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Quarterly Report

November 2005 – January 2006

TAX POLICY & ADMINISTRATION REFORM (TPAR) PROJECT
EI SALVADOR

February 2006

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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.

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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

- Administrative and Functional Modernization Plan
- Information Technology Modernization Plan
- Procurement Plan
- Plan for the Effective Implementation of the Reforms
- Analysis on Ways to Maximize Collections
- Training on Course Design and Development
- West Regional Office Administrative and Functional Restructuring Project
- Criminal Investigation Office Creation –First Stage
- Anti-Corruption Unit Office Creation – First stage
- Taxpayer Advocate Office Creation-First Stage
- Control Plan Design
- Training Program Curriculum Development

Quarterly Results

- Earned approval of the Life-of-Activity (LOA) Work Plan from the Ministry of Finance and approval for the Tax Administration Modernization Plan
- Developed the Administrative and Functional Modernization Plan
- Developed the Information Technology (IT) Modernization Plan
- Developed the IT Procurement Plan
- Developed the plan for the effective implementation of the reforms
- Developed the study on the ways to maximize collection
- Developed the Income Tax Evasion Study
- Obtained the approval from the Tax Administration Directorate for the administrative and functional restructuring of the DGII
- Started the IT procurement process
- Developed the first curriculum for the tax administration training program
- Trained 18 officials of DGII on course design and development
- Began the DGII data migration program
- Planned for the creation of the Criminal Investigation Office
- Planned for the creation of the Anti-Corruption 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 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 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 Performed

During the second quarter, the project started to put our preliminary recommendations into action. The activities performed during the quarter included:

1. Analysis on Ways to Maximize Collections

This study evaluated the tax administration's capacity to collect taxes and enforce the law, identifying strengths and weaknesses. The study included recommendations regarding policy, technical activities, and related tasks needed to maximize tax collections.

The study included an Income Tax Gap Analysis, which estimated the tax evasion rate for corporations and individuals. The Analysis also evaluated the DGII's current statistical indicators and data sources, recommending the necessary statistical indicators and data procurement required for the future analysis.

The study found that tax evasion was generally quite high. (For details, see page 18.) It also found that the DGII's means for measuring tax evasion are inadequate. The study recommended that immediate attention be given to improving the statistical indicators and data sources. It was suggested that a consultant be brought in to analyze the data needs and structure them to data generation.

The task was completed by Art Mann during the period of October 31 to November 19, 2005.

2. Plan for the effective implementation of the fiscal reforms

The TPAR Team assessed the recent fiscal reforms and proposed a plan for their implementation. This task evaluated the recent fiscal reforms by tax and developed a proposal for the actions and projects required to implement and guarantee the effectiveness of the reforms.

The project conducted an assessment of the VAT control systems currently in use at the DGII. The study evaluated the existing electronic invoicing control and approval system, the fedatarios program status, and the status of the auditing processes and procedures. The assessment's recommendations address the VAT control automatization and the implementation of new processes and procedures.

- **Invoicing approval:** This process has been adapted in several tax administrations in Latin America. The taxpayers are obliged to acquire the DGII's

approval of invoices they will be issuing in their operations. Invoice printing shops need to be registered at the DGII; and invoices may only be produced by these shops. To improve compliance, the VAT invoice control system must be restructured and modernized. Provisions to upgrade the current system were included in the IT Modernization Plan.

- **The fedatarios:** This program has been very successful in the Peruvian and Ecuadorian tax administrations. It helps the tax administration to enforce the law in an efficient manner and increase voluntary compliance of the VAT and the Excise Tax. The DGII has poorly implemented a similar program and the study addressed and recommended the necessary changes to strengthen this area.
- **Auditing process:** Quick and effective enforcement; significant consequences for non-compliance; and widespread publicity about application of sanctions to specific taxpayers undoubtedly have a very significant impact on eliciting higher voluntary compliance from taxpayers on the VAT. The project evaluated the auditing programs and strategies and recommended the necessary control lines for more effective compliance results.
- **Electronic transmission of invoices:** One of the goals of the DGII is to structure a system that allows taxpayers to transmit their invoices electronically. This task evaluated the current status of invoice transmission and recommended the necessary actions to implement this task.

