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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

EL SALVADOR

TAX ADMINISTRATION STRENGTHENING PROGRAM

(ES-L1131)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Carola Pessino (IFD/FMM), Project Team Leader; Martín Ardanaz (FMM/CNI), Alternate Project Team Leader; Gustavo García, Edna Armendáriz, and Huáscar Eguino (IFD/FMM); Mario Cuevas (CID/CES); Sandra Corcuera (INT/TIN); Carlos Scartascini (RES/RES); Marco Andrés Aleman (FMP/CES); Ernesto Patricio Crausaz (FMP/CES); María Sofía Greco (LEG/SGO); María del Pilar Jiménez de Arechaga (LEG/SGO); Joaquín Zentner, Ida Fernández, and María Lorena Kevish (IFD/FMM).

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ELECTRONIC LINKS

REQUIRED

1. Multiyear execution plan
2. Annual work plan
3. Monitoring and evaluation plan
4. Procurement plan

OPTIONAL

1. Economic analysis
2. Itemized budget
3. Institutional Capacity Assessment System (ICAS) report
4. Expanded Results Matrix

ABBREVIATIONS

BCR	Central Reserve Bank of El Salvador
CAPTAC	Central America—Panama—Dominican Republic Regional Technical Assistance Center
CCR	Corte de Cuentas de la República [Court of Accounts]
DGA	Dirección General de Aduanas [General Customs Administration]
DGII	Dirección General de Impuestos Internos [Internal Revenue Department]
DGT	Dirección General de Tesorería [Department of the Treasury]
ICB	International competitive bidding
FAD	Fiscal Affairs Department
FGR	Fiscalía General de la República [Office of the Attorney General]
LACAP	Public Procurement Law
OECD	Organization for Economic Cooperation and Development
PCU	Program coordination unit
QCBS	Quality- and cost-based selection
RUC	Registro Único de Contribuyentes [Taxpayer Master File]
SAFI	Sistema de Administración Financiera Integrado [Integrated Financial Administration System]
SIIT	Sistema Integrado de Información Tributaria [Integrated Tax Information System]
USAID	United States Agency for International Development
VAT	Value-added tax
VMI	Deputy Ministry of Revenue

PROJECT SUMMARY
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Financial Terms and Conditions				
Borrower: Republic of El Salvador			**Flexible Financing Facility**[a]	
			Amortization period:	25 years
Executing agency: Ministry of Finance, through the Deputy Ministry of Revenue			**Original WAL:**	15.25 years
			Disbursement period:	5 years
			Grace period:	5.5 years
Source		**Amount (US$)**	**Inspection and supervision fee:**	[b]
IDB Ordinary Capital:[c]		30,000,000	**Interest rate:**	LIBOR-based
			Credit fee:	[b]
Total:		30,000,000	**Approval currency:**	U.S. dollars from the Bank's Ordinary Capital

Project at a Glance
Program objective and description: The objective of this operation is to improve tax revenue intake by: (i) reducing noncompliance with taxes managed by the Internal Revenue Department (DGII); (ii) reducing noncompliance with customs duties managed by the General Customs Administration (DGA); and (iii) improving the quality of information for decision-making purposes.
Special contractual conditions precedent to the first disbursement of loan proceeds: The executing agency will present evidence, to the Bank's satisfaction, of fulfillment of the following conditions: (i) appointment of a general coordinator and creation of a program coordination unit (PCU) to support implementation of the program in accordance with the profiles and terms of reference agreed upon with the Bank; and (ii) approval and entry into force of the program Operating Manual as previously agreed upon with the Bank, with a detailed description of the execution mechanism, procedures, coordination mechanisms, process flows, roles and responsibilities, and actions to be implemented for program execution (paragraph 3.6).
Exceptions to Bank policy: None

Strategic Alignment			
Challenges:[d]	SI ☐	PI ☐	EI ☐
Crosscutting themes:[e]	GD ☐	CC ☐	IC ☑

[a] Under the terms of the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

[b] The credit fee and the inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable policies.

[c] In accordance with document AB-2990, disbursement of the loan proceeds will be subject to the following maximum limits: (i) up to 15% in the first 12 months; (ii) up to 30% in the first 24 months; and (iii) up to 50% in the first 36 months, in all cases as of the date of loan approval by the Bank's Board of Executive Directors (paragraph 2.2).

[d] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[e] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1.1 El Salvador's fiscal situation weakened following the 2008 global crisis, which also brought about a slowdown in economic growth. This led the government to implement an expansionary fiscal policy by increasing current expenditure by approximately 3% of GDP from 2008 to 2009. While steps were taken to reduce the fiscal deficit from 5.7% of GDP in 2009 to 3.3% of GDP in 2015, a 4% deficit is projected for 2016, meaning that the debt will reach 62% of GDP by year-end 2016.[1]

1.2 The country's economic performance is not enough to close the fiscal gap. In the years following the 2008 crisis, the economy lost momentum, posting growth rates of 1.3% to 2.4% in the 2010-2015 period.[2] Future expectations are also less than auspicious, as the economy is projected to grow at an average annual rate of 2% over the next five years (International Monetary Fund, 2016).[3] The public finance imbalance limits fiscal space for investing in social expenditure and infrastructure.[4]

1.3 In recent years, the government launched tax policy reforms aimed at increasing the revenue intake, which from 2009 to 2015 went from 13.5% to 15.2% of GDP (Source: BCR). However, these reforms were insufficient to cover the rise in public spending, which in 2015 amounted to 23.2% of GDP. The tax reforms focused on: (i) increasing income tax rates and certain other tax rates and bases;[5] and (ii) creating new taxes.[6]

1.4 Despite these advances, El Salvador has one of the lowest tax effort levels in the region, at just 48%, compared with an average of 58% for Latin America.[7] Revenue relies on two taxes: income tax and value-added tax (VAT), which in 2015 accounted for a combined 85.5% of tax collection.

1.5 The factors leading to the country's low tax effort are classified into two groups: (i) tax policy factors, related to low rate and/or high exemption levels; and (ii) collection

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1 The nonfinancial public sector's expenditure and deficit include deficit spending on pensions (Source: Ministry of Finance).

2 While the economy grew at an average rate of 3.8% in the years prior to the crisis, it has grown at the following rates since the crisis: 1.3% (2010), 2.1% (2011), 1.8% (2012), 1.8% (2013), 1.9% (2014), and 2.4% (2015). (Source: BCR).

3 Capital expenditures have not been given priority over the demands and inflexibility of current expenditures, limiting this line of action.

4 The 2014-2019 Five-year Development Plan is based on three broad priorities: (i) sustained economic growth; (ii) inclusive and socially equitable education; and (iii) effective citizen security. To this end, as set forth in the Five-year Development Plan, the government must have a fiscal policy in place that enables it to obtain the resources needed to strengthen economic productivity and competitiveness, expand the delivery and quality of basic public services with a view to enhancing public welfare, and provide a reliable environment (Ministry of Finance, 2015–2025 Medium-term Fiscal Framework, 2015).

5 The most significant was an increase in the income tax rate for the highest income bracket from 25% to 30% and an increase in the tax exemption threshold (Decree Law 957 of 2011. Source: Ministry of Finance).

6 Newly created taxes included a tax on financial transactions (Decree Law 764 of 2014).

7 El Salvador's tax effort was compared with that of other countries using the methodology described in Pessino and Fenochietto (2013). The estimated tax effort is a measure of how close or far a country is from achieving its maximum collection potential (compared with other countries with similar characteristics).

effectiveness and efficiency factors, related to the level of noncompliance.[8] If El Salvador's tax effort were brought in line with the average for Latin America, collection could be increased by approximately 3.4% of GDP.[9] Tax policy would take care of approximately half of this potential, while the other half—1.7% of GDP—would be generated by reducing noncompliance to the average level for Latin America, by improving tax[10] and customs[11] administration. The responsibilities for managing the internal revenue and customs processes are primarily divided between the Internal Revenue Department (DGII), the General Customs Administration (DGA), and the Department of the Treasury (DGT). The DGII and DGA operate under the aegis of the Deputy Ministry of Revenue (VMI), while the DGT reports to the Ministry of Finance.

1.6 To strengthen tax administration, the Government of El Salvador is promoting reforms to the Tax Code, the Penal Code, and other legal provisions, as well as an alignment of these laws with international standards.[12] This is needed to reduce evasion and will require significant investment to be successfully implemented. While efforts have been made in recent years to fight evasion by improving the management instruments,[13] there is still room for improving tax administration, which to date is the primary source of the new resources required by the country to strengthen public finance.[14]

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8 Tax noncompliance is essentially comprised of three factors: (i) evasion; (ii) avoidance; and (iii) default. Studies estimate the gap between what should be collected under the law and what is actually collected, and they therefore include all three factors. These studies typically use the term evasion to refer to this gap, without identifying the reason for noncompliance due to the difficulty of making this estimate. Accordingly, the emphasis in this program will be on reducing overall noncompliance.

