

**TECHNICAL-COOPERATION LOAN
FOR MODERNIZATION OF THE TAX SYSTEM**

(EC-0175)

EXECUTIVE SUMMARY

BORROWER AND GUARANTOR:	The Republic of Ecuador
EXECUTING AGENCY:	The Ministry of Finance [Ministerio de Finanzas y Crédito Público] through the Internal Revenue Service [Servicio de Rentas Internas]
AMOUNT AND SOURCE:	IDB: US\$15,800,000 (OC) Local contribution: US\$ 7,290,000 Total: US\$23,090,000
FINANCIAL TERMS AND CONDITIONS:	Amortization period: 25 years Execution 36 months Disbursement period: 48 years Interest rate: Variable Inspection and supervision: 1% Credit fee: 0.75% Currency U.S. dollars under the Single Currency Facility
OBJECTIVES:	To support the Government of Ecuador in its establishment of the Internal Revenue Service as a professionalized and administratively autonomous tax administration.
DESCRIPTION:	<p>The project has five components:</p> <p>Component 1 - Organizational development (US\$630,000) This component seeks to put the Internal Revenue Service into operation such that it operates on the basis of three strategies: (i) institutional autonomy; (ii) consolidation of operational decentralization; and (iii) treatment of taxpayers in relation to their financial significance.</p> <p>Component 2 - Human resources management and training (US\$11,914,400). This component aims to professionalize the Internal Revenue Service and promote the development of its human resources in keeping with the new organization and to secure their commitment to forward-moving organizational change and ethics in taxation; in addition to paying off the financial entitlements of the personnel of the</p>

present organization who are not selected for employment in the new Internal Revenue Service, on the basis of the studies being done with resources of the PPF operation (EC-0178).

Component 3 - Redesign of tax administration processes (US\$825,800). Under this component, the main processes of tax administration will be adapted to the new organizational definitions, with a view to higher productivity.

Component 4 - Information processing technology (US\$3,894,000). This component will be aimed at integrating tax information systems and consolidating the technological infrastructure.

Component 5 - Regulatory provisions with regard to taxation (US\$228,000). Under this component, regulatory provisions will be adapted to the new structure of the tax administration, and particularly to the monitoring and enforcement of tax laws and of changes stemming from the tax reform whose viability is now being assessed by the national government.

The executing agency will receive technical support from the Inter-American Center for Tax Administration [Centro Interamericano de Administraciones Tributarias] (CIAT), the specialized agency that will have charge of the technical aspects of execution of the program and assist the executing agency in all aspects of its implementation, and will act through the long-term Technical Coordinator. With the prior clearance of the Bank and the executing agency, this specialized agency will also propose, contract, and supervise the consultants to be hired, and will oversee the overall carrying out of the program.

**ENVIRONMENTAL AND
SOCIAL
CLASSIFICATION:**

At meeting 17/97 on May 30, 1997, the CESI concluded that no special recommendation or further analysis was required in connection with this project.

**CRITERIA FOR
POVERTY
REDUCTION**

Pursuant to the Eighth Replenishment mandate in regard to poverty alleviation and the implementation criteria established by the Bank, this program does not qualify as an investment targeted at poverty alleviation.

BENEFITS:

Creation of the Internal Revenue Service makes the proposed project an essential element of the Program for Modernization of the State. The country will now have a new tax administration that society can believe in and accept and with the institutional capacity to sustain the process of change in the long

term, reduce tax evasion, and so increase revenue by an amount estimated at as much as 3% of GDP, which will have a positive impact on macroeconomic stability.

RISKS:

The firm, unwavering support of the highest national authorities, and of the Ministry of Finance in particular, is essential to implementation of the Internal Revenue Service, and the salient risk facing this project is the possibility that the requisite political support will falter. To minimize this risk and facilitate the process, the PPF operation (EC-0178) approved on August 1 includes the carrying out of studies for organizational structuring and personnel selection, to provide a basis for the national authorities to put the new organization into operation. Moreover, during the analysis mission of October 14-18, 1997, the Ministry of Finance confirmed the priority of the operation and stressed its direct commitment to the activities provided in the PPF and to the implementation of its results. The Ministry further confirmed that the draft legislation creating the Internal Revenue Service will be placed on the desk of the President of the Republic in the course of October for approval and presentation to the National Congress as a matter of economic urgency, which means that it will have to be considered within 15 days.

**PROCUREMENT OF
GOODS AND
CONSULTING
SERVICES**

At the government's request it is recommended that the CIAT, a specialized agency, be hired directly to support execution of the project. This hiring complies with all the criteria stated in the Procurement Manual (GS-403) as an exception to the international public bidding procedure provided under IDB policy. As well, it should be pointed out that the CIAT has satisfactorily rendered its services as a specialized agency for the two previous operations financed by the Bank (see paragraphs 3.42 and 3.43).

The executing agency or the specialized agency will apply the Bank's current policy for procurement of goods and the hiring of consulting services to be financed with resources of the program subject to the following limits: the thresholds above which procurement for this project will be based on international public bids are US\$1 million for works, US\$250,000 for goods, and US\$200,000 for the hiring of consulting services.

**EXCEPTIONS TO
BANK POLICY:**

None.

**THE BANK'S
COUNTRY STRATEGY:**

The Bank's strategy for Ecuador defines five primary goals for the country's development, three of which bear directly on the purposes of the operation presented in this document. These goals are: (i) to consolidate macroeconomic stability; (ii) to reactivate sustained economic growth with a view to the improvement of income distribution; and (iii) to support the efficient modernization and decentralization of the government and public administration. This operation is designed to establish a new, autonomous, and efficient tax administration structure staffed by human resources of high professional and ethical quality, in addition to contributing to the modernization and transparency of public administration. With this structure it is considered that revenue could be significantly increased, which will be beneficial to the management of the fiscal deficit, improve macroeconomic stability, and reactivate sustained growth.

**SPECIAL
CONTRACTUAL
CONDITIONS:**

As conditions precedent to the first disbursement, the executing agency must present, to the Bank's satisfaction:

- a. Evidence that the Executive Branch has sent the National Congress the draft legislation creating the Internal Revenue Service [Servicio de Rentas Internas] (see paragraph 1.15).
- b. Evidence that the process of selecting personnel for the Internal Revenue Service has been completed (see paragraph 3.3).
- c. Evidence that an agreement has been signed between the executing agency and the CIAT (see paragraphs 3.46 and 3.47).
- d. Evidence that the necessary physical premises have been provided for the installations and work of the CIAT's resident mission (paragraph 3.55).
- e. Information on the appointment of the officials of the Internal Revenue Service who will represent the national authorities in all acts relating to execution of the agreement, and authenticated copies of their signatures.
- f. The initial report on activities under the program.

I. BACKGROUND

A. Macroeconomic framework

- 1.1 Since the 1980s, Ecuador's economy has been marked by instability and stagnation. The foreign debt crisis and the end of the oil boom prompted several fiscal and exchange adjustments and the launching of a number of structural reforms that failed to take hold, which hindered reform of the conditioning factors inherited from the eleven-year oil boom, such as intensification of political, administrative, and fiscal centralization and deepening of the culture of nonpayment of taxes and the perception of government as a generator of employment and dispenser of goods and services free of charge. The period from 1982 to 1989 was a time of very slow and volatile growth (averaging 1.9 percent) and high inflation (averaging 39 percent).
- 1.2 In the 1990s the economy has been growing somewhat faster (an average of 3.2 percent) and at a more stable rate as a result of the first generation of structural reforms and, since the end of 1992, thanks to successive economic programs which, albeit with ups and downs, have provided greater macroeconomic stability. However, the stabilization process began to flag under the shocks of 1995 (the border conflict, the energy crisis, and especially the political crisis), when the government of the time lost its ability to sustain the momentum of the program, particularly in the fiscal sphere.
- 1.3 In 1996 the economy began to deteriorate in a climate of uncertainty, increasing inflation, and declining growth and private investment. Until August 1996 the sources of this unfavorable climate were the electoral cycle, which saw a spate of populist programs, and from August onwards the new government's economic policy, under which announcements abounded but no effective measures were taken to address the rising fiscal deficit. The perception of vast corruption and arbitrary action led to the President's being removed from office on February 6, 1997.
- 1.4 The new government, given an 18-month term of office, has focused on a political reform that will assure the country's governance and the feasibility of the economic reforms hereafter. In the economic sphere it hopes to check the inflationary and fiscal downtrend, reduce tax evasion, and achieve a growth rate of about 3 percent in 1997 and 1998.

B. Tax structure and revenue

- 1.5 Current revenues under the central government's 1996 budget amount to 17.4 percent of GDP, broken down as follows: 8.3 percent from oil; 7.4 percent from the net tax revenue collected by the National

Revenue Directorate [Dirección General de Rentas] (DGR), and 1.7 percent from other nonoil revenue.

