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# Quarterly Report

## August – October 2008

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.



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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

1. International Visitors' Program on Transfer Pricing, Mexico
2. Training on VAT Audit Techniques
3. Follow Up on Recommendations for Criminal Investigation Unit
4. Training on Criminal Investigation Techniques
5. Third Phase of Implementation of Fiscal Compliance Call Center
6. Case Selection Function moved from Tax Analysis office (UPET) to Tax Obligation Control office (DICOT)
7. Development of the Data Entry System
8. Creation of the Supervision and Control Office
9. Creation of the Excise Tax Unit
10. Creation of the Transfer Pricing Unit
11. Development of Vision Document and Use Cases of Case Management System
12. Development Vision Document and Use Cases of Case Selection System
13. Programming and Development of the Case Management & Selection System
14. Follow Up on Deployment of DGII IT System

### Quarterly Results

1. **International Visitors' Program (IVP) on Transfer Pricing, Mexico:** The project developed an IVP in Mexico in coordination with the Superintendencia de Administración Tributaria (SAT) to train 3 officials of the DGII on Transfer Pricing.
2. **Training on VAT Audit Techniques:** The project delivered training on VAT audit techniques. The training was attended by 27 auditors of DGII.
3. **Follow Up on Recommendations for Criminal Investigation Unit (CIU):** The project conducted an assessment of the status of the implementation of TPAR's recommendations for the CIU.
4. **Training on Criminal Investigation Techniques:** The project delivered a training on criminal investigation techniques that was attended by 27 DGII officials and prosecutors from the Fiscalía.

5. **Third Phase of the Implementation of the Fiscal Compliance Call Center:** The project continued with the implementation of the Fiscal Compliance Call Center. The FCCC began operations on August 20<sup>th</sup>, 2008. The project delivered the last activity of support and follow up in September.
6. **Case Selection Function moved from Tax Analysis office (UPET) to Tax Obligation Control office (DICOT):** The DGII finally adopted TPAR's recommendations to move the audit case selection function out of UPET to DICOT.
7. **Development of the Data Entry System (EDA):** The EDA development finished in October and was delivered to the DGII IT Department.
8. **Creation of the Supervision and Control Office:** The project continued to urge for the creation of the Supervision and Control Office, as agreed with the Vice Ministry of Finance. To date, no decision has been taken by the DGII.
9. **Creation of the Excise Tax Unit:** During this quarter, the DGII created the Excise Tax Unit and selected the auditors to staff the unit. TPAR delivered 8 laptops to the Unit and prepared for training and implementation expected in January.
10. **Creation of the Transfer Pricing Unit:** In October the DGII created the Transfer Pricing Unit. The DGII is still selecting the personnel to staff the Unit.
11. **Development of a Vision Document and Use Cases for the Case Management System:** During the quarter, the project finished the development and review of the Vision Document and Use Cases for the Case Management System.
12. **Development of a Vision Document and Use Cases for the Case Selection System:** During the quarter the project finished the development and review of the Vision Document and Use Cases for the Case Selection System.
13. **Programming and development of the Case Selection & Management System (CSMS):** The project began programming and developing the CSMS in team with the DGII IT staff.
14. **Follow Up on Deployment of DGII IT System:** The project continued to conduct follow up of the DGII IT system (SIIT-Web). The project also continued to request that the DGII comply with the timetable agreed with the MOF for deployment of the SIIT-Web.