TPAR passed the recommendations of the study on to UPET, (the Office of Tax Analysis). UPET included these recommendations in their annual control program for the fiscal year 2006. The recommendations were particularly helpful for the preventive controls program.

This activity was performed by Luis Alberto Arias during the period of October 24th to November 4th, 2005.

3. Tax Administration Modernization Plan (TAMP)—IT

Along this quarter the TPAR Team developed an IT modernization plan, this plan included:

- **Data Warehouse:** The DGII does not have a data warehouse. It is necessary to build one that incorporates tax data and other pertinent data like banking information, real estate, credit cards, automobile registration, and other related data. A data warehouse would allow the tax administration to set up a cross reference system for control and future data mining.
- **Case Management System:** This comprises an integrated work flow program that will incorporate:

- Case selection
- Automatization of auditing procedures
- Automatization of collection procedures
- Automatization of the appeals process
- Management demographics
- Integrity programs, and
- Performance evaluation programs.

This system will be the basis of the new process and procedure implementation. All the major operative process will be conducted through the CMS, allowing the standardization of all processes, procedures and activities, which will positively affect the productivity and the achievement of the different functions.

The system will also produce management statistics for control purposes.

- **Cross-referenced analysis, targeting and case selection program**, which will focus on narrowing the tax gap. The case selection process will be performed by an automated system directly linked to the control programs. This case selection system must reflect the control policy determined in the strategic planning activity, in order to eliminate discretionary management in case selection. This will ensure a more accurate and transparent process.
- **Database regarding third party information for case selection and evidentiary material procurement.** It is necessary to evaluate the technical and legal issues around setting up the new databases for third party information. We will help determine how the DGII will get that information, and how they are going to use it. It is a common issue in Latin America that third party information is requested and never used.
- **Scanning program for return processing:** The main solution for return processing is e-filing. In the meantime, an ICR could be the fast way to solve the problem. The TPAR team will evaluate the possibilities for using this technology. Our goal is to identify technology that will improve the current process and make this data as timely and accurate as possible.
- **Microfilm system for key documents.** The condition of the archives in the DGII is really problematic. It is necessary to guarantee the protection of the tax returns, which are not only data but legal documents as well. The project will evaluate the convenience of the microfilm process and will recommend the necessary steps for its implementation.
- **Improvement of the taxpayer current account:** The DGII has no accurate current account, which generates all kind of problems for the taxpayer service activities, auditing, collection and taxpayer registration. It is necessary to build a

current account system that can be the basic input for the taxpayer service policy and the control environment.

- **Other applications as needed.**

A final document with the Information Technology Modernization Plan was produced and submitted to the DGII IT Department, the General Director, Deputy General Director and to USAID.

Salvador Rivera, TPAR's Lead IT Consultant, developed the plan during the period of October 17th and November 11th, 2005.

4. Tax Administration Modernization Plan (TAMP)—Administrative Structure

Working closely with DGII staff, the TPAR team designed a comprehensive plan for the modernization of the tax administration, from the perspective of administrative structure and processes. This plan addressed the administrative reforms needed for the different functional areas of the DGII, focusing on the audit, collection, appeals and criminal function.

The plan focuses on:

- a) Administrative and financial autonomy;
- b) Strengthening of the control areas processes and procedures;
- c) Consolidation of all the processes of taxpayer control and enforced collections into the same environment; and
- d) Strategic plan of medium-term priorities, actions and basic indicators to improve tax collection.

To ensure that the DGII achieves its goal of becoming a modern, effective tax administration, TPAR's modernization plan included the following proposals:

- Transform the current DGII into an institution with administrative and financial autonomy.
- Transfer collection functions,¹ taxpayer control and enforced tax collection to the new institution.
- Make modifications in the new entity's organizational structure, clearly separating the normative functions from the operational ones.

¹ This includes the solicitation and supervision of the agreed treaty with banks.