9 In El Salvador, administration costs are only 0.4% of revenue, while in countries in which tax administration is under development, the ratio is 1.5% to 2% (FAD, Key Considerations for Strengthening Tax and Customs Administration, 2014).

10 Estimated on the basis of the 2015-2025 Medium-term Fiscal Framework, Ministry of Finance (2015). The VAT rate (13%) is lower than the average for Latin America and the Caribbean (15.5%). The property tax rate is also lower. While personal income tax rates are similar to those of Latin America and the Caribbean, the corporate income tax rate (35%) is higher than the average for Latin America (27.6%) and, as an indicator of exemptions, tax spending is comparatively low (2.9% of GDP) (Ministry of Finance, 2015). VAT evasion is also high: at 33.1%, it exceeds the average for Latin America and the Caribbean, which is 26.4% (DGII, 2012). Income tax evasion is high, ranging from 45% to 50% according to unofficial estimates (Fretes Cibils et al., 2013).

11 Studies on customs fraud indicate that it amounts to US$697 million, equivalent to 2.8% of El Salvador's GDP (Konrad Adenauer Foundation, 2015).

12 The proposed legal provisions include: (i) valuation methods to determine transfer prices according to the Organization for Economic Cooperation and Development (OECD); (ii) classification of evasion as a criminal offense, making it punishable by imprisonment; and (iii) creation of a collections office within the Deputy Ministry of Revenue (VMI), transferring administrative collection powers from the Department of the Treasury (DGT) and enforced collection powers from the Office of the Attorney General (FGR). To date, only provision (i) has been approved. Standards include those set forth in the World Customs Organization's Framework of Standards to Secure and Facilitate Global Trade (SAFE), signed by the General Customs Administration (DGA), and in the World Trade Organization's Trade Facilitation Agreement, ratified in 2016.

13 Information Technology for Tax Administration, USAID (2013).

14 A new fiscal agreement under discussion since July 2016 would involve raising the current tax rates and introducing new taxes.

1.7 This program is framed in the context of the Bank's support for the tax and customs administrations in the region.[15] In particular, the Northern Triangle countries (Guatemala, Honduras, and El Salvador) seek to expand the customs union, with support from the Bank and other multilateral organizations, in the framework of the Alliance for Prosperity Plan in the Northern Triangle.[16]

1.8 **The problem and its causes.** The core problem is insufficient tax revenue in El Salvador (15.2% of GDP) as compared with Latin America (19.4%). This is partly due to shortcomings in the actions of the tax and customs administrations. At present, the country's tax administration exhibits a series of weaknesses in managing both internal and customs revenue.[17] Specifically, the following problems are observed: (i) weaknesses in operational processes at the DGII; (ii) deficiencies in customs revenue control and trade facilitation processes at the DGA; and (iii) inadequate strategic management of human resources and information at the VMI. The weaknesses associated with these specific problems are presented below.

1.9 First, the principal causes associated with the problem of ineffective tax management processes are:

a. **Registration.** The Taxpayer Master File (RUC) does not have the updated and consistent basic information needed to properly manage the taxpayer base. Partly as a result of this, the Salvadoran tax system's tax base falls well below international standards. Of a total of 5.6 million taxpayers registered in the RUC, only 1.3 million—a mere 23%—are active (FAD, 2014, p.19; IDB, Tax administration diagnostic update, 2016). Moreover, only 485,740 taxpayers filed income tax returns. A basic problem hindering an effective and continuous cleanup of the RUC is the system's weakness in managing third-party information by cross-checking data,[18] due to the scarcity of agreements, protocols, and common standards with providers of non-tax data.[19]

b. **Tax returns.** The procedures for managing taxpayers' current accounts are deficient and outdated. There are delays of up to four months in processing

[15] The Bank is implementing a tax and customs strengthening program in Honduras (3541/BL-HO) and has a program in the pipeline with Guatemala (GU-L1162) that could facilitate a trade and customs union in the region.

[16] The agreement between Guatemala and Honduras to create a customs union was signed in 2015 and became effective in May 2016. El Salvador is expected to join the customs union once Honduras and Guatemala complete the process. To this end, strengthening the tax and customs administrations is essential.

[17] These weaknesses translate into high tax compliance costs. According to the 2015 Doing Business Report (World Bank), El Salvador is ranked 162nd out of 189 countries on the "ease of paying taxes" indicator. Other country rankings include: Guatemala (50th), Costa Rica (80th), Honduras (155th), and Nicaragua (165th).

[18] The DGII reports specific cross-checks with nine sources of information, including real estate, automobiles, aircraft, watercraft, State suppliers, DGA data, bank data, and social security data. However, most of these cross-checks are ad hoc and there is no interface between the various databases and agencies that would allow continuous updating and cleanup of the databases. In 2015, these cross-checks made it possible to collect an additional US$1,867,000, and this figure could be significantly increased with updated databases and a permanent interface (IDB, 2016).

[19] The DGII reports that it should cross-check data, including financial information, with at least eight additional agencies.

returns, and RUC data and details of taxpayer debts and payments[20] are manually assembled. As a result, these delays make it impossible to know the tax status of taxpayers in real time (IDB, 2016).

c. **Invoicing.** It is difficult to control invoicing as there is no limit on the number of invoices authorized as a function of a taxpayer's risk. The authorized invoices do not have an expiration date and may be used indefinitely, creating nonexistent tax credits (FAD, 2014, p.21; IDB, 2016). The use of paper invoices limits the tax administration's effectiveness in the fight against evasion, since it results in deficient information for decision-making purposes. Electronic invoicing, which could largely do away with these shortcomings, is still in the early stages of development.[21]

d. **Auditing.** The auditing capacity of the DGII is inadequate. There is limited comprehensive audit coverage, leading taxpayers to perceive the likelihood of being audited as low. Comprehensive and verification audits (8,546) covered an average of 0.66% of the active taxpayer universe. In 2015, there were a total of 47,665 large compliance verification audits (through data cross-checking), covering 3.7% of active taxpayers and 9.8% of the 485,740 taxpayers that had filed returns. In 2015, only 126 comprehensive audits were performed on a total of 816 large taxpayers (15%). While settlements resulting from comprehensive audits have increased from US$97 million in 2013 to US$137 million in 2015, they continue to be very low as a percentage of total tax revenue: a mere 0.86% in 2014, compared with 3.5% in Costa Rica, 2.4% in Honduras, and slightly more than 1% in Panama. Countries outside of Central America report much higher audit settlement amounts (France, 4.9%; Spain, 6.5%, United Kingdom, 4.4%; Chile, 4%) (CAPTAC, Assessment of Tax Administrations' Maturity Level for Central America, 2016, Part II).

e. **Collection.** The organizational structure of the VMI is inadequate for effective control over the collection of tax obligations. Collection is fragmented, being performed by different agencies, precluding the possibility of control over the full revenue collection cycle. Collection at the administrative stage, performed by the DGT, shows an average debt recovery rate of 31% for the 2012-2015 period. Enforced collection, performed by the FGR, shows an average expected recovery rate of only 2.9% for the same period (IDB, 2016).

1.10 Second, the principal causes associated with the weakness of customs management processes are:

a. **Ex ante controls.** Ex ante controls are the controls that the customs administration can exercise before the cargo arrives, based on advance

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[20] Six modules are used to integrate current account data. These modules include the Integrated Tax Information System (SIIT); the Case Study Management System; and the online services portal.

[21] Electronic invoicing does not exist in El Salvador, but it does in Guatemala, and efforts are under way to implement it in Honduras. In Latin America and the Caribbean, the leaders in implementing electronic billing are Chile, Brazil, and Mexico. Brazil introduced e-invoicing as a voluntary system in 2007, but it became obligatory in 2011. In addition, Brazil is the only country with online electronic invoicing. Mexico made electronic invoicing obligatory for large companies, as did Chile, in 2014. However, these systems are not online as in the case of Brazil. In Chile, the mandatory nature of the e-invoicing system resulted in an increase in revenue intake of close to US$600 million per year due to a drop in evasion through false invoices (Edicom, 2014).

electronic information, which in the case of El Salvador is of deficient quality. While all air and ocean cargo manifests are now transmitted electronically, the associated transportation documents do not provide enough information for performing an effective risk analysis (FAD 2014, p. 40). With regard to ground transportation, implementation of a requirement to deliver the cargo manifest information electronically and in advance is pending implementation.

b. **Controls during clearance.** There are weaknesses in the controls deployed during clearance once the goods arrive and the declarations are presented. The selectivity of goods inspection channels in import transactions is ineffective. The green channel is selected in 77% of cases, the yellow channel in 17% of cases, and the red channel in 6% of cases. The confirmation percentage of findings generated through selectivity is not optimal, and revenue intake from selectivity accounts for only 0.5% of the DGA's total revenue intake, indicating that case selection is inadequate. In addition, the average clearance time through the red channel is more than 30 hours. Changes are made from the red to the green channel on a discretionary basis without any established protocols. This is not a good practice as it can lead to corruption (FAD 2014, p. 35). Another weakness is poor communication between the systems used by the DGA, which currently uses the automated customs system SIDUNEA++ and has been planning to migrate to SIDUNEA World since 2010, and the systems used by other control agencies, particularly the DGII. There are also problems in terms of integration with the Import and Export Processing Center, which is responsible for issuing certifications (customs clearance requirements). In addition, use of the electronic tax payment option is low (in 2015 it accounted for 62% of the total, the remainder consisting of cash payments at DGT windows) (IDB, 2016), and border crossings lack the adequate infrastructure for physical inspection of goods.[22]

c. **Ex post controls.** While the DGA has made significant strides in facilitating trade,[23] the use of risk analysis in compliance control has not been sufficiently emphasized. Ex post audits are a key to strengthening the customs processes, but regulatory, operational, and technological deficiencies prevent the risk of an audit from being perceived by operators as a significant deterrent. On average, only 20 yearly audits are conducted jointly with the DGII, resulting in an average assessment of US$2.6 million (FAD, 2014; IDB, 2016). In 2015, 963 large ex post audits were completed, and US$5.17 million was recovered, representing 0.4% of total customs revenue.

