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Quarterly Report

November 2008 – January 2009

TAX POLICY & ADMINISTRATION REFORM (TPAR) PROJECT
EI SALVADOR

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The authors' views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.



Table of Contents

1. EXECUTIVE SUMMARY	4
2. INTRODUCTION.....	6
3. ACTIVITIES AND QUARTERLY RESULTS.....	7
4. DGII PERFORMANCE—QUARTERLY REVIEW	11
5. TPAR PROJECT PERFORMANCE—QUARTERLY REVIEW.....	15

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:

Activities Performed

1. Training on Transfer Pricing Audit Techniques
2. Implementation of Transfer Pricing Unit
3. Fourth Phase of the Implementation of the Fiscal Compliance Call Center
4. Creation of the Supervision and Control Office
5. Creation of the Tax Analysis Unit
6. Programming and Development of the Case Selection & Management System (CSMS)
7. Follow Up on Deployment of DGII IT System
8. Development of Proposal for an Electronic Invoicing for Individuals and Small Businesses
9. Meeting with the IMF and the World Bank Technical Mission for El Salvador
10. Development of a Website Module to Advise Taxpayers on Tax Regulations and Rulings
11. Implementation of the Taxpayer Advocate Unit
12. Procurement of Equipment for DGII Units

Quarterly Results

1. **Training on Transfer Pricing Audit Techniques:** The project delivered advanced transfer pricing training to 40 DGII officials.
2. **Implementation of Transfer Pricing Unit:** The Transfer Pricing Unit that the project recommended was created with the support of TPAR.
3. **Fourth Phase of Implementation of the Fiscal Compliance Call Center (FCCC):** The implementation of the FCCC continued with the technical support of TPAR. Along the period of August-December the collection goals increased 100%.
4. **Creation of the Supervision and Control Office:** The project continued to vocally advocate for the Ministry of Finance to create a Supervision and Control

Unit, as has been agreed several times with the DGII. A final decision has not yet been made.

5. **Creation of the Tax Analysis Unit:** The project continued advocating for the Ministry of Finance to create the Tax Analysis Unit, as has been agreed several times with the DGII. A final decision has not yet been made.
6. **Programming and Development of the CSMS:** The project continued with the development of the Case Selection and Management System. It was finished by the end of January.
7. **Follow Up on Deployment DGII IT System:** The project continued discussing with the DGII the need to begin deployment of the SIIT Web by February 28th, 2009 at the latest. No schedule has been submitted yet.
8. **Development of Proposal for Electronic Invoicing for Individuals and Small Business:** TPAR drafted a proposal for the development of an electronic invoicing system for individuals and small and medium enterprises (SMEs). The proposal will be submitted to the new government once it is in place.
9. **Meeting with the IMF and the World Bank Technical Mission for El Salvador:** The COP had several meetings with the technical missions of the World Bank and the IMF regarding the advances and recommendations of the project. All of them agreed with the project's recommendations and recognized the importance of the achievements.
10. **Development of a Website Module to Advise Taxpayers on Tax Regulations and Rulings:** The project recommended the development of a website consultancy system for taxpayers. TPAR anticipates that this new system will be fully functional in 2009.
11. **Implementation of the Taxpayer Advocate Unit:** As recommended by TPAR, the Taxpayer Advocate Unit was created by the DGII with the project's technical support.
12. **Procurement of equipment for the DGII Units:** The project provided computers and office equipment for the Transfer Pricing Unit, Excise Tax Unit, Fiscal Compliance Call Center, and the Taxpayer Advocate Unit.

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 General Directorate 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, Stop filers 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 DGII 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.