- Create an ad-hoc unit of large taxpayers to deal with the processes of taxpayer assistance, control of delinquent accounts, enforced collection, auditing, and taxpayer appeals.
- Create a strong Taxpayer Service Center, linked with a Call Center.
- Other elements as recommended in the final report of the task.

These recommendations were developed by the TPAR Consultant Arturo Jacobs and were submitted to the DGII executive staff and to USAID. Currently the TPAR Project is working on its implementation.

Arturo Jacobs completed this task during the period of October 24th to November 17th, 2005.

5. Procurement Analysis

A key component of this project is to procure, on behalf of USAID, priority IT hardware and software for the DGII. To identify which IT equipment would add the most benefit, TPAR IT expert worked with the MOF staff in every division to conduct a thorough IT Needs Assessment. This assessment was used to develop detailed specifications for the hardware and software required for the DGII system modernization plan. The documents recommend and justify the technology to be purchased. On December 23rd, the TPAR project submitted an IT Procurement Plan, which incorporated proposed purchases and specifications, to DAI Headquarters in Bethesda in order to start the procurement process.

Salvador Rivera completed this task during the period of October 24th to December 23rd, 2005.

6. Course Design, Development and Instructor Training

TPAR delivered training to 18 MOF officials, focusing on the design and development of courses. The training focused on:

- Needs assessment procedures
- Training planning
- Tools development
- Methodologies
- Training techniques
- Training scheduling
- Participant selection
- Post-training participant monitoring & evaluation
- Other related skills

The program monitored the trainers and their trainees to ensure that the proper topics were absorbed well and that the concepts are being implemented by the training participants. Evaluations for each training exercise were collected and analyzed.

The training was developed by Lee Niederman and Genaro Martinez during the period of November 4th to the 19th, 2005.

7. Curriculum Development

After the course design training, the TPAR Project in coordination with the TPAR Counterpart Team began developing a curriculum program for the DGII. This program is being developed with careful consideration for how to strengthen tax administration functions, (Auditing, Legal, Taxpayer Service, etc.). This program covers several courses, which are being developed by each of the trainees of the Course Design and Development Training. The proposed goal is to finish all the course designs (instructor guide, student guide, reading material and Power Point presentation) by April 2006.

8. On the Job instruction Training

The proposed methodology of training for the DGII is the On the Job Training. TPAR consultants delivered a week-long training on on-the-job training techniques. The 18 trainees of the previous course were again involved in this training program.

This training was developed and delivered by Genaro Martinez during the period of January 27th to February 3rd, 2006.

9. Criminal Investigation Unit Creation

During this quarter, and in coordination with the Office of Technical Assistance of the US Department of the Treasury, Chief of Party Enrique Giraldo developed a plan for the creation of the Criminal Investigation Unit. This plan was then proposed to and accepted by the General Directorate of the DGII. Once the plan was approved, implementation began. The following activities were performed:

- Office security assessment
- Personnel selection program development
- Drafting of the Resolution for the creation of the unit

By the end of the quarter the office was created, the logistics resources were underway, and the personnel assigned to the unit were selected and incorporated into the office.

During the period of January the proposed training program was drafted. Proposed trainings for 2006 include:

- Tax Legislation Training (DGII), February 27th through March 10th
- Financial Crimes Investigation Techniques (OTA) April 10th -May 5th
- Criminal investigation and Criminal Law (OTA-Fiscalia GOES) Jun 5th – 30th

The TPAR project team will coordinate these training programs, which the organizations in parentheses (e.g. the US Treasury's Office of Transition Assistance).

10. Anti-Corruption Unit Creation

During this quarter and in coordination with the Office of Technical Assistance of the US Department of the Treasury, the plan for the creation of the Anti-Corruption Unit began. The DGII selected personnel and a new office chief. It is expected that during the first week of February the Resolution creating the office will be signed by the Deputy Director and the new office will start to perform its functions.

The training program for the Criminal Investigation Unit will be extended to include the Anti-Corruption Unit personnel.

