DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

GUATEMALA

PROGRAM TO STRENGTHEN PUBLIC FINANCE

(GU-L1020)

LOAN PROPOSAL

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REQUIRED

1. Policy letter
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1419233
2. Means of verification
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1423704
3. Results matrix
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1423719
4. Independent macroeconomic assessment
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1544947
4. Safeguard and Screening Form for Screening and Classification of Projects (SSF)
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1537768

OPTIONAL

1. Modernization of the tax system
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1423314
2. Income tax
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1423184
3. Transparency of public spending and investment
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1423223

Abbreviations

CAFTA	Central American Free Trade Agreement
GDP	Gross domestic product
IETAAP	Special Temporary Tax to Support the Peace Accords
IMF	International Monetary Fund
ISR	Income tax
MDGS	Millennium Development Goals
MFP	Ministry of Public Finance
MIF	Multilateral Investment Fund
NGO	Nongovernmental organization
SAFE	SAFE Framework of Standards to secure and facilitate global trade
SAT	Superintendency of Tax Administration
SMEs	Small and medium-sized enterprises
VAT	Value-added tax
WCO	World Customs Organization
WMS	Workflow management system

PROJECT SUMMARY

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Financial Terms and Conditions[1]				
Borrower: Republic of Guatemala			Amortization period:	20 years
Executing agency: Ministry of Public Finance			Grace period:	5 years
Source	**Amount**	**%**	Disbursement period:	3 years
IDB (Ordinary Capital)	US$400 million	100%	Interest rate:	Variable
Local	0	0%	Inspection and supervision fee:	*
Total	US$400 million	100%	Credit fee:	*
			Currency:	U.S. dollars

Project at a Glance

Project objective:
The program's objective is to improve fiscal management by: (i) increasing tax collections and equity through a new income tax system; (ii) modernizing administration, especially in customs; and (iii) improving the quality and transparency of government spending by implementing a system to control budget expenditures executed via transfers, and strengthening the public procurement system. The program will also shore up fiscal sustainability, given the deteriorating external conditions. The operation amount will be US$400 million in three tranches, supplemented by two institutional strengthening operations, one for the Ministry of Public Finance (GU-L1031), the other for the Superintendency of Tax Administration (GU-L1032).

Special contractual clauses:
The disbursement of resources for each of the tranches will be subject to performance of the policy reform measures or institutional changes agreed upon for the release of each tranche, as established in Chapter I, Section D, and in Annex I (Policy Matrix).

Exceptions to Bank policies:
None.

Project consistent with country strategy: Yes [X] No [ ]
Project qualifies as: SEQ [ ] PTI [ ] Sector [ ] Geographic [ ] Headcount [X]

Procurement: Not applicable.
ESR review on: 24 March 2008

* The credit fee and 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 provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

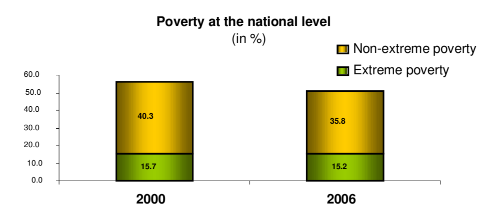
1.1 The long-term growth of Guatemala's economy has lagged behind most other economies in the region. In the period 1980-2007, it grew on average 0.5%, compared to an average of 1.5% for Latin America.[1] A recent Bank study[2] found that this was due chiefly to insufficient investment in physical infrastructure, too little human capital development, and low appropriability of returns for businesspeople, essentially owing to uncertain ownership rights and institutional weaknesses (public sector transparency and efficiency).

1.2 Nonetheless, the Guatemalan economy grew steadily in the past four years, especially in 2006 and 2007, reaching rates of 5% and 5.7%, respectively, at the peak of the cycle. This growth can be attributed in part to increased exports of goods (15%), tourism (18%), as well as a healthy increase in family remittances (14.4%) and consumer credit (27%). The growth outlook for 2008 is positive, although a deceleration is projected with respect to 2007.

1.3 However, several factors could adversely impact the economy. First, the deceleration of the United States and European economies will result in a drop in export demand, and in remittances from workers. In addition, international market restrictions and risk adjustments may cause interest rate hikes and tighten credit in the country, especially since Guatemala still runs a large current account deficit, almost 5% of gross domestic product (GDP).

1.4 Social conditions have improved, yet Guatemala is still far from meeting the Millennium Development Goals (MDGs) and the objectives under the Peace Accords, mainly in the areas of poverty, health, and education. Poverty declined 5% from 2000 to 2006, but the current rate of 51% of the population is still far from the 30.8% goal for 2015. Extreme poverty held steady through 2006 at levels similar to 2000 (15.2%), whereas the MDG for 2015 is 9% (see Figure 1).