[22] Building improvements are being considered to reduce bottlenecks of trucks at the border and conduct clearance procedures at transit customs stations.

[23] El Salvador is ranked 46th out of 189 countries, while Honduras is ranked 136th and Guatemala 78th. El Salvador is the highest-ranked country in Latin America and the Caribbean (World Bank, Trading Across Borders Ranking in the Doing Business Report, 2016).

1.11 Third, with regard to the crosscutting institutional weaknesses in tax processes related to tax information management systems and the VMI's strategic and human resources management, the following determining factors stand out:

a. **Technological infrastructure.** The VMI's technological infrastructure is ineffective and unreliable,[24] owing to the fact that the hardware and software[25] are not maintained and have limited capacity for expansion, and there is no connection redundancy. The data center at the Ministry of Finance headquarters is approaching its capacity limits, and physical conditions are far from ideal. Data security is insufficient, revealing a considerable gap in alignment with international standards. There is no backup infrastructure in the event of damage to the DGII and DGA computer centers. VMI laptops have no security or encryption. Lastly, data exchange with other agencies is performed through physical means (IDB, 2016).

b. **Online transaction services.** Electronic filing of returns is still unreliable.[26] In 2015, in-person filing[27] (primarily through a preprinted form or an electronic return on a diskette or USB memory card) accounted for 60.6% of income tax returns and 75.2% of VAT returns, while electronic filing made up only 39.4% of income tax returns and 24.8% of VAT returns, averaging 28.5% for both types of tax. In comparison to previous years, there was an increase in electronic filing: income tax returns filed online accounted for 30% of total income tax returns in 2013 and for 35% in 2014 (FAD, 2014, p. 23; IDB, 2016). However, El Salvador continues to lag very far behind. In 2014, the average proportion of electronic filings in six Central American countries (not including El Salvador) was 89.9%.[28] The payment process takes place through banks and at Ministry of Finance windows, but primarily at the DGT. In most countries, these payments are handled by the tax administration and the DGT equivalent is only responsible for bank reconciliation of the funds received and transferred to the treasury account. These service inefficiencies translate into high compliance costs for taxpayers.[29]

c. **Human resources.** The VMI does not have adequate strategic planning. In the human resources area, based on an index developed by CAPTAC, El Salvador trails the average for seven countries in the region, including

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24 The information technology area of the DGII had 14 reported service drops in the month of June (IDB, 2016).

25 Of the DGII's 1,154 computers, 41.6% still run under Microsoft Windows XP and cannot be updated to more modern operating systems because they lack the necessary hardware (IDB, 2016).

26 See online services.

27 The DGII has various procedures in place for filing returns: (i) in person at authorized bank institutions, DGT collection offices, or DGII express centers; or (ii) online. In turn, returns may be delivered in different ways, which include: (i) preprinted forms; and (ii) base module of the DET system, which provides for delivery of the file on a USB memory card. Banks have encountered difficulties in reading USB memory cards, which then have to be manually captured. This can create several months of delay in obtaining the information and lead to transcription errors.

28 (CAPTAC, 2016).

29 Several indicators suggest that the Salvadoran tax system is rather complex. These include the "ease of paying taxes" indicator, which combines information on the number of taxes that a medium-sized business is required to pay in a given year (in El Salvador that number is 53) and on the associated administrative burden (in El Salvador it is 312 hours per year). See Doing Business for 2015 (World Bank).

Costa Rica, Honduras, Nicaragua, El Salvador, Guatemala, the Dominican Republic, and Panama. This index (in which El Salvador scores 1.42, compared with an average of 2.40 for the above-listed countries) assesses factors such as recruitment policy, staff training strategy and resource allocation, incentives associated with wage policy, and others (CAPTAC 2016). Its staff has limited training in effective tax administration. Until 2010 there was not even an internal training unit (one of only a few Latin American and Caribbean countries in that situation). Approximately one hour of training is provided per person per year (including DGII, DGA, and DGT), which is insufficient (IDB, 2016), and its personnel are subject to the same labor regulations as other public officials, with staff evaluation systems that assign high scores to most and thus fail to reward merit.[30] In addition, there is no administrative career track aligned with performance evaluations within the DGII (State of Tax Administrations in Latin America 2006-2010, IDB, CAPTAC, Inter-American Center of Tax Administrations (CIAT), 2013, p.114).

d. **Knowledge of the sector.** There is no research and development strategy in place in the form of tax studies aimed at combatting evasion and contraband and improving tax administration efficiency. For example, while the DGII did conduct a study on VAT evasion from 2000 to 2010,[31] there have been no updates. The DGII's tax studies unit devotes two thirds of its time to answering operational questions from the public and private sectors on special tax regimes, rather than to producing statistics and studies to diagnose problems and provide guidelines to strengthen the tax administration.

1.12 In view of the weaknesses in managing the tax and customs administrations, the Government of El Salvador requested the Bank's support in designing a program aimed at strengthening these management capacities in order to improve revenue intake. In addition, this program has been coordinated with the United States Agency for International Development (USAID), which has performed diagnostic assessments of the tax administration and is currently developing software to improve the administration's audit processes.

1.13 **Experience, lessons learned, and international evidence.** This program is in line with the Bank's support for tax and customs administrations in the region. In particular, the Bank's recent experience with tax administration reform in Jamaica (2658/OC-JA), Ecuador (3325/OC-EC), Honduras (3541/BL-HO), and Peru (3214/OC-PE), as well as its present experience in Guatemala (GU-L1096), has been taken into account for the proposed operation. The Bank's experience underscores the importance of improving the information, tax processes and systems, and quality of human resources to achieve a more effective tax administration. These three elements have been strengthened in a number of recent technical cooperation operations in the region, including reform initiatives in Brazil, Chile, Mexico, and Uruguay (IDB-CAPTAC-CIAT, 2013). With the objective of improving levels of voluntary compliance, one area that has been strengthened was the incorporation of technology in taxpayer services, such as online filing of tax

[30] 71.9% of the DGII, DGA, and DGT staff is evaluated as excellent, with a score of more than 90%; 27.5% of the staff is evaluated as very good (scoring between 75% and 90%); and only 0.5% of the staff has a score of good or lower (IDB, 2016).

[31] DGII, Estimate of VAT Evasion in El Salvador, Tax Studies Unit, 2012.

statements, which has been on the rise in several countries in Latin America and the Caribbean, including Argentina, Chile, Ecuador, Mexico, and Peru, as well as in Brazil, where e-filing is practically the only method of payment (USAID, 2013). Meanwhile, e-billing is obligatory and increasingly widespread in Brazil, Chile, and Mexico, the countries that have taken the lead in this area in Latin America and the Caribbean. The proposed program has also incorporated the lessons learned from the Bank's support in the customs area, including good practices with Central American countries, particularly with regard to improving the efficiency of border management and associated information technology systems.[32] The program benefited from lessons learned from Ecuador in a similar operation carried out in 1998-2004 and evaluated by the Office of Evaluation and Oversight in 2006.[33] The impact produced by the Ecuadorian operation generated an average annual increase in tax revenue (1998-2006) of approximately 7% per increment of 100,000 active RUC-listed taxpayers. The Bank has supported various institutional tax administration reforms in El Salvador in recent years. The 2010 Fiscal Strengthening Program (2296/OC-ES) supported tax and customs strengthening actions, creating the VMI to coordinate the various areas that will be strengthened through the proposed program. The Comprehensive Fiscal Sustainability and Climate Change Adaptation Program for El Salvador (2710/OC-ES) also included measures to institutionally strengthen the VMI, such as creating the Large Taxpayer Unit. In addition, the Bank has used technical cooperation resources to support strengthening tax and customs management.[34]

1.14 International evidence (based on experimental assessments and comparative analysis of tax administrations in developing countries) indicates that in order to perform its revenue collection role and provide the best possible service to taxpayers, the tax administration should comprehensively strengthen various aspects of its organizational structure and processes, including: (i) improve access and quality of the information available: the greater the tax administration's capacity to obtain complete, updated, and automated records (e.g., through third-party information), the fewer tend to be the taxpayers' opportunities to evade taxes;[35] (ii) implement auditing models that rely on intensive use of quality information;[36] (iii) develop an integrated information system that feeds all tax administration processes;[37] (iv) simplify procedures to make it easier for taxpayers to comply with their tax obligations;[38] and (v) identify strategies to ensure that human resources are

[32] 3484/BL-NI, 3488/OC-CR, 2094/OC-GU, and 2467/BL-HO in execution; and GU-L1086 and PN-1107 in the design process.