3. Activities and Quarterly Results

A more detailed description of activities completed and results achieved in the fourteenth quarter includes:

- 1. Training on Transfer Pricing Audit Techniques:** The project has recommended that the tax administration start actively controlling transfer pricing practices in El Salvador; these practices have been shown to have a considerable negative impact on tax revenues. During the quarter, TPAR delivered an advanced transfer pricing workshop to 40 DGII officials. Increasing the technical level of the auditors on this matter is a task of paramount importance for the project. The training was attended by the staff of the recently created Transfer Pricing Unit.
- 2. Implementation of Transfer Pricing Unit:** Since 2005, the project has recommended that the tax administration create a Transfer Pricing Unit that would be in charge of conducting the TP auditing. Finally, during this quarter, the Unit was created with technical assistance from the project. TPAR additionally provided the Unit's staff with computers.
- 3. Fourth Phase of Implementation of the Fiscal Compliance Call Center:** Throughout the last quarter, the project has been supporting the implementation of the Fiscal Compliance Call Center (FCCC). The Case Selection and Management System, developed by TPAR, will enable the FCCC to detect stop filers and assign their cases. By the end of the quarter, the system was finished and the implementation process begun. Meanwhile, the performance of the FCCC has been exceeding expectations: they doubled the collections goal set by the MoF; while the cost saving for the MoF is approx. \$215,000 per month in operational costs.
- 4. Creation of the Supervision and Control Office:** The project continued vocally advocating for the Ministry of Finance to create the Supervision and Control Unit, as has been agreed several times with the DGII. To date, no final decision has been made.
- 5. Creation of the Tax Analysis Unit:** The project continued advocating for the MoF to create the Tax Analysis Unit, as has been agreed several times with the DGII. To date, no final decision has been made. The Director General of the DGII promised to create the Unit by mid-April. The project is already scheduling the technical support that will be provided for the Unit's implementation.
- 6. Programming and Development of the CSMS:** The project continued with the development of the Case Selection and Management System. By the end of

January, the programming phase was finished. The remaining steps in the System's implementation include:

- **Tuning:** In this phase, the development is internally reviewed and some business logic is being completed.
- **Tests:** In this phase, we will test the application together with the users' committee. Some aspects will need to be polished, to complete the software's development.
- **Delivery:** The software's delivery to the DGII's IT Department will be performed, so that they can take control of the program's sources. In this phase, the TPAR project will provide technical assistance, so that they can assume the code and the knowledge.
- **Training:** Training will be delivered to the users that have a supervisory role over the software, so that they understand the software's potential and so that they can pass this knowledge to the auditors.
- **Pilot:** The project's implementation coordinator assigned by the DGII, together with the TPAR coordinator, will develop a calendar with different assignments for the CSMS test pilot.
- **Start in Production:** It is the DGII's responsibility to establish the dates and to agree the minimal preconditions, for the operational launch of the CSMS. The TPAR Project will be pushing and supporting so that the preconditions are fulfilled, and so that the system becomes fully operational as soon as possible.

The following table provides dates by which these preconditions must be fulfilled, in order to operationalize the system by May, 2009.

Summary of deadline dates for preconditions:

Preconditions	Deadline Dates
SIIT-Web Modules in production	April 13, 2009
Creation of the Case Selection Unit	March 16, 2009
CSMS Reception	February 23-27, 2009
Administration of the OID Tests	February 20, 2009
Administration of the OID Production	March 31, 2009
Punctual auditing and integral auditing	February 15, 2009

Implementation Coordinator	February 12, 2009
CSMS Pilot	April 13-May 4, 2009
Production servers and equipment	March 31, 2009
Training	March 23-27, 2009
Start in Production	May 24, 2009

7. **Follow Up on Deployment DGII IT System:** The project continued discussing with the DGII the need to begin deployment of the SIIT Web by February 28th at the latest. No schedule has been submitted yet by the DGII. It has been complicated to get a commitment from the DGII on a schedule to deploy the system; the Director General continues insisting that by the end of February it will take place, but the IT department of DGII (USI) insists that no schedule will be issued yet. The COP sent a final communication to the DG explaining that by April at the latest, the Current Account, the RUC (Taxpayer Registration) and the Database must be in production in Oracle in order to implement the CSMS. No response has been obtained yet.

