USAID ASSISTANCE IN FISCAL REFORM

TAX POLICY AND ADMINISTRATION REFORM IN EL SALVADOR

JUNE 2006

This publication was produced for review by the United States Agency for International Development. It was prepared by Development Alternatives, Inc.

EL SALVADOR
USAID ASSISTANCE IN TAX POLICY AND ADMINISTRATION

I. PROJECT DATA

Level of Funding: $9 million

Period of Assistance: 1991-1995; 2002-2004

Types of Assistance:

1. Technical Assistance: (a) Resident Project Team; (b) Short-term Consultants; (c) Advisors to the Ministry of Finance and its Directorates
2. Training: Tax and customs operations, tax and economic modeling, computerized audits, and software development; including on-the-job, in-country and external classroom, degree and non-degree study abroad and study tours of operations in other countries
3. Materials and equipment: hardware and software in support of operations and administration, forecasting and policy analysis

Areas of assistance

1. Policy analysis and forecasting
2. Legal and regulatory drafting
3. Institutional development: organizational restructuring, training, technical assistance.
4. Information technology: systems design, hardware & software procurement, software development, implementation, and training
5. Constituency building, public information and education

Main Counterparts

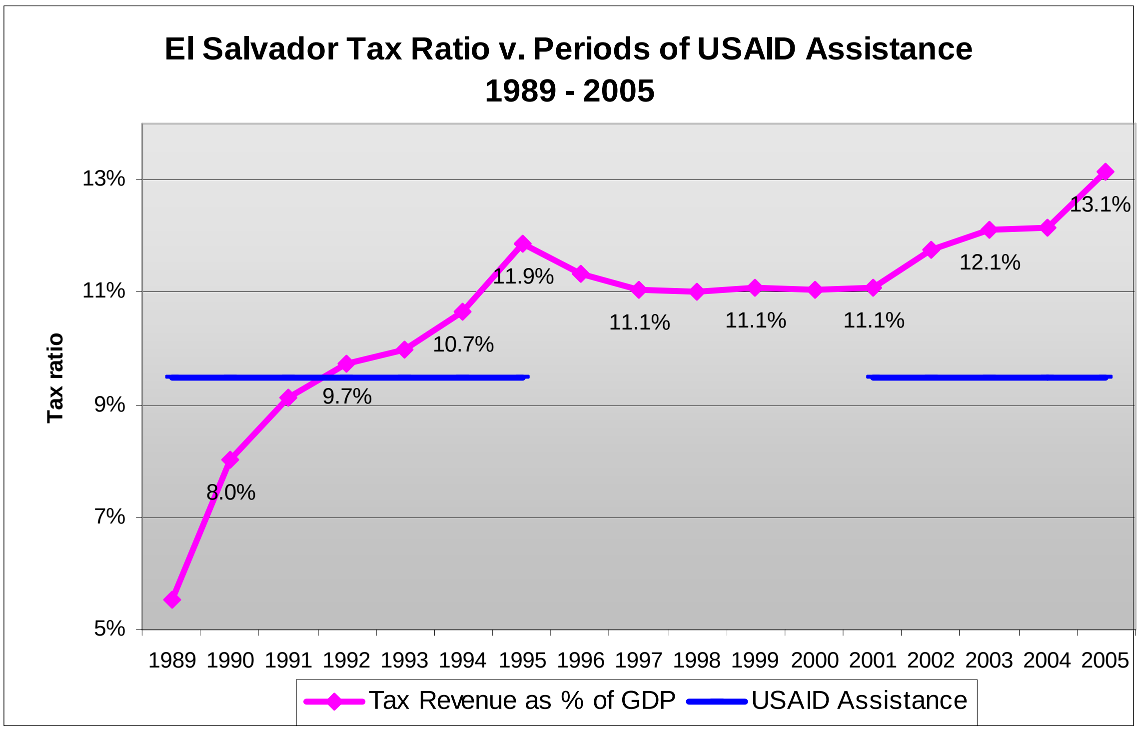
1. Internal Revenue Directorate
2. Customs Directorate
3. Treasury Directorate
4. Ministry of Finance
5. Offices of the Minister and Vice Minister of Finance

II. THE PROJECT: BACKGROUND, PRINCIPAL RESULTS AND IMPACTS

Introduction

USAID assistance in tax policy and administration began shortly after the end of El Salvador's civil war in 1989 and extended through the passage of a key package of fiscal reforms in 2004. USAID provided long-term and intermittent technical assistance through two projects over two periods: the first, the Modernization of Salvadoran Taxation (MOST) project, ran from 1991 to 1995; the second, the Tax Administration Project ran from 2002 to 2004. The first project supported the development of sweeping changes in tax and customs policy and administration; the second provided more focused assistance in audit computerization and audit capacity strengthening.