[33] Modernization of the Ecuadorian Tax Administration.

[34] ATN/OC-10137-RG; ATN/MR-13902-RG; ATN/FG-13371-RG; ATN/MR-13844-RG; ATN/FU-12988-ES.

[35] The return on having access to third-party information on tax compliance is high: evasion rates are up to eight times higher on taxes for which the tax administration lacks automated instruments to verify taxpayer sources of income (Slemrod et al., 2015; Pomeranz, 2015; Kleven et al., 2015; 2011; Carillo et al., 2014).

[36] Castro and Scartascini, 2015; Pomeranz et al., 2014; Fellner et al., 2013; Blumenthal et al., 2001. Using experimental data from the United States, DeBacker et al. (2015) found that audits increase voluntary tax compliance, and consequently revenue, by 14%.

[37] CAPTAC, 2016.

[38] Simplifying procedures can lead to increases in payment rates of up to 4 percentage points (Hallsworth et al., 2014).

qualified and motivated.[39] In short, strengthening tax administration requires: (i) the capacity to analyze information and focus on the most important compliance risks; and (ii) improvements to the basic tax processes.[40]

1.15 **Strategic alignment.** This operation helps to strengthen public finance, a priority area in the Bank's country strategy with El Salvador for the period 2015-2019 (document GN-2828) and in the government's policy planning instruments.[41, 42] The program also supports the objective of promoting/facilitating Mesoamerican regional integration included in the Bank's country strategy with El Salvador. The program is consistent with the 2010-2020 Update to the Institutional Strategy (document AB-3008) and is strategically aligned with the crosscutting area of institutional capacity and rule of law inasmuch as it will strengthen the tax administration and improve DGII, DGA, and DGT processes. Additionally, the program is aligned with and contributes to the Corporate Results Framework for the period 2016-2019 (document GN-2727-6) through the outcome indicator "percent of GDP collected in taxes," by increasing GDP by 1% by improving tax compliance, and through the output indicator "government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery," by strengthening the taxation and customs systems of the agencies targeted in El Salvador. The program is aligned with the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2) with regard to revenue mobilization capacities. It is consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-3) with regard to improving revenue collection, and with the Integration and Trade Sector Framework Document (document GN-2715-6) with regard to improvements in customs operations.

1.16 This operation is aligned with the institutional strengthening line of the Alliance for Prosperity Plan in the Northern Triangle by promoting improvement in the State's financial capacity.

B. Objectives, components, and cost

1.17 **Objective.** The objective of this operation is to improve tax revenue intake by: (i) reducing noncompliance with taxes managed by the DGII; (ii) reducing noncompliance with customs duties managed by the DGA; and (iii) improving the quality of information for decision-making purposes.[43] The primary beneficiaries will be: (i) the Government of El Salvador, which will have more resources available to

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[39] Incentive systems for key tax administration staff to generate additional revenue, like those envisaged for this program, yielded return rates ranging from 35% to 51% (Khan et al., 2016; Khan et al., 2001).

[40] For analysis of the international experience in terms of the impact of tax administration strengthening measures on revenue intake in developing countries, see Keen et al., 2015, and IMF (2011): Revenue mobilization in developing countries.

[41] See footnote 5 on what the 2014-2019 Five-year Development Plan underscores regarding fiscal policy, along similar lines to what is indicated by the 2015-2025 Medium-term Fiscal Framework.

[42] The country strategy also alludes to achieving greater efficiency and equity in public spending. Complementary interventions (ATN/FI-15360-ES and ATN/AA-15681-RG) to enhance fiscal transparency and public spending equity and efficiency are currently being carried out.

[43] This will also lead to improved taxpayer services, increasing voluntary tax compliance. Implementation of these administrative measures is expected to result in substantial increases in revenue intake without altering the current tax rate structure or levels.

implement its public policies; and (ii) the country's entire population, as a result of the implementation of a more equitable taxation system.

1.18 These objectives will be pursued through the program components and main activities, described below.

1.19 **Component I. Improvement of tax revenue management (US$13.5 million).** The objective of this component is to make tax processes more effective so as to improve tax compliance. The following and other activities will be financed: (i) implementing the integrated tax information consolidation system under the responsibility of the VMI with a single taxpayer identification number, to be integrated (through agreements, protocols, and common standards) with tax-related third-party databases, including electronic invoicing data that can improve the quality of the RUC, thereby expanding the tax base; (ii) adapting the DGII, DGA, and DGT systems, including the Integrated Tax Information System (SIIT), to taxpayers' current accounts; (iii) improving invoicing control[44] until electronic invoicing is fully implemented, starting with a pilot plan that includes a group of large taxpayers and technology providers, exclusively for business-to-business goods and services transactions;[45] (iv) strengthening audits and controls so as to integrate the entire process and optimize pre-audits;[46] and (v) fully and comprehensively institutionalizing a new collection process under VMI jurisdiction.[47]

1.20 **Component II. Strengthening of customs revenue management (US$3.9 million**). The objective of this component is to strengthen the revenue collection capacity of the DGA through more effective customs processes. To this end, the following and other activities will be financed: (i) improving the ex ante control model, strengthening the mandatory electronic processing of cargo manifests and bills of lading; (ii) complementing the functionality of SIDUNEA World and interoperability with DGII systems; (iii) perfecting the selection of large cases for post-audits based on risk analysis; and (iv) improving the ex post control model by fully implementing electronic payment of customs taxes and duties online, coordinating post-audits with the DGII.

1.21 **Component III. Improvement of information management and strategic strengthening of the VMI and its human resources (US$9.9 million).** The objective of this component is to strengthen the information and human resources management areas to ensure higher revenue intake levels. The following and other activities will be financed:

[44] Control of sequential numbering and printouts in paper invoicing according to taxpayer risk will be improved in parallel with the gradual implementation of electronic invoicing.

[45] This group of businesses (which includes a group of large taxpayers and technology providers participating on a voluntary basis) will perform all tests jointly with the VMI until the first electronic invoice is produced. Electronic invoicing will subsequently be expanded to large taxpayers for business-to-business transactions. A third stage will involve developing the foreign trade module. Lastly, electronic invoicing will be expanded to the level of sales deemed appropriate in the case of El Salvador.

[46] Current comprehensive audit procedures will be evaluated, and a model of joint audits with the DGA will be developed, including risk profiles.

[47] The collection module will be implemented in the Case Study Management System, integrated with the taxpayer's current account. This will also include technical training on invoice issuance and its legal adaptations.

a. **Improvement of the technological and information management infrastructure.** Activities include: (i) strengthening the integration of information technology at the DGII, DGA, and DGT, improving data security through a new technological infrastructure system that resolves the problem of obsolescence and through the implementation of electronic signature;[48] and (ii) strengthening a single portal with all applications and filings online through the use of a bar code for the payment of taxes at bank agencies or on the Internet.

b. **Strategic strengthening of the VMI and its human resources.** Activities include: (i) strengthening the VMI's strategic and human resources management in a way that envisages and incentivizes an increase in revenue collection by establishing ongoing training and performance evaluation for officials at all VMI agencies with a view to boosting employee productivity; and (ii) strengthening the tax and customs studies area so that it provides indicators, diagnostics, and evaluations with a view to achieving an efficient increase in revenue.[49]

1.22 **Program administration (US$2.5 million).** As part of program administration, financing will be provided to hire a consulting firm to provide technical and management execution support to the VMI, to assemble and run a program coordination unit (PCU), and to cover the cost of reports and contingencies.

Table 1. Total program budget (US$)

Categories	IDB	%
COMPONENTS	**27,278,036**	**90.93**
I. Improvement of tax revenue management	13,457,859	44.86
II. Strengthening of customs revenue management	3,872,919	12.91
III. Improvement of information management and strategic strengthening of the VMI and its human resources	9,947,258	33.16
Program administration	**2,489,400**	**8.30**
Contingencies	**232,564**	**0.77**
Total	**30,000,000**	**100.00**

C. Key results indicators

1.23 **Expected impact and outcomes.** The expected impact is an increase in tax revenue of at least 1% of GDP, from 15.2% of GDP in 2015 to 16.2% of GDP in 2021, through a reduction in noncompliance with tax obligations.[50] Some of the

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48 Implementing electronic signature is a prerequisite both for electronic invoicing and for ensuring the integrity of online information services.

