PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: PIDA91686

Project Name	Transparency and Efficiency in Tax Administration (P153366)
Region	LATIN AMERICA AND CARIBBEAN
Country	Guatemala
Lending Instrument	Investment Project Financing
Project ID	P153366
Borrower(s)	Ministry of Public Finance
Implementing Agency	Superintendencia de Administracion Tributaria
Environmental Category	C-Not Required
Date PID Prepared/Updated	17-Nov-2016
Date PID Approved/Disclosed	17-Nov-2016
Estimated Date of Appraisal Completion	
Estimated Date of Board Approval	17-Jan-2017
Appraisal Review Decision (from Decision Note)	

I. Project Context

Country Context

Guatemala is a country with significant potential for growth and for improved welfare. The country's strategic location vis-Ã -vis international trade, its substantial natural resources, and its young multi-ethnic population all contribute to this potential. The country's complex topography provides a range of climatic zones that encompass rich biodiversity and economic potential for agriculture, forestry, and hydropower generation. Guatemala has become a leading exporter of agricultural products and is the fourth largest exporter of sugar in the world and the largest exporter of cardamom. Large mineral deposits of gold, nickel, lead, zinc, and iron, among others, add to Guatemala's wealth of natural resources.

However, Guatemala has the second highest poverty rate in LAC, and income growth among the bottom 40 percent of the population has been negligible in recent years. Poverty and extreme poverty increased between 2006 and 2014, from 52 percent to 60 percent and 33 percent to 37 percent, respectively. The increases in overall poverty were largely driven by price increases, particularly for food, with low growth having a partial mitigating effect. Additionally, mobility analysis between 2006 and 2014 shows that there were more people that fell into poverty than those that moved out. Inequality has been declining (the GINI coefficient was decreased from 0.55 in 2006 to 0.49 by 2014), but this was mainly driven by falling incomes at the higher end of the distribution. There has been no shared prosperity, as average incomes of the bottom 40 percent of the population have declined over the 2000-2014 period. High poverty levels are also evident in the country's social indicators, such as chronic malnutrition, affecting in particular the poor (66 percent), rural dwellers (59 percent), and Indigenous groups (61 percent).

Guatemala's stable macroeconomic framework has not translated into high growth or poverty reduction. The country is the largest economy in Central America, with a Gross Domestic Product (GDP) of US$63.8 billion (2015). Since 1990, economic volatility was less than half the regional average, and the country experienced less of an economic deceleration during the 2009 recession than most of the Latin America and Caribbean (LAC) countries. Much of Guatemala's economic stability can be attributed to prudent macroeconomic policies that have kept fiscal deficits and public debt low. However, given that Guatemala has one of the lowest tax burdens in the world, low fiscal deficits were achieved by modest spending on social sectors and delivery of public services. Moreover, per capita growth is stubbornly low at 1.5 percent on average over the past decade (per-capita gross national income increased to an estimated US$3,804 in 2015) and is hampering the country's income convergence. Today, Guatemala is the fifth-poorest economy in terms of GDP per capita in LAC.

Guatemala is at a historic juncture, following a political and institutional crisis in 2015, a newly elected government is starting to take on deep-rooted development problems. The crisis was triggered by the uncovering of a corruption scheme that permeated the Tax Administration Superintendence (SAT) and the highest political levels. Subsequently, a massive social uprising demanded the resignation of the President and the strengthening of governance. In October 2015, Jimmy Morales won the election with 67 percent of the vote having campaigned on a platform against corruption. The new Administration took office in January 2016 and, during its first three months, developed its 20/20 Vision for Guatemala, building on the KÃ¢③(③ atun 2032 National Development Plan. Priorities include: (i) combating corruption and improving transparency; (ii) increasing access to better quality health services; (iii) tackling food insecurity and malnutrition; (iv) enhancing access to better quality education; (v) generating good quality jobs and creating opportunities for growth by promoting tourism and supporting micro, medium and small enterprises (MSMEs); (vi) improving citizen security; and (vii) increasing resilience and adaptation to the changing environment.

Sectoral and institutional Context

Guatemala has one of the lowest levels of tax collection in the LAC region and the world. Modest gains in revenue mobilization that had been achieved in 2013 were lost amidst high-level corruption in customs administration. After reaching 11 percent in 2013, the tax-to-GDP ratio fell to 10.8 percent in 2014 and to 10.2 percent by the end of 2015, below the 13 percent target foreseen in the tax reform of 2012 and significantly below the LAC average of 16.9 percent. In addition, Guatemala's tax effort is the lowest in the Region and the lowest among its lower-middle income peers. Low levels of revenues are due to narrow bases and low rates of certain taxes, but also to widespread tax evasion, lack of transparency, weak monitoring and controls, Value Added Tax (VAT) revenue leakages due to fraudulent invoicing, and high levels of informality. While it is critical to expand the tax base and raise certain tax rates to increase the tax-to-GDP ratio, a prerequisite for building political and public support for such fiscal reforms is to strengthen the regulatory framework to enhance tax collection, and re-build trust in SAT.