Figure 1



Source: ENCOVI-INE, 2007

1.5 Public health in Guatemala lags behind the other Central American countries (Nicaragua, Honduras, El Salvador, and Costa Rica), despite a higher average gross national income per capita. Guatemala also has worse outcomes for indicators such as life expectancy at birth, infant mortality, under-5 child mortality, and child immunizations. Concerning nutrition, one in every two children under the age of 5

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1 Simple average.

2 See, "Mas crecimiento, mas equidad: Prioridades de desarrollo en Guatemala" [More growth, more equity: Priorities for Guatemala's development]. IDB (2008).

is undernourished, a figure the country hopes to bring down to one in six by 2015. Concerning education, one in four children aged 13 completed primary school in 2000. Today, that indicator is up to one in three, although the MDG aims for all children to do so. Clearly, social spending must be scaled up significantly to attain these important objectives. Spending grew by only about 0.3% of GDP from 2001 to 2007, reaching 7.4% of GDP and remaining among the lowest in the region.

1.6 The government plan of the Unidad Nacional de la Esperanza party [National Unity of Hope] (UNE) is to reduce poverty, ensuring compliance with the Peace Accords and meeting the MDGs goals for social development. The plan further acknowledges a social debt, and the priority of providing special care for the most vulnerable population groups, so as to build their capacity and better integrate them into the productive sector, while respecting their ethnic values.

1.7 The administration is pursuing the necessary political agreements to advance a fiscal and economic policy comprising four areas of major focus, notably increased and reoriented public spending, and citizen security. The other areas include ensuring macroeconomic stability and making government more transparent. To address these challenges in a framework of fiscal sustainability, the government is committed to two parallel actions: increase tax revenue collection, and make government spending more efficient.

1.8 The Bank has been supporting Guatemala with a series of fiscal programs initiated by the framework document (PR-3046) and the Public Financial Management Reform Program II (1900/SF-GU), whose objectives were to expand coverage of financial planning and management systems, institute a multiyear budgeting structure, and improve management of contingent liabilities relating to the risk of natural disasters and municipal indebtedness. In regard to revenues, the program sought to introduce measures to increase productivity in value-added tax collections, and expand the number of municipalities certified for decentralization and collection of the single property tax (IUSI).

1.9 The Bank has also supported the Fiscal Pact process pursuant to the Peace Accords with studies on taxation, spending, and transparency financed by two technical cooperation operations (ATN/SF-10612-GU and ATN/SF-10207-GU). This work produced the broad outlines for the proposed reforms included in this operation.

B. Fiscal framework

1.10 Guatemala has one of the lowest and most stable public debt to GDP ratios (22.1%). However, despite the economic growth and higher revenues driven by very favorable international conditions, the fiscal deficit remains at about 2% of GDP (1.6% in 2007), even though Guatemala has the lowest social spending in the region at less than 8% of GDP. Indeed, Guatemala has had a tradition of low taxes and blocked reform proposals. Since the late 1990s, the National Peace Accords Committee has been part of the Fiscal Pact Preparatory Committee that leads a dialogue to enlist and convey to the private sector the importance of having a funded government with efficient and effective public spending. Much remains to

be done, but the country is better positioned now than in years past to accomplish fiscal reform.

1.11 **Tax revenues.** Guatemala has the lowest tax revenues in Latin America (see Figure 2), an inequitable system, and high tax evasion. Yet the tax burden has increased, due mainly to improved management at the Superintendency of Tax Administration (SAT), reaching 12.3% of GDP in 2007 (see Figure 3). However, the Special Temporary Tax to Support the Peace Accords (IETAAP), whose revenues represent 1% of GDP, ends this year, which will put additional financial pressure on the public coffers. This change, taken in conjunction with the economic slowdown, should result in a drop in revenues for 2008, which are estimated at 11.7% of GDP. Hence, the projected fiscal deficit for 2008 will be 1.6% of GDP, or approximately US$640 million, a sum the first tranche of this operation will help finance.

Figure 2

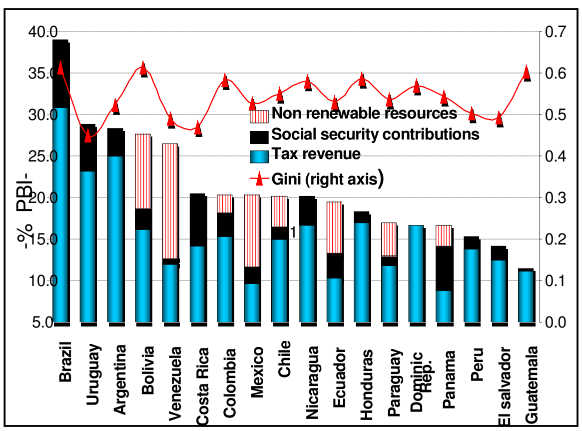
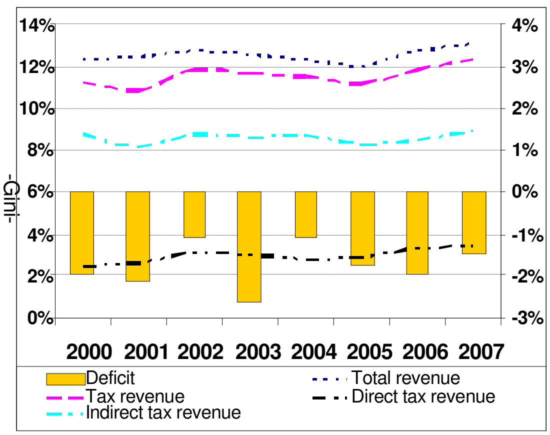