## 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 Thirteenth quarter includes:

- 1. International Visitors' Program (IVP) on Transfer Pricing-Mexico:** The project developed an IVP in Mexico in coordination with the SAT (Superintendencia de Administración Tributaria) to train 3 officials of the DGII on Transfer Pricing (TP). The training was attended by the new chief of the TP Unit and two auditors; and additionally by officials from the MoF of Guatemala. The attendees learned about the SAT's substantial experience with TP control, and particularly Advance Pricing Agreements. This knowledge will help the attendees to implement sound processes and procedures for the TP Unit, and to conduct better audits.
- 2. Training on VAT Audit Techniques:** The project delivered training on VAT audit techniques. The training was attended by 27 auditors of the DGII. The TPAR expert detected a very low level of expertise on this matter from the DGII auditors, a lack of adequate understanding of their statutory power to enforce the law, and weak support from the legal department. These observations were shared with the Director General, to encourage him to make appropriate adjustments. The TPAR expert focused training on auditing techniques and special programs to be developed by the auditors through their day by day activities. It is expected that all the lessons and techniques learned will help them to improve the current auditing methodologies and increase the current VAT collection.
- 3. Follow Up on Recommendations for Criminal Investigation Unit (CIU):** The project conducted an assessment of the status of the implementation of TPAR recommendations for the CIU. The consultant evaluated the implementation of TPAR-recommended processes and procedures and the coordination efforts of DGII with the Fiscalía. Additionally the consultant worked with the head of the Unit and her staff to develop legal analyses to improve the current performance of the Unit. The COP and the consultant then briefed the Director General and the Deputy Director General on these issues.
- 4. Training on Criminal Investigation Techniques:** The project delivered a training on criminal investigation techniques that was attended by 27 DGII officials and prosecutors from the Fiscalía. The training covered techniques they must apply under the current criminal system, a review of the governing Law and how to apply it, and discussions of how to coordinate efforts with the Fiscalía.
- 5. Third Phase of Implementation of Fiscal Compliance Call Center:** The project continued with the implementation of the Fiscal Compliance Call Center. The FCCC started operations on August 20<sup>th</sup>. The project completed the last support activity and follow up in September. To date, the Call Center has

generated 10,000 filed tax returns from stop filers, and is improving the control of taxpayer compliance.

6. **Case selection moved to DICOT:** The case selection function was finally removed from UPET and assigned to DICOT (Division de Control de Obligaciones Tributarias) as requested by the project. This will help the DGII to improve the selection procedures and results, and to make a case selection more transparent.
7. **Development of the Data Entry System (EDA):** The project developed the EDA (which includes tax return reception, data entry, data validation and data posting) as agreed with the DGII. (Last minute requests from the Return Processing Department were successfully integrated.) The source code was delivered to USI (DGII IT Department) and it is expected that the system will be deployed by February 28 2009, at the latest, as agreed with the Director General.
8. **Creation of the Supervision and Control Office:** The project continued to urge for the creation of the Supervision and Control Office as agreed with the Vice Ministry of Finance, but to date no decision has been taken by DGII. The DGII pledged to pursue the SCO next year, given that the Fiscal Compliance Call Center, Transfer Pricing Unit and the Excise Tax Unit were all created this quarter.
9. **Creation of the Excise Tax Unit:** During this quarter the DGII created the Excise Tax Unit and selected the auditors to staff the Unit. TPAR delivered 8 laptops to the Unit, and prepared for the training and implementation expected in January.
10. **Creation of the Transfer Pricing Unit:** In October the DGII created the Transfer Pricing Unit. The Director General expressed the MoF's willingness to enforce the current TP regulation and to make all efforts, as recommended by TPAR, to combat evasive practices. The DGII is still selecting the personnel that will staff the Unit. The project will provide them with computers. The project is also currently evaluating the possibility of purchasing a TP database for the Unit.
11. **Development of Vision Document and Use Cases of the Case Management System:** During the quarter the project finished the development and review of the Vision Document and Use Cases of the Case Management System. The documents were submitted to the Directorate of DGII for review and approval.
12. **Development of Vision Document and Use Cases of the Case Selection System:** During the quarter the project finished the development and review of the Vision Document and Use Cases of the Case Selection System. The documents were submitted to the Directorate of DGII for review and approval.

13. **Programming and development of the CSMS:** Once finished and approved, the project started the development and programming of the CSMS. The TPAR IT staff is fully dedicated to the development of the system and will be supported by two IT employees from the DGII IT department. These employees will be in charge not only of supporting the programming, but also receiving the transfer of knowledge to continue improving the system once it is delivered.
  