49 A knowledge strategy will be developed, identifying issues to be studied and supporting the production of studies that yield reliable data and evaluations aimed at improving tax revenue.

50 This expected result is based on the work of Fenochietto and Pessino (2013) and the analysis described in paragraph 1.5. After deducting the portion of the potential increase of 3.4% of GDP that is a result of raising taxes or reducing exemptions to the average level for Latin America and the Caribbean, 1.7% of GDP is left over to improve revenue collection through administrative reform. Of the actions proposed by the government, this operation will contribute approximately 60%, resulting in a revenue increase of 1% of GDP gradually materializing over the next five years. It is worth noting that the program currently being carried out in Honduras (3541/BL-HO) envisages a tax revenue increase of 1.8% over five years.

program outcomes are: (i) increase in the tax base of the RUC, with the proportion of active RUC-listed taxpayers rising from 23% to 28%; (ii) increase in electronic invoices as a percentage of total invoices, from 0% to 20%; (iii) increase in effective revenue intake from audit processes, from 0.8% to 2% of total revenue; (iv) increase of at least 50% in the percentage of electronic ground manifests processed by the DGA; (v) increase in the percentage of electronically filed tax returns from 28.5% to 60%; and (vi) increase from one to three total training hours per official at the VMI's agencies (see Annex II).

1.24 **Economic evaluation.** The project team performed an analysis of the financial costs and benefits of the program, considering the real increase in tax revenue as a result of: (i) the increase in active RUC-listed taxpayers as a percentage of total RUC-listed taxpayers; and (ii) the increase in revenue from tax audits as a percentage of total tax revenue. Using a discount rate of 12% over a period of 10 years, it is projected that by end-2026 the program will be generating an internal rate of return of 154%, with a net present value of US$94.3 million. According to the sensitivity analysis, in the worst-case scenario, the program would yield an internal rate of return of 112%, with a net present value of US$132.3 million. These results are within the range of forecasts for similar tax administration strengthening operations in the region (see economic analysis).

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 **Program resources and schedule of disbursements.** The total cost of the program is US$30 million, to be financed by the Bank from Ordinary Capital. The financing instrument will be a sovereign-guaranteed specific investment loan. The disbursements will be made within a period of five years starting on the effective date of the loan contract, as set forth in the disbursement schedule presented in Table 2.

2.2 In accordance with document AB-2990, disbursement of the loan proceeds will be subject to the following maximum limits: (i) up to 15% in the first 12 months; (ii) up to 30% in the first 24 months; and (iii) up to 50% in the first 36 months, in all cases as of the date of loan approval by the Bank's Board of Executive Directors. These limits may cease to be applicable if the requirements set by Bank policy with respect to the limits are satisfied, provided the borrower has been notified in writing.

Table 2. Disbursement schedule (US$)

Source	Year 1	Year 2	Year 3	Year 4	Year 5	Total
IDB	4,149,961.00	4,812,473.70	5,987,163.40	8,793,389.40	6,257,012.50	30,000,000
%	14	16	20	29	21	100

2.3 **Fiduciary context of the country.** With regard to the national financial system, a public expenditure and financial accountability assessment was performed in 2013. The results indicate that the country's public financial management system is solid and its development level is medium. The national public procurement system was analyzed and diagnosed in 2010 using the OECD's methodology for assessing procurement systems (MAPS/OECD). The results indicate that, while the system contains good practices that have allowed El Salvador to make progress on the efficiency and transparency of its procurement processes, legal reforms are needed in order to consolidate the system's development. Application of the Institutional Capacity Evaluation System (ICAS) shows that the Ministry of Finance has satisfactory capacity to manage the proposed program. However, the evaluation identifies room for improvement in the flow of fiduciary processes. Training workshops will be held during program execution, as well as specific work meetings to address procurements identified as critical to the program. In addition, technical assistance will be provided to the fiduciary areas of the Ministry of Finance with a view to facilitating program implementation.

B. Environmental and social risks

2.4 Pursuant to the Bank's Environment and Safeguards Compliance Policy (OP-703), the program has been classified as a category "C" operation. The program will support the strengthening of tax processes through systems development and institutional strengthening, and no social or environmental risks are anticipated.

C. Fiduciary risks

2.5 A risk management workshop was conducted following the Bank's methodology, and it was determined that this operation has a medium level of risk. The fiduciary risk is medium and is associated with potential delays in the envisaged procurement processes due to the executing agency's lack of recent experience in the execution of Bank-financed programs. This risk will be mitigated through intensive training, participation by the technical areas involved and by the legal and financial areas, and technical assistance on fiduciary issues in support of the PCU.

D. Other risks

2.6 Six risks assessed as being of medium severity were identified during the program identification and analysis process. These risks are primarily associated with: (i) potential effects of macroeconomic shocks that diminish the expected revenue increase, to be mitigated by preparing a study simulating economic shocks as well as designing adjustments in the program's interventions to offset potential difficulties in achieving the increase in revenue; (ii) potential delays in the approval of the loan, to be mitigated by presenting the expected benefits of the loan to the Legislative Assembly by a technical committee of the VMI; (iii) delays in implementing electronic signature and in signing information exchange agreements, and ongoing use of technologically incompatible processes, to be mitigated by preparing studies showing the advantages of deploying instruments of this nature and by developing a strategic plan that provides solutions for lingering incompatibilities and envisages coordination with other agencies able to provide software, such as USAID; (iv) potential deterioration in procedures and systems implemented by the program once it is finalized, to be mitigated by implementing a strategic plan that calls for monitoring maintenance of the procured goods and training human resources, taking into account potential effects of the change in government administration in 2019; and (v) possibility that the reports presented by the PCU will not be consistent with the standards required by the Bank, given the PCU's lack of recent program execution experience, to be mitigated by a training program conducted by the Bank for the PCU on monitoring and accountability issues. In addition, the program will implement a computer tool to support program monitoring and supervision.

2.7 The Salvadoran government authorities have stated their commitment to ensuring the medium- and long-term sustainability of the technological infrastructure to be procured, as well as continuous improvement of processes, procedures, and ongoing training programs aimed at optimizing tax administration.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 The borrower will be the Republic of El Salvador, and the executing agency will be the Ministry of Finance, acting through the VMI.

3.2 The VMI will be responsible for technical and financial management of the program. To this end, it may hire a specialized external consulting firm to provide technical and management support as required. The characteristics of the consulting firm to be hired and the scope of its services will be determined as part of the terms of reference, which must have the Bank's prior no objection. In addition, the VMI will create a program coordination unit (PCU) to support program implementation. The PCU will be comprised of qualified professionals with significant experience in the execution of externally financed programs. Its staff will include at least a general coordinator, a financial specialist, and a procurement specialist. The general coordinator will report directly to the VMI.

3.3 The primary duties of the PCU with regard to program implementation will be: (i) budgetary and financial management; (ii) coordination and monitoring with the institutional procurement and financial areas of the Ministry of Finance for bidding processes, award and signing of contracts, and payments relating to program activities; (iii) financial reporting, processing of disbursement requests, and external audits, in collaboration with the fiduciary areas of the Ministry of Finance; (iv) attention to and coordination of fulfillment of the contractual clauses set forth in the loan contract; and (v) management of the relationship with the Bank and other interested parties.

3.4 The program Operating Manual will describe the execution arrangements in detail and establish the procedures, coordination mechanisms, process flows, roles and responsibilities, actions to be implemented for program execution, technical and fiduciary supervision structure, and frequency and minimum content of monitoring reports.

3.5 Program activities will follow a schedule set forth in the multiyear execution plan, which contains a detailed description of execution of the entire program. A yearly review of the multiyear execution plan will be reflected in the respective annual work plan. Multiyear execution plan and annual work plan reviews will be submitted to the Bank for approval.

3.6 **Special contractual conditions precedent to the first disbursement of loan proceeds. The executing agency will present evidence, to the Bank's satisfaction, of fulfillment of the following conditions: (i) appointment of a general coordinator and creation of a program coordination unit (PCU) to support implementation of the program in accordance with the profiles and terms of reference agreed upon with the Bank; and (ii) approval and entry into force of the program Operating Manual as previously agreed upon with the**

Bank, with a detailed description of the execution mechanism, procedures, coordination mechanisms, process flows, roles and responsibilities, and actions to be implemented for program execution.

3.7 **Financial and procurement management.** The procurements planned under this operation will be handled in accordance with the Policies for the procurement of works and goods financed by the IDB (document GN-2349-9) and the Policies for the selection and contracting of consultants financed by the IDB (document GN-2350-9), both of March 2011. In addition, the Bank and the Government of El Salvador have signed an agreement for partial use of El Salvador's national procurement system in Bank-financed operations as established by the Bank's Board of Executive Directors, which in September 2013 approved the use of the independent management subsystem provided for in El Salvador's Public Procurement Law (LACAP). Subject to fulfillment of the conditions set forth in the aforementioned agreement, use of the independent management subsystem may be implemented during program execution. Works, goods, and services procured using program resources will be supervised by the Bank in accordance with the provisions set forth in Annex III to this document and with the procurement plan in effect. Financial management and supervision of the program will be performed in accordance with the Guidelines for financial management of Bank-financed projects (OP-273-6) and the Fiduciary Agreements and Requirements (see Annex III).