- 1.6 The principal domestic taxes are the value-added tax (VAT), the income tax, and the Special Consumer Tax (ICE). The net yield of the VAT in 1996 was the equivalent of 3.31 percent of GDP. Analyzing this result requires distinguishing between the VAT yield from domestic transactions and that from imports. The yield from domestic transactions came to 1.95 percent of GDP, while the yield on imports came to 1.36 percent.
- 1.7 Net revenue from income taxes came to 1.8 percent of GDP. Net revenue from the Special Consumer Tax totaled 0.51 percent of ICE – 0.47 percent from domestic products and 0.04 percent from imports. The following table provides further details:

Revenues (as percentage of GDP)	1994	1995	1996
Tax revenues	7.6	8.4	7.4
Income tax	1.4	1.9	1.8
Value-added tax (VAT)	3.4	3.5	3.3
Special Consumer Tax (ICE)	0.7	0.5	0.5
Foreign trade (tariffs)	1.8	1.8	1.4
Other taxes	0.3	0.7	0.4
Nontax revenues (petroleum sales)	6.4	6.6	8.3

C. The tax system and IDB support

- 1.8 The tax system has been one of the most refractory to the reform of structures and procedures engendered by the oil boom. Tax evasion and the lack of a systematic policy that might permit more voluntary compliance and increase tax receipts have helped encourage a culture of evasion and nonfiling of tax returns. Tax revenues remain below 6 percent of GDP, and have been of very little weight compared with the revenue generated by the petroleum sector. This is one of the lowest proportions of tax revenue in Latin America. Some of the measures taken between February and August 1997, if sustained and intensified, and those proposed in the present operation, could increase the economic significance of domestic taxation.
- 1.9 In the late 1980s the Ecuadorian government promoted a tax reform which was supported by the Bank with technical-cooperation funding operation ATN/SF-3661-EC, approved in 1989 with the participation of the Inter-American Center for Tax Administration [Centro Interamericano de Administraciones Tributarias] (CIAT) as specialized agency. The key accomplishments of this operation were: (i) The first Internal Tax Act [Ley de Régimen Tributario Interno] was passed, providing for a new tax structure based on income tax, the VAT, and the ICE; this constituted the most

important advance towards changing the Ecuadorian tax system, for it drastically reduced the number of taxes then in force (almost 100), and the number of tax return forms and schedules. This new tax system represented a major step forward towards simplification in tax administration and was widely accepted by the public; (ii) A new collection system was set up through the banking system, which made for greater security in handling tax revenues; and (iii) The mechanism of withholding at the source was implemented more widely, as an effective way to increase collections.

- 1.10 One of the weaknesses of the 1989 reform was the lack of measures for concurrent strengthening of the institutional aspects of tax administration. Starting in 1993, institutional development became the focus of the efforts made with the support of the international cooperation financed by the Bank under project 904/SF-EC, which had the CIAT as specialized agency and was completed in November 1996, and the additional financings of the first half of 1997. The main results include: (i) advances in autonomy in managing the DGR's human and financial resources, such as organizing and putting into operation the basic units for human resources administration, financial administration, and asset administration and control; (ii) design and implementation of systems for developing, carrying out, and evaluating monitoring plans; (iii) setting up, fitting out, and operating a central computer unit, which gave the DGR a degree of autonomy in the area of information processing; and (iv) design and implementation of a system for special taxpayers.
- 1.11 Despite these efforts, however, the DGR has not developed to the extent desired. The principal reasons for this are:
 1. The lack of real autonomy led to recurring shortages of resources, while the evident politicization of its management corps critically impaired the professionalization of its technical staff. It is worth mentioning that since 1990 the DGR has been headed by nine Directors General.
 2. In this context, decisions and many functions have become strongly centralized, which has made the DGR excessively bureaucratic and has heightened weaknesses in those areas operating in decentralized fashion.
 3. Only the collection sections in the offices of special taxpayers have properly decentralized systems that enable them to operated autonomously. The other units are highly subordinate to the central units.

D. Design and strategy of the program

- 1.12 The present Ecuadorian government has taken for its economic goals the pursuit of a policy of fiscal austerity, the reduction of inflation, and specific economic goals for 1997 such as a 3.3 percent GDP growth rate, reduction of the fiscal deficit to the

range of 2 percent to 2.7 percent of GDP, and 28-percent inflation by the end of the year. To achieve these goals it has put into execution a plan of austerity in fiscal expenditure accompanied by several tax collection measures.

- 1.13 Renewed momentum has been given to customs reform to eliminate corruption in that sector, improve significantly the level of tariff collections, and assure proper treatment of the user. In fiscal policy there is obvious emphasis on the reduction of public expenditure and the increase of revenue.
- 1.14 It is in this context that the project proposed in this document acquires strategic importance for the government's fiscal policy. Indeed, it is thought that by the end of the program tax revenue could rise three percentage points above the 6.34 percent of GDP recorded in 1996.
- 1.15 In the broader field of government modernization the Ministry of Finance and the National Council on Modernization of the State [Consejo Nacional de Modernización del Estado] (CONAM) are actively promoting a streamlining of the public sector, notably reform of the customs sector and the institutional strengthening of the internal revenue sector, the latter through the establishment of an Internal Revenue Service, for which the draft legislation coincides in its fundamental aspects with the financing proposed in the present operation.
- 1.16 The requested technical cooperation would lend significant support to a process of high fiscal yield that would contribute to fiscal equilibrium by increasing revenue and would collaborate with the government in the implementation of a professionalized and administratively autonomous tax administration.
- 1.17 The central feature of this operation is the implementation of a new autonomous and professionalized organization with a staff that would be hired through competition based on merit. Because of this, the strategy agreed upon with the national authorities and confirmed by the Minister of Finance resulted in the preparation of PPF operation EC-0178, whose primary purpose is to conduct studies on how the tax administration should be organized and how personnel should be selected. On the basis of the results of these studies the authorities can set these two processes in motion and establish the conditions for launching the operation of the Internal Revenue Service.

E. Technical assistance from other agencies

- 1.18 At the request of the Ecuadorian government, the International Monetary Fund has since late 1994 been assisting in matters of tax policy and administration in coordination with the program financed by the Bank. This cooperation has concentrated on overseeing the

VAT, invoicing, and tracking nonfilers, all of which has helped increase revenues.

F. Background of the executing agency

- 1.19 Responsibility for the administration of internal revenue lies with the National Revenue Directorate (DGR), a public body under the Ministry of Finance. The DGR has a workforce of about 1,200, of whom about 28 percent perform inspection functions. The DGR's performance has been conditioned by its lack of real autonomy, the politicization of its management as reflected in the fact that since 1990 it has had nine Directors General, a lack of professionalism and ethical discipline on the part of its technical personnel, and the centralization of its decisions and many of its functions (see paragraph 1.11).

II. OBJECTIVES

A. General objective

- 2.1 The overall objective of the project is to support the Government of Ecuador in establishing a professional, administratively independent tax administration in the form of an Internal Revenue Service [Servicio de Rentas Internas] (SRI).

B. Specific objectives

- 2.2 The specific objectives are as follows:

- a. To put the Internal Revenue Service into operation such that it operates on the basis of three strategies: (i) institutional autonomy; (ii) consolidation of operational decentralization; and (iii) treatment of taxpayers in relation to their financial significance.
- b. To professionalize the SRI and promote the development of its human resources in keeping with the new organization and to secure their commitment to forward-moving organizational change and ethics in taxation.
- c. To adapt the main processes of tax administration to the new organizational definitions, with a view to higher productivity.
- d. To strengthen the computer systems area by adapting it to the new tax administration structure, unifying tax information systems, and consolidating the technological infrastructure.
- e. To adjust the tax regime to the new tax administration structure, particularly in regard to tax enforcement and the changes brought about by the tax reform whose viability is being assessed by the national government.

III. DESCRIPTION OF THE PROGRAM

A. Components

- 3.1 To accomplish the above objectives, the project will consist of five components carried out in integrated fashion:

1. Organizational development (US\$630,000)

- 3.2 This component encompasses activities relating to the establishment of a new organizational structure and the effective realization of the tax administration's autonomy. This will be achieved by establishing the Internal Revenue Service pursuant to legislation that defines it as an autonomous technical body created under public law and having its own legal status as a juristic person, its own equity and resources, and national jurisdiction, with headquarters in the city of Quito. Its operations will be subject to the provisions of the law establishing the tax code and the Internal Tax Act, and it will be autonomous in respect of its administration, finances, and operations.

2. Human resources administration and training (US\$11,914,400)

- 3.3 This component takes in high-priority activities such as the establishment of an institutionalized personnel selection process before staff are appointed to posts in the Internal Revenue Service; the establishment of a new staffing table that includes a pay scale more competitive with the private sector; the establishment of selection, promotion, and incentive systems that will assure the continued professionalization of the Internal Revenue Service; and the provision of training in the requisite areas, especially management, monitoring, and computer systems. This component also includes severance settlements for DGR personnel not selected for employment in the Internal Revenue Service. For this purpose, up to US\$4 million will be allocated from the resources provided by the Bank against up to US\$6 million in counterpart funds. The criteria for the use of these resources will be based on the findings of the study for the selection of DGR personnel being financed through PPF operation EC-0178 and the decisions taken by the national authorities on the basis of those findings.

3. Redesign of tax administration processes (US\$825,800)

- 3.4 Under this component, activities will be conducted aimed at reviewing and redefining the fundamental processes carried on by the tax administration, with a view to providing taxpayers with an integrated service, improving and extending the system for the collection of tax liabilities in arrears, improving monitoring and enforcement with an orientation towards audits based on analyses

and exchanges of information between economic sectors, and processes for tracking overpayment compensations and tax refunds applied for by taxpayers.