Like other lower-middle income countries in Latin America, El Salvador has had a chronically low level of tax-revenue mobilization, which strongly limits the ability of the government to finance basic public services. Thus, one broad measure of success of the tax system for such a country is the ratio of tax revenues to GDP. As shown in the following chart, El Salvador achieved a dramatic improvement in its tax-mobilization performance during the periods of USAID assistance that are covered by this review.



A. *Background*

In 1989, toward the end of the 12-year civil war and during the presidential election campaign period, USAID funded economic advisors (led by Professor Arnold Harberger) to assist the Salvadoran Foundation for Social and Economic Development (FUSADES) in the preparation of a national development plan. The National Republican Party (ARENA) embraced the FUSADES plan. In fact, when ARENA's Alfredo Cristiani won the presidency, he adopted the FUSADES plan as his own "Plan of Government."

The FUSADES plan included recommendations for various reforms to restore macroeconomic stability, prepare the country for peace, create a more private sectororiented economy, rationalize the Government's finances, and open the country to international trade. Within the context of the plan, reforms of tax and trade policy and modernization of tax and customs operations were among the highest priorities. These included eliminating export, wealth and stamp taxes, reducing income and profit tax rates, revising the import duty schedule, introducing a Value-Added Tax (VAT), and rationalizing personal and corporate income taxes.

During the first two years of Cristiani's administration, the Government's major focus was to end the country's civil war. By 1991, the war was winding down and international diplomatic efforts helped to bring the two sides in the conflict to agreement on the future of the Salvadoran polity. Then in February 1992, the Government of El Salvador and the Frente Farabundo Marti para la Liberacion National (FMLN) signed the Peace Accords in Chapultapec in Mexico City.

The country was ready to start on a new path of peace and there was an atmosphere of optimism and a readiness to embrace change. There was broad consensus on the need to reduce the role of the state in the economy, reduce protectionism and open the economy to international competition, and to deregulate the country's economic sectors. USAID's assistance in tax modernization began as this optimism was taking hold.

B. *Economic Context of the Project*

The new Government quickly recognized that some of the distortions in the economy were being created by the tax system. Import duties, for example, were a significant source of tax revenue, but were very high, protecting domestic industry from international competition and encouraging corruption and smuggling. Export taxes, especially on coffee, were another major source of government revenue, but hurt the private sector's ability to compete in international markets. An inefficient stamp tax, essentially a sales tax applied at most levels of production, caused distortions that encouraged the importation of industrial or other inputs when domestic production could have been provided more economically. Correcting these and other policies would have revenue implications that called for compensating changes in the tax system. Thus the Government saw the urgency for a comprehensive review and reform of the tax system as an integral part of the overall economic reform agenda. USAID was asked to provide technical and material assistance to design, promote, and implement these reforms.

USAID assistance was provided in a number of ways, including: technical assistance to the Ministry of Finance; funding and dissemination of research; public seminars and policy dialogue with counterparts (both within and outside of government to influence the national discussion of economic policies); support for a series of studies on public finances; training to Ministry of Finance economists and tax administration staff; major upgrades to computerization in the General Directorate of Internal Revenue (DGII); and, strengthening of audit capacity within the DGII.

One of the most important modalities was the $6 million MOST project. MOST was followed by post-MOST activities, which included the financing of two long-term resident advisors under host country contracts as well as a training program for DGII enforcement staff.

Between 1996 and 2001, USAID/El Salvador's direct assistance to the DGII ceased. During this period, there was a clear deterioration in tax administration performance. Particular weaknesses appeared to be in audit and enforcement. IT systems developed during the MOST project were under-utilized. Auditors' reports were hand-written. Audit staffing was inadequate, and existing staff lacked incentives to perform, as there were no salary distinctions between experienced staff and new hires. By 2001, tax evasion was estimated to be as high as 34%. Yet Salvadoran legislation impeded DGII efforts to combat tax evasion.

In 2001, USAID revived its tax technical assistance program through the $3 million TAP project. TAP focused on audit capacity building, largely through computerization and training. Just after the project ended in 2004, the DGII passed an important set of fiscal reforms which introduced key administrative and structural changes. TAP project staff provided substantial technical support and advocacy to promote these reforms.

