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Quarterly Report

February – April 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. Training on Anti-Corruption investigation techniques
2. Second phase of the implementation of the Fiscal Compliance Call Center
3. Java technology training
4. Oracle technology training
5. Negotiation techniques training
6. Submission to USAID of the Tax Policy Document
7. Creation of the Return Processing Office
8. Creation of the Supervision and Control Office
9. Creation of the Excise Office
10. Development of Mission Document for the Case Management System
11. Development of Mission Document for the Case Selection System
12. Development of EDA (Data Entry) System
13. Update of 2007 tax benchmarking
14. Investigation of Case Selection & Management System (CSMS) Software

Quarterly Results

- 1. Training on anti-corruption investigation techniques:** TPAR delivered training on investigation techniques for the Anti-Corruption Unit and provided recommendations for improvements.
- 2. Second phase of the implementation of the Fiscal Compliance Call Center:** The project continues to implement the plan for the creation of the Fiscal Compliance Call Center. The procedures manual and the final requirements were completed, enabling the Ministry of Finance (MoF) to begin working on the purchase of the necessary equipment and other logistics.
- 3. Java technology training:** The project continued delivering training on Java technology to the IT department of the DGII.

4. **Oracle technology training:** TPAR delivered training on Oracle technology use and management to the IT department of the DGII.
5. **Negotiation techniques training:** TPAR delivered training on negotiation techniques to the staff of the Stop Filers' Office.
6. **Submission to USAID of the Tax Policy Document:** TPAR finished the development of the tax policy, and it was submitted to USAID.
7. **Creation of the Return Processing Office:** Upon request and recommendation of TPAR, the DGII created the Return Processing Office. This area will report directly to the DGII Directorate.
8. **Creation of the Supervision and Control Office:** The project continued to urge the MoF to create this new office. The MoF promised to do this by January 2008, but the office has yet to be created. TPAR will continue insisting on this matter.
9. **Creation of the Excise Office:** The project also continued insisting on the creation of the Excise Office, which the MoF pledged to do by January 2008. The office has not yet been created. TPAR will continue insisting on this matter.
10. **Development of Mission Document for the Case Management System:** The project worked with the DGII staff on the development of the Mission Document in order to begin the creation of the Case Management System. This System will be the auditing and control tool to improve the current audit system.
11. **Development of Mission Document for the Case Selection System:** The project worked with the DGII staff on the development of the Mission Document in order to begin the creation of the Case Selection System, which will provide transparency to the tax investigation activities of DGII.
12. **Development EDA (Data Entry) System:** TPAR continued with the development of the EDA System in order to provide DGII with the new program on Java technology.
13. **2007 Benchmarking Update:** TPAR and the counterpart team worked on an update of the benchmarking study. Its completion is stalled, awaiting the provision of key data from the MoF. The project will continue insisting that the MoF move quickly on this matter.
14. **Investigation of CSMS Software:** TPAR developed an investigation to determine whether there is a new system more efficient to develop the

CSMS. We found that Intalio, an open source solution, is another alternative. The related recommendations were given to the MoF. The project is now waiting for a final decision from DGII and the MoF.

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 Eleventh quarter includes:

1. **Training on anti-corruption investigation techniques:** Continuing with the strengthening of the Anti-Corruption Unit, a TPAR consultant conducted an assessment of the Unit's current processes and procedures in order to customize the training program and help the staff to improve the current investigation techniques and procedures. Several meetings were held with the AU staff and with the Fiscales Unit in order to solve procedural problems that were then addressed in the training. The training was focused on solving the investigation techniques issues still pending and the processes and procedures that must be improved. All AU staff attended the training.
2. **Second phase of the implementation of the Fiscal Compliance Call Center:** The project continued with the plan for the creation and implementation of the Fiscal Compliance Call Center. The Call Center will be in charge of the stop filers and delinquent accounts control, using call center technology. The project provided recommendations for the processes and procedures required to significantly improve the current status, (e.g. increase the collection and diminish the stop filers). The plan for the creation of the Call Center started being implemented: the MoF will provide the carpets and the desks for the Call Center and TPAR will provide technical assistance, training, the technology, hardware and software and computer terminals for all the operators of the unit. It is expected that in July the Call Center will start operations.
3. **Java technology training:** The project developed an important component of the new IT system of DGII using Java technology. This new technology has necessitated the training of DGII IT staff in the use of Java programs. TPAR completed the delivery of these trainings in February.
4. **Oracle technology training:** TPAR delivered training on Oracle technology use and management to the IT department of the DGII. The DGII IT staff is now prepared to deal with the new environment, once the full SATI (DGII IT system) is operational.
5. **Negotiation techniques training:** The new stop filers control to be implemented by the DGII requires that the staff use negotiation techniques to induce the taxpayers to comply with their tax return filing duties. TPAR delivered training on these techniques to the Fiscal Compliance Call Center staff.