Modest tax collection is due to low tax rates and persistent low levels of tax compliance. Low tax compliance is mainly caused by institutional weakness in the tax administration and a chronic low tax culture in the country. The former is a result of structural problems linked to the weak internal governance framework in SAT, the outdated core business and support processes in the tax administration, and the weak controls and enforcement procedures in both internal revenues and customs. Low tax culture, in turn, is a consequence of the perception of weakness and lack of transparency of public institutions in general and in SAT in particular.

The tax policy framework depends heavily on indirect taxation, accounting for over a half of total government revenues, with around 50 percent of these coming from VAT. Despite the relative importance of VAT in revenue collection, VAT rates are among the lowest in Latin America, with numerous exemptions and loopholes. A decrease in VAT revenues from 3 percent of GDP in 2013 to 2.6 percent in 2015 was the main contributor to the persistent decline in the tax-to-GDP ratio during this same period. Direct taxation comprises 30.9 percent of total revenue, of which only 2.9 percent is from personal income tax. Direct taxation remains hampered by a small tax base, excessive exemptions, extensive evasion and widespread informality in the economy. Furthermore, the current framework is regressive: a fiscal incidence analysis based on the 2009-2010 National Survey of Family Income and Expenditures has revealed that the current tax system and transfers do little to reduce inequality and poverty overall or along ethnic and rural-urban lines.

Weak taxpayer compliance stems from a lack of trust in institutions and inefficiencies in revenue administration. The prevailing public perception that compliance is costly, tax administration is inefficient and has poor governance and that the tax structure is regressive, limits the scope for voluntary compliance and grind down the tax culture in the country. In 2015, Guatemala ranked 123 out of 168 countries on public sector corruption perception index. High levels of tax evasion erode the tax base, and continue to undermine both vertical and horizontal equity in the tax system. An estimated 74.5 percent of the economically active population is part of the informal economy, and informalities relating to contraband and fraudulent customs activities are estimated to cause a loss of revenue in the order of 2.8 percent and 4.4 percent of GDP, respectively.

The 2015 political and institutional crisis exposed the extent and importance of the underlying structural problems in SAT. The Government's revenue administration capacity deteriorated significantly in recent years as the SAT fell behind in keeping up with the institutional and technological requirements needed to maintain its operations at international standards. Several diagnostic assessments performed by international development partners including the World Bank, United States Treasury, International Monetary Fund (IMF), and the Inter-American Development Bank (IDB) in recent years, have found that SAT suffers from (i) disintegrated and inefficient tax administration processes; (ii) a dysfunctional governance structure that lacks transparency and is characterized by weak internal controls and ineffective information sharing between units; (iii) fragmented and vulnerable information systems; and (iv) lack of a human resource strategy.

Particularly, customs operations processes in Guatemala are characterized for being inefficient and ineffective. Customs operations in Guatemala have been characterized by limited transparency, lack of cross-control mechanisms, and costly and inefficient clearance procedures. Even though in recent years Guatemala made some progress aligning its trade facilitation practices with current international standards, a large number of physical inspections are still conducted at the border which has not reduced the time for cargo to be released by Customs. In addition, efforts to mitigate contraband have failed repeatedly due to high levels of discretion by customs officers, lack of infrastructure and supporting equipment for controlling merchandise transit in customs field offices, and a weak and fragmented risk management model.

The new administration has given priority to mobilizing tax revenues through strengthening SAT➢(s core operations and its governance framework. The Government has recognized the present context as an opportunity to reverse the trend of SAT➢(s poor performance through the implementation of a comprehensive reform. The reform plan includes critical modifications in the institutional and legal framework along with short, medium and long-term actions for improving SAT➢(s operations and its transparency.

As a first step, the Government succeeded in reforming the SAT➢(s legal and institutional framework with the approval of the amendments to the Organic Law for SAT (Ley OrgÃ¡nica de la SAT-Decree 1-98). The amendments address critical governance issues in the existing organization of the tax administration. Among the most important aspects included in the reform are: (i) the separation of functions related to administrative tax appeals with the creation of TRIBUTA, an administrative tribunal within SAT, that eliminates the risks of conflict of interest and incompatibilities when the role was exercised by members of the Board of Directors; (ii) limiting political influence in SAT nominations through the modification of appointments procedures for the SAT Superintendent, the members of the Board of Directors and the members of TRIBUTA; (iii) the revision of roles and responsibilities for the Board of Directors and the administrative instances in SAT; (iv) the creation of a specialized internal investigation unit with the capacity to detect and investigate corruption and conflict of interest practices in SAT; and (v) the regulation of financial confidentiality provisions granting SAT the authority to access taxpayers➢(bank information for auditing and investigation purposes.

