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Quarterly Report

February 2006 – April 2006

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

- Tax Administration Modernization Plan (TAMP) - IT
- Tax Administration Modernization Plan (TAMP) - Administrative Structure
- Procurement Changes
- Course Development Tax Administration Curriculum
- On the Job Instructor Training
- Criminal Investigation Unit Implementation
- Anti-Corruption Unit Implementation
- VAT Tax Return and Account Payment Return Development

Quarterly Results

- Tax Administration Modernization Plan (TAMP) - IT
- Tax Administration Modernization Plan (TAMP) - Administrative Structure
 - Data migration reached 80% completion
- Procurement Changes
 - A new open source Call Center system was selected
 - 92 computers were added to the procurement list
- Course Development Tax Administration Curriculum
 - 12 courses were developed for the DGII training programs
- On-the-Job Instructor Training (OJIT)
 - The second part of the OJIT was performed during the quarter
- Criminal Investigation Unit Implementation

- The strategic plan was developed
- The procedure manual is being developed
- Anti-Corruption Unit Implementation
 - The Agreement was developed and evaluated with the General and Deputy Director of DGII.
 - The TPAR project is working in collaboration with the US Treasury Office of Technical Assistance (OTA)
- VAT Tax Return and Account Payment Return Development
 - In order to continue with the new data entry process, a committee was created and coordinated by TPAR with the purpose of developing the new forms of the VAT and the Account Payment returns. The preliminary returns format was developed.

2. Introduction

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

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

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

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

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

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

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. Tax Administration Modernization Plan (TAMP)—IT

During this quarter the TPAR Team developed an IT modernization plan, a plan that 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 will 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 major operative processes will be conducted through the CMS, allowing the standardization of all processes, procedures, and activities. This will positively affect the productivity and achievement of the different functions.

The system will also produce management statistics for control purposes.

- **Cross-referenced analysis, targeting and case selection program.** This program 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 fastest 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 a microfilm system and will recommend the necessary steps for its implementation.
- **Improvement of the taxpayer current account.** The DGII has no accurate current account, which generates multiple problems for 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.**

During this period the project will continue with the data migration and work jointly with the DGII to get MOF approval for the application migration, a necessity for the IT modernization plan. A document with the justification of the migration plan has been produced.

2. 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 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 functions.

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 and effective tax administration, TPAR's modernization plan includes 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 to the new entity's organizational structure, clearly separating the normative functions from the operational ones;
- 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.

During the quarter the TPAR project worked jointly with DGII to get MOF approval on the plan. Different documents were produced in order to explain the benefits of the plan.

3. Procurement Changes

During the month of April a new program for the call center was evaluated. This program comes from an open source and will significantly reduce the cost of the call center for the project. It will also give the DGII the opportunity to duplicate the number of servers relative to the previously selected system.

With the savings obtained from our plan to acquire open source software, we were also able to include 92 new laptops in the procurement plan. This equipment will be used for the offices of tax audit.

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

4. Course Development - Tax Administration Curriculum

As required, the TPAR project has worked to develop a set of tax administration training courses. After an initial session during which project staff teach the courses, MOF and DGII staff will assume teaching responsibilities as well as ownership of course materials. These courses are:

- 1 - Analysis and Interpretation of Financial Statements
- 2 - International Accounting Rules
- 3 - Auditing Rules
- 4 - Auditing Techniques
- 5 - Indirect Methods
- 6 - Cost Accounting
- 7 - Auditing Manual
- 8 - Paper Work for the Auditing Process
- 9 - Tax Code Regulations and Ruling
- 10 - Income Tax Regulations and Ruling
- 11 - VAT Regulations and Ruling

The development of these courses includes a student manual, instructor manual, reading material, and Power Point presentations.

5. On the Job Instructor Training

The proposed DGII Training methodology is On the Job Instructor Training. TPAR consultants previously delivered a week-long training in on-the-job training techniques for 18 participants. During the second week of this past quarter the participants were trained in guideline development.

6. Criminal Investigation Unit Implementation

In collaboration with the Office of Technical Assistance of the US Department of the Treasury, the TPAR Project developed a plan for the creation of the Criminal Investigation Unit. During the Quarter, the project worked on the logistic and technical issues related to Unit implementation. A training plan was developed and the strategic plan and procedure manual were jointly coordinated by TPAR and the OTA.