11. West Regional Office administrative and functional restructuring project

The administrative and functional restructuring process will be implemented progressively at the regional and central levels. The first regional office that will be restructured is the West Regional Office. The TPAR project, in coordination with our DGII counterpart team, evaluated the proposal of TPAR consultant Arturo Jacobs, and developed a proposal that was approved by the General and Deputy Directors of the DGII. The facilities were evaluated as well and the necessary recommendations were provided for the DGII.

The Resolution was drafted and proposed to the DGII directorate, who should be approving and enacting it by the first week of February. It is expected that the Regional Office will begin operating under the new structure by the end of February.

12. Taxpayer Advocate Office Creation-First Stage

The TPAR team proposed the creation of a Taxpayer Advocate Office, under the General Director's office. This office was proposed by Arturo Jacobs in his Administrative Structure Modernization Plan. The TPAR team discussed the proposal with the DGII General Directorate, who agreed to create this new office. The corresponding Resolution was drafted and proposed to the General Director. It will likely

be signed the first week of February; the office should be created by the last week of February.

13. Audit Plan Design

The project has scheduled a task of Audit Strategic Planning for the month of June, in order to start fighting tax evasion. The project began developing with the DGII an audit plan that currently is being developed and will likely be implemented by the first week of March. This process will prepare the DGII to develop the audit strategic plan in June.

14. Tax Gap Analysis

The studies of Potential Performance under the Current Structure and the Analysis on Ways to Maximize Collections included a Tax Gap Analysis of the Corporate Income Tax, Personal Income Tax and the Value Added Tax. This model has been proposed to the tax administration to enable and encourage them to conduct similar estimations on a yearly basis.

4. Results

The most important results of the project in the second quarter include:

- **Earned the Ministry of Finance's approval of the LOA Work Plan and the tax administration modernization plan.** The Ministry of Finance signed off on TPAR's preliminary recommendations regarding the IT procurement plan, IT Modernization Plan and the administrative and functional restructuring plan for the DGII.
- Developed the **administrative and functional modernization plan.** Upon earning approval for the modernization plan, the TPAR project began restructuring internal functions of the DGII. The modernization plan calls first for an internal restructuring of the DGII; followed by the transfer of appeals and collections functions to the DGII, through a legislative process.
- Developed the information technology **(IT) modernization plan.** The IT Modernization Plan was developed by the project and was proposed to the MOF. After several meetings and discussions with the MOF's IT Technical Committee, the Plan was approved and received the full support of DINAFI and all related parties.
- Developed the **IT procurement plan.** The IT procurement plan was developed and proposed to USAID and the MOF. The TPAR project helped secure the commitment of the MOF to allocate \$2 million to the purchase of new hardware and software for the DGII. This amount is in addition to USAID's estimated \$750,000 contribution to new hardware and software for the DGII. These commitments will go some way towards ensuring that the DGII fully modernizes its tax administration. The MOF submitted a memorandum to the TPAR Project approving the proposed items to be purchased and the pertinent schedule.
- Developed the **plan for the effective implementation of the fiscal reforms.** TPAR submitted the recommendations to the General Directorate of the DGII and to UPET who will be implementing them. Special attention was applied to the tracking statistics for this plan.
- Developed the **study on ways to maximize collection.** This study provided recommendations regarding the audit targets and the data and information systems necessary to improve the DGII collection targets. These recommendations were submitted to the DGII General Directorate and to UPET. The TPAR project requested that UPET begin acquiring data and providing the information so the project can include it in the Data Warehouse and the Case Management System. A plan for auditing non-filers has been in production by the Counterpart Team based on the recommendations of the study.