4. Information technology (US\$3,894,000)

- 3.5 This component provides for the refinement and integration of information systems to support the functions of the tax administration and the development of the computer systems area in keeping not only with the distribution of functions in the organization but also with new computer technologies (hardware, basic software, data communication systems, etc.) to be implemented.

5. Regulatory provisions with regard to taxation (US\$228,000)

- 3.6 This component provides for the necessary legal amendments to facilitate the use of information technology and simplify penalty procedures, promote the draft Tax Code, improve regulations on invoicing, introduce standards for transfers of goods, prepare draft legislation, regulations, decrees, and decisions to improve the operation of the tax administration, design new systems for withholding taxes and making final payments and advance payments, and design a simplified regime for small taxpayers. It also covers all aspects of the changes brought about by the tax reform whose viability is being assessed by the national government.
- 3.7 The program's components and activities are described in detail in the logical framework in Annex II, which includes the indicators, means of verification and monitoring, and assumptions taking into account in the project design.

B. Results of the program

1. Summary of quantifiable results

- 3.8 To reduce in nonfiling by principal VAT payers, currently estimated at over 30 percent, to not more than 10 percent, and set a maximum of five working days for the tax administration to initiate collection procedures.
- 3.9 To double the tax administration's capacity to achieve 100-percent followup in regard both to taxes in arrears and to the application of enforcement measures for special taxpayers using decentralized computer procedures.
- 3.10 To increase the number of inspections by at least 300 percent and reduce challenges of inspection reports by 50 percent. In recent years, over 70 percent of the inspection reports prepared by the tax administration have been challenged by taxpayers.

- 3.11 To offer at least 4,000 training opportunities during execution of the program in the areas of inspection, collection, organizational development, and information technology.
- 3.12 To provide for all 32 decentralized units to be connected to the Internal Revenue Service's communications network, for a total of more than 700 workstations. At present, the tax administration does not have any network linking the units, and only six units have any computer systems capability.
- 3.13 To achieve a level of at least 70 percent in the filing of tax returns on magnetic media, which would represent a reduction of more than 50 percent in the volume of paper processed by the tax administration and assure the quality of the information processed. The tax administration does not currently offer taxpayers a way to submit returns on magnetic media.

2. Summary of results by component

a. Organizational development

- 3.14 There will be an organic operating structure that will meet the requirements of separating regulatory and operational functions, decentralizing operations, and establishing different treatment for taxpayers according to financial importance and complexity.
- 3.15 Decentralizing operations to units close to taxpayers will facilitate coordinated operation of the areas of taxpayer records, collection, inspection, and claims. The tax administration's attention will be focused on the taxpayer as an integrated whole rather than as a fragmented entity.
- 3.16 Differential treatment of taxpayers is based on the need to endeavor to secure for the Treasury the substantial taxes due from a small number of taxpayers.
- 3.17 An essential part of the organic and functional structure will be an overall evaluation and redefinition of the tax administration and a general determination of the staff positions and resources needed.
- 3.18 A plan of public information on the new tax administration will be drawn up and put into operation and will also cover motivational aspects, information on taxpayers' rights and duties, and penalties for noncompliance with tax obligations.
- 3.19 The adoption of the criteria of separation of regulatory and operational functions and of operational decentralization, combined with the autonomous handling of the resources so generated, will accentuate the already existing need to strengthen essential areas that must accompany this strategy - to wit, internal auditing,

administrative planning and oversight, and budget preparation and execution.

b. Human resources management and training

- 3.20 It is expected that the personnel will achieve the highest degree of professionalism and make an ongoing commitment to the organization.
- 3.21 The starting point is the study for selection of personnel for the Internal Revenue Service, to be conducted under the PPF operation by a specialized consulting firm.
- 3.22 A plan for the selection of personnel for the new tax administration will be drawn up based on (i) the functional organic structure to be established and the personnel posts and resources found to be needed, and (ii) the results of the personnel selection study.
- 3.23 Based on the new staffing table to be drawn up under the PPF operation, which will include provisions regarding selection, promotion, and incentives, a pay scale will be established that is competitive with the private sector, as well as a scale of incentives that is consistent with productivity and performance criteria.
- 3.24 To energize quickly key areas of the organization, such as information systems and inspection, a total of 60 staff members (20 per year) will be hired under the program, who must afterwards be absorbed into the tax administration.
- 3.25 A training plan focusing on the skills needed for efficient performance will be carried out for staff members, with emphasis on the areas of management, inspection, and information systems, as well as for new personnel. Basic infrastructure and technical and material resources will be provided to set up a specific training area for the Service.

c. Redesign of tax administration processes

- 3.26 Processes will be redesigned on the basis of the criteria of decentralizing procedures to the operating units and integrating them in those units.
- 3.27 The justification for centralized information processing has disappeared, and technology allows the use of relatively powerful computers in small operating units. These operating units will be directly responsible for developing and implementing computer systems. Accordingly, the operating units will be able to address the taxpayer as an integrated whole and carry out a comprehensive verification of tax compliance. From the standpoint of the allocation of responsibilities, this principle will make it possible to fill many of the present gaps when attempts are being

made to determine the causes of inefficiency in control procedures. In future, the operating units will assume the greatest possible responsibility for monitoring taxpayers in their respective jurisdictions.

- 3.28 Future development will be based on the experience gained in handling special taxpayers, inasmuch as this meets the criteria as to organization and the redesign of proposed processes. Hence priority will be given to the strengthening and integration of the processes for the monitoring of special taxpayers. Mechanisms will be devised for the receipt of returns using magnetic and electronic media in order not only to improve the quality of the information received, but also to diminish the operational burden on the tax administration and hence increase the number of taxpayers that can be processed.
- 3.29 The processes for the collection of liabilities in arrears will be improved, and procedures will be established for culling the portfolio of credit certificates, facilitating the reconciliation of inventories, and expediting enforcement procedures.
- 3.30 Tax auditing work will be subjected to a strategy of specialization in economic sectors and to the performance of quick, preventive inspections that make the tax administration a more visible presence in the community. Inspections of VAT taxpayers will be given priority because of the magnitude of the VAT in the tax structure.
- 3.31 To this end, quick VAT inspection procedures will be implemented together with systems for the selection of cases for inspection based on information provided by the taxpayers themselves and by third parties, such as (i) consecutive balances in favor of the taxpayer, or consecutive returns filed with no change in the VAT; (ii) analysis of VAT debit/credit ratios; (iii) cross-referencing of information on purchases and sales; (iv) payments made using credit cards; and (v) information on import operations.
- 3.32 To supplement these quick VAT audits, a system will be devised for monitoring the production of invoice forms by printing firms and their use by taxpayers.
- 3.33 To monitor the management of inspection activities, a system will be put in place to determine output by program and by inspector, track the allocation of working hours, and report the results of cases examined.
- 3.34 New processes will be set up for overpayment compensation and refunds, for which no provision had been made in the earlier stages of technical-cooperation activities, and which are very important for the tax administration because much tax evasion is committed in this area. To do this, the processes for the analysis and review of claims will be revised; a system will be designed for the

issuance and use of credit and compensation notes; systems will be set up to monitor tax withholding and deductions of advances; the processes for income tax refunds will be redefined; and systems will be established to support the monitoring of VAT refunds on exports.

d. Information technology

- 3.35 The information processing systems for monitoring special taxpayers will be unified and computerized to strengthen the tax administration's efforts in this area. To this end, the requisite communications media will be installed and the data processing capability increased.
- 3.36 Computer systems will be installed in the different units of the Internal Revenue Service throughout the country and integrated at the central level. At the same time, extensive networks will be set in operation to unify them. In addition, a local area network will be installed in each operating unit.
- 3.37 The systems needed for autonomous administration and management of human, financial, and material resources will be consolidated.

e. Regulatory provisions

- 3.38 Some specific features of the regime established under the Internal Tax Act and tax procedures will be adjusted so as to give the tax administration legal weapons with which to deal more effectively with tax evasion and to support the new procedures and technological changes to be implemented. As well, all aspects of the changes stemming from the tax reform whose viability is now being assessed by the national government will be reviewed.
- 3.39 In addition to giving as much support as possible to the treatment of the Tax Code already drawn up by the Congress, some minor legal amendments will be drafted in tax procedures that are easiest to promote in the Congress and will enable the tax administration to expedite the administration of taxes, primarily in the application of penalties, and also to introduce in the control systems some procedures and techniques that are now prohibited, such as replacement of the signature as an expression of the will of the taxpayer, acceptance of facsimile signature among the general provisions on computerized returns, and receipt of information by electronic means.
- 3.40 The invoicing regulations now in effect will be improved to establish additional conditions that will increase the risk for evaders and optimize the procedures for the transfer of merchandise.
- 3.41 Modifications will be made in decrees and decisions now in force to improve some aspects and correct certain gaps that now exist with

respect to specific points, among them: (i) establishment of a system for dealing with presumed failures to file VAT returns; (ii) simplification of the system of appeal authorities; (iii) elimination of the obligation on the tax administration to collect nontax revenues; (iv) consolidation of the returns of different units of State enterprises and agencies; and (v) improvement of systems for withholding, final payments, and advances of taxes.