7. Anti-Corruption Unit Implementation

The TPAR project has been working on the creation of an Anti-Corruption Unit. The project developed a draft of the Acuerdo and met with the DGII directorate to discuss the document and Unit implementation. Additionally, the COP requested support from OTA and Joe Cortesi, the OTA expert, who to El Salvador to support Implementation. In the coming months, the TPAR Project and Mr. Cortesi will continue this effort. The current schedule is to incorporate top level personnel by the first week of June.

8. VAT Tax Return and Account Payments Return Development

In order to improve the data entry process, the TPAR Project has proposed the development of a new system that will scan each tax return, convert the image in a digital program, and feed the data into a warehouse system.

It is necessary to change the current form of the returns. To address this issue, the TPAR project formed a committee with a mission to draft new tax return forms. The committee was successful during the past quarter in devising new return forms for the VAT and the Account Payments. These forms are currently being tested for formatting purposes.

4. Results

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

- *Tax Administration Modernization Plan – Information Technology (TAMP-IT):* During this quarter, the TPAR Project has been defending the restructuring proposal with the Ministry of Finance and the DGII. When the proposal was developed and submitted in December 2005, it was approved by the DGII and received the consent of the MOF. A special committee was created in order to implement the plan. But this quarter, the MOF and the DGII requested more information, which the TPAR COP has now developed and delivered. A final decision by the MOF and DGII is pending. Part of the delay is due to the appointment of a new Minister of Finance in April of this year.
- *Tax Administration Modernization Plan (TAMP) Administrative Structure:* During this quarter, the migration of data from Informix to Oracle advanced to approximately 80% completion. These system-based changes are prerequisites for any administrative structure changes. The TPAR project requested from the DGII a plan for the complete migration of the applications. The TPAR project has also requested that the MOF approve the plan and the recruit the necessary personnel.
- *Procurement Changes:* During this quarter, the TPAR project discovered a new Call Center technology developed by ASTERISK that delivers higher quality at 1/3 of the price of the originally proposed Call Center application (ININ CIC). It has always been understood that ASTERISK offers a number of advantages, but until recently, ASTERISK programs were incompatible with the existing telephony system at the DGII. This has now been corrected, making ASTERISK the clear choice for the DGII's Call Center. This technology change allows the DGII to increase Call Center operators from 24 to 48, and increase the number of channels from 30 to 120. Moreover, the cost savings enable USAID, through the TPAR project, to procure 92 additional laptops for the DGII's audit staff. These changes were submitted to USAID/El Salvador in the form of a revised procurement proposal.
- *On the Job Instructor Training (OJIT):* The second part of the OJIT was delivered during this quarter, and was used as a basis for the development of the courses for the curriculum of the DGII training system.
- *Course Development – Tax Administration Curriculum:* The TPAR counterpart team implemented the training framework offered during the OJIT, by developing a full curriculum and courses for the DGII. The course materials developed include Student Guides, Professor Guides, reading materials and PowerPoint presentations.

These courses form the basis of the new training system to be implemented by the Ministry of Finance. The courses developed were:

- 1- Analysis and Interpretation of Financial Statements
- 2.- International Accounting Rules
- 3.- Auditing Rules
- 4.- Auditing Techniques
- 5.- Indirect Methods
- 6.- Cost accounting
- 7.- Auditing Manual
- 8.- Paper Work For the auditing Process
- 9.- Tax Code regulations and ruling
- 10.- Income Tax Regulation and ruling
- 11.- VAT Regulations and Ruling

- *Criminal Investigation Unit Implementation:* In coordination with the U.S. Department of Treasury's Office of Technical Assistance (OTA) and the DGII, the strategic plan for the Criminal Investigation Unit was developed. Work also started on the development of a Procedures Manual. This manual will provide technical guidelines for investigators and will help the office to determine standards in order to control the performance of the unit.
- *Anti-Corruption Unit Implementation:* An agreement to develop the Anti-Corruption Unit was developed by the TPAR project and evaluated by the General and Deputy Directors of the DGII. These efforts were made in cooperation with the OTA of the US Treasury.
- *VAT Tax Return and Account Payment Return Development:* In order to advance the new data entry process, TPAR created and coordinated a committee to develop the new forms for VAT returns and Account Payment returns. Preliminary formats were completed this quarter.

