Executive summary

Digital inclusion and mobile sector taxation in El Salvador

Deloitte.

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Executive summary

Around five million Salvadorans subscribe to mobile services, but use of mobile broadband remains limited

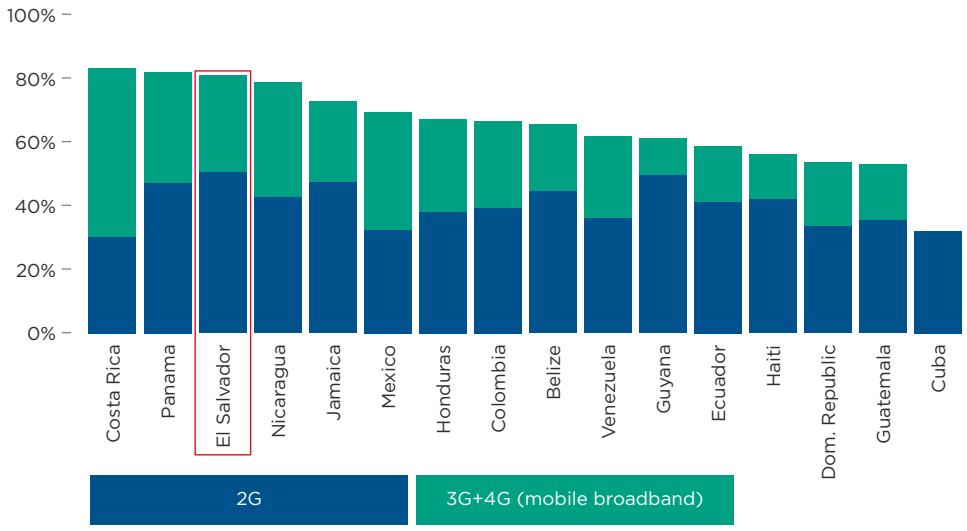
The Republic of El Salvador has the fourth largest economy in Central America. Its economy has grown slowly compared to other Central American countries,[1] constrained by a range of economic and social challenges, as highlighted by the International Monetary Fund (IMF): *"El Salvador continues to suffer from low growth due to a host of complex issues, including low investment, high crime and emigration, and weak competitiveness".*[2]

Total mobile sector revenues represented 2.7% of GDP in 2015[3] and the country's five mobile operators have successfully delivered mobile coverage across the country's largely mountainous terrain. This is despite mobile sector revenues having declined by more than a third between 2008 and 2015, while minutes of use have increased by 60% over the same period.[4]

In 2016, around 80% of the population subscribed to mobile services, which is high compared to most other countries in the region.[5] However, growth in mobile penetration has slowed recently, leaving one in five Salvadorans still unconnected. Over two thirds of subscribers are yet to benefit from mobile broadband services, with a tender to release spectrum suitable for 4G having been delayed since 2013.[6] The tender is now planned to take place in the first half of 2017.[7] Uncertainty about sector policy, such as the license renewal process, is reported to have stalled infrastructure investment decisions.[8]

Figure 1

Mobile penetration (unique subscribers) by technology in LAC[9] countries for which data is available, Q3 2016[10]



