Administrative Dimensions of Tax Reform

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Contents

I. Introduction

II. Tax Policy and Tax Administration
   1. Keep it simple
   2. The taxpayer as “client”

III. Approaches to Tax Administration Reform
   1. The environmental context
   2. Tax administration as a production process
   3. The key ingredients of reform
   4. Facilitating compliance
   5. Keeping taxpayers honest
   6. Controlling corruption
   7. Conclusion

IV. Some Further Issues
   1. Inflation adjustment
   2. Presumptive taxes
   3. Sanctions and penalties
   4. Tax amnesties
   5. Organizing to tax
   6. Computerization

V. Tax Policy and Tax Administration in Tax Reform -- The Example of Poland
   1. Policy formulation
   2. Sequencing administrative and policy reform
   3. Reforming tax administration
   4. Conclusion
I. Introduction

The theme of this course is supposed to be practical issues of tax policy in developing countries. Nothing is more practical than the administrative aspects of tax policy or, correspondingly, the administrative dimension of tax reform. The best tax policy in the world is worth little if it cannot be implemented effectively. Tax policy design in developing countries must therefore take the administrative dimension of taxation carefully into account. What can be done may to a considerable extent determine what is done in any country. In many developing countries, for example, there is a large traditional agricultural sector that is not easily taxed. In many countries, there is often also a significant informal (shadow) economy that also is largely outside the formal tax structure. The potentially reachable tax base thus constitutes a smaller portion of total economic activity than in developed countries.

The extent of this untaxed economy is, of course, in part a function of the design and implementation of the tax system. For example, the high social insurance tax rates levied in some countries create an incentive for a large informal economy by discouraging employers from reporting the extent of employment and encouraging the under-reporting of wage levels. The resulting lower tax revenues often lead governments to raise tax rates, thus further exacerbating incentives to evade taxes. Unfortunately, all too often, when a country’s “real” tax base -- that is, the base its tax administration can effectively reach -- is small, so, almost by definition, is the administrative capacity to reach it effectively. Improving tax administration is thus often central both to the choice of tax structures in the first place and to tax reform in developing countries.

Part II discusses in a little more detail the relationship between tax policy and tax administration. When can policy lead administration? When must policy initiatives wait on administrative reform? How exactly can both sides of the policy and administrative agenda be advanced together? Part III then sets out the broad outlines of administrative reform --- the essential conditions for such reform, its principal components, and its limits as a way of solving critical tax problems. Part IV reviews several key issues in tax administration, with particular attention to their implications for successful tax policy reform and implementation. Finally, Part V brings together some of the earlier
discussion, and adds a few new elements, in a short case study of the interaction of tax policy and tax administration in the Polish tax reform of the early 1990s.

II. Tax Policy and Tax Administration

The importance of good administration has long been as obvious to those concerned with tax policy in developing countries as has its absence. Experience suggests that it is not possible to ignore the administrative dimension of tax reform, to assume that whatever policy designers can think up can be done, or to assume that any administrative problems may easily and quickly be remedied. As a rule, the real tax system facing people and businesses in most developing countries is not what a quick reading of the tax law might suggest but rather results from how that system is actually implemented in practice. How a tax system is administered affects its yield, its incidence, and its efficiency. Tax administration is simply too important to policy outcomes to be neglected by tax policy reformers.

Unfortunately, tax administration is a difficult task even at the best of time and in the best of places, and conditions in few developing countries match these specifications. Moreover, it is inherently country-specific and surprisingly hard to quantify in terms of both outputs and inputs. The "best" tax administration is not simply that which collects the most revenues; facilitating tax compliance is not simply a matter of adequately penalizing noncompliance; tax administration depends as much or more on private as on public actions (and reactions); and there is a complex interaction between various environmental factors, the specifics of substantive and procedural tax law, and the outcome of a given administrative effort. All this makes tax administration a complex matter.