- Developed the **Income Tax evasion study**. The studies of Tax Gap for VAT and corporate and personal income tax were developed in the studies of Arthur Mann and Luis Arias. These studies were submitted to the UPET and the unit agreed to apply the methodology and conduct the study every year.
- **Plan for the creation of the Criminal Investigation Office**. In coordination with the Office of Technical Assistance of the US Department of the Treasury the plan for the creation of the Criminal Investigation Unit was developed, and its implementation started. By the end of January the personnel had been selected, the office space was assigned, and the training program had been scheduled.
- **Plan for the Creation of the Anti-Corruption Unit**. In coordination with the US Department of the Treasury OTA, a Resolution governing the creation of the Anti-Corruption Unit was drafted, and personnel selection was initiated. Currently, the Resolution is ready to be signed and the office space assignment and training program has been scheduled for February and March.
- **IT procurement process underway**. The process of IT procurement started in December, with the TPAR project's submission of the IT procurement plan. The DAI Office in Bethesda submitted a cost proposal to USAID on 20 Jan 2006, to procure hardware and software for the DGII. The DAI Office in Bethesda also submitted the materials for USAID/IRM approval on 2 Feb 2003. We expect that the equipment will arrive in El Salvador by the first week of April, if not sooner.
- **Developing the first curriculum for the tax administration training program system**. As a continuation of the Train the Trainers program, a preliminary curriculum for the tax administration training program was developed.
- **Training of 18 DGII officials on course design and development**. By the end of January, TPAR trained 18 DGII officials on the techniques of On the Job Training. The first courses developed by the trainers in the implementation of the program were evaluated in this course.
- **Beginning of the DGII data migration program**. The TPAR Project began the migration of the DGII Data from Informix to Oracle. The process will be coordinated by the TPAR Project over the next 4 months. As a complement of this task, the DGII has been required to prepare a plan to start the migration of the applications from Informix to Oracle. The TPAR team is on schedule to complete the migration by the end of February. This timing is important to ensure that the Data Warehousing process, the building of the Tax Current Account, Case Selection System, Case Management System, and the Cross Reference Database program can proceed according to schedule.

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.

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% (3% increases from 2004). The revised target adjusts the goal to achieve a 2.2% increase, with a tax ratio of 14.4%.

Revenues have been increasing significantly during the last 3 months, due largely to the fiscal reforms. The results are:

INTERNAL VAT

	2004-5	2005-6	Difference	Growth Rate
November	\$36,640.0	\$39,875.5	\$3,235.5	8.83%
December	\$37,811.6	\$43,412.4	\$5,600.8	14.81%
January	\$48,424.8	\$63,710.3	\$15,285.5	31.57%
Average	\$40,958.8	\$48,999.4	\$8,040.6	19.63%

IMPORT VAT

	2004-5	2005-6	Difference	Growth Rate
November	\$57,679.0	\$58,304.8	\$625.8	1.08%
December	\$50,564.3	\$62,747.2	\$12,182.9	24.09%
January	\$45,846.2	\$51,461.1	\$5,614.9	12.25%
Average	\$51,363.2	\$57,504.4	6,141.2	11.96%

INCOME TAX WITHOLDING

	2004-5	2005-6	Difference	Growth Rate
November	\$22,365.1	\$26,096.7	\$3,731.6	16.68%
December	\$22,697.7	\$28,795.4	\$6,097.7	26.86%
January	\$37,912.9	\$49,860.0	\$11,947.1	31.51%
Average	\$27,658.3	\$34,917.4	\$7,258.8	26.24%

ACCOUNT PAYMENTS

	2004-5	2005-6	Difference	Growth Rate
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November	\$13,655.8	\$18,740.9	\$5,085.1	37.24%
December	\$15,068.0	\$21,746.1	\$6,678.1	44.32%
January	\$21,124.8	\$28,217.9	\$7,093.1	33.58%
Average	\$16,616.2	\$22,901.6	\$6,285.4	37.83%

The results of the tax reform are quite significant. We can see how, compared with the same period at the previous year, the internal VAT collections (the VAT returns submitted and generated on internal sales) have on average increased by almost 20%. The Import VAT has increased on average by about 12% since the same time last year.

Income Tax withholding witnessed a large average increase of 26%, compared with the same period the previous year.

Finally, the Account Payments registered the largest increase: on average increasing by nearly 40% since last year.

This substantial growth in collections can be primarily attributed to the successful implementation of the fiscal reforms.

Tax Productivity measures can be another good proxy of tax performance. The following figures demonstrate the change in tax productivity from Nov-Jan of 2004/5, to the same period the following year (2005/6).