3.8 **Disbursements.** The borrower will open a specially designated account at the Central Reserve Bank of El Salvador (BCR) to receive disbursements of loan proceeds and make payments to program suppliers, relying on the treasury subsystem of the Integrated Financial Administration System (SAFI). Disbursements will be primarily in the form of advances of funds based on projected liquidity needs. Advances of funds will be processed on the basis of the cash flow plan, in line with operational planning, and will cover the program's estimated liquidity needs for periods of up to six months. Subsequent disbursements may be processed once 80% of the total advanced amount has been substantiated with supporting documentation. This plan will reflect, in financial terms, the annual work plan and the procurement plan.

3.9 **Audits.** The executing agency will deliver audited financial statements for the program on an annual basis and at the end of the program. These statements will be delivered within 120 days after the close of the respective fiscal year and, in the case of the final statements, 120 days after the date of the last disbursement, as provided in the Bank's policies. External auditing services will be provided, at the Bank's discretion, by an eligible private firm of auditors or by the Court of Accounts (CCR) of El Salvador. Prior to this, the CCR and the Bank will sign an agreement providing for the CCR to perform financial audits of Bank-financed operations.

B. Summary of arrangements for results monitoring

3.10 **Monitoring.** Program monitoring will be based on: (i) the Results Matrix (see Annex II); (ii) the schedule of activities; (iii) the itemized description of physical and financial execution of outputs; and (iv) the descriptions of procurements set forth in the procurement plan. The program will be monitored through the following instruments: the multiyear execution plan, the annual work plan, and semiannual reports that will include the progress monitoring report (PMR) as one of their sections. This will be complemented with a periodic update of the risk analysis. Monitoring and evaluation resources are included as part of the program (see monitoring and evaluation plan).

3.11 **Impact evaluations.** The program will be evaluated against the annual indicators and targets corresponding to the outcomes and outputs that comprise the program's Results Matrix. The monitoring and evaluation plan calls for a midterm and final evaluation. The VMI will prepare and deliver a midterm evaluation report to the Bank within 90 days after 50% of the loan proceeds have been disbursed or 36 months into the execution period, whichever occurs first. The VMI will also deliver a final evaluation to the Bank, to serve as an input for the program completion report (PCR), within 90 days after 95% of the loan proceeds have been disbursed. Lastly, the program calls for two random impact evaluations to be performed in collaboration with the DGII-DGA to identify the causal effect on tax revenue of the following interventions: (i) introduction of electronic invoicing; and (ii) improvement of the auditing process. These impact evaluations will provide valuable knowledge on how these tools work in countries with tax administrations in development. The VMI will be responsible for implementing the evaluations in close coordination with the Bank's project team.

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives	**Aligned**		
Development Challenges & Cross-cutting Themes	**-Institutional Capacity and the Rule of Law**		
Regional Context Indicators			
Country Development Results Indicators	**-Percent of GDP collected in taxes (%)* -Government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery (#)***		
2. Country Strategy Development Objectives	**Aligned**		
Country Strategy Results Matrix	**GN-2828**	**Strengthen fiscal sustainability.**	
Country Program Results Matrix		**The intervention is not included in the 2016 Operational Program.**	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability	**Highly Evaluable**	**Weight**	**Maximum Score**
	9.8		**10**
3. Evidence-based Assessment & Solution	**9.7**	**33.33%**	**10**
3.1 Program Diagnosis	**3.0**		
3.2 Proposed Interventions or Solutions	**4.0**		
3.3 Results Matrix Quality	**2.7**		
4. Ex ante Economic Analysis	**10.0**	**33.33%**	**10**
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis	**4.0**		
4.2 Identified and Quantified Benefits	**1.5**		
4.3 Identified and Quantified Costs	**1.5**		
4.4 Reasonable Assumptions	**1.5**		
4.5 Sensitivity Analysis	**1.5**		
5. Monitoring and Evaluation	**9.6**	**33.33%**	**10**
5.1 Monitoring Mechanisms	**2.5**		
5.2 Evaluation Plan	**7.1**		
III. Risks & Mitigation Monitoring Matrix			
Overall risks rate = magnitude of risks*likelihood	**Medium**		
Identified risks have been rated for magnitude and likelihood	**Yes**		
Mitigation measures have been identified for major risks	**Yes**		
Mitigation measures have indicators for tracking their implementation	**Yes**		
Environmental & social risk classification	**C**		
IV. IDB´s Role - Additionality			
The project relies on the use of country systems			
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, Accounting and Reporting. Procurement: Information System, Shopping Method.**	
Non-Fiduciary			
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment			
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**Resources from ES-T1207 Technical Cooperation.**	
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan	**Yes**	**Impact assessments will provide insight on how electronic invoicing and audit control work in countries where tax administration is still evolving. Most evidence of such interventions comes from OECD countries and within the region, in countries where the degree of tax administration is higher.**	

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

The objective of this program is to improve tax collection revenues by: (i) reducing taxpayer non-compliance on internal taxes managed by the General Internal Revenue Department (DGII), (ii) reducing taxpayer non-compliance with customs taxes managed by the General Directorate of Customs (DGA), and (iii) increasing the quality of the information available for decision making.

This program focuses in the general problem associated with the insufficient tax revenue partially due to management deficiencies of the Tax and Customs Administration. Three specific problems were identified: (i) weakness in the operational processes of the DGII, (ii) shortcomings in the process of customs tax control and trade facilitation administered by the DGA, and (iii) inadequate strategic human resource management and information available in the Vice Ministry of Revenues.

The POD clearly identifies the potential beneficiaries of the project. The project´s vertical logic is clear and well specified. The link between interventions and problems has been properly established. The project presents adequate evidence of external and internal validity of the proposed solutions. The Result Matrix is adequately constructed and contains the required elements for monitoring the project. The proposed impact, outcomes and output indicators are SMART.

The POD documentation includes an ex ante Economic Analysis where the economic benefits have been clearly quantified and the costs reflect real resource costs to the economy. The estimated Net present Value (NPV) is US$ 94,3 million and the Internal Rate of Return (IRR) 154%.The assumptions used are clearly presented and a sensitivity analysis has been performed undertaking variations in key assumptions.

The program includes an adequate monitoring and evaluation plan. The program includes two impact evaluations with experimental designs. The first evaluates the introduction of an electronic billing system, and the second assesses the introduction of strategies to improve tax control.

The POD documentation includes a risk matrix. Mitigation measures were identified with appropriate monitoring indicators.

RESULTS MATRIX[1]

Program objective:	The objective of this operation is to improve tax revenue intake by: (i) reducing noncompliance with taxes managed by the Internal Revenue Department (DGII); (ii) reducing noncompliance with customs duties managed by the General Customs Administration (DGA); and (iii) improving the quality of information for decision-making purposes.

EXPECTED IMPACT

Indicators	Unit of measure	Baseline		Targets		Means of verification	Comments
		Value	Year	Value	Year		
EXPECTED IMPACT. INCREASE IN THE RATIO OF TAX REVENUE TO NOMINAL GROSS DOMESTIC PRODUCT (GDP)							
Net tax revenue/GDP	%	15.2	2015	16.2	2021	DGT (Ministry of Finance) report	

EXPECTED OUTCOMES

Expected outcomes	Unit of measure	Baseline		Intermediate		Target		Means of verification	Comments
		Value	Year	Value	Year	Value	Year		
OUTCOME 1. INCREASE IN THE RATIO OF VAT REVENUE TO NOMINAL GDP									
Net internal VAT revenue / GDP	%	3.3	2015	3.4	2019	3.5	2021	Tax Studies Unit (DGII) report	
OUTCOME 2. INCREASE IN THE RATIO OF INCOME TAX REVENUE TO NOMINAL GDP									
Income tax revenue / GDP	%	6.0	2015	6.1	2019	6.5	2021	Tax Studies Unit (DGII) report	
OUTCOME 3. INCREASE IN THE RATIO OF ACTIVE RUC-LISTED TAXPAYERS TO TOTAL RUC-LISTED TAXPAYERS (TAX BASE)									
Number of active RUC-listed taxpayers / Total number of RUC-listed taxpayers	%	23	2015	25	2019	28	2021	DGII report	
OUTCOME 4. INCREASE IN TAX REVENUE AS A RESULT OF CROSS-CHECKING RUC DATABASES WITH THIRD PARTIES									
Additional revenue resulting from data cross-checking with third parties	US$000	1,867.73	2015	2,427.00	2019	3,735.00	2021	Financial Office-DGII report	
OUTCOME 5. INCREASE IN THE PERCENTAGE OF INVOICES ISSUED ELECTRONICALLY									
Number of electronic invoices / Total invoices	%	0	2015	10	2019	20	2022	Financial Office-DGII report	

[1] There is an expanded version of this matrix with references on the targets and the full set of comments.