Despite its perhaps surprising complexity, it is important for those concerned with tax policy and its effects on the economy to understand tax administration. In a very real sense, "tax administration is tax policy" (Casanegra de Jantscher, 1990). Maximizing revenue for a given administrative outlay is only one dimension of the task of tax administration. Revenue outcomes may not always be the most appropriate basis for assessing administrative performance. How the revenue is raised - the effect of revenue-generation effort on equity, the political fortunes of the government, and the level of economic welfare - may be equally or more important in some contexts. Similarly, private as well as public costs of tax administration must be taken into account and due attention

3 For example, although many tax administrators understandably cite the relatively low average costs (often around 1 percent of revenues) of collecting revenue in developed countries -- the costs may be considerably higher in some developing countries (Mann, 2002) -- as evidence that additional funds allocated to tax administration will be returned a hundredfold, this conclusion does not follow. In the first place, such figures are very sensitive to tax rates - higher excise taxes, for example, will generally show lower collection costs per dollar than lower excise taxes. Secondly, the marginal revenue that could be collected as a result of adding an additional dollar to the administrative budget will equal the average only under very special circumstances (Vazquez-Caro, Reid, and Bird, 1991). Finally, theoretical arguments (Slemrod and Yitzhaki, 2002) show that the optimal size of a tax administration is likely to be where marginal revenue exceeds marginal cost, perhaps by a wide margin.
given to the extent to which revenue is attributable to "enforcement" (the active intervention of the administration) rather than "compliance" (the relatively passive role of the administration as the recipient of revenues generated by other features of the system). Assessing the relation between administrative effort and revenue outcome is by no means a simple task.

Increasing attention has been paid in the last few years to the importance of tax administration and its role in tax reform. As Tanzi (1991) has pointed out, tax administration has a crucial role in determining the real (or effective) tax system, as opposed to the statutory tax system. There is a growing conviction among tax policy specialists in developing countries that "policy change without administrative change is nothing" (Bird, 1989) and that it is critical to ensure that "changes in tax policy are compatible with administrative capacity" (World Bank, 1991). But how much is actually known about the experience of countries that have reformed - or tried to reform - their tax administration?

1. Keep It Simple

One of the most important lessons emerging from experience in various countries -- Bird and Casanegra, 1992; Das-Gupta and Mookherjee, 1998 -- is that, as a rule, an essential precondition for the reform of tax administration is to simplify the tax system to ensure that it can be applied effectively in the generally "low compliance" contexts of developing countries. The experience of Bolivia, which introduced a major simplification of its tax system in 1986, is instructive in this respect, for example. Much of the initial success achieved in reforming the tax administration in Bolivia was clearly attributable to the extensive simplifications made in the tax system. Indeed, as Bahl and Martinez-Vazquez (1992) argue in the case of Jamaica, it seldom makes sense to try to reform tax administration without simultaneously reforming the tax structure into something that is both sensible and administrable. Of course, as experience in both Chile (Harberger, 1989) and Colombia (Pardo and McLure, 1992) demonstrates, it is possible to achieve considerable improvement in administration with less drastic but nonetheless effective simplifications in tax policy. Reducing the number of income tax deductions, for instance, permitted these countries to eliminate filing requirements for most wage earners, thus greatly reducing the administrative burden, since withholding alone then sufficed to enable most income taxpayers to fulfill their obligations.

There is no single set of prescriptions - no secret recipe - that, once introduced, will ensure improved tax administration in any country. Developing countries exhibit a wide variety of tax compliance levels, reflecting not only the effectiveness of their tax administrations but also taxpayer attitudes toward taxation and toward government in

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4In one of the few books on how tax administrations actually function in developing countries, Radian (1980) emphasizes the extent to which such administrations tend to be passive recipients of funds rather than active collectors of them. Radian labels this important aspect of the activity of many tax administrations "tellering" rather than "collecting": rather than go out and look for tax revenues, such administrations tend to sit behind a counter and wait for people to bring money to them. In fact, of course, the facilitating and monitoring of "quasi-voluntary" compliance (Levi, 1988) constitute important tasks for any tax administration.
general as well as many other environmental factors. Attitudes affect intentions and intentions affect behavior. Attitudes are formed in a social context by such factors as the perceived level of evasion, the perceived fairness of the tax structure, its complexity and stability, how it is administered, the value attached to government activities, and the legitimacy of government. Government policies affecting any of these factors may thus influence taxpayer attitudes and hence the observed level of taxpayer compliance. Measures sometimes recommended for countries with very low compliance levels - such as massive application of administrative penalties, for example - may be quite inappropriate for countries with higher compliance levels, where selective application of stricter penalties may be effective in enhancing more "voluntary" compliance.