14. **Follow Up on Deployment of the DGII IT System:** The project continues with the follow up of the DGII system. The project also continues to request that DGII comply with the deployment of the SIIT-Web according to the milestones agreed with the MoF. The DGII IT Department still has not delivered a schedule for the deployment of the system, despite all of TPAR's requests. The COP has requested the Director General to confirm the schedule because it will impact the implementation of the CSMS. The COP explained to the DG that the last day for the system to be implemented should be February 28<sup>th</sup>, 2009. The DG pledged to comply with the project's request, based on the MoF's previous commitment.

## 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, with a tax ratio of 14.4%. If needed, the goal will be adjusted.

The tax revenues on some taxes have been growing, while others have had a small or even negative growth rate during the last 3 months.

### INTERNAL VAT

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
August	44,890.1	47,671.9	2,781.8	6.2	48,128.9	47,671.9	-457.0	-0.9
September	44,217.4	46,971.8	2,754.4	6.2	44,798.9	46,971.8	2,172.9	4.9
October	42,814.2	50,017.5	7,203.3	16.8	46,236.7	50,017.5	3,780.8	8.2
<b>Average</b>	<b>131,921.7</b>	<b>144,661.2</b>	<b>12,739.5</b>	<b>9.7</b>	<b>139,164.5</b>	<b>144,661.2</b>	<b>5,496.7</b>	<b>3.9</b>

Thousands of Dollars

Source: Collections report, Treasurer's Office, MOF

The internal VAT collection for the quarter improved on the previous quarter. Compared with 2006, the increase between these two periods was 6.2% for August, 6.2% for September and 16.8% for October 2008. Though less internal VAT revenue was collected in Oct 2008 than Oct 2007, revenues on average during this quarter were up on the previous year.

### IMPORT VAT

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
August	62,600.2	85,907.7	23,307.5	37.2	78,177.6	85,907.7	7,730.1	9.9
September	65,847.4	82,859.2	17,011.8	25.8	69,596.1	82,859.2	13,263.1	19.1
October	66,222.2	87,542.9	21,320.7	32.2	85,784.7	87,542.9	1,758.2	2.0
<b>Average</b>	<b>194,669.8</b>	<b>256,309.8</b>	<b>61,640.0</b>	<b>31.7</b>	<b>233,558.4</b>	<b>256,309.8</b>	<b>22,751.4</b>	<b>9.7</b>

Millions of dollars

Source: Collections Report, Treasurer Office, MOF

Import VAT brought in large returns over the same period. Between 2006 and 2008, the import VAT grew at rates of 37.2% in August, 23.8% in September, and 32.2% in October 2008. Import VAT revenues remained fairly steady through the quarter, and continue to sustain impressive growth rates over prior years.

### INCOME TAX WITHOLDING

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
August	30,916.4	38,883.2	7,966.8	25.8	34,789.0	38,883.2	4,094.2	11.8
September	32,416.0	38,617.8	6,201.8	19.1	33,813.4	38,617.8	4,804.4	14.2
October	30,765.7	37,968.4	7,202.7	23.4	33,508.0	37,968.4	4,460.4	13.3
<b>Average</b>	<b>94,098.1</b>	<b>115,469.4</b>	<b>21,371.3</b>	<b>22.7</b>	<b>102,110.4</b>	<b>115,469.4</b>	<b>13,359.0</b>	<b>13.1</b>

Thousands of Dollars

Source: Collections Report, Treasurer Office, MOF

Income tax withholding experienced substantial growth compared with 2006: the rates increased to 25.8% in August, 19.1% in September, and 23.4% in October. Between 2007 and 2008, revenues in August grew 11.8%, 14.2% in September, and 13.3% in October.