6. **Submission to USAID of the Tax Policy Document:** One of the key tasks of the project is the Analysis and Drafting of New Tax policy reforms in order to help the MoF to maximize collections and minimize tax evasion and avoidance. During the previous quarter, several TPAR experts worked on the development of the document. It was completed during the early part of this quarter and was submitted to USAID in order to have it sent to the GOES for consideration. It is expected that the recommendations will help the MoF build a more fair and efficient tax system for El Salvador.
7. **Creation of the Return Processing Office:** The project has been urging the DGII to create an office for return processing separate from the taxpayer assistance department, in order to improve efficiency and improve the accuracy of taxpayer data. The DGII has accepted this TPAR recommendation, and has created the Return Processing Office separate from the taxpayer service area and reporting directly to the General Director. The project continued insisting with the new Office on the need for the implementation of the digitalization process that was developed by TPAR and that to date has not been implemented. Without these standards and procedures, it will be difficult for the DGII to obtain accurate data to support the investigation process. We expect that the new office will implement the digitalization system.
8. **Creation of the Supervision and Control Office:** The project continued to press for the creation of the office that the MoF agreed to create by January 2008. TPAR will continue insisting on this matter.
9. **Creation of the Excise Office:** The project continued to push for the creation of the Excise Office that the MoF pledged to create by January 2008. TPAR will continue insisting on this matter.
10. **Development of Mission Document for the Case Management System:** In the previous quarter, the MoF agreed to support the development of a Case Management System that will help the GOES to have a more efficient and transparent control system and will help the DGII to attack tax evasion. The first step toward the creation of this System is the development of the Mission Document. TPAR has been working with the DGII's Auditing Department staff on the development of the document during this quarter.
11. **Development of Mission Document for the Case Selection System:** The project worked with the DGII staff to begin drafting the Mission Document for the Case Selection System, an IT solution to improve the transparency of the DGII's tax investigation activities. The project has experienced difficulties with this task, because the counterpart office, UPET, has not provided adequate support, despite MoF pledges of full support for this system's development. The project continues requesting support from the UPET on this matter. If the DGII does not

provide any assistance, the project will experience delays and problems in the development of the case selection system.

12. **Development of EDA (Data Entry) System:** TPAR continued with the development of the EDA System in order to provide DGII with the new program in Java technology. By May the program will be delivered to the DGII IT Department.
13. **2007 Benchmarking Update:** TPAR and the counterpart team worked on the update of the benchmarking study, though the UPET has not provided all the necessary data to finish the task. The project will continue insisting on this matter.
14. **Investigation of CSMS Software:** In order to evaluate the state-of-the-art technology for the development of the CSMS, TPAR IT staff conducted a new investigation to determine the most appropriate software to be used. When the project proposed the development of the CSMS in 2005, the SOA SUITE of Oracle was the suitable system to be used. But technology moved fast and new alternatives are now available on the market. TPAR is concerned about the sustainability of the system in the long term, and this was one of the issues that the project took into account. The investigation conducted by TPAR led the team to the conclusion that the INTALIO software can be another alternative. The MoF will take the decision on Intalio Vs SOA Suite and TPAR will use the technology that they decide is the right for their technological platform

As agreed previously, the MoF must purchase the necessary software and technical support from the provider. TPAR already submitted the proposal to the MoF and is waiting for its decision in order to start the development of the CSMS.

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% (3% increases 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 rate will be adjusted.

The tax revenues on some taxes have been growing while other have had a small growing rate and even negative during the last 3 months.