Even taking the external environment facing a tax administration as given, it is useful to think of the problem of tax administration at three levels. The first level concerns the design of the general legal framework - not only the substance of the tax laws to be administered but also a wide range of important procedural features. Once this general "architectural design" has been determined, the "engineer" takes over and sets up the specific organizational structure and operating rules for the tax administration. Finally, once the critical institutional "infrastructure" has been erected, the tax managers charged with actually administering the tax system can do their jobs. The point, of course, is that one cannot assess how well a tax administration is functioning, let alone suggest how to improve it, without taking into account the environment in which it has to function, the laws it is supposed to administer, and the institutional infrastructure with which it has been equipped.

For example, it is not possible to appraise the efficiency or effectiveness of tax administration without taking into account both the degree of complexity of the tax structure it is expected to administer and the extent to which that structure remains stable over time. Complexity and its implications for tax administration has long been a concern even in the most developed countries (IRS, 1988). Even the most sophisticated tax administration can easily be overloaded with impossible tasks (Hood, 1976). Such concerns are obviously even more important in developing countries in which less well-equipped administrators are asked to tackle inherently complex tasks in a generally hostile and information-poor environment. The life of the tax administrator is even more complicated by the propensity of many governments, reflecting in part the often unstable political and economic environment, to alter tax legislation annually, or even more frequently. Both the complexity of the tax structure and its stability are thus important factors to be weighed in assessing tax administration.

Such disaggregation of the "black box" of tax administration is particularly important since the main ways in which most existing administrations can be improved are either by altering the tasks with which they are charged or by strengthening the tools with which they are equipped (as in the countless attempts to "computerize" one's way out of the administrative dilemma). Exhortations to "do better" are of little use to resource-strapped administrators faced with impossible tasks, nor are the various "gimmicks" or "quick-fixes" that have sometimes been thought up by clever policy designers of much use in resolving tax administration problems (Bird, 1989).

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5 This analogy draws on one set out in Shoup (1991).
Some such gimmicks - for example, lotteries in which tax invoices constitute lottery numbers - have long (and properly) been derided by experts as costly and of dubious effectiveness (Goode, 1981). Another popular device is to introduce widespread withholding, covering not only traditional items such as wages, interest and dividends but also extending to professional fees, rents, and in some instances to practically all business transactions. Some countries have even introduced what may be called "reverse withholding" in which purchasers (government agencies or large enterprises) "withhold" tax from sellers (small enterprises). Such widespread withholding is no panacea (Soos, 1990). The tax administration must be able to control withholding to make sure they hand over to the Treasury the amounts withheld, and it must also be able to check whether the amounts taxpayers credit against their liabilities as taxes withheld have in fact been withheld. In short, the mere expansion of withholding will not improve compliance unless the administration is able to control both withholding and taxpayers subject to withholding.

As emphasized above, an important element in any successful administrative reform is simplicity. The earlier discussion emphasized giving the administration simpler, and hence potentially, enforceable laws to administer. In addition, it is equally important to simplify procedures for taxpayers, for example, by eliminating demands for superfluous information in tax returns and perhaps consolidating return and payment invoices. Once procedures are simplified, the tax administration can then concentrate on its main tasks: facilitating compliance, monitoring compliance, and dealing with non-compliance.

2. The Taxpayer as “Client”

Facilitating compliance involves such elements as improving services to taxpayers by providing them clear instructions, understandable forms, and assistance and information as necessary. Monitoring compliance requires the establishment and maintenance of taxpayer current accounts and management information systems covering both ultimate taxpayers and third-party agents, such as banks, involved in the tax system as well as appropriate and prompt procedures to detect and follow up on non-filers and delayed payments. Improving compliance requires a judicious mix of both these measures as well as additional measures to deter non-compliance such as establishing a reasonable risk of detection and the effective application of penalties (see Part IV). The ideal approach is to combine these measures so as to maximize their effect on compliance. For example, when introducing a VAT or other new tax, emphasis should first be given to assisting taxpayers to comply with the new tax, then to detecting noncompliance, and finally to applying penalties. As a rule, successful reform strategies require an appropriate mix of all these approaches.