C. *Outcomes and Impacts in USAID's Principal Areas of Assistance*

The USAID assistance over these periods helped to radically reform the Salvadoran tax system. Aspects of the reformed tax system include greater economic efficiency, simplicity, 'horizontal equity' for taxpayers with similar incomes, greater openness to international trade, and drastically improved revenues for the Government.

USAID assistance was instrumental in helping the Government increase tax receipts while reducing economic distortions, opening the country to international trade, reducing corruption and evasion, and improving taxpayer services. The program helped to raise the tax ratio from 9.7% of GDP in 1991 to 13.1% in 2005, while lowering income tax rates and import duties and eliminating economically distorting taxes, such as the fiscal stamp and net wealth taxes. These accomplishment were made possible by the introduction of the VAT; rationalization of the personal and corporate income taxes; targeted capacity building in audit; and strengthening of all aspects of tax and customs administration.

During the MOST project, USAID worked with the Ministry of Finance to change its approach to meeting revenue requirements, with the focus on measures to improve compliance. In promoting voluntary compliance, treatment of Salvadoran taxpayers improved: it became easier to get tax forms, register in the tax system, make tax payments, and register and pay levies such as the vehicle tax without having to pay bribes or face long delays.

USAID's second phase of assistance, the TAP project, considerably strengthened the tax administration staff, structure, and systems. Audit staff were equipped with 100 new laptops (matched by the DGII's purchase of 100 additional laptops for auditors). 180 auditors were trained to conduct computerized audits. A Computer Audit Specialist unit was created to support the new technology-based audits. A Tax Auditor Evaluation

System was created to better monitor performance of audit staff. Treasury, Customs, and DGII databases were integrated and cross-referenced against several other third-party information databases to enhance the quality of audit case selection. And, 10 DGII information technology (IT) officers were trained to manage and maintain these sophisticated new systems.

1. Overall tax structure

USAID's tax policy assistance has played a substantial role in shaping the reforms to El Salvador's tax code over the past 15 years. Two major tax laws were enacted with assistance from the MOST project team: the VAT law and the income tax law. The project helped implement changes to the import duty schedule, including reductions in the top rates. The project also assisted in designing the withholding system, and in the passage of the 1993 fiscal felonies law (and its subsequent revision in 1995).

Before the MOST project began there was little analytic capability in the Ministry of Finance. Ministry staff had little ability and few economic tools to defend their policy proposals and decisions. To address this, the MOST project developed several PC-based micro-simulation models. These included models for indirect taxes, business income taxes, personal income taxes, a Computable General Equilibrium model, a receipts forecasting model, and an expenditures model. MOST provided comprehensive training to Ministry staff, first in economic theory and practice and later in model design and application. Some time after the completion of the project, the Ministry created a Macroeconomic Advisory Group (now called the Directorate of Economic and Fiscal Policy) to maintain and use these models for ongoing policy analysis.

Between 2001 and 2004, USAID's primary focus was on tax *administration*. However, the TAP project's Chief of Party was deeply involved in helping to design and promote the key package of tax policy reforms passed in 2004. These reforms (which are now being implemented with the support of a subsequent USAID project) covered VAT, income tax, excise tax, tax amnesty, and changes to the tax and penal codes. The TAP project effectively gave the DGII the tools to justify key reforms. As a result, El Salvador passed legislation in 2004 that, for example, allows large taxpayers to withhold, to medium and small taxpayers, 1% of VAT otherwise payable to a provider of goods and services, and to deposit that amount as a credit for the provider. This is one key reform that is helping to reduce VAT credit-invoice fraud directly and income tax evasion indirectly. TAP staff persuaded the DGII to create a Tax Evasion Investigation Unit. They also helped modify bank secrecy laws to allow tax auditors access to taxpayer accounts at banks and financial institutions.

2. Information systems and process automation

When the MOST project initiated assistance in October 1991, the state of computerization and information management in the Ministry of Finance was highly centralized in its Computer Center. Only partial information from tax declarations was entered into a Mainframe-resident database, and this information was not available for analytic or accounting purposes. This made the information of limited value to the

Ministry. The MOST team helped the Ministry develop a computerization plan, including considerable decentralization to the users' level. Using "rapid application development" – a technique for bringing new programs and systems on-line rapidly, with methods for fixing problems along the way – teams of foreign advisors and highly competent and enthusiastic local programmers and systems designers revolutionized the Ministry's tax information systems.