C. Organization and execution

1. Execution

- 3.42 The executing agency, which will bear final responsibility for execution of the project, will be the Ministry of Finance [Ministerio de Finanzas y Crédito Público] of Ecuador through the Internal Revenue Service. The country has asked that the Inter-American Center for Tax Administration (CIAT) be engaged as a specialized agency in execution of this program. The contracting of the CIAT meets all the criteria set forth in the Procurement Manual (GS-403) as an exception to the international public bidding procedure prescribed by the Bank's policies. It must also be pointed out that in the past the CIAT has satisfactorily rendered its services as a specialized agency for the two previous operations financed by the Bank (ATN/SF-3661-EC and 904/SF-EC) (see paragraphs 1.9 and 1.10).
- 3.43 The CIAT will be responsible for technical execution of the project and will work through the long-term Technical Coordinator. The CIAT will take it upon itself to identify, commission, supervise, and pay the consultants needed to do the work under the program, in accordance with the Bank's procedures. It will also see to procurement of the budgeted equipment in accordance with the Bank's standards and procedures (see paragraph 3.70).
- 3.44 The CIAT is a nonprofit international public agency established in 1967. Since its inception it has been engaging successfully in technical-assistance programs in tax matters with financing from the IDB and the World Bank in most of the countries in the region. It has also acted as a specialized agency in projects financed by AID and the World Bank.
- 3.45 The CIAT's experience and technical track record have been described in earlier documents presented in support of a variety of IDB technical-cooperation projects. With a long tradition in its field it has a high capacity and takes a multidisciplinary approach, and can offer the competent authorities a selection of the best consultants available in the area. Because of the scope and nature of this operation, engaging the CIAT has the advantage that the ongoing relations it maintains with the countries it has assisted allow it to monitor the activities in which it has participated both formally and informally, which consulting firms

and individual consultants cannot do. This is a very significant factor considering that even in developed countries tax administration is a difficult area that requires ongoing technical attention and review of processes, methods and technologies.

2. Agreements

- 3.46 Two agreements will be signed: one between the Government of Ecuador and the Bank, and the other between the Internal Revenue Service and the CIAT as the specialized agency responsible for the technical execution of the operation.
- 3.47 The agreement between the Internal Revenue Service and the CIAT must reflect all the main points of the agreement to be signed by the Government of Ecuador and the Bank. The contract between the Internal Revenue Service and the CIAT will be submitted in advance to the Bank for approval.

3. Organizational structure of the Program

- 3.48 The Internal Revenue Service will be the executing agency and will bear final responsibility for execution of the program. Technical execution of the program will be carried out jointly by staff of the Service and the CIAT. The following structure is established for execution and supervision of the program:
- a. **Advisory Committee.** Chaired by the Director of the Internal Revenue Service and consisting of officers of that Service, the Technical Coordinator of the CIAT Mission, and a National Coordinator. Its principal functions are to approve the work plans, coordinate implementation of the systems designed, approve the reports, and evaluate the progress of the project, for which purpose it will meet at least every three months.
 - b. **National Coordinator.** A qualified official of the Internal Revenue Service, reporting to its Director and assigned to the project on a full-time basis. He is in charge of day-to-day project execution, coordinates the national counterpart staff and takes care of other administrative aspects, and serves as Secretary to the Advisory Committee.

D. Requirements

- 3.49 To carry out the activities planned, the specialized agency will engage consulting services in accordance with the terms of reference established in Annex V, which may be found in the technical files for the operation, and, at the request of the executing agency, will purchase the equipment described under heading III.D.4 in accordance with the Bank's standards and procedures.

1. Consulting services

- 3.50 The consulting services which the CIAT will contract for, charged to the Bank's contribution, include: (a) international consultants; (b) local consultants; and (c) up to 60 technical staff recruited at the rate of approximately 20 per year, who will subsequently be absorbed by the Internal Revenue Service. Annex V, which may be found in the technical files for the operation, contains a detailed listing of the months of consulting services to be contracted for.

2. Training program

- 3.51 An intensive training program would be carried out for all personnel in the different areas of the Service, primarily in such subjects as management techniques, planning, management oversight, total quality management, human resources management, inspection, information technology, ethics, and tax provisions. Execution of the training program will require the hiring of specialized enterprises and local and international instructors. The program's consultants will also be employed in training work, and, to the extent possible, the counterpart personnel will be used for this purpose as well.
- 3.52 The plan will be carried out nationwide, and financing will have to be provided for the requisite infrastructure. The expectation is that at least 4,000 training opportunities will have been provided for all staff of the Internal Revenue Service by the end of the program.

3. Internships

- 3.53 The internship plan will stress the aspects directly relating to the content of the program. The areas to be dealt with in this plan must cover a broad range of functions and activities, with emphasis on management, inspection, information technology, and legal collection procedures. Preparation of the selection criteria for admission to internships is under way.

4. Information technology and training equipment

- 3.54 The following will be purchased using the contribution from the Bank:
- a. Computer equipment, extended area and local area networks, basic software, relational database managers and ancillary items, and accessories required to operate them both at the central level and in the operational units where computer systems are to be introduced.
 - b. Audiovisual and computer equipment needed for the training activities.

5. Remodeling of physical premises

- 3.55 Against the local counterpart contribution the Internal Revenue Service will cover the cost of remodeling physical premises so that the aforementioned equipment can be installed, including appropriate wiring, air conditioning systems, and measures to assure the safety and security of the equipment.

6. CIAT overhead

- 3.56 For the CIAT's services, 14 percent of the direct costs referred to above will be paid. In addition to its technical responsibility for execution of the project, the CIAT will administer and supervise the hiring of consultants, and related payments and administrative actions, will coordinate arrangements with the institutions in the countries where the internships will take place, and will purchase the materials to be financed from the Bank's contribution. These goods will be purchased following the Bank's standards and procedures.

7. Local contribution

- 3.57 Using funds of the local contribution, the Internal Revenue Service will be responsible for logistical support for the operation, including: offices, equipment, materials and supplies; data transmission services; technical and administrative services and personnel; communications media for disseminating information; hiring of advertising agencies; and local transport and communications. It will also provide the necessary physical and logistical facilities to assure proper functioning of the CIAT's resident mission on its premises. The local contribution includes a further US\$6 million from other sources of financing to fund the indemnification program.

8. Local counterpart personnel

- 3.58 The Internal Revenue Service undertakes to provide the technical and administrative support personnel for execution of the activities under the Program.

E. Monitoring

- 3.59 The Internal Revenue Service will undertake to prepare the following reports with the support of the CIAT and present them to the Bank for approval:
- a. A baseline report within 60 days following the signing of the contract between the CIAT and the Government of Ecuador covering at least (a) the General Plan and Timetable of Activities to be carried out, including a yearly, cumulative approximation of the percentage in which the purposes are expected to be accomplished as quantified in section III B.1,

and the indicators of the logical framework (Annex II); (b) standards for coordination of the execution and supervision of the project; (c) detailed terms of reference for the consultants; (d) the name of the person designated as National Coordinator; and e) the names of the counterpart officers to be appointed in each area of the project.

- b. Semiannual progress reports itemizing the activities carried out during the corresponding six-month period. These reports will be presented to the Advisory Committee within 15 days following the close of each six-month period. Each report will contain a description of the activities carried out in the period, the extent to which the activities scheduled for the six-month period have been completed, deviations from the timetable, and explanations of those deviations and of courses of corrective action found necessary.
- c. A final report within three months following completion of the project, which will summarize the activities carried out, the results obtained relative to those intended, and the extent to which the expected results were achieved based on the methodology presented in the baseline report.

3.60 The CIAT will prepare yearly financial reports within 90 days following the end of each year of execution of the project, and one final report within three months following the date of the last disbursement. All these financial reports must be audited by an independent firm approved by the Bank. The Internal Revenue Service will present both the yearly financial reports and the auditing reports to the Bank for approval.

F. Cost and financing

- 3.61 The total cost of the program will be the equivalent of US\$23,090,000, of which the Bank will provide US\$15,800,000 on a reimbursable basis from the ordinary capital resources and the local counterpart contribution will be the equivalent of US\$7,290,000.
- 3.62 The consolidated cost structure for the program is given in the table that follows.

CONSOLIDATED COST TABLE (in US\$ equivalent)				
Item	IDB	Local contribution	Total cost	%
1. Organizational development	530,000	100,000	<u>630,000</u>	2.73
1.1 Consulting services	420,000		420,000	
1.2 Training	110,000	100,000	210,000	
2. Human resources and training	5,764,000	6,150,000	<u>11,914,000</u>	51.6
2.1 Consulting services	110,000		110,000	
2.2 Personnel costs	4,504,000	6,000,000	10,504,000	
2.3 Training	300,000	150,000	450,000	
2.4 Training equipment	250,000		250,000	
2.5 Infrastructure	500,000		500,000	
2.6 Dissemination	100,000		100,000	
3. Process redesign	805,800	20,000	<u>825,800</u>	3.58
3.1 Consulting services	685,800		685,800	
3.2 Training	120,000	20,000	140,000	
4. Information technology	3,744,000	150,000	<u>3,894,000</u>	16.86
4.1 Consulting services	604,000		604,000	
4.2 Training	300,000	150,000	450,000	
4.3 Computer equipment	2,840,000		2,840,000	
5. Regulatory provisions	228,000		<u>228,000</u>	0.99
5.1 Consulting services	128,000		128,000	
5.2 Training	50,000		50,000	
5.3 Publication and dissemination	50,000		50,000	
6. General expenditures	1,634,000	800,000	<u>2,434,000</u>	10.54
7. Contingencies	400,000	70,000	<u>470,000</u>	2.04
8. Evaluations	50,000		<u>50,000</u>	0.22
9. Repayment of PPF operation	600,000		<u>600,000</u>	2.6
10. Finance charges	2,044,200		<u>2,044,200</u>	8.85
Project total	15,800,000	7,290,000	23,090,000	100
Percentages	68	32	100	

G. Execution and disbursement periods

- 3.63 The execution period will be 36 months and the disbursement period 48 months from the date of signing the technical-cooperation loan agreement between the beneficiary and the Bank.