In this respect, it is important to emphasize that improving tax compliance is not the same as discouraging noncompliance. This perhaps paradoxical conclusion emerges from the numerous sociological and psychological studies of taxation that have been carried out in recent years, based largely on experimental and survey evidence (Slemrod, 1992). While most tax compliance in most countries most of the time can perhaps best be characterized as "quasi-voluntary compliance" (Levi, 1988), because taxpayers have little choice as to whether their income sources have tax withheld or not, there nonetheless appear to be two
distinct groups of taxpayers in any country at any time: those who comply and those who do not - almost irrespective of whether they can get away with it or not.

Some compliers comply not just because they do not have the opportunity to evade or because they are exceedingly risk-averse but because they think it is the right thing to do, and, importantly, they think other "right-thinking" people are also complying. By definition, there are more such people in "high-compliance" countries than in "low-compliance" countries. Even in the latter, however, it is a gross oversimplification to pretend that every taxpayer views the decision as to whether to pay his taxes as a gamble to be decided independently of his membership in and loyalty to the community. Some always pay; some always cheat; and some cheat when they think they can get away with it. An important task of tax administration is to prevent the mix from "tipping" in the direction of pervasive non-compliance.

The very limited international comparisons that can be made on the basis of existing literature suggest that considerable care must be exercised in extrapolating results from one context to another. In particular, while non-compliers may be similar in some respects everywhere, both the size and the nature of the factors inducing compliers to comply may be quite different in different countries. Aspects that may differ from country to country include the value attached to "fairness" (and its meaning), the degree of deference to authority (and the legitimacy attached to that authority), and the extent to which contributing to the finance of government activities is seen as socially -- as opposed to privately, as in the economic model of tax evasion, discussed below -- desirable.

Increased enforcement actions (like amnesties - whether viewed separately or jointly from increased enforcement) may have quite different results on "compliers" than on "non-compliers." So may increased efforts at public education about taxpayer rights and obligations or increased efforts by tax authorities to provide improved service to taxpayers. Such policies may change attitudes, although not all changes for all groups will necessarily be in the desired direction. Nonetheless, a good case can generally be made that the "optimal" enforcement strategy is likely to include both rewards (support) for compliers and penalties for non-compliers.

In addition, while there are few studies of private compliance costs in developing countries, the evidence from studies in developed countries (Sandford, 1995) is that these costs are larger than public costs, that they are largely substituted for public costs, and that their incidence can be quite different from those of the taxes themselves. The complexity and cumbersome administrative methods employed with respect to some taxes found in some developing countries - for example, stamp taxes and the variety of minor excises - suggest that compliance costs may well be very high in such countries. Moreover, compliance costs have been found to be particularly sensitive to the stability of the tax legislation and to such changes in the external environment as inflation. All these factors are more important in the "low compliance" environment of most Latin American and Caribbean countries than in the "high compliance" environment of the few developed countries.

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6 A recent study of compliance costs in India (Chattopadhyay and Das Gupta, 2002) however, suggests that such costs may be considerably higher in some instances than in most developed countries.
countries where such costs have been studied. Low compliance may thus at least to some extent be a function of high compliance costs, as well as of such more basic problems as lack of state legitimacy, inadequate connection between taxes and benefits, and perceptions of tax fairness.

The taxpayer's decision to comply, or not comply, with his fiscal obligations is of course the subject of a large formal theoretical literature on the economics of tax evasion (Cowell, 1990; Slemrod and Yitzhaki, 2002). While some progress has been made both in incorporating the "strategic" aspects of the evasion decision in a game-theoretic framework and in modelling it in principal-agent terms, much remains to be done before the results of such analysis have much to say about the real world "tax game" in developing countries. For example, most literature on tax evasion assumes that tax officials are completely honest. If not all officials are honest (and in the expected utility framework it is not clear why they should be expected to be), the game is very different than that usually modelled. "Leakage costs," as Shaw (1981) calls that portion of tax revenues that flows into the pockets of officials rather than into the coffers of government, may simply be transfers in economic terms, but they may nonetheless result in significant distortions as new taxes are invented and tax rates increased in an attempt to make up the revenue loss. (The problem of corrupt officials is discussed further in Part III.)