### ACCOUNT PAYMENT

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
August	17,547.0	23,791.9	6,244.9	35.6	19,851.7	23,791.9	3,940.2	19.8
September	18,370.9	23,122.5	4,751.6	25.9	21,387.4	23,122.5	1,735.1	8.1
October	19,356.0	24,455.4	5,099.4	26.3	22,025.4	24,455.4	2,430.0	11.0
<b>Average</b>	<b>55,273.9</b>	<b>71,369.8</b>	<b>16,095.9</b>	<b>29.1</b>	<b>63,264.5</b>	<b>71,369.8</b>	<b>8,105.3</b>	<b>12.8</b>

Millions of Dollars

Source: Collections Report Treasurer Office-MOF

Account payments also registered important increases compared with prior years. Since 2006, Account Payments increased by 35.6% in August, 25.9% in September, and 26.3% in October. Between 2007 and 2008, growth rates remained high, increasing 19.8% in August, 8.1% in September and 11% in October.

### 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.

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 will work with the vision of achieving a 50% reduction of tax evasion. This early indicator suggests that there is significant room for El Salvador to improve VAT compliance.

Due to the fact that the UPET continues been 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 and determine the tax evasion rates for VAT and Income Tax. It is expected that along the following quarter the data will be delivered to TPAR and the study will be developed.

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:** Over the last 2 years, the project has recommended changes to the DGII in the auditing areas in order to improve the current structure and implement the fiscal reforms of 2004. We have addressed account 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.
- 2. Creation of the Transfer Pricing Unit:** During the month of October the Transfer Pricing Unit was created, and the personnel for the Unit were selected. The project led an International Visitors Program on Transfer Pricing to Mexico, which is one of the most advanced Latin American countries on this matter. The head of the new TP Unit and some of its personnel attended this training. In the next quarter the Unit will start operations and will be provided with computers by TPAR. Additionally the project is evaluating the possible purchase of a transfer pricing database that will help the Unit to conduct better investigations. However,

the procurement of this system will depend on the commitment of the MoF to annually update the database.

- 3. Supervision and Control Office creation plan development:** The Supervision and Control Office will help the TPAR Project with the implementation of the new system by documenting and overseeing the changes to management systems and business processes. During the quarter, the project and the DGII Director General agreed to begin working on the creation of the Unit next year.
- 4. Fiscal Compliance Call Center:** During the quarter, the Call Center was launched and successfully began operations, helping the DGII to reduce non-compliance by more than 10,000 tax returns. The project continued to provide the Call Center with technical support and guidance during the quarter.
- 5. Development of the Case Selection and Management System:** In order to increase productivity in the auditing area, improve transparency of the control function, and improve the fight against tax evasion, TPAR proposed back in 2005 the development and implementation of a Case Selection and Management System. During this quarter the Vision Document and Use Cases were approved by the DGII, and TPAR began programming the system.
- 6. Creation of the Excise Tax Unit:** During this quarter, the excise tax unit was created. The personnel were selected and began operations. The project provided computers for the Unit and prepared a training expected in January.
- 7. Criminal Investigation Unit Strengthening:** The project continued providing technical support and training to the Criminal Investigation Unit. The Unit has achieved significant results to date. The Fiscalia continues working with the DGII to improve enforcement of tax fraud regulations. The project has been working effectively with both entities, helping them to understand the law and how can they enforce it to reduce tax evasion.

## 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):

<b>Performance Standard</b>	<b>TPAR Progress</b>
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 finished the development of the EDA system and delivered it to DGII so it can be deployed. The Case Selection System is in development.
c) Ascertain liability according to the law	The project continued supporting the Criminal Investigation Unit, providing them training during this quarter.
d) Monitors, records, and controls payments in a timely manner	The Fiscal Compliance Call Center started operations; TPAR continued supporting its implementation.
e) Compares payments at decentralized sites with forecast payments	The procurement of data for the data warehouse continued. The project continued urging the DGII to obtain data to populate the cross reference analysis system. Although the third parties are reluctant to provide the data, it is critical that the tax administration enforce the law and make them comply with the information requirement. Additional recommendations were provided in the Tax Policy Document.
f) Selects and performs audits and collections activities fairly and effectively	The project continued developing the Case Selection and Management System that will bring transparency and efficiency in the fight against the tax evasion. The project worked on the selection process of the stop filers, infusing more transparency, accuracy and results into the process.

<b>Performance Standard</b>	<b>TPAR Progress</b>
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 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.