document was produced and delivered.

The consultant continued in the country with the administrative structure assessment and recommendations activity.

5. Administrative Structure Assessment and Recommendations

An assessment of the current administrative and functional structure was developed, in order to determine the current status of the tax administration compared with international benchmarks and best practices. The study detects the deficiencies of the tax administration and the problems that will require a restructuring of the current system.

The task was performed by Arturo Jacobs during the period of September 12th to 22nd with a day approved to work at home after leaving the country; a document was produced and delivered.

6. IT Assessment and Recommendations

Salvador Rivera, the TPAR IT expert, conducted an analysis of the current structure and condition of the databases, return processing performance, data validation, data warehousing, software used for every business area, and all related topics of the IT structure.

Salvador Rivera, a cooperating country national (CCN), performed the task during the period of August 29 to September 29; a document with the findings and results of the tasks was produced and delivered.

7. Training Plan

Lee Niederman, TPAR Training Expert, conducted a rapid training needs assessment of the MOF Training capacity. His analysis assessed:

1) The current status of the training programs and facilities of the MOF.
2) Priority training needs in the DGII, including: Auditing, Collections, Appeals, Management, Training Department and other related areas.

Based on this assessment, Mr. Niederman made recommendations for how to structure a training program—both for the Training Center at the MOF, and for the four years of the TPAR project. A document with the assessment and recommended training plan was produced and delivered.

Lee Niederman arrived in El Salvador on August 29th and left on September 3rd.

8. Assessment of Potential Performance under Current Structure

Luis Alberto Arias, TPAR tax administration expert, conducted an assessment of the performance expected from the tax administration given the current structure, including the reforms of the year 2004-05. The study determined whether the proposed goals of the project were reasonable, or whether performance expectations should be realigned.

The study was compiled in a document that served as the basis for project targeting and goal-setting; a document was produced and delivered.

Luis Arias arrived in the country on August 29th and left on September 9th.

4. Results

This first quarter of the project has been dedicated to the project start-up, which included the following activities:

- Organized administrative and financial aspects of the project: During the first quarter the correspondent bank account for the project was opened and all the necessary arrangements were made with the hotels in order to guarantee the appropriate lodging for STTA. The office for the project at the Ministry of the Treasury was equipped by the DGII with the necessary computers, photocopier, desks and air-conditioning.

- Developed the work plans: The Life of Activity work plan was developed in coordination with the USAID CTO and the General Director and Deputy Director of the DGII. The Annual work plan was developed as well. This coordinated process allowed the TPAR Team to build a very comprehensive and integrated project proposal for the next 4 years, including the tasks that the MOF considers to be a high priority, (see Annexes 1 and 2).

- Established a strong relationship with the MOF: During the first three months, the COP worked closely with the executive staff at the DGII to build a strong technical relationship. This has been a very important input for the success of the project.

- Determined the targets and goals with USAID and the MOF: During the first three months and in coordination with the USAID CTO and the General and Deputy Director of the DGII, the TPAR Team worked on reviewing targets and setting goals. This task relied on the information from the TPAR's initial studies related to the *Potential Performance under the Current Structure* and the *Benchmarking Study*. Together, TPAR, USAID, and DGII staff have effectively set goals and targets that allow us to evaluate and track the results of the project (see Annexes 3 and 4).

- Developed the necessary studies to evaluate the current status of the Tax Administration: One of the important tasks during this period was to determine the current status of the tax administration in El Salvador. This allowed the TPAR team to detect the breakdowns and structural problems of the system in El Salvador and propose a coherent and well adjusted plan. It also enabled the TPAR team to design, in coordination with DGII and USAID, an effective strategy to generate the needed changes in the current system and to achieve the proposed goals—both for the DGII and the TPAR project.

5. DGII Performance—Quarterly Review

The Task Order document mandates that DAI report quarterly on the Government of El Salvador's (GOES) progress towards the following targets:

- Increase tax revenues equivalent to 2.5-3.0% of GDP by 2009.
- 50% reduction in tax evasion and avoidance in VAT, income tax, and excise tax.
- Successful implementation of the current tax reforms recently enacted.

For the most part, it is too soon to report on progress in these areas. This first quarter of project work has focused on laying the groundwork for implementing reforms and measuring progress. Our TPAR Life-of-Activity Work Plan and the First Year Work Plan define our approach to implementing the reforms; while the Benchmarking Study provides a yardstick for monitoring TPAR and GOES progress.

Increase tax revenues equivalent to 2.5-3.0% of GDP by 2009. In future Quarterly Reports, we will be able to compare performance with the state of the tax administration when the project began. At this point, however, we can only reiterate the starting-point benchmark:

Sept 2005 Tax Ratio 12.2%[1]

The Ministry of Finance (MOF) target for 2009, according to the Task Order document, is a tax ratio of 15.2% (3% increases from 2004). The revised target, maintaining a goal of 2.2% increase, with a tax ratio of 14.4%. This would bring El Salvador's Tax Ratio squarely in line with the Central American benchmark.

50% reduction in tax evasion and avoidance in VAT, income tax, and excise tax. The second GOES target is to reduce tax evasion in VAT, income tax, and excise tax by 50 percent. Again, first quarter TPAR work has focused on establishing a starting point—a benchmark against which to measure evasion. Thus far, TPAR has only determined an estimate for VAT evasion. The methodology for estimating Income Tax and Excise Tax is more complex—and will be developed during the study of analysis of Ways to Maximize Collection during November. Estimates for these other types of evasion will be forthcoming in the next Quarterly Report.