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. These strong gains may still be attributed largely to the 2004 fiscal reforms.

INTERNAL VAT

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
February	39,444.6	48,086.8	8,642.2	21.9%	45,509.1	48,086.8	2,577.7	5.7%
March	37,867.4	44,090.2	6,222.8	16.4%	42,915.7	44,090.2	1,174.5	2.7%
April	36,395.6	46,763.9	10,368.3	28.5%	42,988.9	46,763.9	3,775.0	8.8%
Average	113,707.6	138,940.9	25,233.3	22.2%	131,413.7	138,940.9	7,527.2	5.7%

Thousand of Dollars

Source: Collections Report, Treasurer's Office - MOF

The results in the collection of the VAT are significant, compared with the year 2004. The increase between these two periods was 21.9% for February, 16.4% for March and 28.5% for April. But perhaps the most important is the growing rate compared with the previous year (2005), the year of the reforms. In February, internal VAT returns increased by 5.7%; in March, they increased by 2.7%; and in April, they displayed strong performance, growing at a rate of 8.8%.

IMPORT VAT

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
February	43,687.9	69,444.8	25,756.9	59.0	46,359.1	69,444.8	23,085.7	49.8
March	49,227.0	67,903.5	18,676.5	37.9	52,149.0	67,903.5	15,754.5	30.2
April	46,386.0	61,654.5	15,268.5	32.9	56,829.3	61,654.5	4,825.2	8.5
Average	139,300.9	199,002.8	59,701.9	42.9	155,337.4	199,002.8	43,665.4	28.1

Thousand of Dollars

Source: Collections report Treasurer office - MOF

Import VAT witnessed substantial growth over the same periods in previous years. Between 2004 and 2006, the import VAT grew at rates of 57% in February, 37.9% in March, and 32.9% in April. Between 2004 and 2005, import VAT grew by 49.8% in February, 30.2% in March and 8.5% in April. The slowing growth in import VAT from February through April is likely attributable to expectations regarding the North American Free Trade Agreement (Tratado de Libre Comercio, TLC).

INCOME TAX

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
February	534.0	2,286.3	1,752.3	328.1	1,105.4	2,286.3	1,180.9	106.8
March	2,001.0	2,833.4	832.4	41.6	4,608.0	2,833.4	-1,774.6	-38.5
April	122,924.2	162,887.4	39,963.2	32.5	138,938.3	162,887.4	23,949.1	17.2
Average	125,459.2	168,007.1	42,547.9	33.9	144,651.7	168,007.1	23,355.4	16.1

Source: Collections Report Treasurer office - MOF

The collection for 2005 and 2006, include the period between February 01 to May 02

Income Tax returns, compared with the same period in previous years, vary—but in general, display strong growth. We must consider for this purpose only the period of April, during which we can see a growth rate of 32.5% from 2004 to 2006, and 17% from 2005 to 2006. These are very significant rates for this type of tax. **This suggests that the tax base has expanded and taxpayer evasion behavior has been changing during the period.**

INCOME TAX WITHHOLDING

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
February	22,155.5	29,162.4	7,006.9	31.6	25,219.9	29,162.4	3,942.5	15.6
March	22,126.2	29,101.1	6,974.9	31.5	24,552.3	29,101.1	4,548.8	18.5
April	23,410.3	30,460.3	7,050.0	30.1	27,313.5	30,460.3	3,146.8	11.5
Average	67,692.0	88,723.8	21,031.8	31.1	77,085.7	88,723.8	11,638.1	15.1

Thousand of Dollars

Source: Collections report Treasurer office - MOF

Income Tax withholding in this quarter witnessed relative stability compared with the same period in 2004 and 2005, with the 2004 the rates increasing 31.6% in February, 31.5% in March and 30.1% in April. Between 2005 and 2006, the income tax withholding increased by 15.6% in February, 18.5% in March and 11.5% in April.