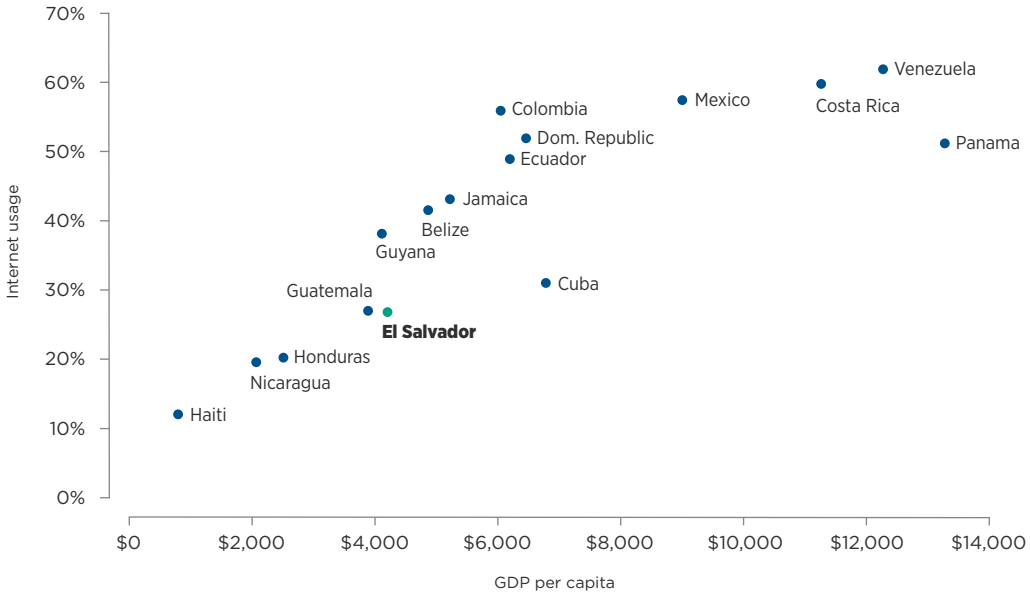
Source: Deloitte analysis based on GSMA Intelligence database

1. IMF (2016): "IMF Executive Board Concludes 2016 Article IV Consultation with El Salvador".
2. IMF (2016): "IMF Executive Board Concludes 2016 Article IV Consultation with El Salvador".
3. Deloitte analysis based on GSMA Intelligence and World Bank databases.
4. Deloitte analysis based on GSMA Intelligence and SIGET.
5. GSMA Intelligence database.
6. TeleGeography (2016): "Movistar El Salvador earmarks USD250m for LTE launch".
7. La Prensa Grafica (2017): "Licitación de 120 MHz para telefonía será en el primer semestre del año".
8. Discussions with mobile operators.
9. Latin America and Caribbean.
10. A 3G connection need not imply that the subscriber is using mobile broadband.

As fixed broadband penetration is limited to 6%,[11] mobile networks play a crucial role in delivering internet access. Reflecting the relatively limited uptake of mobile broadband, smartphone adoption was only 31% in 2016, compared to an average of 43% across LAC.[12] Internet usage remains low compared to other countries in the region, falling short of the developing country average of 35%.[13]

Figure 2

Percentage of individuals using the internet and GDP per capita in LAC countries for which data is available, 2015



Source: Deloitte analysis on ITU (2016): "Measuring the Information Society Report 2016" and World Bank database

Increased use of mobile services is widely recognised as a driver of economic and social growth in countries such as El Salvador,[14] and mobile broadband specifically may deliver economic benefits over and above those generated by basic mobile telephony.[15] In particular, the country's mobile money services such as Tigo Money and m-Banco represent a success story, growing rapidly to support the government's financial inclusion objectives, and facilitating receipt of remittances, which correspond to one sixth of GDP.[16] The IMF reports that *"financial development and broadening inclusion will likely yield relatively high gains in terms of GDP growth"*.[17] Mobile services may also be a low-cost means of improving information flows and making markets work more efficiently. Smartphone applications such as the UN World Food Programme's P4P and Figaro's *Agromovil* provide Salvadoran farmers, traders and other stakeholders with timely market price information and weather updates.[18]

11. ITU database.
12. The average is based on 16 LAC countries. GSMA Intelligence database.
13. ITU (2015): "Facts and Figures 2015".
14. For example: World Bank (2012): "Maximising Mobile"; McKinsey & Company (2012): "Online and Upcoming: The Internet's impact on aspiring countries"; Goyal, A. (2010): "Information, Direct Access to Farmers, and Rural Market Performance in Central India". American Economic Journal: Applied Economics; Aker, J.C. and Mbiti, M. (2010): "Mobile Phones and Economic; Development in Africa", Journal of Economic perspectives.
15. ITU (2012): "Impact of broadband on the economy".
16. World Bank database.
17. IMF (2016): "IMF Country Report No. 16/209".
18. GSMA (2017): "mAgri Deployment Tracker".

Around five million Salvadorans subscribe to mobile services, but use of mobile broadband remains limited. Recent increases in mobile sector taxation and uncertainty surrounding sector policy create affordability and investment barriers.