Figure 3



1.12 The value-added tax (VAT) is one of the region's most productive[3] given its broad base and relatively low uniform rate (12%). In addition, it is regressive (see Table 1). The individual income tax, on the other hand, is progressive but not very redistributive since the wealthiest 10% pay a low effective rate (less than 0.5%).[4]

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[3] Measured as the ratio of VAT revenue, as a percentage of GDP, to the VAT rate (average).

[4] Measured as the average tax revenues over income for each individual in the decile.

Table 1

(deciles based on individual income)

Progressivity	VAT		Personal income	
	Effective rate [a]	Who pays (%)	Effective rate	Who pays (%)
1 -	20.2	3.3%	0.06	0.1%
2 -	9.1	3.8%	0.07	0.4%
9 +	5.4	16.0%	0.14	5.8%
10 +	4.9	34.2%	0.48	86.9%
Who pays tax	**VAT**		**Income**	
40 -	16.5%		1.9%	
20 +	50.3%		92.7%	
20 + / 40 -	3		49	
Collections (% GDP)	6		0.5	
Tax expenditure	1.4		1.2	

1.13 Furthermore, income tax collections remain low, especially personal income (see Table 1), and the system needs to be overhauled and adapted to an open economy: (i) not all income is included, such as dividends and earnings; (ii) the individual income tax (ISR) still benefits from a VAT credit, running counter to savings and vertical equity;[5] and (iii) there are no international taxation laws.

1.14 **Tax administration.** Revenue collections are up in the past four years, but much remains to be done. The SAT has increased the number of effective taxpayers by 31%, tax enforcement effectiveness by 50% (see Figure 4, Chart A), and reduced VAT evasion by 25% (see Figure 4, Chart B) in the past three years. But still, tax evasion remains at more than 1 in 4 quetzales.

Figure 4

Chart A

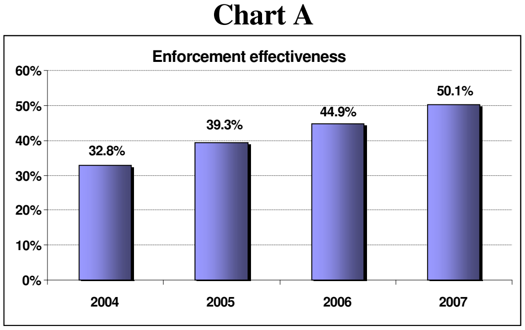
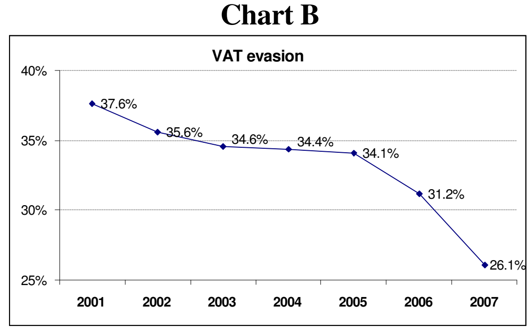


Chart B



1.15 The SAT modernization process targets the following strategic areas: (i) streamline customs clearance and control; (ii) improve relations with users and economic agents engaged in foreign trade; (iii) generalize the withholding-at-source system for the two principal taxes (VAT and ISR); and (iv) implement smart tax services and fiscal current account. To attain these goals, the chief programs include: professionalizing human resources, streamlining processes using state-of-the-art

[5] Defined as the increase of the effective tax rate in proportion to the increase in income.

technology, and conducting audits based on risk analysis. The 2007 SAT annual report shows the advances made in these areas.

1.16 Despite these advances, many problems relating to crossborder smuggling remain unsolved, especially so-called "ant smuggling"[6] across the Mexico border. At the same time, trade facilitation through lower transaction costs, to enhance competitive position and economic activity, is a challenge for the SAT at the borders, calling for process reengineering and improvements to infrastructure and equipment.

1.17 The SAT has committed to implement best international practices to address this problem. Specifically, it intends to institute the World Customs Organization (WCO) SAFE Framework of Standards to secure and facilitate global trade ("SAFE Framework"). In addition, the entry into force of the Central American Free Trade Agreement (CAFTA), and the likely agreement with the European Union, demand an ongoing effort to strengthen the SAT's institutional capabilities.