The early advances were among the most dramatic. The switch to PCs and away from the Mainframe added flexibility and creativity. By including users in systems development, the MOST project developed systems that were capable of producing information relevant to Ministry counterparts. As a result, Ministry management supported the project with greater resource allocations. Indeed, prior to the MOST project, the Ministry spent almost nothing on computers. After MOST demonstrated the benefits that decentralized IT made possible, the Ministry began to use its own funds to purchase large numbers of computer systems.

Several years later, under the TAP project, USAID again contracted foreign advisors to develop more sophisticated software programs targeted towards improving the DGII's audit capacity. These new, advanced uses of IT vastly improved the accuracy and reliability of the DGII's audits; and in so doing, raised tax revenues for the Salvadoran government, while ensuring that taxpayer audits became more transparent and fair.

One of the first steps towards introducing this technology was to strengthen the operating platform for DGII's software and hardware. Prior to the TAP project, the central computer system lacked hardware capacity and adequate backup procedures. TAP specialists developed an open-source solution using a Linux operating system to improve performance, develop a reliable backup strategy, and increase speed and storage space. They also trained DGII programmers to use Linux and development tools like PowerBuilder, and trained system administrators to maintain and fine-tune the Linux platform and the Storage Area Network.

The TAP-supported IT solution delivered remarkable results: processing time for income tax returns fell from 4 hours under the old system to 40 minutes with the new system; the data entry process was completed 50% faster; and, available storage space increased from 3GB to 75GB.

3. VAT and Income Tax Systems and Tax Data Analysis

VAT data in El Salvador is processed through three different institutions. The Treasury processes information regarding tax return filings and payments. Customs processes taxpayer information related to imports (classification, values and VAT paid on imports) and exports (classification and VAT credits claimed). The DGII processes taxpayer master file data, tax assessments and payments or credits applied.

Before the TAP project, these data sources were not linked electronically. As a result, information transfer was slow and inefficient. For example, Treasury would receive information from banks related to payments and returns filed. Treasury would then validate the totals and transmit returns and related payment data to the DGII. The DGII would then key-in the tax return data and re-key the information received from the banks related to tax payments. A consequence of this significant and duplicative data entry effort was thousands of keystroke errors both for assessments and payments. The result was a substantial number of taxpayer current accounts that were out of balance. Similar inefficiencies occurred between Customs and the DGII.

To resolve these problems, TAP advisors developed and implemented a “Linked Database System,” integrating the databases of Treasury, Customs and the DGII. The DGII now has direct access to payments registered in the Treasury computer database. Tax auditors also have instant access to customs information and can easily download a taxpayer’s complete customs or payment history for any tax period under audit.

USAID assistance was also fundamental in designing the first systems for capturing, processing, and analyzing VAT and income tax data during the early 1990s. The MOST project designed and implemented a system for VAT and income tax data entry; a system for analyzing VAT taxpayer behavior, enabling comparison of taxpayer behavior with that of other firms in the same sector or of similar size; and a system for classifying inconsistencies in income tax declarations with prioritization by size and number of occurrences. In addition, the MOST project developed a system for better tracking income tax withholdings, linking the withholding firms to the taxpayers, and to the individual receipts. Prior to 1995, the Ministry had never been able to account for withholdings. It was just assumed that what someone declared to be withheld was actually withheld and paid to the Treasury. As technology has changed, so have many of the systems developed by the MOST project. However, many of them continue to run in parallel to the newer systems, allowing DGII staff to access historical taxpayer data.

4. <u>Payment system</u>

The MOST project developed an innovative “point-of-sale” (POS) system that continues to be used in Customs offices to handle payment of taxes, fines, fees, and interest payments. POS is commonly used in retailing in other countries, especially to check credit card validity and credit levels. Through the POS system, Customs is able to gather electronic data from each transaction, which it then reports daily to the Treasury Directorate. Prior to the POS system, the Government had never actually known how much had been collected, from whom, for what, when or in what amounts. The Government’s bank accounts had never been reconciled with payment slips, and although fraud had never been shown it was very likely that it permeated the entire receipts system. Today, accounts are reconciled daily and revenues are transmitted more easily.