Internal VAT

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
February	48,086.80	52,744.80	4,658.00	9.7	53,093.00	52,744.80	-348.2	-0.7
March	44,090.20	50,192.00	6,101.80	13.8	47,149.00	50,192.00	3,043.00	6.5
April	45,986.70	53,390.90	7,404.20	16.1	52,538.20	53,390.90	852.7	1.6
Average	138,163.70	156,327.70	18,164.00	13.1	152,780.20	156,327.70	3,547.50	2.3

Thousand of Dollars

Source: Collections Report, Treasurer’s Office – MOF

The internal VAT collections continues with the behavior shown in the previous quarter, low growing rates and even negative for the first month. Compare with the year 2005 the increase between these two periods was 9.7% for February, 13.8% for March and 16.1% for April 2008. The growth rate compared with the previous year 2007 for February was negative on -0.7%, March was 6.5% and April was 1.6%. As we can see the internal VAT collection hasn’t increase significantly while the import VAT has grown at highest rates, as it was experience in the previous quarter. We have two possible scenarios that are causing this, increase in tax evasion or accumulations of stocks in the economy generated by a slow down in sales.

Import VAT

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
February	69,444.80	82,528.80	13,084.00	18.8	68,506.70	82,528.80	14,022.10	20.5
March	67,903.50	73,137.50	5,234.00	7.7	72,064.00	73,137.50	1,073.50	1.5
April	59,669.40	95,626.90	35,957.50	60.3	63,738.30	95,626.90	31,888.60	50
Average	197,017.70	251,293.20	54,275.50	27.5	204,309.00	251,293.20	46,984.20	23

Thousand 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 18.8% in February, 7.7% in March, and 60.3% in April 2008. The growth rates compared with 2007 for February were 20.5%, in March 1.5% and April, 50.0%.

Income Tax Withholding

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
February	29,162.40	37,985.70	8,823.30	30.3	33,871.00	37,985.70	4,114.70	12.1
March	29,101.10	36,621.40	7,520.30	25.8	33,696.80	36,621.40	2,924.60	8.7
April	31,176.90	40,152.00	8,975.10	28.8	36,229.30	40,152.00	3,922.70	10.8
Average	89,440.40	114,759.10	25,318.70	28.3	103,797.10	114,759.10	10,962.00	10.6

Thousand of Dollars

Source: Collections report Treasurer office - MOF

Income Tax withholding experienced substantial growth compared with the year 2006. The rates increased to 30.3% in February, 25.8% in March, and 28.8% in April. Between 2007 and 2008, the rate for February was 12.1%, 8.7% in March, and 10.8% in April.

Account Payments

	2006	2008	Difference	Growth Rate	2007	2008	Difference	Growth Rate
February	20,700.60	28,283.90	7,583.30	36.6	23,836.80	28,283.90	4,447.10	18.7
March	19,235.70	24,988.50	5,752.80	29.9	21,449.80	24,988.50	3,538.70	16.5
April	19,705.10	23,789.00	4,083.90	20.7	22,747.90	23,789.00	1,041.10	4.6
Average	59,641.40	77,061.40	17,420.00	29.2	68,034.50	77,061.40	9,026.90	13.3

Thousand of Dollars

Source: Collections report Treasurer office – MOF

Account Payments also registered important increases compared with prior years. Compared with the year 2006, Account Payments increased by 36.6% in February, 29.9% in March, and 20.7% in April. Between 2007 and 2008, rates increased 18.7% in February, 16.5% in March and 4.6% in April.

Income Tax

	2006	2008 ^{1/}	Difference	Growth Rate	2007	2008 ^{1/}	Difference	Growth Rate
Total Collections	190,415.5	262,031.6	71,616.1	37.6	256,042.7	262,031.6	5,988.9	2.3
Average	190,415.5	262,031.6	71,616.1	37.6	256,042.7	262,031.6	5,988.9	2.3

Thousand of Dollars

Source: Collections report Treasurer office – MOF

1/ Includes the effective collection from January 01 to April 30 of 2008 (\$235,231.6 miles), plus the amount of authorization of payments by installments (\$26,800.00 miles). The 2008 collections comes from the FY 2007, 2007 is FY 2006 and 2006 is FY 2005

The income tax, unlike the previous year's collection outcomes, experienced very little growth compared with the year 2006 (FY 2005), with revenue growth at a rate of 37.6% (the previous year's rate was 50.6%). Compared with the year 2007 (FY 2006) the rate of growth was 2.3% (previous year was 29.8%). The main reason for the decreasing growth rate was that the Fiscal Reform results had come to an end and the increase in the deductions for personal income tax included in the plan ALIANZA PARA LA FAMILIA. If the MoF wants to increase the income tax collection, another fiscal reform as recommended by TPAR must be undertaken.