8. **Development of Proposal for an Electronic Invoicing for Individual and Small Business:** One of the expected results of the project was to support the MoF in the development of an electronic invoicing system. To achieve this task in 2007, the project developed an international visitors program (IVP) for DGII staff to Chile. They were trained on all issues related to the experience of the SII (Chilean tax administration) in the planning, development and implementation of this type of system. As a result of the IVP, a paper with a proposal for the development of the Electronic Invoicing System for El Salvador was developed and delivered to the Director General of the DGII. Due to the high cost of the system and to the requirement for deep legal reforms, the Director General informed TPAR that the MoF does not have the resources, nor is the political timing adequate for such legal reforms. It was decided that the paper would instead be delivered to the new government for its consideration. In this regard, during the quarter, TPAR developed a more limited (and cheaper) proposal for the development of an electronic invoicing system for individuals and small business, in order to submit it to the new government as an alternative system. The new proposed system will help control small and medium taxpayers and make it easier for them to comply with their obligations. Both proposals will be submitted to the new government for consideration.

9. **Meeting with the IMF and the World Bank Technical Mission for El Salvador:** The COP had several meeting with technical missions of the World Bank and the IMF regarding the advances and recommendations of the project. Both missions agreed on the importance for the MoF to start conducting office and field audits again and implement efficiently the CSMS that the project is developing. They concur with the Administrative and Functional Modernization

Plan the project recommended in 2005 to the MoF, and also with the Tax Policy Paper recommendations. Additionally, they recognized the importance of the project's achievements.

10. **Development of a Website Module to Advise Taxpayers on Tax Regulations and Rulings:** The project recommended that the DGII develop a website consultancy system for taxpayers that would provide simple access to laws, decrees, rulings and court decisions. Previously, the project developed the CAT Legal System for internal consultancy purposes at the DGII, using open source technology customized by the TPAR staff. Now the DGII has finally accepted the project's recommendation to post the system on the public website, to help the taxpayers understand their obligations and comply with the law. In January, the project started working on the proposal to migrate the system from the current environment to Oracle. It is expected that the system will be deployed in 2009.
11. **Implementation of the Taxpayer Advocate Unit:** In the Administrative and Functional Modernization Plan developed by the project in 2005 and proposed to the MoF, the project recommended the creation of a Taxpayer Advocate Unit that would protect the constitutional and legal rights of the taxpayers, and help the Tax Administration to improve accountability and transparency. The MoF agreed recently to create the Unit. The project supported its creation with technical assistance in the development of the reform agreement, procedures manual, and direct support to the appointed taxpayer advocate as operations began. Now the office is in place and operational.
12. **Procurement:** During the quarter, the project supported the offices of Taxpayer Advocate, Transfer Pricing, Fiscal Compliance Call Center, and Excise Tax by providing them with personal computers for their staff and office equipment.

4. 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.

Increase tax revenues equivalent to 2.5-3.0% of GDP by 2009. The Ministry of Finance (MOF) target for 2009, according to the Task Order document, is a tax ratio of 15.2% (a 3% increase from 2004). The revised target adjusts the goal to achieve a 2.2% increase, to a tax ratio of 14.4%. If needed, the goal will be adjusted.

The tax revenues contracted during this quarter in two areas: the imports VAT and the Pago a Cuenta. This reflects the complex economic environment and the impact the international crisis is having in the Salvadorian economy. On the other hand, the tax withholding and the internal VAT grew significantly compared with previous years.

INTERNAL VAT

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
November	43,739.2	48,133.0	4,393.8	10.0	48,020.4	48,133.0	112.6	0.2
December	48,249.2	56,167.6	7,918.4	16.4	52,323.7	56,167.6	3,843.9	7.3
January1/	64,325.2	66,463.0	2,137.8	3.3	65,316.2	66,463.0	1,146.8	1.8
Average	156,313.6	170,763.6	14,450.0	9.2	165,660.3	170,763.6	5,103.3	3.1

Thousands of Dollars

Source: Collections report, Treasurer's Office, MOF

The internal VAT collection for the quarter in general performed better than the previous period. Compared with 2006, the increase between these two periods was 10.0% for November, 16.4% for December and 3.3% for January 2009. Compared with 2007, the collection increase for November was 0.2%, 7.3% for December and 1.8% for January (between Jan 2008 and Jan 2009).