In addition to this serious gap in the existing formal analysis, the literature has not as yet managed to model very well either the long-term, repetitive nature of the tax game or the role of "norms" in determining how people play the game. Consideration of the temporal dimension of tax administration emphasizes the importance both of the interaction of officials and taxpayers and of changes in "tax technology" and taxpayer attitudes to government. The problem of tax administration reform is essentially how to alter the outcomes of administrative effort by appropriate investment in developing new legal and organizational frameworks, adopting new technology (computerization), and altering the allocation of administrative resources.

Finally, in recent years virtually all attempts to reform tax administration have centered on some form of computer application. Certainly, it is difficult to conceive of a tax administration that can perform its tasks efficiently without using some form of computer technology. In too many instances, however, the expectation of greater effectiveness from computerization has not materialized. As discussed further in Part III, the more successful reforms did not merely involve computerizing antiquate processes but rather redesigned and streamlined systems and procedures - for example, consolidating return and payment forms, eliminating unnecessary and unused information required from taxpayers, and so on. As much experience shows, successful computerization requires a fundamental reorganization in both systems and procedures and cannot be used to side-step such needed reforms. Moreover, even the best computerized system will not produce useful results unless there are real incentives for tax administrators to utilize the system properly.

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7 See, for example, the historical discussion in Webber and Wildavsky (1986).
III. Approaches to Tax Administration Reform

In an ideal, law-abiding society, people would pay the taxes they owe, and tax administration would amount to little more than the provision of facilities for citizens to discharge this responsibility. No such country exists, or is likely ever to exist. Compliance with tax laws must be created, cultivated, monitored, and enforced in all countries.

What induces compliance with tax laws has been the subject of extensive research in recent years. The conventional view in economic models of taxpayer behavior is that people comply with tax laws so long as they feel that non-compliance may cost more, that is, that the penalties likely to be suffered in case evasion is detected exceed the tax to be paid. This view does not explain why people pay taxes even when enforcement is weak. A host of other factors such as social values, public morality, and people’s perception about the fairness of the system also matter in shaping attitudes to tax laws. Nonetheless, although the role of societal and cultural factors cannot be denied, compliance is unlikely to be high if the belief prevails that evasion can be practiced with impunity. Tax administrations must foster, not simply enforce, tax compliance. How effectively they can do so depends ultimately upon their perceived ability to detect and bring tax offenders to book.

Resources are always limited, of course, so no tax administration can play the policeman for every potential taxpayer. Partly for this reason, tax systems all over the world have over the years tended to move toward a regime in which taxpayers themselves determine and report - in other words, “self-assess”- their tax liability and pay the amounts due without any special prodding from tax authorities. But self-assessment will result in high levels of compliance only if accompanied by actions that lend credibility to the sanctions prescribed in the law against non-compliance. Effective tax administration requires establishing an environment in which citizens are induced to comply with tax laws voluntarily, while efficient tax administration requires that this task be performed at minimum cost to the community. This is not a simple task anywhere.

The job is particularly difficult in developing countries with large informal sectors, low levels of literacy and public morality, poor salary structure for public servants, poor communications, malfunctioning judicial systems, and entrenched interests against radical reform. Despite such handicaps, the experience of several countries in recent years shows that substantial improvement can be achieved with determined effort and an appropriately designed strategy. What a tax administration can do, however, and how it can best be reformed depends largely upon the environment in which it operates.

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8 Much of this section is based on Bagchi, Bird, and Das Gupta (1995).
9 For a recent study emphasizing the social dimension of compliance, see Alm and Martinez-Vazquez (2001).
1. The Environmental Context

Among the “cultural” factors that may matter, for example, are the extent of institutionalization of corruption, the extent of criminalization of politics, standards of public morality, and the attitude towards compliance of peers. Although none of these factors is immutable, and their effects on tax compliance are by no means always obvious, the extent and nature of feasible tax administration reform depends in part upon such important but largely intangible factors.

Similarly, such political factors as the extent of public acceptance of government in general or of its expenditure or taxation measures may affect reform, as may the structure of intergovernmental fiscal arrangements.