H. Administration of disbursements

- 3.64 Disbursements of the Bank's contribution of up to the equivalent of US\$15.8 million would be administered by the specialized agency to which the Bank would transfer the loan funds. To this end the Bank, at the request of the Internal Revenue Service, could set up a revolving fund in an amount up to 5 percent of the Bank's total

contribution. In each instance of purchasing equipment or of paying a final severance settlement to a DGR employee a disbursement larger than the equivalent of 5 percent of the amount of revolving fund may be authorized.

3.65 Conditions precedent to the first disbursement. As conditions precedent to the first disbursement, the executing agency must present, to the Bank's satisfaction:

- a. Evidence that the Executive Branch has sent the National Congress the draft legislation creating the Internal Revenue Service [Servicio de Rentas Internas] (see paragraph 1.15).
- b. Evidence that the process of selecting personnel for the Internal Revenue Service has been completed (see paragraph 3.3).
- c. Evidence that an agreement has been signed between the executing agency and the CIAT (see paragraphs 3.46 and 3.47).
- d. Evidence that the necessary physical premises have been provided for the installations and work of the CIAT's resident mission (paragraph 3.55).
- e. Information on the appointment of the officers of the Internal Revenue Service who will represent the national authorities in all acts relating to execution of the agreement, and authenticated copies of their signatures.
- f. The baseline report on activities under the program.

3.66 The revolving fund will be replenished in accordance with the Bank's applicable procedures. Such replenishment is to be requested by the Internal Revenue Service, accompanied by the presentation of an itemized statement of the expenditures made from the Bank's contribution.

I. Financial conditions

3.67 The funds provided by the Bank will be from the ordinary capital resources (OC) on the following terms:

- a. Amount and currency: Up to US\$15.8 million in United States dollars under the Single Currency Facility.
- b. Guarantee: The general responsibility of the borrower.
- c. Credit fee: 0.75 percent *per annum* on the undisbursed portion of the loan.
- d. Amortization period: 25 years.

e. Interest rate: Variable.

J. Disbursement timetable

3.68 The forecast of disbursements of the Bank's resources is as follows:

DISBURSEMENT FORECAST (in thousands of United States dollars)			
	Year 1	Year 2	Year 3
IDB	7,454	5,174	3,172
Local contribution	6,300	500	490

K. Procurement and procurement plan

3.69 Procurement. The executing agency or the specialized agency will apply the Bank's current policy for procurement of goods and the hiring of consulting services to be financed with resources of the program subject to the following limits: the thresholds above which procurement for this project will be based on international public bids are US\$1 million for works, US\$250,000 for goods, and US\$200,000 for the hiring of consulting services.

3.70 Procurement plan. The following procurement plan will be carried out during execution of the program:

Principal procurement items under the program	Amount (in US\$000)	Quantities or number of calls for bids	Method and year
1. Consultancies (taxation and information systems)	2,097		
Long-term consultancies	1,206	4 consultants	SAG-98
Short-term consultancies	891	21 consultants	SAG
2. Computer equipment	2,840	4 calls for bids	IPB-98/99
3. Training	1,590	6 calls for bids	LPB-98/99
4. Infrastructure	800	2 calls for bids	LPB-98

SAG = specialized agency

LPB = local public bidding

IPB = international public bidding

IV. BENEFITS AND RISKS

A. Benefits

- 4.1 The establishment of the Internal Revenue Service makes the proposed program a key component of the Program for Modernization of the State. The Bank's contribution under this program is expected to improve substantially the management capability of the Tax Administration by putting in place a new organization based on decentralization, automation, and streamlining of procedures, and the projection of a solid institutional image. It is expected that this will significantly cut delays in the payment of taxes and reduce tax evasion, and hence make for an increase in tax revenues of 3 percentage points over the 1996 level, which will help improve the country's fiscal situation.
- 4.2 The program has been designed with a strategy that combines measures to strengthen the tax administration over the long term, along with pragmatic and profitable measures that will give real results in the short term.
- 4.3 The change of image that will result from the measures to be taken to strengthen the presence of the tax administration, on the one hand, and better servicing of the taxpayer to facilitate voluntary compliance with his tax obligations, on the other hand, will place the tax administration in a better position to reach the tax collection goals and increase its capacity to service the public.
- 4.4 Tax revenue is expected to rise 3 percentage points above the 6.34 percent of GDP it posted in 1996.

B. Risks

- 4.5 Firm and ongoing support by the highest national authorities and by the Ministry of Finance in particular is essential to the setting up of the Internal Revenue Service, which makes lack of the requisite political support the greatest risk in this project. To minimize this risk and facilitate the process, the PPF operation (EC-0178) approved on August 1 includes the carrying out of studies for organizational structuring and personnel selection, as a basis for the national authorities to put the new organization in place. In addition, during the analysis mission carried out from October 14 to 18, 1997, the Minister of Finance confirmed the priority of this operation and underscored his direct commitment to the activities planned under the PPF operation and to the implementation of its results. As well, the draft legislation creating the Internal Revenue Service will be placed before the President of Ecuador in October for approval and transmittal to the National Congress as a matter of economic urgency.

V. EVALUATION

A. Yearly evaluations

- 5.1 There will be three yearly evaluations, one at the end of each year of execution. They will be carried out in each case by individual consultants whom the Bank will hire directly using resources of the operation. These evaluators will use, among other tools, the programming in terms of quantifiable results to be described in the initial report on the project. The evaluation report will be discussed in the yearly evaluation meetings, and it has been provided that each consultancy will have to include the results of these meetings in its annual evaluation report.
- 5.2 The members of the annual evaluation meetings will be the Minister of Finance or his representative, the Director of the Internal Revenue Service, the evaluating consultant, the National Coordinator for the project, the Technical Coordinator, who will serve as technical secretary at the meetings, and the team from the Bank.
- 5.3 The yearly evaluation report for the third and last year of execution will not only cover that year but also provide an overall evaluation of the entire execution period.

B. Evaluation of execution (PCR)

- 5.4 At the end of the program execution period, the Bank will make a final evaluation (project completion report) that will consider, *inter alia*, the following: (a) the overall impact of the operation on tax collections; (b) the level of functioning of the organizational, operational, and technical structure of the Internal Revenue Service; (c) the absorption into the tax administration of the staff financed by the program for a one-year period, and (d) the institutional image projected by the Internal Revenue Service.

BACKGROUND INFORMATION ON OPERATION EC-0175

I. BACKGROUND INFORMATION ON OPERATION ATN/SF-3361-EC

A. General

- 1.1 In September 1989, the Government of Ecuador and the IDB signed a nonreimbursable technical cooperation agreement for modernization of the tax system.

B. Objective

- 1.2 The main objective of the technical cooperation was to move forward on the structural reform of the tax regime, which was adopted as a government policy and was directed primarily at simplifying the tax system.
- 1.3 Great importance was attached to massive training for tax administration personnel under the new tax regime, and to the conduct of public information campaigns to educate the taxpayer on the new simplified system.

C. Principal accomplishments

- 1.4 The following accomplishments may be credited to the efforts made:
 1. Enactment of the first Internal Tax Act [Ley de Régimen Tributario Interno], which contains the new tax structure based on the income tax, the value-added tax (VAT), and the Special Consumer Tax [Impuesto a los Consumos Especiales], took the most important step towards changing the tax system of Ecuador at that time, for it drastically reduced the number of taxes then in force (almost 100) and the number of tax forms and annexes.

This new tax regime was widely accepted by the public.
 2. The new regime also embodied a major advance in simplification of the administration of taxes.
 3. A new system for collection through the banks was implemented, which greatly improved the security of the handling of tax revenues.
 4. Tax collections were increased by extending the coverage of withholding at the source.

- 1.5 While at that stage receipts rose steadily and a beginning was made towards rationalization of information by introducing new, simplified tax return forms, the tax administration encountered organizational and structural difficulties that could not be addressed.
- 1.6 The basic reasons for these difficulties were as follows:
 1. Total dependence of the National Revenue Directorate [Dirección General de Rentas] (DGR) on the Ministry of Finance for the administration of the new arrangement.
 2. An inappropriate organizational structure for the DGR.
 3. Insufficient financial and material resources and inappropriate physical premises for servicing taxpayers.
 4. Tax control and administration processes and procedures carried out manually.