1.18 **Spending transparency and efficiency.** Lack of spending transparency is a problem for both the public and private sectors because it undermines government efficiency, reduces investment flows, erodes public confidence and government responsibilities, and diminishes the fiscal space to finance poverty-targeted programs. This lack of clarity is further exacerbated by the absence of controls over government expenditures executed via transfers to trust funds[7] and agreements with nongovernmental organizations (NGOs) and other entities. These operate with total autonomy and independence from the legal, technical, and administrative rules and procedures applicable to the government, and have come to account for 20% of total central government expenditures, equivalent to 2.2% of GDP in 2007.[8]

1.19 Too little transparency and too much red tape replicated in these mechanisms the very same problems incurred by government agencies. Consequently, the 2008 Budget Act sets budget rules designed to control these transfers. The new provisions require transfer recipients to enter into execution agreements, deliver physical and financial progress reports, and provide more comprehensive data. The transferred resources are also treated as an accounting advance subject to later payment.

1.20 One advance in recent years has been the roll-out of the Government Procurement Information System (Guatecompras) to publish public procurement processes. All government agencies and entities subject to the Government Contracting Act are required to use this system. Nonetheless, there is still much to be done to enhance procurement efficiency and control. Lastly, the lack of a policy to analyze procurements from a strategic and holistic perspective rather than merely as

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6 Mainly fuels, which significantly impact certain taxes.

7 As of 31 December 2007, there were 57 registered public trust funds, 49 of which were created by the central government, and 8 by decentralized, autonomous entities.

8 For example, the Ministry of Public Health and Social Welfare transferred resources to 95 NGOs in 2006.

processes, and the persistent institutional weaknesses hindering compliance with rules and procedures, point to the need for a new legal framework.

1.21 Despite the progress made to improve procurement transparency using the Guatecompras system, more work is needed to improve procurement efficiency and control. For instance, the existing system lacks the functionality for e-purchasing or e-tendering, nor is it ready to make better use of statistics for procurement planning and expand the use of open-ended contracts.

C. Program objective and structure

1.22 The **program objective** is to improve fiscal management by: (i) increasing tax collections and equity of the tax burden, and improving tax administration; and (ii) improving the quality of government spending through greater transparency and control in budget execution.

1.23 On the revenue side, improvements will be driven by a tax reform to modernize income tax assessments and update tax evasion laws so as to boost collections, and achieve greater efficiency and progressivity. This effort will be complemented by an institutional-building program for the SAT, including improvements to customs processes, equipment and infrastructure.

1.24 On the expenditure side, the program aims to improve quality and transparency by implementing a system to control budget expenditures executed via transfers, and strengthen the public procurement system. The program will also update the existing policy framework and processes of the apex agency, the Ministry of Public Finance (MFP). An institutional strengthening operation for the MFP will supplement and integrated with this effort.

1.25 The **program structure** is a three-tranche policy-based loan (PBL), supplemented by institutional strengthening in the form of restructuring of the MFP and modernization of the SAT, supported by two complementary investment projects in preparation: Support for Modernization of the Ministry of Public Finance (GU-L1031), and Support for the Superintendency of Tax Administration (GU-L1032).

D. Program components

1.26 The program target areas are to: (i) support the development of a stable macroeconomic policy; (ii) modernize the tax system through tax reform centered on a new income tax model, providing for international taxation; (iii) strengthen tax administration and institute a series of measures to combat evasion; and (iv) make public spending more efficient and transparent, especially through control of budget expenditures executed via transfers and upgrading the public procurement system.

1.27 **Maintain a stable macroeconomic framework.** The operation will support the development of a stable macroeconomic policy, consistent with the program objectives and the sector policy letter. The targets include keeping inflation at a moderate level, and a low fiscal deficit.

1.28 **Modernize tax policy.** The program will help design and implement a modern income tax system, based on studies agreed by consensus with the Fiscal Dialogue Support Group. This design[9] envisages a universal system that taxes all income, but affords differential treatment for earned income from work (personal), capital gains, and business income. The structure will simplify personal income taxes, making it more progressive (vertical equity) with fewer tax brackets (down from the current four to two), and eliminating certain benefits, such as the VAT credit that is difficult to control.

1.29 The tax base will now include all capital income, without exception, with the full tax liability withheld and paid to the tax authorities at the source. This mechanism not only lowers the cost of compliance for the taxpayer, but also allows the administration to combat tax evasion and avoidance more effectively. The business income tax rate will be lowered to boost competitiveness to attract investment, moving to a rate in line with the regional and international trend.[10] Returns on equity will be taxed when removed from the business circuit (dividends and distributed earnings), to encourage reinvestment and vertical equity.

1.30 The reform also introduces international taxation. With the signing of CAFTA, Guatemala is increasing its international engagement. This legislation (Guatemalan Tax System Modernization and Strengthening Act) establishes a modern income tax structure that includes the regional models for transfer pricing, undercapitalization, and tax treaties approved by the Council of Secretaries of Finance and Ministers of the Treasury of Central America, Panama and the Dominican Republic (COSEFIM), prepared with Bank support. The package is rounded out with antievasion measures supplemental to the 2004 Antievasion Act I, providing a series of control requirements such as introduction of a VAT withholding system and an update to the motor vehicle traffic tax. The net impact of the reform will be an increase of more than 10% in total revenues collected, and 33% in income tax revenues.

