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Quarterly Report

May 2006 – July 2006

TAX POLICY & ADMINISTRATION REFORM (TPAR) PROJECT
EI SALVADOR

August 2006

Produced for review by the United States Agency for International Development. Prepared by Development Alternatives, Inc.

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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
- Plan for the Creation of the Excise Tax Office
- Development of new tax returns forms
- Basic Management Training
- Training on Strategic Planning for Audit
- Training on VAT audit techniques
- Final stage of the procurement
- Creation of the Anti-Corruption unit

Quarterly Results

- Tax Administration Modernization Plan (TAMP) – IT
- Tax Administration Modernization Plan (TAMP) - Administrative Structure
 - Agreement on and approval for selected proposed reforms
- Plan for the Creation of the Excise Tax Office
 - Development of the plan for the office creation
 - Tax gap analysis on excise tax
- Development of the tax returns forms
 - Forms to be used in the new data entry process developed
- Basic Management Training
 - 19 managers of DGII trained
- Training on Strategic Planning for Audit
 - 18 officials from UPET (Office of Tax Analysis) and the Audit Division were trained
- Training on VAT Audit Techniques
 - 36 auditors trained

- Final stage of the procurement
 - Hardware and software purchased and shipped to El Salvador

- Creation of the Anti-Corruption Unit
 - Drafting of the agreement for the unit creation
 - Unit creation

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, 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. Tax Administration Modernization Plan (TAMP)—IT

The following components comprise TPAR's IT Tax Administration Modernization Plan:

- **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, and automobile registration. A data warehouse will allow the tax administration to set up a cross reference system for control and future data mining.
- **Case Management System (CMS).** This comprises an integrated work flow program that will incorporate:
 - Case selection
 - Automation of auditing procedures
 - Automation of collection procedures
 - Automation 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 administrative 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

- **Scanning program for return processing.** The main solution for return processing is e-filing. In the meantime, OCR (Optical Character Recognition) 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 DGII archives 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 quarter, the project continued migrating both DGII software applications and data. TPAR continued work on the Data Warehouse project. We conducted preliminary tests of the Asterix software to be used for the Call Center. Finally, the project made administrative and technical arrangements for the August 2006 reception, configuration, and storage of the hardware and software being procured for the DGII, on behalf of USAID.

An additional issue addressed during this period was the development of the applications of the current SIIT in Oracle and Java. TPAR made this request to the Ministry of Finance in November 2005, and has worked with MOF to find different ways of developing these applications; however, the MOF has not yet made a decision on this issue. Since this is a key prerequisite for the project's IT Modernization Plan activities, the DGII, MOF IT Director, USAID and the TPAR project agreed that the project would hire 3 programmers who are expert in Oracle and Java to develop 9 of the most critical applications.

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

The Modernization Plan for the DGII's administrative and functional structure was developed in November 2005. The TPAR project found that the current structure has considerable weaknesses in the normative and audit functions; which may seriously affect the long-term implementation of the 2004 reforms, and the efficiency of the tax administration. The plan was submitted to the DGII Directorate and proposed to the Ministry, who ordered the creation of a special committee in charge of the implementation of the reform, particularly with regard to the procurement of the necessary human resources and logistics. The committee was created and had its first meeting on March 6th, 2006. Following the meeting, several tasks were assigned to the DGII and MOF personnel. However, the subsequent meeting was suspended by the MOF, so the tasks proposed were never performed.

During this period the project insisted on the need to comply with a schedule to complete these tasks. TPAR developed documents to show the DGII the benefits of the reform. So far, no decision has been made by the MOF. The COP met with the General Director in July to communicate his concerns regarding the delay in the administrative reform. The Director General and deputy Director General requested an adjustment to the proposal.

As an alternative to the original administrative and functional proposal by TPAR consultant, Arturo Jacobs, the TPAR project proposed the creation of an office of Supervision and Control. This new office would sit operationally within the DGII at the staff level of the Director General. It would perform the control and supervision role, and would be responsible for developing manuals, standards and procedures for the DGII.

3. Plan for the Creation of the Excise Tax Office

During this quarter, the project carried out the necessary activities for the development of a plan for the creation of the Excise Tax Office. The TPAR consultant, Fidel Castaño, conducted an assessment of the current structure, previous experience, and needs. He additionally developed a tax gap analysis. He then developed the plan for the creation of the office and proposed it to the DGII Directors. The project and the Director General agreed that the Excise Tax Office will be created by January 2007, and its implementation will take place during the first quarter of the year.

4. Development of the tax returns forms

During this period, the project developed the forms for corporate income tax, individual income tax, excise tax, ad valorem tax and taxpayer information update. These forms will be in effect beginning in January 2007, and will be used in the scanning and data recognition process.

