



Salary bonuses in revenue departments: do they work?

Many revenue departments offer bonuses in hopes of improving worker performance. But such mechanisms pose enormous risks—and so require careful design and cautious implementation.

Compensation provides a major incentive for workers to perform well. Accordingly, bonus payments are often used to enhance staff effectiveness and efficiency—and have become increasingly common in revenue departments around the world. A recent World Bank study analyzed the bonus systems applied by revenue authorities in seven countries, and was complemented by questionnaires completed by tax and customs administrations in seven others. Though the sample was small, the study generated interesting findings and points to areas requiring further analysis.

The countries analyzed indicate that bonus systems are fraught with danger and so must be designed with the utmost care. There is no evidence that bonuses automatically increase the effectiveness of revenue departments. And because staff performance is influenced by factors other than salaries and bonuses, it is not easy to determine the effects of such systems. This note reviews reasons for introducing bonus systems and discusses a number of crucial design features, particularly the importance of effective and transparent performance appraisal systems based on clear performance measures.

Why offer bonuses?

A revenue department is supposed to collect government revenue at low cost and low inconvenience to taxpayers. Many factors influence the effectiveness and efficiency of revenue authorities. But among the most

important are attracting, motivating, and retaining skilled staff—efforts that are strongly influenced by compensation packages, including potential bonuses. There is also reason to believe that bonuses can help prevent corruption, especially if it results from unreasonably low pay for tax officials. However, there is no conclusive evidence on the link between compensation and corruption.

A system's design should reflect its goals

To be effective, a revenue department's bonus system must be generous enough to make a difference in employees' take-home pay. In addition, criteria for allocating bonuses should reflect the system's goals. If the main goal is to increase revenue, the bonus system should reward revenue-generating efforts by, for example, measuring revenue in excess of a given target.

Such a limited focus is risky, however, because it can undermine other aspects of performance. For instance, Denmark's bonus scheme initially focused exclusively on enhancing revenue, leading to taxpayer harassment. Similarly, Latvian taxpayers felt gouged by tax collectors eager to qualify for bonuses. As a result both systems had to be modified.

If the aim is to make the revenue department more efficient in specific operational areas, performance criteria should reflect expected results—such as the number and results of audits conducted in a given period, the reduction in taxpayer complaints, and

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the increased satisfaction of importers with the customs regime.

A bonus system's target group also needs to be based on expected results. Should the system be limited to managers, as it initially was in Denmark? Should it cover all staff equally, as in Ghana and Latvia? Or should it provide equal bonuses to all staff plus supplemental bonuses based on individual performance, as in Brazil? In Romania individual performance determines 70 percent of the bonus, with the rest based on collective performance. In South Africa the ratio is half and half, while in Iran collective performance accounts for 90 percent of the reward. In Morocco evaluations are based on individual performance, but all staff receive some bonus.

Award criteria should have widespread legitimacy

Without internal and external legitimacy a bonus system will not be sustainable, because stakeholders in the revenue administration will work against the system. Excessive discretion in allocating bonuses undermines internal legitimacy. Albania addressed this issue by installing a three-tier responsibility system so that no single manager has the final say in awarding bonuses: staff are allowed to see their evaluations, there is an appeals mechanism, and the names of bonus recipients are published.

Staff rotation, common in most customs administrations, helps prevent collusion between managers and staff and can signal that evaluations are unbiased. A bonus system that by design excludes a large portion of staff—such as the Philippine system, which only benefits staff involved in detecting customs fraud—risks undermining staff morale and ultimately its own effective operation. The more discretionary factors that are built into a system, the greater are the efforts required to build confidence in it.

External legitimacy is also important, because the budget resources required to fund the bonus system need to be appropriated on a regular basis. Government approval is difficult to obtain and sustain if the rest of the civil service objects to bonuses

for revenue administration staff. To deal with this resentment, efforts may be needed to explain the crucial function of mobilizing budget revenue to finance public services, as well as the high risk of corruption in revenue departments.

In Ghana the bonus system for the Internal Revenue Service (IRS), introduced in 1986, substantially raised take-home pay for IRS staff. Although this situation was initially accepted by other civil servants, support eroded over time. As a result the compensation of IRS staff became the reference point for salary demands in the rest of the civil service. In response the government froze IRS staff compensation until the rest of the civil service reached its level, undermining the system's initial objective.