1.31 **Strengthen tax and customs administration.** The strategy for administration of internal revenue is to close the information loop in order to combat evasion. This will be achieved through universal withholding of both VAT and income tax, which account for 70% of tax revenues, by importers, public entities, and large taxpayers. Data will be reported to the SAT electronically or, optionally, via Internet, to facilitate the large-scale crosschecking of data.

1.32 In an effort to control the entire taxpayer universe and pay special attention to small taxpayers,[11] representing about 99.7% of businesses and 15% of tax revenues collected, the reform will be further supplemented by a simplified tax return, payment, and accounting system. This will involve providing small and medium-

[9] Currently in force in Germany (2008), Slovenia (2007), Spain (2007), and Uruguay (2007).

[10] The average rate for the European Union is 23.5%, down by about 4% in the last decade, whereas the current rate in Guatemala is 31%.

[11] This includes micro, small and medium-sized enterprises.

sized enterprises (SMEs), electronically or via Internet, with an application meeting the requirements of Guatemalan legislation that allows them to prepare their accounting reports and tax returns automatically. The SAT has begun this process with Bank support under a MIF-financed operation in preparation (GU-M1022). This will be supported by a special simplified VAT and income tax regime for micro and small taxpayers.

1.33 With respect to customs, the objective is to expand control processes to guarantee revenue collection, using nonintrusive means, equipment and infrastructure at the border to lower transaction costs, thus promoting investment and exports. Improved infrastructure and procedures will, in turn, help control smuggling.

1.34 The SAT intends to implement the WCO SAFE Framework, a commitment stated in its Institutional Strategic Plan 2008-2011. This system will further advance the work to improve operational management, as well as the relationship between links in the logistics chain at borders, through improved processes, technology, equipment, and infrastructure.

1.35 These actions will improve customs performance, making the clearance process more efficient and ensuring sound controls. They include implementing a customs administration system to handle freight management and customs clearance processes for imports, exports, and goods in transit, using the Workflow Management System (WMS),[12] and a customs transit control system. The customs infrastructure will also be updated, deploying modern technology such as scanners to control customs fraud.

1.36 **Make public spending more efficient and transparent.** The program will target two areas: (i) control of total budget expenditures, including those executed via transfers, subscribed by the central government; and (ii) the government (electronic) procurement process. The following activities will enhance the transparency and control of budget execution: (a) modernize the MFP, strengthen the policy-making bodies for financial administration (with additional support from technical cooperation operation GU-T1074 under PRODEV Account B to implement a management-for-results system), and government procurement by drafting and enforcing rules to promote fiscal transparency in public spending; and (b) develop, introduce, and enforce across-the-board accountability mechanisms for advances made for delegated expenditures, revolving funds, and trust funds subscribed by the central government for budget expenditures executed via transfers.

1.37 To strengthen the government procurement system, this program will build upon recent progress in introducing the open-ended contract mechanism, and the use and development of the "Guatecompras" portal. Support will take the form of: (i) developing rules and regulations that will culminate in formulation of a proposal

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[12] These processes use as a platform the information system developed by the SAT (SAQB'E).

for a modern procurement law; and (ii) strengthening and developing the informational and transactional features of the "Guatecompras" portal.

1.38 Additionally, modernization of the MFP under loan GU-L1031 will consolidate its role as the lead agency for government procurement policy-making by strengthening the Government Procurement Policy Office (DNCAE).

E. Expected outcomes

1.39 The medium-term outcomes of the program are expected to result in strengthened fiscal management, namely improvements in tax revenue collection and greater transparency in public spending. The specific indicators are described in Section F. The principal program outcomes are described below.

1.40 **Maintain a stable macroeconomic framework.** This includes commitments to relatively low and stable inflation rates, sustained GDP growth, and an overall public sector balance that favors long term fiscal sustainability.

1.41 **Increase revenues by improving the tax system, especially income tax.** The combined impact of the income tax reform and the Antievasion Act II is expected to yield 1.4% of GDP in the medium term (12% of estimated 2008 tax collections). However, bearing in mind this annual tax takes effect in 2009, and the changes provided in the law will be phased-in gradually, the reform will not generate a 1% of GDP increase until the program's third tranche (projected for 2010).[13] Consequently, total tax revenue is expected to grow by about 0.6% of GDP in 2010,[14] with respect to 2007, with a tax system made more progressive by a strengthened personal income tax.

1.42 **Make tax administration more efficient.** Better large-scale control of tax bills, returns, and payments will be needed, to administratively establish the current good design of the VAT and income tax, once the reform is approved. This will be achieved through generalized withholding systems for both taxes, with electronic reporting allowing for crosschecking[15] of taxpayer transactions.