PRODUCTIVITY of INTERNAL VAT

Period	Productivity 2004	Productivity 2005	Difference
November	1.78	1.80	1.1%
December	1.84	1.96	6.5%
January	2.19	2.70	23.3%
Average	1.94	2.15	10.8%

PRODUCTIVITY of IMPORTS VAT

Period	Productivity 2004	Productivity 2005	Difference
November	2.80	2.64	-5.7%
December	2.46	2.84	15.5%
January	2.15	2.34	8.8%
Average	2.47	2.61	5.7%

PRODUCTIVITY of INCOME TAX WITHOLDING

Period	Productivity 2004	Productivity 2005	Difference
November	0.81	0.88	8.6%
December	0.82	0.97	18.3%
January	1.28	1.57	23.4%
Average	0.97	1.14	17.5%

PRODUCTIVITY of PAYMENT ACCOUNTS

Period	Productivity 2004-5	Productivity 2005-6	Difference
November	5.75	7.34	27.6%
December	6.35	8.52	34.2%

January	8.29	10.35	24.8%
Average	6.80	8.74	28.5%

There are two key observations here: i) tax productivity varies significantly month to month; and ii) productivity appears to be improving on most taxes. The most productive tax is VAT on imports; due largely to imports' increasing share of GDP.

Accounts Payments productivity registers the highest rates of productivity. These numbers are likely high because they measure gross payments, rather than payments net of refunds. As we know from TPAR consultant, Luis Arias' report on "Global Collecting Capacity and Potential Performance Evaluation of El Salvador's Tax Administration," El Salvador's tax revenues fall to about 0.7% of GDP (from 11-12% of GDP) when tax refunds are deducted. Tax refunds include exporter tax credit, VAT refunds, income tax overpayment refunds, and exporter overpayment refunds.

The other key column is the "Difference", which measures the change in monthly productivity between this year, and the last. This represents the difference before and after the introduction of the fiscal reforms.

Income Tax is the only tax performing poorly in terms of productivity. When productivity is less than 1, income tax revenues as a share of GDP are lower than the tax rate. For the most part, tax productivity has improved. (The one exception is the November figure for VAT Import productivity; which improves in the following months.) The quarterly averages all indicate improvements in productivity since the prior year.

These figures highlight that a) the fiscal reforms are making a positive impact on tax productivity; and b) that the TPAR project is working to improve an already good system of tax administration in El Salvador. Our goals are to make these taxes even more productive, and to increase productivity quickly and sustainably over the coming years.

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 the benchmarking study to measure and track this evasion. The UPET has agreed to implement the evasion study every year during the second quarter.

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 the tax evasion to 30.7%, meaning a reduction of 25% on the evasion rate. Nevertheless, the TPAR Team will work with the vision of achieving a 50% reduction on tax evasion. This early indicator suggests that there is significant room for El Salvador to improve VAT compliance.

A key deliverable during this quarter was the Analysis of Ways to Maximize Collections, which included a thorough analysis of tax evasion in El Salvador. The study found that

evasion rates are generally quite low, though vary depending on the particular tax and measurement method. For example, estimates for personal income tax evasion range from 29% (cross-referencing the pensions database against the DGII database) to 31% (using the Encuesta de Hogares de Propósitos Múltiples—EHPM). Estimates of corporate income tax evasion were estimated to average 58.7% across sectors. Finally, estimates of VAT evasion ranged tremendously depending on sector. VAT evasion in the agricultural sector is estimated to be 92%; 72% for restaurants and hotels; 71% for manufacturing; 67% for construction; but only 9% for most other sectors. The average of all sectors, using UPET's methodology, was 32.7% evasion in 2002. TPAR's benchmarking study estimated a higher rate—of about 40.9%.

These estimates suggest tax evasion is, indeed, a significant problem. Evasion measurement, and fine-tuning which sectors are most egregious, is, and will continue to be a key focus of UPET staff. The measurement of the reduction in the tax gap will be done by the end of July every year, due to the fact that the tax gap analysis will be done every year by the end of the second quarter, as it has been agreed with the DGII.