The legal environment is also crucial to tax administration. Enforcing a bad tax law well is usually not a good idea. For a law to be enforced properly, it should both be appropriate to the environment and enforceable: good enforcement requires good tax law. As noted in Part II, it is easy to attempt to incorporate too many objectives of social and economic policy in tax policy, thus resulting in complexities with which neither taxpayers nor tax administrations can easily cope. Voluntary compliance (self-assessment) cannot work where taxpayers find it hard to figure out their obligations correctly. Similarly, withholding (and its verification) also encounters problems when the tax base is ill-defined or when there are many exemptions and deductions.

Tax enforcement is also strongly influenced by administrative law - the public sector management rules that establish the incentives which motivate the performance of government officials. In addition to specifying salary scales, rewards for performance, and career paths, such rules also specify mechanisms for ensuring financial and management accountability.

Finally, the economic environment may also have an important bearing on the effectiveness of tax administration. For example, as discussed further in Part IV, one factor that has received considerable attention is inflation. When inflation is high, the tax structure must be altered to recognize this fact to make effective tax administration possible. Financial development, and particularly the use of banking channels for payment, makes transactions easier to observe and hence broadens the potential scope of taxation and makes administration of certain taxes easier. With sophisticated payments systems income-generating transactions leave temporal traces, unlike the cash or barter transactions that dominate the so-called “irregular” or “informal” economy. On the other hand, sophisticated financial systems coupled with openness increase the ease with which funds may cross international borders to escape taxes. The possibility of international income shifting through various forms of transfer pricing and related financial transactions limits the scope of feasible administrative actions by national tax authorities, as may the growth of cross-border electronic commerce.

More generally, economic growth is closely related to the size of the base for most broad-based taxes and is usually accompanied by a rising share of the formal or organized sector. As the attractiveness of the formal sector grows, in principle voluntary compliance should also increase. The widespread adoption of modern systems of business accounting is a necessary prerequisite for the introduction of many modern taxes, particularly the income tax, the corporation tax and the value-added tax (VAT).
Such accounts permit movement away from the burdensome and harassing physical verification of items on which old taxes like stamp taxes and excises are based. An accounting profession does not develop overnight: it depends on and reflects the overall sophistication and size of business enterprises in the country.

2. Tax Administration as a Production Process

Tax administration may be viewed as a production process, where the inputs consist of men, materials and information and the outputs consist of revenue for the government and taxpayer equity. This process may be broken down into a number of separable components, of which only a few key aspects are discussed here.

- First, a tax administration must have resources in terms of manpower, infrastructural and equipment support, and managerial input through an organizational hierarchy and an intra-organization communication and information sharing system. Thus, organizational design and resource employment decisions are involved: only the latter are discussed here, although Part IV touches on the organizational issue.

- Second, a tax administration needs an information system to ascertain the existing and potential tax base. Ideally, such a system consists of five subsystems:

  1. a system to assess the potential tax base for the aggregate economy;
  2. a system which identifies potential taxable entities and estimates the amount of the tax base for each of these entities;
  3. a system that classifies potential taxpayers into relatively homogenous groups from the point of view of differences in the resources needed and the strategy the tax administration must employ to collect taxes from them;
  4. a system which monitors and provides feedback on the effectiveness of strategies employed by the tax administration in collecting taxes from different groups of potential taxpayers; and
  5. a system to monitor equity violations induced by existing procedural law.

The second component of the information system is by far the most important from the point of view of producing revenues. It includes the collection of information from potential taxpayers themselves, from third parties, and from internal sources of the tax administration through the internal communication system. As a rule, the key to success in this area is an appropriate computer system.

- Third, as discussed further in Part IV, a tax administration needs a system of penalties for non-complying taxpayers and perhaps also a system of rewards for complying taxpayers. It must also define what constitutes sufficient proof of non-compliance in the context of the country.
Fourth, a tax administration must select strategies and set out administrative rules governing activities to counter each type of non-compliance by different groups of taxpayers. Such activities include requiring new or non-filing potential taxpayers to file; preventing or punishing tax avoidance; preventing or punishing incorrect tax base reporting by filers; recovering taxes due but not paid voluntarily by taxpayers and imposing penalties when required; and preventing or removing further resource re-allocations of resources by taxpayers in the face of tax administration action.