ACCOUNT PAYMENTS

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
February	12,702.1	20,700.6	7,998.5	63.0	17,557.9	20,700.6	3,142.7	17.9
March	12,510.1	19,235.7	6,725.6	53.8	16,505.6	19,235.7	2,730.1	16.5
April	12,346.1	20,315.9	7,969.8	64.6	17,306.1	20,315.9	3,009.8	17.4
Average	37,558.3	60,252.2	22,693.9	60.4	51,369.6	60,252.2	8,882.6	17.3

Thousand of Dollars

Source: Collections report Treasurer office - MOF

Finally, Account Payments registered some of the largest increases compared with prior years. Between 2004 and 2006, Account Payments increased by 63% in February, 53.78% in March, and 64.6% in April. Between 2005 and 2006, rates increased 17.9% in February, 16.5% in March, and 17.4% in April.

These results suggest a very stable, positive response by the taxpayers to the implementation of the 2004 fiscal reforms. The TPAR Team has been supporting the DGII in the implementation of the recommendations made regarding the reforms. It is a key political issue that these 2006 returns show the real impact of the reform. So far, we can see a very significant improvement in the collection of all taxes. The challenge continues to be keeping up these gains and reducing tax evasion.

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 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.

To achieve this goal, the project has been working over the past several months to implement the IT Modernization Plan, which will strengthen the DGII's ability to detect and control evasion. In the mean time, the project's administrative and functional Modernization Plan seeks to sensibly increase staff productivity, which should lead to noticeable improvements in voluntary and enforced compliance.

Successful implementation of the current tax reforms recently enacted. In the previous quarter the TPAR project developed a Plan for the Implementation of the Fiscal Reforms. Our recommendations were submitted to the UPET for implementation. The team has been following the implementation of the recommendations and the

results on the control side. A key concern of the project is to develop a strategic plan on the control/audit side, as well as to develop audit standards. Those issues will be addressed in the next quarter with the support of TPAR consultants.

The TPAR project's most significant recommendation was that the Ministry of Finance and the Central Government should authorize the reconfiguration of the DGII as a Semi-Autonomous Revenue Authority (SARA). 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 a regional office;
- A new Telephone Call Center with modern equipment and adequate staffing should be developed;
- A special office to process tax declarations should be established;
- 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 continued during this quarter with the migration of data from Informix to Oracle, and the restructuring of the data entry process. The data migrations were 80% completed, and the Data Entry process began with the VAT and the Account Payment forms redesign. The IT Procurement Plan constituted another major activity related to implementing the fiscal reforms. The IT Procurement Plan was adjusted during this quarter, which freed enough resources to procure an additional 92 laptops for the support of the auditing areas.

The plan for the creation of the Criminal Investigation Unit was developed in the previous quarter and during this period, its implementation successfully began.

The curriculum for the DGII training system was developed in the previous period and during this quarter 11 courses were developed. This new training system will allow the DGII to strengthen the auditors' abilities to detect evasion and enable them to generate a higher collection.

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	The TPAR project continued during the period to support the DGII on 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 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 coordinated all the activities of the team in charge of the redesign of the VAT and the Account Payment forms regarding the new data entry process to be implemented. The new data entry process will improve the quality and accuracy of the tax database.
b) Monitors filings against the master files	The data migration program started in January and a plan and schedule was developed. During this period the migration reach the 80% level. Once the migration is complete, TPAR can support the DGII with this task.
c) Ascertain liability according to the law	During this quarter the TPAR Team coordinated the development of 11 courses of the curriculum. The first training program implementing this curriculum was planned, and is set to begin during the following quarter.
d) Monitors, records, and controls payments in a timely manner	TPAR's Team continues to advance the IT Modernization Plan and the IT Procurement Plan. TPAR has significantly improved the scope of the procurement, by freeing resources to buy 92 additional laptops on behalf of USAID. These will help the tax administration audit staff in the control of payments and the auditing improvements.
e) Compares payments at decentralized sites with forecast payments	The creation of a cross referencing database started during this period with the selection of the sources of information. During the next semester, the necessary action will be taken in order to obtain the proprietary technical and legal information and approval.
f) Selects and performs audits and collections activities fairly and effectively	The TPAR Project has been tracking the implementation of the recommendations regarding the control issues. TPAR is in the early stages of developing an audit selection system, which will mechanize the selection of audits using fair and effective parameters.
g) Assists taxpayers with compliance through an efficient call center	TPAR determined a robust 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.