Proper performance indicators are crucial

Performance evaluations must be fair and based on robust, relevant indicators. These indicators should be clear to staff and to managers preparing evaluations, and measured performance should be clearly attributable to the staff member receiving a bonus. Indicators must provide a sound basis for measuring and comparing individuals, teams, and departments, including changes over time. This requires agreed definitions, standardized concepts, and efficient information collection. Good indicators minimize the risk of data manipulation and do not neglect performance areas that are not measured. Targets used as performance indicators should be SMART: specific, measurable, achievable, relevant, and timed.

Most of the countries surveyed rely more on effectiveness than efficiency indicators and generally use just three or four. Evaluations and negotiations are especially important in systems with unclear indicators, and ensuring their legitimacy requires special attention. In the absence of a universal set of indicators that suits all countries, each revenue administration needs to develop its own—taking into account intended goals, institutional arrangements, the civil service culture, and the relationships between the pay system for the system's beneficiaries and

that for the rest of the civil service. The designs of the bonus systems in Denmark and Brazil are instructive in this context.

Denmark's system is complex but effective

Denmark's Customs and Taxation Department has experimented with bonus systems since the early 1990s, and settled on a new one in 1999. Initially limited to regional managers, the scheme was extended to all managers in 2000 and to all staff in 2001. Regional managers can obtain a 5–15 percent salary supplement, depending on the size of the office they manage, plus a performance bonus capped at 15 percent of base salary. The best-performing managers—those that exceed by 100 percent the targets stated in their performance contracts—receive an additional bonus, but the total performance bonus cannot exceed 25 percent of base salary.

Regional managers' performance bonuses are based on several components:

- 40 percent is determined by hard numeric results. From about a hundred goals, the department chairman and regional director each select four or five that reflect the circumstances of regional offices and offer verifiable improvements in effectiveness and efficiency.
- 20 percent depends on achieving a performance target set by the minister of finance.
- 20 percent depends on achieving targets for human resource management (such as results from staff surveys or reductions in staff sick leave).
- 20 percent depends on contributions toward achieving the department's strategic objectives.

The process starts with a self-assessment by the regional manager, backed by internal statistics, and is followed by sometimes arduous negotiations with the department chairman.

One criticism of the Danish bonus system is that it risks not being attractive enough to influence staff performance. The same has been said of bonus systems for revenue departments in some other industrial countries, such as Canada. In developing countries, where civil service

base pay is lower, bonuses are far more substantial. For instance, in Morocco's customs administration performance bonuses have replaced all others and can reach 100 percent of base salaries—aiding recruitment efforts. In Romania bonuses can reach three times base salary.

Brazil's scheme has had mixed results

Brazil's revenue department has also experimented with bonus systems over the past decade. Early systems distributed about two-thirds of the fines collected from taxpayer audits. Bonuses were initially based on individual performance but evolved into equal salary supplements for all staff.

Bonuses still have a collective component, with 40 percent determined by whether a unit achieves its revenue collection target. (The full bonus is awarded if 97 percent of the target is reached—and forfeited if less than 90 percent is achieved.) But in 1999 the revenue department reintroduced bonuses for individual performance, and these account for the other 60 percent. Supervisors conduct performance evaluations, which staff can review and appeal. All staff are eligible for bonuses of up to 50 percent of base salary.

Since the bonus system was introduced, auditors have increasingly focused on large taxpayers with high revenue potential—suggesting that collective bonuses provide their intended incentives. But bonuses for individual performance are poorly managed, with nearly all staff members receiving the maximum score. Greater reliance on management reviews of individual performance evaluations could prevent this outcome.

Conclusion

In some cases bonuses may enhance a revenue department's effectiveness and efficiency. To do so, the bonus system must be legitimate, objective, transparent, and easy to administer. But these requirements pose substantial challenges for design and implementation. Only well-designed schemes will achieve the desired results.

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oping countries, current information on their operations and effects does not confirm their universal success and usefulness. More information is needed on these schemes. Moreover, it might be possible to achieve their intended results by placing staff in revenue administrations on a higher pay scale than the rest of the civil service. Such a move would be justified by the importance of their function and could help contain corruption—and would avoid the pitfalls of the schemes described here.

Further reading

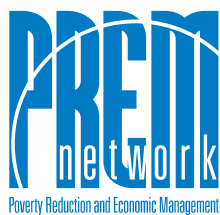
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This note was written by Luc De Wulf (Consultant, PRMTR) and is based on a 2001 study by PLS Ramboll that was largely financed by the Danish Governance Trust Fund. The full study is available on the Website of the Tax Policy and Administration Thematic Group (www.world-bank.org/publicsector/taxation).

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