Recently increased taxation on the mobile sector risks limiting connectivity, especially for the poorest Salvadorans

The mobile sector is subject to various general taxes, such as VAT, corporation tax, salary taxes and withholding taxes. On top of this, operators pay a sector-specific spectrum administration fee and municipal taxes levied on towers.

In November 2015, the introduction of two new taxes substantially increased the level of taxation applied to the mobile sector.

- The *Contribución Especial para la Seguridad Ciudadana y Convivencia* (CESC) is a 5% tax on all forms of telecommunications, including calls, SMS, mobile broadband, SIM cards, handsets and network equipment.[19]

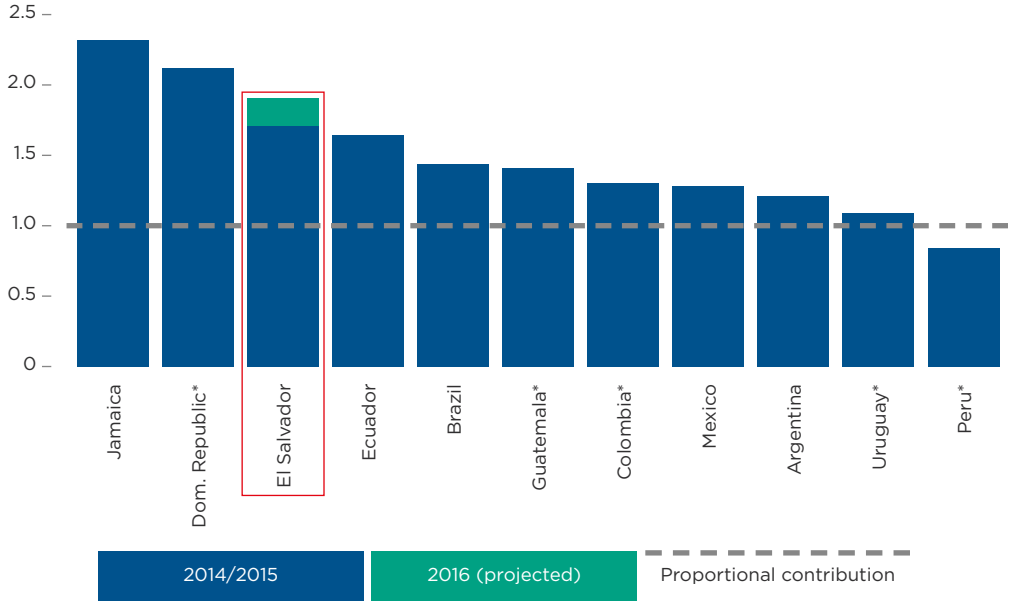
- The *Contribución Especial A Los Grandes Contribuyentes Para El Plan De Seguridad Ciudadana* (CEGC) is levied at a rate of 5% on the net income of companies whose net income exceeds $ 500,000.[20]

As a result of these taxes, in 2016 mobile operators are estimated to have paid $ 197 million in taxes and regulatory fees, representing 30% of their revenue. This is a sharp increase from 26% in 2015.

The mobile sector makes a large contribution relative to its economic footprint. The sector's tax and regulatory fee payments in 2015 are estimated to represent around 4.5%[21] of government tax revenues, while the sector's revenue only corresponds to around 2.7% of GDP.[22] That is, the mobile sector's "share of tax" is estimated to be around twice its "share of GDP". The sector's over-contribution to tax revenues, relative to its size, appears more pronounced in El Salvador compared to other countries in the region.

Figure 3

Ratio of mobile share of tax revenue to mobile share of GDP in LAC countries for which data is available, 2014/2015 and 2016 (projected change)



Source: Deloitte analysis based on operator data, GSMA Intelligence database, Banco Central de Reserva de El Salvador, and previous Deloitte studies. *2014 data