Expected outcomes	Unit of measure	Baseline		Intermediate		Target		Means of verification	Comments
		Value	Year	Value	Year	Value	Year		
OUTCOME 6. INCREASE IN EFFECTIVE REVENUE FROM AUDIT PROCESSES									
Effective tax revenue from audits / Tax revenue	%	0.77	Average -2014-2015	0.9	2017-2019	2	2020-2022	Financial Office-DGII report	
OUTCOME 7. INCREASE IN THE RATIO OF REVENUE FROM IMPORT VAT (EXCLUDING OIL) TO NOMINAL GDP									
Revenue from import VAT (excluding oil) / GDP	%	3.5	Average -2012-2015	3.6	2019	3.7	2021	DGA and Central Reserve Bank (BCR) report	
OUTCOME 8. INCREASE IN THE PERCENTAGE OF ELECTRONIC GROUND MANIFESTS PROCESSED BY CUSTOMS									
Electronic ground manifests / Total ground manifests	%	0	2015	20	2019	50	2021	DGA report	The target for 2021 is at least 50%.
OUTCOME 9. INCREASE IN THE RATIO OF RETURNS FILED ONLINE (THROUGH THE DGII PORTAL) TO TOTAL RETURNS									
Number of returns filed online / Total returns	%	28.5	2015	40	2019	60	2021	DGII report	Baseline
OUTCOME 10. INCREASE IN THE RATIO OF TOTAL ANNUAL TRAINING HOURS TO TOTAL NUMBER OF EMPLOYEES									
Total number of annual employee training hours / total number of employees	Hours	1	2015	2	2019	3	2021	DGII/DGA report	

OUTPUTS

Outputs	Unit of measure	Baseline	2017	2018	2019	2020	2021	Final target	Means of verification	Comments
Component I: Improvement of tax revenue management										
Output 1.1 Integrated tax information consolidation system implemented and in operation	System	2016	0	0	0	1	0	1	VMI technical monitoring report	
Output 1.2 DGII, DGA, and DGT systems, adapted to the current account, implemented and in operation	System	2016	0	0	0	1	0	1	VMI technical monitoring report	
Output 1.3 Electronic invoicing system implemented and in operation	System	2016	0	0	0	1	0	1	DGII technical monitoring report	
Output 1.4 Audit and control model implemented and in operation	Model	2016	0	0	0	1	0	1	Idem	
Output 1.5 Integrated collections model implemented and in operation	Model	2016	0	0	0	1	0	1	VMI technical monitoring report	

Component II: Strengthening of customs revenue management										
Output 2.1 Ex ante control model implemented and in operation	Model	2016	0	0	0	1	0	1	DGA technical monitoring report	
Output 2.2 SIDUNEA system implemented and connected to the DGII systems	System	2016	0	1	0	0	0	1	DGA technical monitoring report	
Output 2.3 Case selection model improved and in operation	Model	2016	0	0	0	1	0	1	Idem	
Output 2.4 Post-clearance control model improved and in operation	Model	2016	0	0	1	0	0	1	Idem	
Component III: Improvement of information management and strategic strengthening of the VMI and its human resources										
Output 3.1.1 Integrated information technology system (DGII, DGA, DGT) implemented and in operation	System	2016	0	0	0	0	1	1	VMI technical monitoring report	
Output 3.1.2 One-stop portal for electronic filing of returns implemented and in operation	Portal	2016	0	0	0	1	0	1	Idem	
Output 3.2.1.a VMI strategic plan designed	Plan	2016	0	0	1	0	0	1	Idem	
Output 3.2.1.b Performance evaluation model designed and implemented	Model	2016	0	0	0	1	0	1	Idem	
Output 3.2.2 Tax and customs studies prepared	Studies	2016	1	3	5	7	10	10	Idem	

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Country:	El Salvador
Program:	ES-L1131
Name:	Tax Administration Strengthening Program
Executing agency:	Ministry of Finance, through the Deputy Ministry of Revenue (VMI)
Prepared by:	Patricio Crausaz, Fiduciary Specialist in Financial Management; and Marco Alemán, Senior Fiduciary Specialist in Procurement (FMP/CES)

I. EXECUTIVE SUMMARY

1.1 The program will be executed by the Ministry of Finance through the Deputy Ministry of Revenue (VMI). To this end, the VMI will create a program coordination unit (PCU) to support program implementation. The PCU will include a general coordinator, a financial specialist, and a procurement specialist, who will coordinate fiduciary management with the Ministry of Finance's corporate units: the Administrative Office and the Financial Office. These units will work together with the VMI and the other operational areas participating in execution of the operation. The VMI may engage a specialized external consulting firm to provide technical and management support as required. The characteristics of the consulting firm to be engaged and the scope of its services will be determined as part of the terms of reference to be agreed upon between the Bank and the Ministry of Finance-VMI.

1.2 The Ministry of Finance-VMI has experience in fiduciary management of programs financed by multilateral and international cooperation agencies such as the World Bank, the United States Agency for International Development (USAID), and the European Union. However, it lacks recent experience as an executing agency of Bank-financed operations. Fiduciary capacity was assessed during the design stage of the program, and it was determined that the Ministry of Finance has the capacity required to perform financial management responsibilities and administer the loan proceeds.

1.3 Financial management will be performed in accordance with the Guidelines for financial management of Bank-financed projects (document OP-273-6) and El Salvador's national legal and regulatory provisions regarding public finance management. Procurements will be handled in accordance with the Policies for the procurement of works and goods financed by the IDB (document GN-2349-9) and the Policies for the selection and contracting of consultants financed by the IDB (document GN-2350-9), as well as in accordance with the independent management subsystem provided for in the Public Procurement Law (LACAP), pursuant to the agreement for partial use of El Salvador's country procurement system in Bank-financed operations, signed by the Bank and the Government of El Salvador on 26 October 2015.

II. FIDUCIARY CONTEXT OF THE EXECUTING AGENCY

2.1 The VMI performs its financial and procurement management responsibilities through the Administrative Office and the Financial Office in the framework of processes, regulations, and application of the Ministry of Finance's Integrated Financial Administration System (SAFI). The Financial Office has sufficient trained staff to perform its tasks and responsibilities with technical proficiency and can therefore support the VMI in implementing the program. The VMI has an internal audit unit and, for internal control purposes, applies its specific technical rules of internal control, which have been prepared on the basis of the general guidelines issued by the Court of Accounts (CCR) in accordance with COSO principles.

2.2 With regard to public procurement, the legal and regulatory framework is provided in the Public Procurement Law (LACAP) and its implementing regulations and supplementary provisions. In 2009, the country's national procurement system was assessed at the request of the Salvadoran government, using the methodology proposed by the OECD. The assessment showed that there is a rather detailed regulatory framework in place and that it contains acceptable controls on public procurement.

2.3 The agreement for partial use of El Salvador's country procurement system in Bank-financed operations was signed on 26 October 2015. As established by the Bank's Board of Executive Directors, which in September 2013 approved the use of the independent management subsystem provided for in the LACAP, upon fulfillment of the conditions set forth in the aforementioned agreement, use of the independent management subsystem may be implemented during program execution.[1]

III. FIDUCIARY RISK EVALUATION AND MITIGATION MEASURES

3.1 The ICAS tool was applied during the design phase of the operation, and it indicated that the Ministry of Finance possesses adequate institutional capacity to execute the program. However, the assessment also showed that the ministry lacks recent experience and staff familiar with the Bank's specific requirements in the areas of financial and procurement management. There is a medium level of fiduciary risk associated with potential delays and coordination challenges between the technical and fiduciary areas. To mitigate this risk, the CES fiduciary specialists will provide the necessary training and support to the relevant personnel. The training will focus on the content and practical application of the procurement policies set forth in documents GN-2349-9 and GN-2350-9, the financial management guidelines provided in document OP-273-6, and supplementary instructions. In addition, the procurement management processes will be analyzed, adjusted, and optimized so as to effectively address program execution, and the plan is to hire a procurement specialist to support the PCU who will focus exclusively on the program.

[1] This subsystem is equivalent to the Bank's shopping method established in document GN-2349-9.

IV. Considerations for the Special Provisions of the Contract

4.1 The executing agency will present evidence, to the Bank's satisfaction, of fulfillment of the following conditions: (i) appointment of a general coordinator and creation of a program coordination unit (PCU) to support implementation of the program in accordance with the profiles and terms of reference agreed upon with the Bank; and (ii) approval and entry into force of the program Operating Manual as previously agreed upon with the Bank, including with a detailed description of the execution mechanism, procedures, coordination mechanisms, process flows, roles and responsibilities, and actions to be implemented for program execution.