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.

The project is still waiting for the tax evasion study for 2005 that should have been conducted by UPET in April 2007. TPAR requested that the Central Bank submit the Input Output matrix to the UPET and they have now done so; but to date, UPET has not submitted the study to TPAR. The project tried to develop the study, but the UPET chief was unwilling to grant access to DGII information to any member of the TPAR team.

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:** During the last 2 years, the project recommended changes to the DGII in the auditing areas in order to improve the current structure and implement the necessary controls of the new tax obligations enacted with the fiscal reforms of 2004 related to the account payments, VAT withholding and percepciones and to more efficiently combat tax evasion. TPAR is now 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:** The DGII with the support of TPAR is working now on the creation of the Transfer Pricing Unit based on TPAR recommendations. It is expected that the Unit will be created before October 2008. TPAR is providing them with training, including organizing an international visitors program to Argentina for transfer pricing. In 2006, the project provided recommendations for the creation of the Unit and the amendment of the law, recommendations that were included in the Tax Policy Document.
- 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 continued to insist on the need for having the unit created by January 2008 as was promised by the Vice Ministry and the DGII Director General. To date, the office has not been created by the DGII. The project expects that during the next quarter, the DGII will create and implement the office.

- 4. Fiscal Compliance Call Center:** The project developed the third phase of the implementation of the Fiscal Compliance Call Center that will be in charge of the control of the stop filers and delinquents helping the DGII to improve the current tax control system and expand the taxpayer base. It will help not only to reduce tax evasion but to maintain the compliance level of taxpayer Account Payments, Withholdings and Deductions, which are among the most important changes generated by the fiscal reforms of 2004. The project started the implementation of the Call Center during this quarter, based on the recommendations provided by TPAR consultant Carmen Garcia.
- 5. Analysis of the Current Tax Structure:** TPAR delivered the Tax Policy Document that includes the Analysis of the Current Tax Structure, which has an evaluation of the performance of the 2004 fiscal reforms; an analysis of the current legislation; and recommendations to improve the current tax system, making it more fair and equitable. USAID has delivered the paper to the MoF and it is expected that they will leverage the recommendations to improve their current tax system.
- 6. Development of the Case Selection and Management System:** In order to increase productivity in the auditing area, make more transparent the control function and improve the fight against tax evasion the project proposed back in 2005 the development and implementation of a Case Selection and Management System. During the quarter the project worked with the counterpart team on the development of the Vision Document and conducted an exhaustive investigation to determine which technology is the most suitable for the development of CSMS. TPAR is working with the MoF to ensure that we are on track to start developing the system in the next quarter.

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 insisting with DGII on the need for them to provide more information to update the system.
b) Monitors filings against the master files	The project continued with the development of the EDA system that will be delivered next quarter. The other applications of the new IT system of DGII that TPAR developed are now being tested and finished by DGII’s IT Department. They are the responsible of its deployment.
c) Ascertain liability according to the law	The project continued supporting the strengthening of the Anti-Corruption Office. During the quarter the project developed an assessment and recommendations to improve the current process and procedures of this office. Additionally, training on Anti-Corruption Investigation Techniques was delivered.
d) Monitors, records, and controls payments in a timely manner	The project already finished the development of the taxpayer current account in the previous quarters; now it is expected that the DGII IT Department will deploy the system.
e) Compares payments at decentralized sites with forecast payments	The procurement of data for the data warehouse continues. The project continued insisting on the need for 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 enforces the law and makes 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 started the development of the Case Selection and Management System that will bring transparency and efficiency in the fight against the tax evasion. Additionally the project is working on the creation of the Fiscal Compliance Call Center.
g) Assists taxpayers with compliance through an efficient call center	TPAR continued supporting the 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 is updating the benchmarking for 2007 despite the lack of support of the UPET and the MoF.