5. Basic Management Training

Nineteen (19) managers of the DGII were trained in Tax Basic Management Training. This training focused on the methodologies and tools necessary to successfully manage a tax administration under the different functions.

6. Training on Strategic Planning for Audit

The TPAR Project developed the first strategic planning for audit at the DGII. Eighteen (18) officials from the offices of UPET, Auditing Division, Large Taxpayers Office, Small and Medium Taxpayers Office, West Regional Office and East Regional Office were trained. During the training, trainees developed the 2007 strategic plan for audit.

7. Training on VAT Audit Techniques

Thirty-six (36) auditors from the offices of Large Taxpayers, Small and Medium Taxpayers, East Regional Office and West Regional Office were trained on VAT audit techniques.

8. Final stage of the procurement

The hardware and software was purchased during this period and was shipped to El Salvador. The shipment is expected to arrive on August 8th, 2006.

9. Creation of the Anti-Corruption Unit

The TPAR Project recommended that the DGII create an Anti-Corruption Unit. This unit would be in charge of all investigations regarding corruption crimes and violations. The Agreement drafted for the creation of the unit was developed by the team and enacted by the Director General. The TPAR project agreed to provide computers and other equipment for the unit.

4. Results

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

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

Given that the DGII and the MOF have not yet made a decision on the administrative reform, and that the political will regarding this issue has not been strong enough, the project proposed the creation of an Office of Supervision and Control for the DGII. This Office was proposed to sit at the staff level of the Director General. It was agreed to perform the control and supervision role, and be responsible for the development of manuals, standards and procedures for the DGII.

2. Plan for the creation of the Excise Tax Office

During the quarter, the project carried out the necessary activities for the development of the plan for the creation of the Excise Tax Office. The plan for the creation of the office was developed and proposed to the DGII Directors. The project and the Director General agreed that the Excise Tax Office will be created by January 2007, and its implementation will take place during the first quarter of the year.

3. Development of tax returns forms

During this period the project developed forms for corporate income tax, individual Income tax, excise tax, ad valorem tax and taxpayer information update. These forms will be enforced from January 2007 and will be used in the scanning and data recognition process.

4. Basic Management Training

Nineteen (19) managers of the DGII were trained in Tax Basic Management Training. This training focused on the methodologies and tools necessary to successfully manage a tax administration under the different functions.

5. Training on Strategic Planning for Audit

The TPAR Project developed the first strategic planning in audit at the DGII. Eighteen (18) officials from the offices of UPET, Auditing Division, Large Taxpayers, Small and

Medium Taxpayers, West Regional Office and East Regional Office were trained. During the training, trainees developed the 2007 strategic plan for auditing.

6. Training on VAT Audit Techniques

Thirty-six (36) auditors from the offices of Large Taxpayers, Small and medium Taxpayers, East Regional office and West regional office were trained on audit techniques applied to the VAT control.

7. Final stage of the procurement

The hardware and software was purchased during the period and was shipped to El Salvador. It is expected that the shipment arrive on August 8th.

8. Creation of the Anti-Corruption Unit

The TPAR Project recommended that the DGII create an Anti-Corruption Unit. This unit would be in charge of all the investigations regarding corruption crimes and violations. The draft Agreement for the creation of the unit was developed by the team and enacted by the Director General. The project will provide computers and other equipment for the unit.

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.

INTERNAL VAT

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
May	33,769.9	46,783.6	13,013.7	38.5%	42,543.5	46,783.6	4,240.1	10.0%
June	36,424.4	47,367.6	10,943.2	30.0%	44,429.1	47,367.6	2,938.5	6.6%
July	36,264.4	43,891.8	7,627.4	21.0%	41,630.5	43,891.8	2,261.3	5.4%
Average	106,458.7	138,043.0	31,584.3	29.7%	128,603.1	138,043.0	9,439.9	7.3%

Thousand of Dollars

Source: Collections Report, Treasurer's Office - MOF

The results in the collection of the VAT are significant, compared with 2004 figures. The increase between these two periods was 38.5% for May, 30% for June and 21% for July. But perhaps the most important is the growing rate compared with the previous year (2005), the year after the reforms were passed. In May, internal VAT returns increased by 10%; in June, they increased by 6.6%; and in July, the increased by 5.4%.

IMPORT VAT

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
May	52,361.6	71,862.8	19,501.2	37.2%	58,529.4	71,862.8	13,333.4	22.8%
June	48,921.0	68,723.6	19,802.6	40.5%	54,902.2	68,723.6	13,821.4	25.2%
July	49,406.9	71,430.4	22,023.5	44.6%	55,968.5	71,430.4	15,461.9	27.6%
Average	150,689.5	212,016.8	61,327.3	40.7%	169,400.1	212,016.8	42,616.7	25.2%

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 37.2% in May, 40.5% in June, and 44.6% in July. Between 2005 and 2006, import VAT grew by 22.8% in May, 25.2% in June and 27.6% in July.