In addition, the authorities have already implemented a number of short-term measures aimed at improving collection. Short term activities implemented by SAT include, among other: (i) the hiring and training of new staff; (ii) the authorization and closure of gates in Puerto Quetzal (EPQ access) to reinforce security and merchandise controls in one of the main import and export points; (iii) implementation of a monitoring system in ports (CCTV); (iv) improvement of containers controls from arrival to release in customs; (v) the strengthening of controls of ramps in customs; (vi) the establishment of an internal investigations unit, its protocols and training; (vii) the acquisition of hardware infrastructure needed to avoid disruptions in the availability of existing information systems in SAT, and (viii) the completion of the definition and development of a data warehouse to support initial tax intelligence initiatives in SAT. All these measures are expected to gradually contribute to increase tax revenue collection. They will be followed and complemented by structural institutional changes in SAT and by medium and long-term reforms to restore the institution's credibility and capability to perform its role in an effective and sustainable way.

The Government has successfully mobilized and coordinated efforts from development partners to support the implementation of SAT④(Â´s integrated reform plan. Several international organizations and donors including the IMF, IDB, World Bank (WB), US Treasury (OTA), and the GIZ have agreed to align their technical assistance and support programs around a common reform plan. The Government has established the areas of priority where each of the organizations is now providing support in a coordinated manner. A summary of the areas is presented in Table 1. As part of these efforts, an IMF led mission took place in May 2016 and produced a comprehensive report covering the various aspects of the tax administration. The report includes recommendations containing both measures geared towards restoring levels of collection in the short-term, as well as indications for medium-term strategies to reinstate full control and credibility in the tax administration.

In particular, the Government has requested the WB to support medium and long-term reforms related to SAT. The proposed Project draws on recommendations from the IMF report as well as previous analysis and diagnostics. It will focus on providing support to both governance and operational aspects of the tax administration in the medium-term. It will primarily address the structural problems causing the tax administration operational inefficiency and would also address governance related aspects in the SAT in order to realign incentives for a more effective tax administration and to restore the credibility of the tax administration to help rebuild taxpayer confidence and thus strengthen the tax culture in the country as a whole. Issues and shortcoming related to the existing tax policy framework and elements linked to quality of transparency in the expenditure side of the fiscal management are beyond the scope of the proposed Project.

The proposed Project is part of a broader package of lending and analytical instruments to support the country's reforms on governance of public resources. It complements policy and institutional actions that are being supported through the First Improved Governance of Public Resources and Nutrition (US$250 million; P160667) Development Policy Financing. The objective of the development policy financing series is to support the Government's efforts to strengthen the regulatory and institutional framework to improve governance of public resources and accountability. These efforts will be accompanied by analytical instruments, including technical assistance on using behavioral insights to motivate citizens to pay taxes, technical assistance related to improving transparency and anti-money laundering systems, and an analysis to better understand the challenges related to high levels of informality.

II. Proposed Development Objectives

The project development objective is to increase levels of compliance with tax and customs obligations.

III. Project Description

Component Name

Component 1. Transparency, Integrity and Institutional Development in SAT

Comments (optional)

The objective of this component is to support implementation of the new SAT➢(s governance model by supporting the implementation of the recently approved amendments to the Organic Law of SAT and by strengthening its internal capacities in areas related to strategic planning, human resource management, institutional integrity, information governance, and information and communication technology (ICT) services. It will also support implementation of a change management strategy and communications initiatives to ensure successful implementation of the proposed reforms.

Component Name

Component 2. Strengthening of Tax Collection Functions in Internal Revenues and Customs

Comments (optional)

The purpose objective of this component is to strengthen the core processes of the primary tax collection and controls functions in both Internal Revenues and Customs with a view to enhancing taxpayer voluntary compliance, taxpayer satisfaction and SAT➢(s efficiency. This component will support: (i) review and redefinition of core processes and management instruments for revenue collection; (ii) the upgrade, replacement and development of information systems; and (iii) the implementation of electronic services for taxpayers.

Component Name

Component 3. Strengthening of Integrated Tax Intelligence and Tax Enforcement

Comments (optional)

The objective of this component is to strengthen tax intelligence and tax enforcement capabilities of SAT. The component will promote an efficient use of tax information sources to support the auditing, control and enforcement functions through the adoption of an integrated compliance risk management model, the promotion of a culture of information analysis within SAT, and the strengthening of tax auditing and legal services for a more effective detection of evasion and tax fraud practices and the effective collection of disputed taxes. The proposed model will cover both internal revenues and customs in order to deter existing silo-based practices and to increase effectiveness of the tax intelligence function through the effective access and use of all available information.

IV. Financing *(in USD Million)*

Total Project Cost:	55.00	Total Bank Financing:	55.00
Financing Gap:	0.00		
For Loans/Credits/Others			**Amount**
International Bank for Reconstruction and Development			55.00
Total			55.00

V. Implementation

VI. Safeguard Policies (including public consultation)

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment OP/BP 4.01		✖
Natural Habitats OP/BP 4.04		✖
Forests OP/BP 4.36		✖
Pest Management OP 4.09		✖
Physical Cultural Resources OP/BP 4.11		✖
Indigenous Peoples OP/BP 4.10		✖
Involuntary Resettlement OP/BP 4.12		✖
Safety of Dams OP/BP 4.37		✖
Projects on International Waterways OP/BP 7.50		✖
Projects in Disputed Areas OP/BP 7.60		✖

Comments (optional)

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