5. <u>Audit and enforcement</u>

Among the most successful areas of USAID assistance was the strengthening of DGII audit capacity. This support began under the MOST project, when foreign advisors helped develop audit plans and monitoring systems, made recommendations for organizational changes in the DGII and provided training to audit staff and audit supervisors in audit, management of audit, and tax administration. USAID's support in automating audit selection and processing was fundamental to increases in tax revenues.

Automation is important for two reasons. A systems-determined tax audit plan makes case selection more efficient and accurate, while also preventing the use of tax audit as a weapon to target specific individuals. Systematizing audit planning allows for selection based upon objective criteria. A case in point: During the MOST project, a close acquaintance of the president was selected for audit. The case was taken to the Minister to ask his permission to pursue the case. When told that the case was computer-selected based on the selection criteria that had been agreed to in generating the audit plans, the Minister authorized the audit, which then proceeded.

Over time, as taxpayers increasingly introduced IT into their day-to-day operations, (e.g., registering transactions using computerized accounting and point-of-sale systems), the DGII had to keep pace. In response to new technological challenges, the TAP project undertook a number of sweeping efforts to modernize and upgrade DGII's audit capacity.

First, with TAP support, the DGII hired a number of recently-graduated IT professionals to staff a new Computer Audit Specialist (CAS) unit. TAP advisors then developed a work program to familiarize the new staff with local accounting and POS software packages, trained them to use data extraction and manipulation tools to aid computerized audits, developed a CAS manual, trained new staff in development and database tools, and provided laptops to each of the new staff. These tools helped the CAS specialists minimize the required time to perform audits and identify tax risk areas.

Second, the TAP project helped integrate several databases into the larger "Linked Database System" that substantially improved auditors' ability to identify potential audit cases and conduct comprehensive tax audits. The first of these, a third-party information database, maintained information on large taxpayers' purchases from their major suppliers. This information could be cross-referenced with the VAT reported by the supplier, and any major discrepancies would motivate an audit.

The second database kept information on Government payments to suppliers (the Government is the largest purchaser of goods and services in El Salvador). The TAP project integrated the Treasury's payment system, which contained information on payments made by the Government for goods and services to various taxpayers. This information could again be cross-referenced with the total value suppliers declared on their monthly VAT returns as well as on their annual income tax returns. Major discrepancies would again motivate an audit.

Other databases that the TAP project helped integrate were those for vehicle registration, the national lottery, and credit cards. Tax auditors can now determine the number and type of vehicle registered to the taxpayer, and the date of acquisition of the vehicle. Tax auditors can also determine whether lottery prize winners included the value of the prizes in their annual income tax returns. In addition, tax auditors can now access the total credit sales a taxpayer made for a given tax period and compare these values against the taxpayer's monthly VAT returns and annual income tax returns.

Audit capacity at the DGII was further strengthened through the provision of 21 specific audit technique manuals. The manuals covered techniques for auditing both income tax and VAT returns. They ranged from industry-specific approaches to specialized audit methodologies, such as “indirect methods” for determining income and balance sheet approach to audit. The manuals were reviewed both by experienced DGII managers and auditors, and by Salvadoran businesses and associations. Later, TAP project staff trained auditors on the use of these manuals.

Finally, the TAP project designed a computerized tax auditor evaluation system to measure the quality of audit staff performance and their use of these new audit tools. Prior to this, an auditor’s performance had been measured based on a supervisor’s subjective evaluation and relied on production statistics, like the value of additional taxes assessed per tax audit. The new evaluation system provided a professional approach to tax auditor evaluation by using quality indicators—like how effectively a tax auditor applies accepted auditing standards—and relies only slightly on indicators like returns to audit. Training was provided to all 175 tax auditors, tax audit supervisors, and branch chiefs, and it was agreed that evaluations would occur every six months.

6. Transfer Pricing Analysis

USAID-financed studies prior to the TAP project indicated that a potential and significant revenue drain was occurring through abusive transfer pricing practices. Transfer pricing is the accounting practice by which taxpayers transfer sales, costs and expenses reporting between related companies in different countries to minimize their total tax bill. To further explore the pros and cons of pursuing transfer pricing abuses, the TAP project conducted an extensive analysis within selected economic sectors. The report’s conclusion was that transfer pricing manipulation was a serious problem in El Salvador. The total tax impact was estimated to be approximately $300 million in uncollected income taxes.

Ultimately, the Minister of Finance decided not to pursue legislative reforms that would prohibit these abuses. His concern was that without concurrent reform by neighboring countries, El Salvador would risk losing businesses to other tax jurisdictions. A compromise was struck in 2004, when the Government passed a tax reform that allowed DGII auditors to review and adjust prices which are excessive compared to market prices.