1.43 Customs management will also be better organized once the WMS and the new transit control system are implemented, linking all actors along the logistics chain via an electronic operation tracking and tracing system. This will facilitate trade while reducing evasion.

1.44 **Improve the quality and control of budgetary spending.** The restructuring of the MFP, begun under the program, will strengthen the lead policy-making bodies for public financial management and create the post of Vice Minister for Transparency and Evaluation. One specific outcome of these actions will be greater control over execution of the budget line item for transfers using trust funds and agreements

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[13] The new income tax also provides for a broad tax assessment base and low rates, allowing for future adjustments, if necessary.

[14] Bear in mind that a decrease of approximately 1% in tax revenues is anticipated, from 2008 onward, with the elimination of the Special Temporary Tax to Support the Peace Accords (IETAAP).

[15] The purchases declared by one taxpayer must match the sales declared by another.

with NGOs or other entities subscribed by the central government. Targets for this have been set, that can be monitored to ensure strict adherence to the new execution, recordation, and control policies. Furthermore, strict adherence to these policies for transfers and the adoption of pertinent accountability mechanisms will be supplemented by an efficiency analysis of these trust funds to determine their relevance and, as applicable, facilitate their closing and redirect their resources to finance priority social spending.

1.45 In relation to strengthening of the government procurement system, the program outcomes relate to: (i) startup of the "Guatecompras" electronic bidding module to increase competition, remove barriers to supplier participation by providing equal access to information; (ii) establish the DNCAE as system lead agency through improved planning and management of public procurement; and (iii) propose a reform to the legal framework for government procurement, based on a participatory consultation process driven by an interagency dialogue forum with civil society participation.

F. Key indicators

1.46 Financing for each of the three tranches under the program will be contingent upon fulfillment of the conditions specified in Annex I to this program. The key indicators are described below.

1.47 **Tax reform.** Under the program's first tranche, the bill for the Guatemalan Tax System Modernization and Strengthening Act, which includes the tax reform and administrative antievasion measures, will be submitted to the Congress of the Republic. Appropriate regulations will have to be in place in time for the second tranche, because the reform includes modern elements such as dual income and international taxation. In the last tranche, the reform is expected to yield 1% of GDP.

1.48 **Strengthened tax administration.** In the first phase, the SAT is expected to add an income tax withholding system to the recently instituted VAT withholding, to control the universal invoicing process and initiate across-the-board controls. To close the information loop, the SME portal will be operational from the second tranche onward, recording purchases by these companies. By the end of the process, the Integrated Tax Current Account[16] is expected to be in effect for 20% of active taxpayers, accounting for approximately 95% of revenues collected.

1.49 The goal of this component is to get the WMS freight and customs clearance management system up and running at the ten largest customs areas,[17] and the customs transit control system at all border posts. A major investment in infrastructure is essential to attain this goal, and is envisaged in the SAT institutional strengthening project.

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[16] This registry at the individual level includes all transactions relating to the sale of goods and services by major taxpayers (large taxpayers, exporters, and public entities).

[17] These customs areas handle over 95% of the country's foreign trade flows.

1.50 **More transparent and efficient spending.** The first tranche provides for publishing and putting into effect the policy restructuring the MFP to strengthen its lead policy-making role and promote transparency. Indicators will be developed to measure implementation of the new policy framework for budget execution through trust funds and agreements with NGOs and other entities subscribed by the central government. These indicators provide for a progressive increase in coverage in the second and third tranches, so as to reach full coverage by the third tranche.

1.51 Progress indicators for the government procurement system include launching the Guatecompras electronic bidding module, and two milestones relating to the legal framework for the government procurement system: one is to initiate the participatory process for the comprehensive reform of the system (second tranche), and the second is to submit the reform bill to Congress (third tranche).

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instrument

2.1 The choice of lending instrument (policy-based loan) selected for this project in concurrence with the Government of Guatemala offers two comparative advantages. The first is technical support and an ongoing policy dialogue during the reform implementation process. The second is that it is the most appropriate type of instrument when working with clearly defined policy objectives. Moreover, this loan structure increases the impact of the policies, securing continuity by making them more independent of the political process.

2.2 The amount of this operation is US$400 million, comprising three tranches: the first tranche for up to US$150 million, the second for up to US$150 million, and the third for up to US$100 million. This tranche structure is necessary for the following reasons: (i) tax reforms, whether to policies or administration, do not take effect immediately, requiring a phased action plan for the changes to mature, corresponding to the tranches under this operation; and (ii) the worsening international economic climate, together with the demands for government spending to meet the needs of disadvantaged social groups, call for countercyclical financing to help maintain fiscal stability.

B. Coordination with other finance and cooperation agencies.

2.3 This operation builds upon the Integrated Financial Management Additional Financing loan (P106993), recently approved by the World Bank. The objective of that loan is to strengthen the Integrated Financial Management System, expanding it to the municipalities, and strengthen the Office of the Comptroller General for the public investment system.