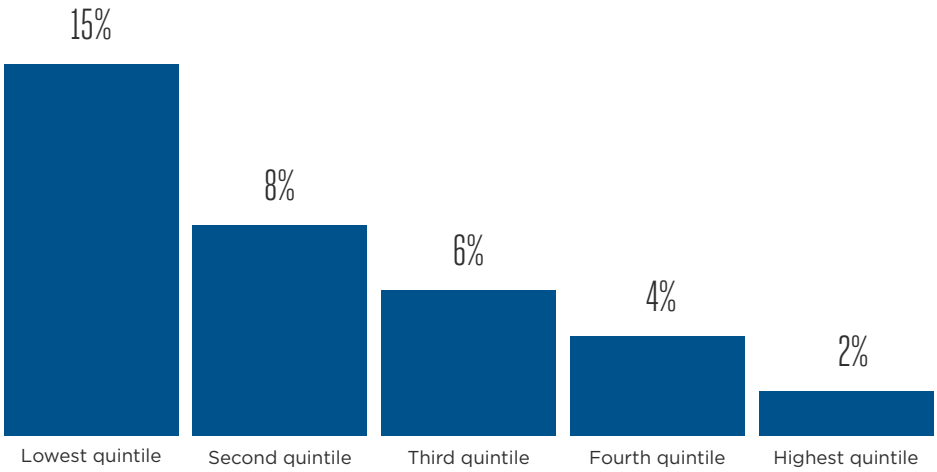
19. Asamblea Legislativa (2015): "Decreto N° 162".
20. IBFD (2016): "El Salvador – Corporate Taxation".
21. Deloitte analysis based on operator data, and GSMA Intelligence, Banco Central de Reserva de El Salvador and World Bank databases.
22. Deloitte analysis based on GSMA Intelligence and World Bank databases.

Taxation over and above that which applies to other standard goods and services is not fully aligned with the best practice principles of taxation set out by international organisations such as the World Bank and IMF, which recommend taxation to be levied on broad bases. The introduction of the sector-specific CESC in particular may create a number of issues:

- **Reduced affordability of mobile services.** The introduction of the CESC may put pressure on margins, potentially limiting the scope for price reductions and constraining further expansion of connectivity. For example, a typical mobile data bundle currently represents more than 15% of Gross National Income (GNI) for the lowest 20% of earners and exceeds 5% of GNI for the majority of Salvadorans.[23]

Figure 4

Cost of mobile broadband bundle as a percentage of GNI by quintile, 2015



Source: Deloitte analysis on ITU (2016): "Measuring the Information Society Report 2016" and World Bank database. A quintile represents 20% of the population, ranked from the lowest to the highest 20% income bracket

- **Disincentives for investment.** Increases in taxation may reduce the returns on investment, potentially leading to inefficient investment decisions. The IMF notes in this regard that *"plans to boost tax collection should be carefully calibrated to avoid dampening the investment climate"*.[24] For one operator, earnings before interest, tax, depreciation and amortisation (EBITDA) have fallen by 11% since the new taxes were introduced and are now lower than in other countries in the region. The current policy risks curbing further improvement in El Salvador's mobile networks.

23. Deloitte analysis based on ITU (2016): "Measuring the Information Society Report 2016" and World Bank database.
24. IMF (2016): "IMF Country Report No. 16/209".
25. IMF (2016): "IMF Country Report No. 16/209".

Reducing or phasing out the CESC has the potential to promote connectivity, economic growth and international competitiveness

The mobile industry recognises that its fiscal contribution remains critical to financing public expenditure, especially given the need to improve the country's security situation. However, the current treatment of the mobile sector may be limiting growth in mobile connectivity that would benefit society and the economy. Reducing taxation on mobile services, to be more in line with other goods and services as was the case before the introduction of the CESC, has the potential to support growth and fiscal stability in the medium term. The IMF argues that the CESC tax has a *"low yield but significantly hamper[s] financial intermediation and inclusion, and should be reduced or phased out"*.[26]

Reducing the CESC to 2.5% has the potential to improve affordability and enable further network investment

As an illustrative example, if the CESC were reduced from 5% to 2.5%, this would equate to an estimated mobile sector tax payment reduction of around $ 14.1 million in 2018, which represents 0.34% of government tax revenues and 7% of the mobile sector's tax and regulatory fee contribution in 2016.[27]

Based on an analysis which examines the impact of this tax reform on mobile penetration and economic growth, price reductions have the potential to generate an **additional 110,000 connections** over the four year period to 2021. In the wider economy, **GDP has the potential to grow by $ 470 million** and **total investment could increase by $ 70 million** over the four years to 2021. Increased resources for investment can potentially result in an **additional 420 new or upgraded mobile sites** by 2021.