II. BACKGROUND INFORMATION ON OPERATION 904/SF-EC

A. General

- 2.1 On January 28, 1994, the Government of Ecuador and the IDB signed a new reimbursable technical-cooperation agreement for the second stage of the tax system modernization program.
- 2.2 The project comprised five subprograms: i) tax education and public information; ii) organizational development and training; iii) administration of receipts and collections; iv) inspection; and v) information systems.

B. Objective

- 2.3 Because of the situation described above, the strategy for the second phase of assistance centered on the institutional strengthening of the DGR by pursuing the following objectives:
 - Autonomy in managing the resources of the tax administration.
 - Design and planning of systems, especially for development, execution, and evaluation of the national monitoring and enforcement plan.
 - Making the DGR independent of the Organization and Systems Directorate of the Ministry of Finance in regard to information technology and computer systems.

- Training DGR officers primarily in information technology, to enable them to manage technological change properly.
- Refining agreements with the banking system for paying taxes through the banks, and ancillary procedures.
- Strengthening the collection process by dividing taxpayers into classes based on their financial importance.

C. Principal accomplishments

2.4 The activities carried out in this phase produced, among others, the following advances:

1. Issuance of a Ministerial Decision decentralizing the management of human and financial resources in the DGR (September 1993).
2. Organization and setting into operation of the basic units for human resources administration, financial administration, and asset administration and control.
3. Adjustment of the provisions for the decentralized administration of resources.
4. Design and planning of the information systems for the decentralized administration of human and financial resources.
5. Consolidation of decentralized management by legal provision (December 1994).
6. Design and planning of the ARCOE and CONGE systems for the preparation, execution, and evaluation of the national plan for comprehensive inspections.
7. Setting up and placement in operation of the DGR's own computer center, independent of the Ministry of Finance's computer center, and system migration.
8. Installation of computer hardware in the computer center and of PCs in administrative units at the national level, and provision of training in their use.

The computer center converted from data management using a traditional file system to hierarchical databases, which were then in vogue.

9. Adjustment of agreements with private banks to shorten reporting times and improve the quality and timeliness of information transmitted through the network.

10. Setting up and placement in operation of five regional tax offices for special taxpayers, at first using manual procedures to compile returns and verify tax liabilities.

In 1996 basic information systems were designed and developed for operation of the area of revenue from special taxpayers.

- 2.5 Although, in formal terms, important gains were initially made in increasing the autonomy of the DGR, the situation reverted to what it had been in the first phase as a result of a political ministerial decision that suspended the autonomy that had been conferred by law on the DGR, and thus nullified many of the efforts made towards implementing that autonomy.
- 2.6 The result was that the DGR fell back into dependence on the Ministry of Finance and lost an appreciable part of its tax administration capacity.
- 2.7 The scarcity of financial resources for management (equipment and building maintenance, lease of premises, personnel hiring, payment for basic services, etc.) hampered effective control of tax liabilities, including those of special taxpayers.
- 2.8 Moreover, the inspection systems developed suffered from operational drawbacks, which were enhanced by a degree of resistance in the regional operational units and insufficient political resolve to exact compliance.
- 2.9 As a result, the ARCOE and CONGE systems fell behind, and have of late become even more outmoded as a result of replacement of the old strategy of comprehensive inspections by quick audits, which allow broader coverage, make the tax authorities a more visible presence, and yield greater receipts.
- 2.10 In the information processing area, while the computer center has been set up, a lack of resources and decision-making power has kept it from gaining the necessary stature, and has hampered categorization of its functions, the making of efforts to set up a data communications network amongst units having processing capabilities of their own, and the use of relational database administrators in keeping with recent technological advances.
- 2.11 The entry into operation of decentralized real-time collection systems in the special taxpayers' units was a step forward in the development of information processing, but those systems must be integrated with the systems at the central level and be given new functions, essentially those that allow the use of information for inspection purposes.
- 2.12 Despite the efforts made, the DGR has not achieved the degree of development aimed for.

- 2.13 The main reasons for this are, first, the lack of real autonomy, which had been achieved and then lost again giving rise to recurring shortages of resources, and second, the politicization that can be seen at the management level, which is exceedingly damaging to the professionalism of its technical staff. It is noteworthy that since 1990 the DGR has eight times seen its Director General change.
- 2.14 In this situation, decisions and many functions are strongly centralized, which makes the DGR excessively bureaucratic and accentuates the weaknesses of the operationally decentralized areas.
- 2.15 Only the collection sections of the special taxpayers' offices have adequate decentralized systems that allow them to operate autonomously. The other units are highly dependent on the central units.

III. BACKGROUND INFORMATION ON THE BRIDGE STAGE

A. General

- 3.1 In December 1998, at the request of the Ecuadorian government, the IDB approved a bridge operation for the period from December 1, 1996, to April 30, 1997, which was later extended to July 31 of this year.
- 3.2 During this period steps were taken to strengthen the internal auditing area, and the basic activities were continued in the consolidation of Special Taxpayers System, information systems, support to the invoicing regime, and preparation of the new operation (EC-0175) and its associated PPF operation (EC-0178).

B. Principal accomplishments

- 3.3 In this stage, and in keeping with the openness to change evidenced by the new authorities, there has been success in getting the DGR to take important decisions, such as:
 - 1. Restoring the DGR's autonomy so that it can manage its own human and financial resources (April 1997).
 - 2. Issuing a directive creating the Office of the Assistant Director General for Information Systems [Subdirección General de Informática].

3. Issuing a directive creating the Office of the Assistant Director General for Regional Offices [Subdirección General de Control de Delegaciones].
 4. Issuing an executive decree authorizing the Director General of National Revenue to hire companies directly in order to speed up the publicity campaign on invoicing.
 5. Undertaking the necessary legal actions to reorganize the DGR's personnel structure.
 6. Securing the explicit support of the tax authorities for going ahead with a third technical-cooperation project with the IDB.
 7. Planning, discussing, and revising the preliminary documents for the third stage of the project.
 8. Preparing and analyzing the document for the Project Preparation Facility operation so as to be able to move forward with the decision-making process for financing the project during the period from August 1997 to January 1998.
 9. Strengthening the Special Taxpayers System in the regulatory, procedural, and information-systems areas.
- 3.4 Although these decisions represent major advances from the formal standpoint of the structuring and organization of the DGR, they need to be implemented from the operational standpoint and consolidated over time. It is noteworthy that some of these measures have already been implemented, but were then overturned.

IV. THE THIRD STAGE

A. Objective

- 4.1 In view of the foregoing, it is important that this new stage of technical-cooperation activity focus on one of the unfulfilled objectives of the second stage -- that is, that the DGR be accorded appropriate autonomy as regards its resources so that it can strengthen its management capacity and structure its activities along the principles of: (i) operational decentralization; and (ii) pursuit of the strategy of establishing different treatment for taxpayers according to their financial importance.
- 4.2 In this context it is essential to professionalize the staff and secure from them a stronger commitment to the agency. To this end a study of the personnel is planned to produce recommendations as to which staff members have profiles that do not meet the require-

ments of the new tax administration so that they may be separated or reassigned.

- 4.3 From the new operational standpoint for the improvement of tax administration, it is considered necessary to redesign the main processes of the tax administration using as models the collection control processes implemented in the special taxpayers' units, with emphasis on the criteria of decentralization, efficiency, and service to taxpayers.
- 4.4 This redesign of processes must be accompanied by new advances in the information systems area. Based on the advances made in the preceding stage, it is now necessary to integrate the systems implemented in the collection offices for special taxpayers with those operating at the central level, to begin using the information from these taxpayers for inspection purposes, extend these systems to the intermediate taxpayers, convert the hierarchical database operated at the central level to a relational one and move the systems now operating, and, lastly, extend the decentralized systems to the other 20 collection offices in the country.
- 4.5 This redesign of the tax administration's main processes and improvement of the information support systems must of necessity be accompanied by a strengthening of the human resources present in each area.
- 4.6 A refining of the inspection process will be launched with the introduction of new techniques and methods that will be inserted into instructions for and guides to verification, some of which are already on file in the DGR; supported by information from third parties, these instructions and guides will simplify the inspection work and make it more effective.
- 4.7 These processes will go hand in hand with a strengthening of the functions of planning, and control of management and of internal auditing. The latter will be given priority for development in relation to the field of inspection and claims.
- 4.8 The third operation will be to promote the achievement of a modern, professional tax administration with the requisite rank and authority and an image that assures a transparent relationship between the Treasury and the taxpayer, and above all which assures a steady and progressive increase of the fiscal collections to support the general budget of the government.