INCOME TAX WITHOLDING

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
May	21,408.0	30,004.9	8,596.9	40.2%	27,277.4	29,162.4	1,885.0	6.9%
June	22,219.8	29,236.0	7,016.2	31.6%	25,493.0	29,101.1	3,608.1	14.2%
July	25,351.8	34,973.5	9,621.7	38.0%	30,334.1	30,460.3	126.2	0.4%
Average	68,979.6	94,214.4	25,234.8	36.6%	83,104.5	88,723.8	5,619.3	6.8%

Thousand of Dollars

Source: Collections report Treasurer office - MOF

Income Tax withholding register important rates compared with the same period in 2004 and 2005, with the 2004 the rates increasing 40.2% in May, 31.6% in June and 38% in July. Between 2005 and 2006, the income tax withholding increased by 6.9% in May, 14.2% in March and 0.4% in July.

ACCOUNT PAYMENTS

	2004	2006	Difference	Growth Rate	2005	2006	Difference	Growth Rate
May	7,528.6	13,451.0	5,922.4	78.7	12,236.0	20,700.6	8,464.6	69.2
June	8,768.7	16,515.0	7,746.3	88.3	15,794.7	19,235.7	3,441.0	21.8
July	9,265.0	16,692.0	7,427.0	80.2	13,050.3	20,315.9	7,265.6	55.7
Average	25,562.3	46,658.0	21,095.7	82.5	41,081.0	60,252.2	19,171.2	46.7

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 78.7% in May, 88.3% in June, and 80.2% in July. Between 2005 and 2006, rates increased 69.2% in May, 21.8% in June, and 55.7% in July.

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.

Additionally, the TPAR project has worked with the DGII to launch two new evasion-targeting offices: the Tax Investigation Unit, which will help prosecute tax evasion more quickly and effectively; and the Excise Tax Unit, which will improve the capacity of the DGII to audit excise taxpayers (and evaders).

Successful implementation of the current tax reforms recently enacted. During this period, the project has focused on three major activities related to implementing the reforms: the creation and strengthening of the Criminal Investigation Unit, the Strategic Planning for Auditing, and the VAT Audit training.

The fiscal reforms strengthened the statutory power of DGII regarding the enforcement of the law. To take advantage of this new statutory power, the TPAR project and the US Treasury collaborated with the DGII to institute an independent Criminal Investigation Unit. Currently the Unit is operating, and is reviewing and processing fiscal fraud cases—preparing them for full prosecution by the Attorney General's office.

The training on Strategic Planning for Auditing focused on the methodology necessary to develop a sound plan for tax control and audit. During the training, trainees not only learned how to develop a strategic plan, but also began developing the actual 2007 Audit Strategic Plan for the DGII. This plan takes into consideration the implementation of the VAT Withholding and the Account Payments regulations enacted in 2004.

The training on VAT audit techniques focused on techniques for detecting evasion, processes and procedures to develop a VAT audit, and evasion *modus operandi*. This training helped the DGII auditors establish a strategy to improve their supervision of VAT Withholdings and Payments.

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 this 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 DGII's performance against its collections targets for the quarter, and the rates and collections have surpassed 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 the redesign of the income tax, income tax withholding, VAT, Account Payment and excise tax forms to reflect the new data entry process being developed. The equipment for the new data entry process will be in country by the month of August. The new forms, processes, and equipment will improve the quality and accuracy of the tax database.
b) Monitors filings against the master files	The data migration continued during this period. A final decision regarding the development of the 9 applications requested for the Case Management System was made; and the TPAR Project agreed to migrate these applications, using Oracle and Java, over the next 10 months.
c) Ascertain liability according to the law	The creation of the Anti-Corruption Unit and the Criminal Investigation Unit focused not only on the audit and control impacts, but also on the transparency and accountability of the tax administration.
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. The development of the 9 applications by the TPAR Team will improve the quality of data records. These applications will also be used for payments control purposes. These will help the tax administration audit staff in monitor payments and improve auditing processes.
e) Compares payments at decentralized sites with forecast payments	The TPAR team continued with the IT modernization plan, which includes the development of the Data Warehouse that will use business intelligence tools in the analysis and control process.
f) Selects and performs audits and collections activities fairly and effectively	The TPAR Project has been tracking the implementation of the recommendations regarding audit issues. During this period the training on strategic planning for auditing and control was developed, as well as the training on VAT audit techniques. During the training, as an implementation measure the strategic plan for audit for the year 2007 was developed.
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. During this quarter, TPAR's IT team ran initial tests of the Asterix software.
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.