2.4 In discussions[18] between the International Monetary Fund (IMF) and the government economic team, moreover, it was agreed that, while recognizing that the macroeconomic outlook is generally favorable, the worsening international economic conditions called for prudent financial and fiscal measures. That makes tax reform all the more necessary, as well as ongoing administrative effort to provide funding for the delivery of essential public services. It was further recommended that greater transparency and efficiency should be built into government spending. The IMF and IDB teams regularly exchange information on these matters.

C. Environmental and social safeguard risks

2.5 The program will have no direct adverse environmental impacts. However, it will have direct social impacts because the measures to improve the tax structure will increase revenue collections, which, combined with improved quality of spending, have been earmarked in the government program for poverty reduction programs.

D. Other key issues and risks

2.6 **Risk analysis.** During the program orientation mission, the program risk analysis was conducted with the involvement of the government authorities. The chief risk to this operation is political, in that Congress may fail to pass the tax reform bill. To mitigate this risk, the government based the reform on solid comparative studies, building on the experience in other countries. Furthermore, the reform is moderate, and both the Fiscal Dialogue Support Group and the Government have held a number of events to disseminate and discuss the reform, where certain key stakeholders have expressed support. The other risks identified for this operation are described in the risk analysis (see electronic link 5).

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary implementation arrangements

3.1 The borrower will be the Republic of Guatemala. The Ministry of Public Finance (MFP) will be the executing agency, even though policy actions will be supported in relation to other institutions such as the Superintendency of Tax Administration (SAT), deemed necessary for the integrity of the proposed reform.

3.2 The MFP will: (i) deliver reports and evidence of fulfillment of the program conditionalities, and such other reports as the Bank may require; (ii) conduct activities necessary to meet the program policy objectives, in particular those identified as triggers for the second and third tranches of this operation; and (iii) gather, retain, and deliver to the Bank all information, indicators, and parameters useful for the government and the Bank to monitor, measure, and assess outcomes in the three program tranches.

[18] Conclusions of the Article IV Consultation with the Government of Guatemala, 18 March 2008 press release, and document to the Board approved on 9 May 2008.

B. Summary of arrangements for monitoring results

3.3 The project team will be responsible for monitoring this program within the Bank. The borrower and the Bank have agreed to supervise program execution through monitoring meetings, to be scheduled by mutual agreement. Upon completion of each tranche of the operation, the project team will prepare a simplified version of the project status report. This report will track program indicators in order to assess progress and make any changes necessary to meet the program's medium-term targets.

3.4 A project completion report (PCR) will be delivered six months after fulfillment of the conditions precedent to the third tranche release. The PCR will assess impacts and achievement of the expected outcomes under the program. The borrower has previously agreed with the Bank on the indicators and baseline to be used for the final evaluation (see electronic link 2).

3.5 The borrower will be responsible for gathering all data necessary for program monitoring and evaluation. The authorities will cover the costs of gathering and processing such data. The indicators in the results matrix are consistent with the activities and commitments under the two Bank investment programs and the MIF-funded operation that complement this loan.

IV. POLICY LETTER

4.1 The Bank has agreed with the Government of Guatemala on the macroeconomic and sector policies included in the Policy Letter sent by the MFP on 25 April 2008 (see electronic link). The letter describes the main components of the government strategy being implemented in the program target areas described in this document, and reaffirms the government's commitment to institute the reforms and activities agreed upon with the Bank.

GUATEMALA
PROGRAM TO STRENGTHEN PUBLIC FINANCE
(GU-L1020)

POLICY MATRIX

Objectives	Tranche 1	Tranche 2	Tranche 3	Outcomes
Macroeconomic stability				
Maintain a stable macroeconomic framework for economic growth with equity.	The macroeconomic environment remains conducive to meeting the program objectives. *Means of verification:* Independent macroeconomic assessment			Fiscal sustainability.
Fiscal structural reforms				
2.1 Tax reform				
Increase collections by improving the tax system, especially income tax.	The bill for the Guatemalan Tax System Modernization and Strengthening Act, which includes the tax reform and antievasion measures, are submitted and filed with the Legislative Office of the Congress of the Republic *Means of verification:* Receipt issued by the Legislative Office of Congress acknowledging receipt and filing of the bills	Publication and entry into force of the Guatemalan Tax System Modernization and Strengthening Act, including: (i) a modern income tax to cover earned income from work, capital gains, and business income, (ii) a simplified VAT and income tax regime for small taxpayers, and (iii) an amendment to the motor vehicle traffic tax *Means of verification:* Publication in the official gazette, Diario de Centroamérica, and entry into effect of the Act	Presentation of evidence showing that the Guatemalan Tax System Modernization and Strengthening Act has yielded at least 1% of GDP *Baseline* Tax revenue breakdown for 2007 *Means of verification:* Official statistics (SAT and Banco de Guatemala)	Collections increase with a fairer and more efficient tax system, for increased tax revenues of at least 0.6% of GDP compared to 2007 *Baseline:* Tax revenues of 12.3% of GDP, with 5.7% GDP growth in 2007 *Means of verification:* Official statistics (SAT and Banco de Guatemala)