Successful implementation of the current tax reforms recently enacted. The TPAR project developed a Plan for the Fiscal Reforms Implementation. Our recommendations were submitted to the UPET for implementation. In response, the UPET is developing an audit program regarding the control of the Payment Account, Perceptions, VAT Withholding, and is implementing all related recommendations included in the plan.

The TPAR project's most significant recommendation was that the Ministry of Finance and the Central Government authorize the reconfiguration of the DGII as a semi-autonomous Revenue Authority. The following comprise TPAR's additional recommendations:

- The DGII should develop its own Strategic Plan;
- The Collection function should be transferred from the DGT to the DGII;
- The Taxpayer Ombudsman should be placed directly under the Director General;
- The overall organization structure of the DGII should be reconfigured, and the current decentralization should be reconfigured as well;
- The Large Taxpayer Program should be reorganized under one Deputy Director;
- A new Telephone Call Center with modern equipment and adequate staffing is needed;
- A separate organization should be established to process tax declarations;
- Top priority for computerized systems should be given to the Taxpayer Current Account and to Taxpayer Registration;
- Significant investments must be made in the DGII's human resources—recruitment, training, and compensation systems; and
- Significant increases must be made in the DGII's financial resources for investment in property, equipment and supplies required to do its work.

The IT Modernization Plan implementation began with the data migration and the restructuring of the Data Entry process. Additionally the IT Procurement Plan for the

effective implementation of the reforms and the IT system modernization was developed, and the process of purchasing the Hardware and Software was started.

The Administrative and Functional Modernization Plan was developed. Its implementation began in January. It will facilitate the implementation of the reforms and their permanence over time.

The plan for the creation of the Criminal Investigation unit was developed and its implementation begun with the support of the Office of Technical Assistance of the US Department of the Treasury.

The curriculum for the DGII training system was developed. With TPAR assistance, this curriculum helps to create the career training system that will enable the tax administration to improve its personnel's skills and their effective implementation of the Law.

Finally, the Minister of Finance has nominally indicated his support for the transformation of the DGII into a semi-autonomous Revenue Authority. Plans are underway to have this resolution placed before the Parliament this Spring.

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	During this quarter a plan for the effective implementation of the reforms was developed by the TPAR Team. Its implementation began in December by structuring the audit programs, and obtaining approval from the DGII executive staff.
Achievement of tax collection targets measured on a quarterly basis	TPAR has been evaluating the performance on the collections targets for the quarter and the rates and collections have superseded the expectations.
a) Enrolls all entities subject to the taxes according to law on master files (tax database)	During this quarter the TPAR team started the process of developing a proposal for the restructuring of the Data Entry Process, the Data cleansing and of the RUC.
b) Monitors filings against the master files	The data migration program started in January and a plan and schedule was developed. This task will continue over the next quarter.
c) ascertain liability according to the law	During this quarter the TPAR Team developed the curriculum and started to coordinate the development of courses that will structure the first integrated fiscal training system in Central America. During this period, on-the-job training also began.
d) Monitors, records, and controls payments in a timely manner	TPAR's Team developed the IT Modernization Plan and the IT Procurement Plan, proposing it to the Minister of Finance and convincing him of the benefits and the priority of the modernization program. The Minister not only agreed but offered to finance the remaining hardware and software equipment proposed in the Procurement Plan.
e) Compares payments at decentralized sites with forecast payments	The study of Analysis on Ways to Maximize Collection included an Income Tax Evasion analysis that determined the tax gap for corporations and for individuals. This project was completed by TPAR expert Art Mann and the UPET representative to the TPAR Team, in a way that not only the tax evasion study was performed but that let the counterpart team official to learn the methodology of the study.
f) Selects and performs audits and collections activities fairly and effectively	The TPAR Project COP started developing an audit program proposal, directed to institutionalize an audit program (recommended in other countries) that will help to enforce the law and encourage voluntary and enforced compliance.
g) Assists taxpayers with compliance through an efficient call center	TPAR determined the call center technology to be procured and included it in the IT Procurement Plan.
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.