The TPAR benchmarking study estimated VAT evasion to be 40.9%; against a Central American benchmark of 25% and an international benchmark of only 10 percent. Based on the studies developed by the TPAR Team, the goal agreed with DGII and USAID has been the reduction of the tax evasion to 30.7, it means a reduction of 25% on the evasion rate. Nevertheless, the TPAR Team will work with the vision of achieve the 50%

[1] From TPAR Benchmarking Study, Sept 2005, in the *Life-of-Activity Work Plan*.

reduction on tax evasion. This early indicator suggests that there is significant room for El Salvador to improve VAT compliance.

There are two other proxies for measuring compliance (or its converse, evasion). First, we can measure the increase in monthly or quarterly tax revenues above inflation and economic growth.

IMPUESTO	RECAUDO
IVA	286,978
RENTA	134,768
ESPECIFICOS	21,183

Second, we can use tax productivity changes to determine changes in compliance or evasion.

IMPUESTO	CARGA TRIBUTARIA
IVA	0.13%
RENTA	0.06%
ESPECIFICOS	0.01%

Successful implementation of the current tax reforms recently enacted. Finally, we can measure progress against the third target, (the successful implementation of recent tax reforms), by listing the reforms and highlighting DGII progress against them. TPAR consultant, Luis Alberto Arias, conducted a preliminary review of the reforms, as they pertained to tax collection measures. He found that by project start-up, the 2004 enacted reforms have already had an important impact on revenue collection. By August 2005, the nominal growth rate of tax revenue increased 16.7%. Within this growth, Income Tax increased 22.5%; VAT increased 13.8%; and Excise Taxes increased 28.9%. Though these numbers represent significant progress, they fall slightly short of the projected targets for the reforms. These targets projected an increase in collections equivalent to 1% of GDP. Net of refunds, the reforms instead caused an increase of about 0.8% of GDP.

The TPAR report cautioned that this revenue growth was unlikely to be sustained for two key reasons: 1) a tax amnesty that encouraged payment in 2005 would not be repeated in 2006; and 2) installment payments collected in 2005 would be deducted during fiscal year 2006, (creating a loss of about 0.2% of GDP in 2006).

These findings suggest that the implementation of recent tax reforms has been successful—and has led to direct increases in revenue. However, to sustain this revenue growth, the longer-term administrative changes (many of which are called for in the recent reforms), will need to be equally successful. And it is likely that additional structural changes will need to be made in order to achieve sustained revenue growth in medium- and long-term.

6. TPAR Project Performance—Quarterly Review

Finally, we measure the TPAR project's performance by comparing our activities and progress against the performance standards set in the Task Order document, (from Section 5, pp. 12-13 of the Task Order):

Performance Standard	**TPAR Progress**
Effective implementation of tax reforms	TPAR's LOA and First Year Work Plans defined the timing and scope of TPAR support for implementing the recent reforms. In the first quarter, we conducted an Assessment of Potential Collections under the Current Structure, which estimated the potential returns if the recent reforms are fully implemented.
Achievement of tax collection targets measured on a quarterly basis	TPAR conducted a Benchmarking Study, which compares El Salvador's current tax performance against Central American and international benchmarks. This pivotal study enables TPAR in future reports to evaluate DGII's progress against its tax collection targets.
Effective improvement of the tax system where the tax administration:	
a) Enrolls all entities subject to the taxes according to law on master files (tax database)	TPAR's LOA and First Year Work Plans define our strategy and timing for improving taxpayer information, and setting up systems (cross-referenced databases) to manage this information. These Work Plans also schedule a study (to occur during the Second Quarter) on widening the tax base.
b) Monitors filings against the master files	The Work Plans set up a strategy for electronically managing taxpayer information—including a case management system and returns processing scanning capabilities that enable DGII to track tax return filings. This information will also help the Taxpayer Service Center to provide taxpayers with up-to-date information on their tax liabilities.
c) Ascertains liability according to the law	TPAR conducted a training assessment during the first quarter which suggested methodologies for training managers and auditors. The Work Plans determined a training plan that will further improve DGII staff's ability to help taxpayers determine their tax liability according to the law.
d) Monitors, records, and controls payments in a timely manner	TPAR's IT Expert, Salvador Rivera has worked throughout the first quarter to develop an assessment and a plan for upgrading electronic capabilities throughout the tax administration. This IT plan determines timing, necessary resources, and training needs to strengthen the Current Account system, improve payment information data entry, and manage taxpayer information.
e) Compares payments at decentralized sites with forecast payments	TPAR's Work Plans and Training Plan provide for training UPET staff to forecast payments and general tax collections. UPET staff and managers will then have the ability to compare actual returns against forecast returns. TPAR's scheduled training for DGII managers will include an overview of how to monitor actual payments against forecast

	payments.
f) Selects and performs audits and collections activities fairly and effectively	As the Work Plans describe, TPAR began during the first quarter developing a comprehensive IT and administrative modernization plan. This plan includes a strategy for designing an audit selection system, developing related procedures, and training staff on its use. Additionally, the Work Plans detail TPAR's plan for training auditors in general techniques and industry-specific techniques.
g) Assists taxpayers with compliance through an efficient call center	TPAR Work Plans detail how and when to assist the DGII set up a call center to improve taxpayer service. This activity will take place during the second quarter.
h) Establishment, Scheduling, and Achievement of a set of key international benchmarks on tax policy & administration.	TPAR's Benchmarking Study—scheduled to be updated on an annual basis—provides the baseline for the DGII to set targets and monitor progress towards improving collections and modernizing the tax administration. .