Exempting mobile broadband data services from the CESC has the potential to support increased internet usage

As an illustrative example, if mobile broadband were exempted from the CESC tax, this would equate to an estimated total tax payment reduction of around $ 7.4 million in 2018, which represents 0.18% of government tax revenues and 4% of the mobile sector's tax and regulatory fee contribution in 2016.

Based on an analysis which examines the impact of this tax reform on mobile penetration and economic growth, price reductions have the potential to generate an **additional 60,000 connections** over the four year period to 2021, **including 40,000 using mobile broadband**. The growth in mobile ownership and usage to 2021 has the potential to **increase GDP by a total of $ 250 million** and **investment by $ 40 million**. Increased resources for investment can potentially result in an **additional 220 new or upgraded mobile sites** by 2021.

26. IMF (2016): "IMF Country Report No. 16/208".
27. These figures relate to CESC payment by the mobile sector. Based on Ministerio de Hacienda data, the total tax revenue from the CESC was $ 49 million in 2016. A 50% cut in the rate would correspond to a total tax revenue reduction of $ 24.5 million in 2016.

Any rise in the general VAT rate would directly affect mobile affordability

The IMF has suggested increasing tax revenues by adjusting the VAT rate upwards, closer to the regional average.[28]

An increase in VAT is likely to result in substantially larger tax revenues for the government. However, this policy, when considered together with the recent introduction of CESC, could create further pressure for the mobile sector. Based on an illustrative analysis which examines the impact of a VAT increase from 13% to 16% on mobile penetration and economic growth, higher prices associated with the raise in VAT may result in **170,000 fewer connections** over the four year period to 2021, **including 120,000 using mobile broadband**. Reduced resources for investment can potentially result in **650 fewer** new or upgraded mobile sites by 2021.

The IMF recommends that *"given the need to increase growth, revenue-raising measures should be accompanied by cuts in distortionary taxation".*[29] If VAT is raised, the budgetary cost of reducing or removing the distortionary and regressive CESC tax may be relatively minor in comparison. The mobile sector has the potential to drive higher GDP growth, attract Foreign Direct Investment (FDI) and boost international competitiveness, which are policy priorities of the recently established PROESA agency.[30] Reducing distortionary taxation on the mobile sector—such as the CESC—may support the achievement of these objectives.

28. IMF (2016): "IMF Country Report No. 16/209".
29. IMF (2016): "IMF Country Report No. 16/209".
30. PROESA (2014): "Aprobada la Ley de Creación del Organismo Promotor de Exportaciones e Inversiones de El Salvador".

Reforming taxation on the mobile sector

While taxation from the mobile sector remains critical to continue financing public expenditure in El Salvador, especially in light of the need to finance security measures, the recent introduction of the CESC tax may be obstructing growth of the mobile sector.

Using mobile phones may still be unaffordable for the poorest Salvadorans, while the country's mobile broadband infrastructure is underdeveloped and internet usage is low relative to other countries. The sector specific CESC is likely to compound limited affordability and dampen further investment in infrastructure.

Reforming mobile taxation could help align with principles of effective taxation recommended by leading international organisations, while benefiting society as a whole through increased mobile and internet usage. Alternative options for tax reform may be available. For example:

- Reducing the CESC rate of 5% to 2.5% could help align consumer taxes on mobile usage more closely to the taxation of standard goods and services.
- Mobile data services could be exempted from the CESC tax to reduce the affordability barrier for consumers and to encourage mobile operators to invest in the necessary infrastructure.

Further, should the government consider an increase in VAT across the economy, there is a risk of negative impacts on mobile usage and investment that could add to the potential negative impacts of the CESC. To mitigate this risk, the government could consider removing the CESC in the event that VAT is raised. An increase in VAT is likely to result in substantially larger tax revenues for the government and the budgetary cost of reducing or removing the distortionary and regressive CESC tax may be relatively small in comparison.

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