V. Agreements and Requirements for Procurement Execution

5.1 Under the program, goods and services will be procured and consultants will be contracted pursuant to the policies set forth in documents GN-2349-9 and GN-2350-9, respectively. The procurements to be carried out during program execution will be described in the procurement plan. The procurement plan will specify: (i) the procurement category; (ii) the procurement type and/or method; and (iii) the type of supervision. Those in charge of program execution will be responsible for keeping the procurement plan up to date and consistent with the annual work plan. Any changes or modifications to the procurement plan will be performed through the Procurement Plan Execution System (SEPA) or any other system that may be implemented by the Bank. The Project Team Leader will be responsible for approving the procurement plan and keeping it up to date during the execution period, with support from the procurement specialist.

5.2 **Procurement of goods and nonconsulting services.** Goods and nonconsulting services will be procured using any of the methods described in the Bank's procurement policies, as provided in the procurement plan agreed upon with the Bank. The threshold for use of international competitive bidding (ICB)[2] will be made available to the executing agency on the Bank's procurement webpage. For amounts below this threshold, the selection method will be determined in accordance with the complexity and characteristics of the procurement, which will be reflected in the procurement plan.

5.3 **Procurement of consulting services.** Consulting services will be procured using any of the methods described in the Bank's policies for the selection and contracting of consultants, as provided in the procurement plan. The threshold for determining whether the shortlist is to include international consultants[3] will be made available to the executing agency on the Bank's procurement webpage. Below this threshold, the shortlist may be comprised entirely of national consultants from the borrower's country.

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[2] At present, the procurement of works involving amounts equal to or greater than US$5,000,000 and of goods and nonconsulting services involving amounts equal to or greater than US$250,000 are subject to international competitive bidding (ICB).

[3] At present, the threshold for contracting consulting firms is US$200,000. For amounts below this threshold, the shortlist may be comprised entirely of national consulting firms.

5.4 **Advance procurement/retroactive financing:** Not applicable.

5.5 **National preference:** Not applicable.

5.6 **Major procurement processes:**[4]

Goods	Reference budget in US$000	Procurement method	Type of supervision
Disk/storage units (2 ICB processes)	1,160	ICB	Ex ante
Desktop computers	400	ICB	Ex ante
Portable computer equipment	402	ICB	Ex ante

Consulting services	Reference budget in US$000	Selection method	Type of supervision
Technical and management consulting in support of execution	990	QCBS	Ex ante
Development of an integrated tax information consolidation system	1,500	QCBS	Ex ante
Development of an electronic invoicing management system, including a pilot	4,000	QCBS	Ex ante
Implementation plan for SIDUNEA migration	1,000	QCBS	Ex ante
Design and implementation of a services portal	500	QCBS	Ex ante

5.7 **Procurement supervision:** Supervision will be performed by the Bank in accordance with the procurement plan.

5.8 **Special provisions:** Not applicable.

5.9 **Records and files:** The Financial Office and the Administrative Office will be responsible, in accordance with their respective competencies, for the safekeeping of documentation on activities financed by the program.

5.10 **Retroactive financing:** Not applicable in El Salvador. At the request of the Ministry of Finance, this clause is not included in loan contracts.

VI. Financial Management Agreements and Requirements

6.1 **Programming and budget.** The country system will be used. The VMI, acting through the Financial Office, will annually manage the budget allocation required to execute the program's operational plan. The requested budgetary credits need to be sufficient to cover the payment commitments arising from each year's execution (on an accrual basis). In accordance with Article 19 of the Annual Budget Act, the VMI may solicit bids for and procure works, goods, and services based on the availability of funds under the loan contract. In this regard, the VMI will be required to program the necessary funds to cover its payment commitments into its institutional budget for each fiscal year based on the annual

[4] An itemized procurement plan covering program execution is included as an annex to the POD.

accrual-basis execution schedule under the aforementioned contract, pursuant to Article 34 of the Basic Law on State Financial Management.

6.2 **Accounting and financial reports.** The country system will be used. The Financial Office of the Ministry of Finance will be responsible for the accounting records and corresponding supporting documentation, using SAFI and also using complementary manual processes when preparing special-purpose financial statements, in the formats required by the Bank in accordance with its financial management guidelines (document OP-273-6).

6.3 **Disbursements and cash flow.** The country treasury subsystem will be used to manage payments and disbursements. The VMI will request that a special account be opened at the Central Reserve Bank of El Salvador (BCR) and instruct the Treasury Office of the Ministry of Finance to make payments to program suppliers and contractors from that account, relying on the SAFI treasury subsystem. These arrangements will be revised or adjusted in the event that the Ministry of Finance's consolidated treasury account mechanism is deemed acceptable to the Bank. As provided in the financial management guidelines (document OP-273-6), the Bank will make loan disbursements in the form of advances of funds. The monetary value of each advance will be calculated based on the cash flow projections prepared by the Financial Office in coordination with the VMI for the execution of scheduled activities and procurements for periods of up to six months. Cash flow projections must be consistent with the annual work plan and the procurement plan and have received the Bank's no objection, and must cover a rolling horizon of at least 12 months. Disbursements by the Bank will be made into the designated account to be opened at the BCR exclusively for the program. The disbursement profile must be consistent with the restrictions established in the Operational Guidelines for the Implementation of the Macroeconomic Safeguards in the IDB (document GN-2753-7). In accordance with document AB-2990, disbursement by the Bank of Ordinary Capital proceeds will be subject to the following maximum limits: (i) up to 15% in the first 12 months; (ii) up to 30% in the first 24 months; and (iii) up to 50% in the first 36 months, in all cases as of the date of loan approval by the Bank's Board of Executive Directors. These limits may cease to be applicable if the requirements set by Bank policy with respect to the limits are satisfied, provided the borrower has been notified in writing.

6.4 **Internal control.** The technical rules on internal control issued by the Court of Accounts will be applicable.[5] Internal control will be the responsibility of all Ministry of Finance officials involved in executing the program, according to their respective lines of action, as well as such complementary personnel as it is deemed necessary to hire. The internal control unit of the Ministry of Finance will include program-related control activities in its annual work plan.

6.5 **External control and reports.** External control will be performed by an external firm of auditors acceptable to the Bank or by the Court of Accounts (CCR). The

[5] Salvadoran legislation establishes the scope of public servants' liability in the performance of their duties, and violations can lead to judicial proceedings against the public servant. Title III "Liability in public service," Articles 52-61 of the Law on the Court of Accounts.

auditing firm will be contracted using loan proceeds, pursuant to a competitive process, and based on terms of references and requests for proposals that have received the Bank's no objection. The audited financial statements will be delivered to the Bank by the VMI no later than 120 days after the end of the corresponding fiscal period. Starting in the second year of execution, the same auditing firm may be contracted on a single-source selection basis under the continuity of services principle, provided the quality of the work performed during the first year has been acceptable to the Bank and the VMI. The Financial Office, in coordination with the VMI, will prepare the annual financial statements and supplementary notes to be audited in accordance with the Bank's guidelines for financial reports and external audits.

6.6 **Supervision.**

Supervision activity	Supervision plan			
	Nature and scope	Frequency	Responsibility	
			Bank	Other
Operational	Review of progress report	Semiannual	Fiduciary and sector team	Ministry of Finance-VMI
	Review of executing agency portfolio	In accordance with the schedule agreed upon by the Ministry of Finance and the Bank	Head of Operations, fiduciary and sector team	STPP/Ministry of Finance/IDB
Financial	Update of cash flow and disbursement projections	With each request for a funds advance. When required by the circumstances.	Fiduciary and operational specialists	Ministry of Finance-VMI
	Supervision visits	Annual	Fiduciary specialist	Consultant
	Financial audit	Annual	Fiduciary specialist	Ministry of Finance / External auditor
Procurement	Ex ante procurement review	During program execution	Project Team Leader / Executing agency	Ministry of Finance
	Procurement plan update	Annual. When required by the circumstances.	Project Team Leader / Executing agency	Ministry of Finance
Compliance	Fulfillment of conditions precedent	Once; 2017 Q2	Fiduciary team/Operations analyst	Ministry of Finance-VMI / IDB
	Pro forma and budget allocation	Annual, January and July of each year	Fiduciary specialist	Ministry of Finance-VMI
	Delivery of audited financial statements	Annual	Fiduciary specialist	Ministry of Finance / Auditor

6.7 **Execution mechanism.** The executing agency will be the Ministry of Finance acting through the VMI and relying on the program coordination unit (PCU) that will be created to support program implementation. The Ministry of Finance's corporate units will work in collaboration with the VMI and other participating operational areas. The VMI may engage a specialized external consulting firm to provide technical and management support as required. The characteristics of the consulting firm to be hired and the scope of its services will be determined as part of the terms of reference, which must have the Bank's prior no objection.

6.8 **Program Operating Manual.** The aspects presented in these fiduciary agreements and requirements will be described in detail in the program Operating Manual, which will require clearance from the fiduciary specialists.

6.9 **Other financial management agreements and requirements*.*** There are no agreements other than the aforementioned.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/16

El Salvador. Loan ____/OC-ES to the Republic of El Salvador
Tax Administration Strengthening Program

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of El Salvador, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the tax administration strengthening program. Such financing will be for the amount of up to US$30,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on ___ _______ 2016)

[LEG/SGO/CID/IDBDOCS#40728448]
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