Objectives	Tranche 1	Tranche 2	Tranche 3	Outcomes
2.2 Strengthen tax and customs administration				
Make tax administration more efficient	Develop and put into operation an income tax withholding system supported by specialized software *Means of verification:* SAT report enclosing the newly developed software, evidence that it is up and running for income tax withholdings	(i) Implement and put into operation the customs administration system to manage cargo and customs clearance for imports, exports, and goods in transit in at least the ten largest customs areas in the country, using the workflow management system (WMS), and the customs transit control system in at least six customs stations (three maritime ports and three land ports) *Means of verification*: SAT report certifying that the cargo management and customs clearance processes for imports, exports, and goods in transit are being handled at the ten largest customs areas using the WMS, and that the new customs transit control system has been introduced at six customs areas (three maritime ports and three land ports) (ii) Implement and put into operation the SMEs payment portal, including the simplified fiscal accounting module *Means of verification:* SAT report certifying that the application is ready and distributed on magnetic media, and that the SAT website (www.sat.gob.gt) contains the relevant information	(i) Implement and put into operation the customs administration system for operational and administrative customs processes in at least the ten largest customs areas in the country, using the workflow management system (WMS), and the customs transit control system in all other customs areas *Means of verification*: SAT report certifying that the operational and administrative processes have been introduced at the ten largest customs areas using the WMS, and that the new customs transit control system has been deployed at all other customs areas (ii) Implement and put into operation the online filing system for both income tax and VAT returns, as an alternative to BANCASAT *Means of verification:* SAT report certifying that the system is up and running, stating the number of returns processed	Increase in collections due to control of returns and large-scale crosschecking of data. *Means of verification*: The Integrated Tax Current Account has been instituted for 20% of payers of VAT and income tax

Objectives	Tranche 1	Tranche 2	Tranche 3	Outcomes
2. 3 Make public spending more efficient and transparent				
Improve control and efficiency of spending	(i) Publish and put into effect the decree restructuring the Ministry of Public Finance (MFP) with a view to consolidating its role as lead agency for the administration systems, and promoting greater transparency in public spending through creation of a Transparency Office *Means of verification*: Publication in the official gazette, Diario de Centroamérica, and entry into effect of the decree	(i) Verify that physical and financial data are reported by at least 25% of central government trust funds in operation, and at least 75% of social programs and projects executed under agreements between the central government and NGOs or other entities, in accordance with the MFP requirements intended to make budgetary spending more efficient and transparent *Means of verification*: MFP report and website on fiscal transparency certifying and verifying that physical and financial data are reported by at least 25% of trust funds in operation, and 75% of social programs executed under agreements between the central government and NGOs or other entities, in accordance with MFP requirements	(i) Verify that physical and financial data are reported by 100% of central government trust funds in operation, and 100% of social programs and projects executed under agreements between the central government and NGOs or other entities, in accordance with the MFP requirements intended to make budgetary spending more efficient and transparent *Means of verification*: MFP report and website on fiscal transparency certifying and verifying, respectively, that physical and financial data are reported by 100% of trust funds in operation, and 100% of social programs and projects executed under agreements between the central government and NGOs or other entities, in accordance with MFP requirements	Increased transparency as a result of control and evaluation of total budgetary spending, including expenditures executed via transfers, and the e-procurement process *Means of verification:* Evaluation reports on budget expenditures executed via transfers under agreements trust funds, NGOs, or other entities
	(ii) All central government agreements with NGOs and other entities executing budget expenditures via transfers adhere to the requirements of Article 12 of Congressional Decree 70-2007 *Means of verification:* MFP report certifying that the applicable policies have been instituted, listing the agreements signed with NGOs and other entities	(ii) Establish and implement an interagency dialogue forum with civil society participation for comprehensive reform of the government procurement system *Means of verification*: MFP invitation to the sectors involved, and report of the first meeting of the interagency dialogue forum with civil society participation for comprehensive reform of the government procurement system	(ii) Presentation and filing of the bill on procurement policies and processes with the Legislative Office of Congress *Means of verification*: Receipt issued by the Legislative Office of Congress acknowledging receipt and filing of the bill on procurement policies and processes	

Objectives	Tranche 1	Tranche 2	Tranche 3	Outcomes
		(iii) Guatecompras: The electronic bidding module is in use *<u>Means of verification</u>:* Guatecompras (http://www.guatecompras.gt)		

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/08

Guatemala. Loan ____/OC-__ to the the Republic of Guatemala
Program to Strengthen Public Finances

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 Guatemala, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a program to strengthen public finances. Such financing will be for the amount of up to US$400,000,000, from the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Executive Summary of the Loan Proposal.

<u>Conditional provision</u>: This resolution will enter into force on January 1, 2009.

(Adopted on ___ _________ 2008)

LEG/SGO/CID/IDBDOCS#1475605
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