IMPORT VAT

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
November	69,933.2	68,897.1	-1,036.1	-1.5	84,482.9	68,897.1	-15,585.8	-18.4
December	67,528.2	66,396.3	-1,131.9	-1.7	72,136.4	66,396.3	-5,740.1	-8.0
January1/	66,165.0	59,054.0	-7,111.0	-10.7	78,370.7	59,054.0	-19,316.7	-24.6
Average	203,626.4	194,347.4	-9,279.0	-4.6	234,990.0	194,347.4	-40,642.6	-17.3

Millions of dollars

Source: Collections Report, Treasurer Office, MOF

Import VAT fell across the board in this quarter. Between 2006 and 2008, the import VAT decreased at rates of -1.5% in November, -1.7% in December, and -10.7% in January. Compared with 2007, the rates for November were -18.4%, -8% for December and -24.6% for January 2009 compared with January 2008. It is clear that the economy is experiencing a huge contraction in imports.

INCOME TAX WITHOLDING

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
November	30,783.0	39,627.6	8,844.6	28.7	35,150.3	39,627.6	4,477.3	12.7
December	33,346.6	41,950.4	8,603.8	25.8	37,900.9	41,950.4	4,049.5	10.7
January1/	57,997.4	65,220.9	7,223.5	12.5	61,079.0	65,220.9	4,141.9	6.8
Average	122,127.0	146,798.9	24,671.9	20.2	134,130.2	146,798.9	12,668.7	9.4

Thousands of Dollars

Source: Collections Report, Treasurer Office, MOF

Income tax withholding experienced substantial growth compared with 2006: growth rates increased to 28.7% in November, 25.8% in December, and 12.5% in January 2009. Between 2007 and 2008, revenues in November grew 12.7%, 10.7% in December, and 6.8% for January 2009 compare with 2008.

ACCOUNT PAYMENTS

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
November	22,213.8	25,865.5	3,651.7	16.4	24,766.9	25,865.5	1,098.6	4.4
December	24,421.4	26,324.3	1,902.9	7.8	26,774.3	26,324.3	-450.0	-1.7
January1/	31,084.5	32,216.0	1,131.5	3.6	33,839.8	32,216.0	-1,623.8	-4.8
Average	77,719.7	84,405.8	6,686.1	8.6	85,381.0	84,405.8	-975.2	-1.1

Millions of Dollars

Source: Collections Report Treasurer Office-MOF

Account Payments (pago a cuenta) experienced negative growth over the past year. Since 2006, Account Payments increased by 16.4% in November, 7.8% in December, and 3.6% in January 2009. Between 2007 and 2008, however, growth rates decreased to 4.4% for November, -1.7% for December, and -4.8% for January 2009 compared with January 2008.

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. The TPAR project conducted a tax evasion study and a benchmarking study to measure and track this evasion. The UPET (DGII Office of Tax Analysis) has agreed to implement the evasion study every year during the second quarter, but no study has been conducted up to date by the Unit.

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%. Based on the studies developed by the TPAR Team, the goal agreed with DGII and USAID has been the reduction of tax evasion to 30.7%, meaning a reduction of 25% on the evasion rate. Nevertheless, the TPAR Team has been providing recommendations and technical support to DGII in order to achieve a 50% reduction of tax evasion. The studies developed by TPAR clearly show that there is significant room for El Salvador to improve VAT compliance.

Due to the fact that the UPET continues to be reluctant to release the results of the tax evasion studies to TPAR, the project has requested the DGII Director General the data in order to develop the studies internally to determine the tax evasion rates for VAT and Income Tax. To date, this has not happened. The project continued requesting that the DGII DG comply with this data request.

To date, TPAR has provided a steady stream of recommendations to support the DGII in the fight against tax evasion: recommendations for the DGII regarding auditing techniques for Income Tax and VAT; recommendations for the reform of the auditing area; development of a data warehouse to more accurately and transparently select cases and detect evasion for control; development of a Fiscal Compliance Call Center that will improve the control of tax evasion; improvements to the information system; and development of a Case Selection and Management System that will provide transparency and more efficiency in the fight against tax evasion and avoidance.