PROGRAM FOR MODERNIZATION OF THE TAX SYSTEM III (EC-0175)

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
<p>Objective of the project is to support the modernization of the tax administration in Ecuador in its implementation decentralized and administratively decentralized tax administration</p>	<ol style="list-style-type: none"> 1. A maximum of 10% nonfilers among the principal VAT payers, and opening of collection proceedings by the tax administration in not more than 5 days. 2. Follow-up of 100% of tax liabilities in arrears and of collection enforcement proceedings against special and intermediate taxpayers in decentralized computerized procedures. 3. An increase of at least 300% in number of inspections and reduction of 50% in challenges to inspection reports. 4. At least 4000 opportunities for training offered during execution of the program in areas of inspection, collection, organizational development, and information technology. 5. All 32 decentralized units connected to the technological network of the tax administration and more than 700 workstations installed on this network. 6. At least 70% of tax returns filed electronically, which would reduce volume of paper processed by the tax administration by more than 50%. 	<p>Reports on and evaluations of the program.</p>	<p>External and internal political will to implement changes, primarily those for organizational development and human resource management. Effective leadership of Ministry of Finance in execution of the PPF and implementation of its results. Ongoing support of national authorities, especially of the Ministry of Finance, in execution of the project.</p>

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
1: Organizational			
operation a new tax administration ned by the strategies of autonomy, ii) consolidation of centralization, and iii) treatment accordance with their financial	<p>1. Effectively autonomous management of budgeted human and financial resources.</p> <p>2. Tax administration operating under the new organizational structure of institutional autonomy, operational decentralization, and differentiated treatment of taxpayers.</p> <p>3. Tax administration has in operation and use a real system of management information that enables it to measure the results of its operations and to take timely corrective action.</p>	<p>1. Review of administrative management procedures (budget utilization, contracts, procurement of goods and services, and personnel hiring and administration).</p> <p>2. Auditing practices.</p> <p>3. Evaluation of statistics and reports.</p> <p>4. Opinion surveys.</p>	<p>1. Decision of competent national to make autonomy real.</p> <p>2. Timely allocation of needed bu resources.</p>
g			
nt and implementation of new ion review methods and ontrol to all functions.	Auditing procedures approved and in use in collection and claim areas by close of first year and in areas of finance, goods and human resources by close of second year of project.	<p>1. Review of auditing procedures in use.</p> <p>2. Inclusion of internal audits as permanent practice in tax administration's plans.</p>	Internal audit area in being and op and counterpart personnel assigne
nt of external audits, f inspections and decisions.	Performance of external audits of about 0.5% of the inspections or administrative decisions as complement to work done by Internal Auditing area in each year of the project.	Review of reports of Internal Auditing and external auditing firms, and of tax administration's management statistics.	Satisfactory governing provisions
structure			
operation of new structure and ucturing plan.	New organizational structure in place and implementation by close of first year of project subject to criteria of operational decentralization and differentiated treatment of taxpayers based on their financial status and complexity.	Audits of formal and real organizational schemes in effect.	Internal and external political decis implement the new structure.
n areas of human and financial			
on of administrative systems in n and financial resources.	Systems for administration of human resources, budget, accounting, treasury, control of goods and pay scale in place and functioning autonomously of Ministry of Finance by close of first year.	Audits of operation of enumerated systems.	Sufficient human and technical res allocated to Administrative Area fo of the systems.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
ion			
t and implementation of plan information on the new tax	Plan for public information to project image of new tax administration into the public. Must include motivational aspects and information on rights and duties of taxpayers, how to exercise and fulfill them, and penalties for noncompliance.	Verification of public information plan and of its implementation by review of the means and vouchers of the advertising agencies and survey to determine impact of the campaign.	Financial resources for implementation of public information plan made available in time by government.
Planning and control			
ing of the management control area and development t information system.	<ol style="list-style-type: none"> 1. Management Planning and Control Area in operation by close of first year. 2. Management Information System in place with data from SRT and on liabilities, collections and principal operational measures taken by second year. 	<ol style="list-style-type: none"> 1. Verification that Management Planning and Control Areas are in operation. 2. Conceptual analysis of data contained in management information system. 	Sufficient human and technical resources provided for Management Planning and Control areas.
2: Human resources and training			
ize the human resources and development in keeping with and secure their commitment to organizational change and to n.	<ol style="list-style-type: none"> 1. Personnel reassigned, absorbed and terminated in accordance with studies to be done under the PPF operation. 2. Staffing table and pay scale approved and in effect in the first year. 3. 100% of training plan executed. 	<ol style="list-style-type: none"> 1. Evaluation of statistics and internal reports. 2. Review of approved staffing table. 3. Opinion surveys. 	<ol style="list-style-type: none"> 1. Firm internal and external political will to make needed adjustments in personnel strength. 2. Government has will to endow tax administration with its own staffing and pay scale.
plan for reassignment and staff members under new preparation of plan for taking on	Implementation of recommendations on reassignment and termination of staff members produced by personnel evaluation study to be done under the PPF operation, prior to first disbursement.	Comparison of recommendations of firms that made personnel evaluation with reports on personnel actions actually carried out.	Internal and external political will to make recommended adjustments and secure appropriate body of provisions.
hiring of personnel financed by who must later be taken into the on, preferably in the areas of cessing and inspection.	<ol style="list-style-type: none"> 1. Hiring of about 20 persons a year, financed by the project. 2. Absorption by tax administration of personnel hired in preceding year. 	Verification through statistics and internal reports of the project and of the tax administration.	Financial resources and vacant positions available in organization so that tax administration may absorb at end of project personnel hired by the project.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
and hiring of new staff members.	Selection and hiring each year of at least 20% of the number of personnel required to be hired according to the study of personnel requirements performed under the PPF operation.	Verification in statistics and internal reports of the project and of the tax administration.	Financial resources and vacant positions available according to staffing table.
pay scale competitive with existing scales and scales of incentives in production and performance	<ol style="list-style-type: none"> 1. Proposal of pay scale and incentives approved in first year after commencement of project. 2. 100% of staff members placed under new scales by close of second year. 	Review of proposed scales.	Internal and external political resolution to approve the initiative. Financial resources allocated by government.
of plans for training in skills to improve efficient personnel performance, on areas of management, and information processing.	<ol style="list-style-type: none"> 1. Training plan drawn up and approved by close of first six months of the project. 2. Conducted for 100% of management staff in first year. 3. 50% of inspectors have been instructed in practice of quick audits by close of first year and remaining 50% by close of second year. 4. 100% of users of information have been trained in its use. 5. New personnel put through introductory courses as they are hired. 	<ol style="list-style-type: none"> 1. Evaluation of training plan. 2. Review of project and tax administration reports on training carried out. 	Training area of tax administration operation and human and technical resources are available for execution of the training plan.
	Conduct of internships as needed.	Internal reports of project and tax administration.	Internship requirements properly established.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
3: Redesign of processes in administration			
Principal processes of tax to new organizational view to higher productivity.	<ol style="list-style-type: none"> 1. Reduction of information from special taxpayers received on paper to 70%. 2. Computerized control of 100% of liabilities in arrears of special and intermediate taxpayers. 3. Warnings to 40% of nonfilers and nonpaying filers, and penalization of 60% of persisting defaulters. 4. 300% increase in field inspections conducted. 5. Reduction of challenges to inspection reports by 50%. 6. Settlement of 50% of claims for undue payments and requests for refunds using information processing systems. 	<ol style="list-style-type: none"> 1. Audits 2. Evaluation of statistics and internal reports. 	Human, technical and material resources available for timely and sustained out of procedures.
with SRT			
methodology for segmentation of categorization processes. single registration of all of government enterprises and	<ol style="list-style-type: none"> 1. New segmentation of taxpayers in effect by close of first year. 2. Filing of consolidated returns of government enterprises and agencies by close of second year. 	<ol style="list-style-type: none"> 1. Review of SRT reports. 2. Review of standards and procedures for filing returns. 	Resources available for design and out of categorization procedures and standards for the purpose issued.
with OSTs			
ent of procedures for filing tax information on magnetic media.	<ol style="list-style-type: none"> 1. Procedures for filing returns on diskette and electronically in use by close of first year. 2. Reduction of information from special taxpayers on paper reduced to 70% in 3rd year of project. 	<ol style="list-style-type: none"> 1. Review of standards and procedures for returns in OSTs. 2. Review of internal statistics on returns filed. 	Willingness to adjust normative framework replacement of the concept of the tax on returns and allocation of required resources.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
ing of processes for control of and design of complementary	Modules for: submission of appeals, control of inspection reports, monitoring of credit certificates, and for payment in installments, adopted and in use in all OSTs by close of first year.	Audits of operating procedures in OSTs.	Requisite counterpart personnel as
with collection of liabilities in			
nt of procedures for collection arrears from special taxpayers of collection system to all units.	1. Computerized control of 100% of liabilities in arrears by close of first year. 2. Control of 100% of liabilities in arrears of intermediate taxpayers by close of second year.	Audits of operating procedures of OSTs and OITs.	Willingness to adjust normative fra and requisite resources allocated.
of procedures for collection of ears from other taxpayers.	Computerized collection procedures drawn up by second year and in operation in all collection offices by close of third year of project.	Audits of operating procedures in collection offices covering other taxpayers.	Willingness to adjust normative fra and requisite resources allocated.
with control of obligations to file er taxpayers			
implementation of system for lers.	1. System for control of nonfilers in operation in second year. 2. Warning of 40% of nonfilers among other taxpayers and penalization of 60% of persistent nonfilers in third year.	1. Audits of operating procedures 2. Analysis of reports for management control	Sufficient resources allocated and personnel assigned.
implementation of system for ment differences and integration n for issuance of credit	1. System for control of payment differences in operation in second year. 2. Warning of 40% of nonpaying other taxpayers and penalization of 60% of persistent defaulters in third year.	1. Audits of operating procedures. 2. Analysis of reports for management control.	Sufficient resources allocated and personnel assigned.
with inspection			
implementation of short VAT edures	Short VAT inspection procedures designed and in use at close of first year.	Review of designed procedures	Counterpart personnel assigned.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
System for selection of cases to be audited based on i) consecutive years of taxpayer or showing no VAT debit/credit ratios; iii) cross-checks of sales and sales; iv) credit-card reports.	1. Selection procedures in use by close of second year. 2. Selection of at least 30% of cases for inspection by procedures implemented in third year.	1. Audits of selection procedures 2. Analysis of reports for management control	Resources for design and execution of selection procedures available and counterpart personnel assigned.
System for control of printing of invoices	System in operation for compilation and cross-referencing of information among printing enterprises, taxpayers and third parties by close of second year of project	Audits of operating procedures	Resources for design and execution of procedures available and counterpart personnel assigned.
New processes for notification of inspection reports	1. Procedure for notification of inspection reports by collection area in operation in second year. 2. New processes for review of inspection reports decentralized to offices for special and intermediate taxpayers in third year.	Review of established procedures.	Willingness to adjust the normative framework and allocation of the necessary resources in the decentralized units.
System for control of management of inspection	System for control of management of inspection in operation in second year to permit operational monitoring of inspection plans, results of each program and of inspections, and control of times and results of interventions.	Audits of operating procedures	Resources for design and execution of procedures available and counterpart personnel assigned.
Design and implementation of preventive controls	Procedures for mass controls of individual cases (invoice printing, recording of operations, etc.) designed and in operation by close of second year of project.	Audits of operating procedures	Resources for design and execution of procedures available and counterpart personnel assigned
Adjustment of new inspection procedures	New inspection procedures adjusted and improved on basis of experience acquired in their use by close of third year of project.	Evaluation of adjustments of procedures	Resources for design and execution of adjustments of procedures available and counterpart personnel assigned.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
with tax compensation and			
of processes for analysis and ns and design of system for ance and use of credit and ompensation notes.	<ol style="list-style-type: none"> 1. New computerized decentralized processes for analysis and control of claims in all offices of special and intermediate taxpayers in second year. 2. System for control of credit and compensation notes in operation in offices of special and intermediate taxpayers in third year 	Audits of operating procedures	Resources for design and execution of procedures available and counterpart personnel assigned.
ment of system for control of nd deducted advances and ocesses for income tax refunds	<ol style="list-style-type: none"> 1. System for control of deducted advances in operation in first year. 2. System for control of withholdings in operation in second year. 3. New computerized, decentralized process for refunds of income taxes in operation in third year. 	Audits of operating procedures	Resources for development and execution of procedures available and counterpart personnel assigned.
ment of system for support of nds of VAT on exports and esses for this purpose.	<ol style="list-style-type: none"> 1. System for administration of customs information in operation, and design of procedures for its operation using manual control procedures in second year. 2. System for support of refunds of VAT on exports in third year. 	Audits of operating procedures.	Resources for development and execution of procedures available and counterpart personnel assigned.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
4: Information processing			
Tax information systems and of the technological	<ol style="list-style-type: none"> 1. Information processing plan approved, with implementation under way. 2. Organizational structure for the information-systems area approved and implemented. 3. Installation of computer services in all decentralized units. 4. Collection and production of only that information which is of practical use and is necessary for the operation of the tax administration. 5. Increased satisfaction with the quality of service, on the part of both internal and external users. 	<ol style="list-style-type: none"> 1. Auditing practices 2. Conceptual analysis of systems implemented and of data flows 3. Opinion surveys 	Decision to strengthen information area with necessary human and technical resources. It is essential that the tax administration have sufficient number of specialists in systems development and management.
Implementation of new information processing area technological and changes.	Proposal for new information processing structure designed and approved in first six months of project. In operation in first year.	Review of decision implementing the structure.	Counterpart personnel assigned.
Institutional model of data and	Institutional model of data and processes designed and approved in first six months of the project.	Conceptual analysis of approved model.	Counterpart personnel assigned.
Physical arrangement for	Physical plan of database designed and approved in first six months of project.	Conceptual analysis of approved model	Counterpart personnel assigned.
Information processing plan, forms to be developed as part of design in Component 3), the man resources to be required, hardware, software and data media, and the methods by to be integrated.	<ol style="list-style-type: none"> 1. Information processing plan designed and approved in first six months of project. 2. Information processing plan in execution during remainder of project. 	Review of approved plan.	Counterpart personnel assigned. V of tax administration to implement information processing plan and allocate requisite resources.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
Rules and processes for accessing the network and databases	Rules and processes for accessing the network and databases framed and approved in second six months of project.	Conceptual analysis of framed rules and processes	Counterpart personnel assigned a of tax administration to implement and processes in question.
Development of specific standards for development and operation of systems	Specific standards for systems development and operation drawn up and approved in the second six months of the project, and implemented in the second year.	Review of standards prepared	Counterpart personnel assigned a of tax administration to implement standards.
Development of security mechanisms for information processing	Mechanisms for security in information processing defined in second six months of project and implemented in second year.	Audits of operating procedures.	Resources available for development and implementation of security mechanisms.
Development, procurement and operation of hardware, basic related elements needed at the central and in the decentralized units (See Annex V.1)	<ol style="list-style-type: none">1. Systems of OSTs linked to Computer Center in second year.2. Offices for other taxpayers computerized and linked to CC in second year.3. Other collection offices computerized and linked to CC in third year.	Audits of operating procedures.	Human, financial and logistical resources available for proper administration of computer equipment to be provided.
Development, procurement and operation of local and extended-area networks and Internet links, with priority with private networks. (See Annex V.2)	<ol style="list-style-type: none">1. Local and extended-area networks operational in first year.2. All autonomous decentralized computer systems linked to CC by close of third year of project (operating in accordance with points 2, 3, 4, 5 and 6)	Audits of operating procedures	Human, financial and logistical resources available for proper administration of computer equipment to be provided.
Development of specific operating systems, and communications (see Annex V.4)	Fifty per cent of personnel involved in use of a new information processing tool trained within six months of its installation and rest of personnel within the year.	Evaluation of internal reports of the project and the tax administration.	Enough human resources available to administer the technological change, development and execution of new systems concurrently.
Development, procurement and placement in operation of new central software platform.	New central software platform, including modern relational database manager, defined and in operation in second year.	Audit of platform in operation.	Enough human and technical resources available for concurrent administration of systems in operation on old platform and the new one during the transitional conversion period.
Development of methodology for redesign of systems operating at central level.	Methodology and plan for redesign systems operating at central level completed and in operation in second year of project.	<ol style="list-style-type: none">1. Evaluation of proposed methodology and plan.2. Audit of procedures for redesign of systems.	Enough human and technical resources available for redesign of systems in operation.