6. Customs Operations

During the early 1990s, the MOST project made significant efforts to improve customs operations. These included the drafting of a variety of laws and regulations, including organizational regulations, national regulation for the Central American Common Customs Code, and the passenger baggage law. The project provided training in classification and valuation. The project also provided technical assistance to familiarize Government counterparts with modernization efforts in Mexico and how these experiences might be applied in El Salvador. Other technical assistance assisted in the design of procedural changes, which helped increase Customs’ administrative efficiency, reduced processing time from days to under an hour, and reduced corruption. The project provided assistance in the development of databases to help in the selection of undervalued goods, and also assisted in the design and implementation of a special system for handling the importation of vehicles, reducing discretion and cheating.

MOST advisors also helped developed and implement a vehicle import duty system that reduced the time necessary for vehicle entry, reduced customs officials' discretion, and ensured a more appropriate valuation of imported vehicles, especially used vehicles. This system was particularly useful because vehicle imports generated approximately 30% of all import duties in El Salvador.

III. FACTORS OF SUCCESS

The following factors were critical to USAID's success in tax assistance in El Salvador:

1. Political capital and commitment. By concluding the long and bloody civil war, President Cristiani was able to amass considerable political capital. His commitment to broad economic reform was matched by the credibility he had within Salvadoran society. His very public commitment to the tax reform made it clear that it was the Government's reform, and that full cooperation from the tax and customs bureaucracy was expected. The MOST project benefited greatly from this political leadership. During the second phase of USAID assistance, the TAP project received critical support from the Ministry of Finance. The Ministry leadership was highly motivated, and the subordinate managers and staff clearly keyed off this high-level support.

2. Participation and public information. During the MOST project, USAID efforts to bring many sectors of Salvadoran society into the policy dialogue and debate process helped reduce political obstacles to reform. USAID supported the development and implementation of a highly sophisticated and well-targeted public information campaign, based on radio, television and newspaper delivery, which was essential to selling some of the key tax reforms, especially the VAT. In addition, the MOST Project, using the computer models it had created, was able to generate revenue and socio-economic impact scenarios that helped the Government explain the tax reform program and illustrate its impacts to the National Assembly (the legislative branch).

3. Committed counterparts at all levels. During the MOST project, USAID staff worked closely with key counterparts in the Ministry of Finance to develop conditionality for budget support to the Government. The rapport established in working out measures of mutual concern with regard to the implementation of policy and administrative reform went far in winning the counterparts' confidence in and support for the tax reforms. In fact, when a new DGII Director was named, one of his first calls was to the MOST project manager to seek assurance of the continuation of USAID support. During the TAP project, the full participation of counterpart staff in all aspects of project development and implementation were central to the project's success. The project enjoyed close and immediate access to counterparts. DGII staff were fully available for training. And, the project was granted access to all needed information.

4. Comprehensive approach to tax and customs policy and administration. Any tax reform entails winners and losers. By taking a comprehensive approach to tax reform, covering taxes on personal and corporate income, substituting the VAT for stamp and other indirect taxes, and reforming import duties, all while making great effort to improve tax and customs administration, systems and enforcement, most of those who lost inadvertently in one respect would gain in others. In this way, opposition to tax reform during the MOST project was diffused and overcome.

5. The country was ready to embrace change. The MOST project began just as the country was shifting its focus from civil war to economic recovery, and counterparts at all levels within the Ministry of Finance were anxious to learn new ways of doing their work. Meanwhile, TAP's launch followed several years of weak or declining revenue growth. The Government was, therefore, ready and eager to improve audit and enforcement and restore tax revenues to finance needed public expenditures.

6. Observational travel. USAID's Economic Advisor led a group of key counterparts from the Ministry of Finance on a study tour to Mexico City and Veracruz to observe Mexican customs operations. The Mexico trip helped build consensus within the Ministry on the need for customs reform. Following the Mexico visit, USAID's Economic Advisor hosted a breakfast meeting where the participants debated the pros and cons of the Mexico system and reached consensus on the modernization steps to be taken in El Salvador.

7. Highly skilled local staff. During the TAP project, the availability of highly qualified in-country teams of systems designers and programmers helped ensure successful IT implementation. These experts could communicate most effectively with DGII counterparts, and provided ample local expertise to draw upon once the project ended.