Successful implementation of the current tax reforms recently enacted. The project has been working on the development of a long-term strategy to successfully modernize the GOES Tax Administration and, in the mean time, help them to implement the fiscal reforms of 2004. The project has been performing, among others, the following activities:

- 1. Reform of the current processes, procedures and structure of the auditing area:** The project continued advocating for the reform of the current auditing structure in order to more effectively attack tax evasion and implement the tax reforms. We have addressed estimated payments, VAT withholding and percepciones, and other areas to more efficiently combat tax evasion. The new DGII Director has agreed with the need to support the auditing areas and institute TPAR-recommended reforms. The project is currently working on the creation of the CSMS that will improve the current auditing system and will provide the DGII with a transparent and efficient tool to investigate and control tax evasion. The project continues to insist on the need for the DGII to implement reforms to the current auditing structure, as recommended by TPAR.
- 2. Strengthening of the Transfer Pricing Unit:** During the previous quarter, the DGII, with the technical support of TPAR, created the TPU. Also during the quarter, the project delivered an advanced transfer pricing training for the TPU staff and other auditing staff of DGII.
- 3. Supervision and Control Office creation plan development:** During the quarter, the project continued insisting on the need for the MoF to create the Supervision and Control Office in order to improve DGII performance. So far no decision has been taken by the MoF.
- 4. Fiscal Compliance Call Center:** During the previous quarter, the Call Center was launched and successfully began operations, helping the DGII to reduce non-compliance by more than 10,000 tax returns, increasing the collection targets in 100% and saving the MoF approx. \$215,000 monthly in operational costs. The project also continued support to the FCCC through the development of the Case Selection and Management System (CSMS) for stop filers.
- 5. Development of the Case Selection and Management System:** This quarter, the project continued the development of the CSMS, and by the end of January finished the programming phase. During the coming months, the fine tuning, testing, pilot and implementation process will take place.

5. TPAR Project Performance—Quarterly Review

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

Performance Standard	TPAR Progress
Effective implementation of tax reforms	The TPAR project continued to support the DGII with the implementation of recommendations regarding the fiscal reforms. Qualitative and quantitative highlights have been discussed throughout this report.
Achievement of tax collection targets measured on a quarterly basis	TPAR has been evaluating the DGII’s performance against collections targets for the quarter.
a) Enrolls all entities subject to the taxes according to law, on master files (tax database)	During this quarter, the project continued urging the DGII to provide more information to update the system.
b) Monitors filings against the master files	The project continued performing follow-up on the deployment of the new IT system. Additionally, TPAR continued developing the Case Selection and Management System for the auditing area and finished the CSMS for the Stop Filers control.
c) Ascertain liability according to the law	The project continued supporting the Criminal Investigation Unit.
d) Monitors, records, and controls payments in a timely manner	TPAR continued supporting the Fiscal Compliance Call Center implementation and continued following up on the deployment plan of the SIIT Web.
e) Compares payments at decentralized sites with	The project continued developing the Case Selection System that will use algorithms to estimate taxpayer non

forecast payments	compliance in order to control them and increase tax collection. During this period, the project finished the Case Selection and is ready to start the testing phase.
f) Selects and performs audits and collections activities fairly and effectively	The project finished the programming phase of the Case Selection and Management System development. The system will bring transparency and efficiency in the fight against the tax evasion.
g) Assists taxpayers with compliance through an efficient call center	TPAR continued supporting the Taxpayer Assistance Call Center and the Consultation System.
h) Establishment, scheduling, and achievement of a set of key international benchmarks on tax policy & administration.	The TPAR team continued updating the benchmarking for 2007 and started updating the 2008 despite the lack of full support in terms of data sharing from UPET and the MoF. The project has requested data from the Director General of DGII to develop the tax evasion studies by so far no information has been provided.