



USAID
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DOMESTIC RESOURCE MOBILIZATION

El Salvador Tax Reform Boosts Revenues for Development

More than a decade after peace accords ended El Salvador's civil conflict, a new government took office in June 2004, confronted with the challenge of putting a struggling economy back on course. Despite postwar efforts to rehabilitate basic infrastructure and expand access to social services, the new administration faced major fiscal demands between the response to the 2001 earthquakes and the cost of moving to a fully-funded pension system. More resources were needed to sustain these efforts, yet in 2004, El Salvador's tax revenues were less than 12 percent of GDP, among the lowest in Central America – due to rampant evasion and public distrust of government.

Against this backdrop, a major tax reform was announced in 2004, designed to broaden the tax base and increase tax collections. Over the ensuing 5 years, USAID leveraged a \$5 million investment and a matching contribution from the Government of El Salvador to implement the reform, upgrade tax collection capacity, and launch new systems for auditing and information technology (IT) at the Directorate General for Internal Taxes (DGII), El Salvador's national tax administration.



A community health worker speaks about women's health. USAID/El Salvador

The investment paid off many times over. The new systems, combined with improved taxpayer outreach, criminal investigation, and other programs created with USAID support, helped El Salvador reap an additional \$1.5 billion between 2005 and 2010—without increasing a single tax rate. And while the

global financial crisis put the brakes on economic growth after 2008, continued USAID support since 2011 has helped raise tax revenues by a further \$900 million, surpassing 15 percent of GDP in 2013.

Part of a sustained USAID engagement to build El Salvador's tax system since the 1990s, these gains in domestic revenue mobilization have translated into concrete results for average Salvadorans. Several periods of rapid revenue growth since the 1990s have allowed the country to double per capita spending on health, education and social protection and reduce extreme poverty by close to 25 percent.

Building a modern tax service

Critical to the success of the 2004 tax reform was transforming DGII into a modern, professional revenue service. With USAID's assistance, DGII was able to establish specialized units and capacity and roll out a web-based IT infrastructure that enabled enhanced taxpayer services, a more robust audit program, and better fraud and corruption control. These improvements were directly responsible for an additional \$40 million in tax revenue that was collected between 2005 and 2010.

Enhanced taxpayer services

Two major efforts in improving taxpayer services were undertaken with USAID support. The first was the creation of a taxpayer assistance center and a network of regional walk-in offices. Second was the creation of a taxpayer advocate unit, empowered to protect and defend the legal rights of taxpayers.

These new taxpayer service platforms swiftly addressed an unmet demand. By 2010, DGII was handling 1,300 taxpayer queries per day and 5,000 on peak days, compared to only 200 daily before the reform. Since then, USAID has helped DGII expand the reach of services to smaller firms, installing self-service kiosks where taxpayers can perform routine transactions and access their accounts in "real time." This has helped taxpayers avoid long lines at the tax office, while also reducing costs for the government.

Dollars to Results

\$5.8 million in total USAID support

\$350 million increase in annual revenue

\$160 million increase in annual social spending

Fewer but better audits

USAID has also helped DGII bolster its audit program by refocusing its resources on the greatest compliance risks. A computer-assisted audit selection system (CSMS) was rolled out in 2010, automating case selection and the assignment of audit personnel, rather than leaving those decisions to the discretion of tax officials. Complementing the CSMS, USAID delivered training to help inspectors conduct more rigorous and productive audits.

Results were immediate. In 2010, over the CSMS's first six months of full application, DGII completed more than 300 audits, detecting more than \$100 million in underreported taxes, compared to \$50 million from audits for all of 2009. Since then, USAID has helped upgrade CSMS to integrate trade data from customs and expand its functionality to support case management through the full audit cycle. These upgrades resulted in the collection of an additional \$26 million in 2013—one-quarter of the \$97 million in total collections that CSMS supported that year.

Reduced Fraud and Corruption

To strengthen fraud prevention, USAID helped DGII stand up new units for criminal investigation and anti-corruption. The criminal investigation team has provided the government with more robust cases for prosecution, increasing the number of cases sent to the Attorney General from 20 in 2006 to 76 in 2009. The anti-corruption unit, meanwhile, has enabled DGII to pursue cases of misconduct internally; from its creation in 2006 through 2010, the unit sanctioned 24 employees and sent 12 cases for prosecution.

This commitment to integrity is working. In the World Bank's 2010 Enterprise Survey of El Salvador, only 0.3 percent of respondents—just one firm out of 360—answered yes when asked whether firms are “expected to give gifts in meeting with tax officials,” compared to 5.9 percent for the rest of the region.

Technology-enhanced service

Information technology has been a cornerstone of USAID's support to DGII and the Ministry of Finance. Among other support, USAID helped launch a system that automatically contacts taxpayers when they miss a filing deadline. In the first half of 2009, when the “robo-call” system was fully operational, almost 2,700 taxpayers who had previously stopped filing tax returns resumed filing, compared to 917 who had responded to mailed notices the year prior. The automated system instantly saved the Ministry \$215,000 in monthly operating expenses and tripled annual collections from late and delinquent taxpayers.

More recently, efforts to clean up its records helped DGII reach out to 19,000 taxpayers in 2013, yielding \$1.2 million in three days. The same year, CSMS upgrades helped DGII collect another \$12.4 million after sending out 27,000 pre-filled income tax bills.

Sustained impact

On the heels of the global financial crisis and with remittances on the decline, a new government took office in 2009, pledging to raise tax revenue to 17 percent of GDP by 2014 and channel more of those resources toward expanding the social safety net and improving educational opportunities for the poor.

While the government did not reach its revenue target, it did manage to boost tax revenue from 12.6 to 15.4 percent of GDP between 2009 and 2013—a tremendous achievement in almost any context.

Meanwhile, the administration also followed through on its expenditure commitment. Social spending rose from 6.6 to 8.1 percent of GDP between 2008 and 2012, including a dramatic ramp-up of the country's chronically underfunded social-protection programs.



Schoolchildren attend school in Ca luco, Sonsonate.
USAID/El Salvador