OBJECTIVE	INDICATORS / RESULTS	MEANS OF VERIFICATION	ASSUMPTIONS
5: Regulatory provisions			
Regulatory provisions to the new tax administration, and the aspects of control of tax	1. Improvements in Tax Code approved by the tax administration. 2. System for withholding and final payments revamped and approved by the tax administration. 3. Simplified regime for small taxpayers approved by the tax administration.	Conceptual analysis of code, tax regime and proposals made.	Policy decision taken to promote proposals.
ent of legal changes required to of information processing and izing processes, and promotion draft Tax Code prepared.	Legal amendments framed and approved by the tax administration by close of first year of project.	Review of approved proposals.	Willingness to promote the proposals assign counterpart personnel.
ent of regulations on billing for g merchandise and on recording of operations.	Amendments to invoicing regulations framed and approved by the tax administration in first year of project.	Review of approved proposals.	Willingness to promote proposals counterpart personnel.
bills of law, regulations, decisions (presumptions of T, appeals procedure, nontax revenue, consolidation overnment agencies, etc.)	1. Proposals on presumption of nonfiling of VAT and for elimination of nontax collection framed and approved by the tax administration in first year. 2. Proposals for appeals procedure and consolidation of returns in second year.	Review of approved proposals.	Willingness to promote proposals counterpart personnel.
and redesign of systems for al payments and advances.	Draft amendments of legal framework of the systems for withholding, final payments, and advances completed and approved by the tax administration in first year of project.	Review of approved proposals.	Willingness to promote proposals counterpart personnel.
and design of simplified regime yers.	Draft simplified regime for small taxpayers completed and approved by the tax administration in second year of project.	Review of approved proposals.	Willingness to promote proposals counterpart personnel.

PROPOSED RESOLUTION

ECUADOR. TECHNICAL COOPERATION LOAN ____/OC-EC
FOR MODERNIZATION OF THE TAX SYSTEM

The Board of Executive Directors

RESOLVES:

1. 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 agreements as may be necessary and to adopt such other measures as may be pertinent for the execution of the plan of operations referred to in Document PR-____ with respect to a technical cooperation loan with the República del Ecuador to support the modernization of the tax system.

2. That up to the sum of US\$15,800,000, is authorized for the purposes of this resolution, chargeable to the Single Currency Facility of the Ordinary Capital of the Bank.

3. That the above-mentioned amount is to be provided on a reimbursable basis, in accordance with the respective conditions which shall be set forth in agreement to be signed for this operation.