Finally, since no tax administration is omniscient, provision must be made to redress mistakes. Two sub-systems are required for this purpose - one to redress taxpayer grievances (appeals, administrative remedies, ombudsmen), and one to identify and correct (or prevent) errors by the tax administration (internal reviews, inspection and anti-corruption).

Implicit in each of these steps in the production process are labor and capital allocation decisions which give rise to direct administrative costs of tax collection. Furthermore, since tax collection is an ongoing process, decisions must be made in each of these stages continually rather than at only one point in time.

3. The Key Ingredients of Reform

Approaching tax administration reform from a different perspective, three ingredients seem essential for effective tax administration in any country: the political will to implement the tax system effectively, a clear strategy as to how to achieve this goal, and adequate resources for the task at hand. As stressed in Part II, it helps, of course, if the tax system is well designed, appropriate for the country in question, and relatively simple, but even the best-designed tax system will not be properly implemented in the absence of any of these three conditions. Much attention is frequently and correctly paid to the resource problem – the need to have sufficient trained officials, adequate information technology and so on. In the absence of a sound implementation strategy, however, even adequate resources will not do the job. And in the absence of sufficient political support, even the best strategy cannot be effectively implemented.

Abundant experience around the world has made it clear that the single most important ingredient for effective tax administration is clear recognition at the highest levels of politics of the importance of the task and the willingness to support good administrative practices even if political friends are hurt (Bird and Casanegra de Jantsher, 1992). Unfortunately, very few developing countries have so far proved able to leap this initial hurdle. More frequently, urged by international agencies or simply desperate to get more revenues, countries have launched frantic efforts to corral defaulters or to rope in new victims without hurting politically powerful interests and without providing the time, resources and consistent long-term political support needed to do a good job. No doubt it would be nice if this could be done, but it cannot. The widespread reluctance to collect taxes efficiently and effectively without fear or favor may be understandable in countries, many of which are somewhat fragile politically, but without major changes in this respect, no viable long-term tax system can possibly be put into place.
If the political will is there, the techniques needed for effective tax administration are not a secret. The tax administration must be given an appropriate institutional form, which in some instances may mean a separate revenue authority (see Part IV). It must be adequately staffed with trained officials. It should be properly organized, which in most countries means on a functional rather than tax-by-tax basis.\textsuperscript{10} Computerization and appropriate use of modern information technology can help a lot, but technology alone cannot do the job. Further, the technology must be carefully integrated into the tax administration. New computer systems have often developed parallel to the existing structure (in the Philippines, for example) and little gain can be seen from a system that does not recognize the skills and needs of the tax agents.

Only well-trained people, with adequate political support, can administer taxes effectively. Provision must be made for training and retraining staff as needed. The information needed for effective administration must be collected from taxpayers, relevant third parties, and other government agencies; it must be stored in an accessible and useful fashion; and it must be used to ensure that those who should be on the tax rolls, are, that those who should file returns, do, that those who should pay on time, do, and that those who do not comply are uncovered, pursued, and sanctioned, as necessary. All this may seem obvious and trite. The reality, however, is that none of this is easy, and little of it is simple. It is not rocket science, however. Countries such as Singapore are models of what can and should be done, and such models should be studied closely and, once adapted as necessary, implemented.\textsuperscript{11}

Once the three central ingredients discussed above are in place, one can then think about designing and implementing effective tax administration reform. One way to approach this task is first to think about what the major tasks of tax administration really are and how they may best be achieved in the country in question. Three such tasks stand out: facilitating tax compliance, keeping taxpayers honest, and controlling corruption. Each of these is spelled out a little further in this section, and some of the key components of such reforms are developed in more detail in Part IV.

4. Facilitating Compliance

The first task of any tax administration is to facilitate compliance, that is, to make sure that those who should be in the system, are in the system, and that they comply with the rules.

- First, taxpayers must be found. They may be required to register, for example: and if not, registration must be made easy, and an appropriate unique taxpayer identification system must be established. Systems must be in place to identify those that do not voluntarily register.
- Secondly, where appropriate, their tax liabilities must be determined. This may be done administratively (as with most property taxes) or by some “self-assessment” procedure as with most income taxes and VATs.

\textsuperscript{10} Alternatively, organization by “client groups” may sometimes be sensible. But what is never sensible is to assign specific taxpayers to specific officials for prolonged periods of time.
\textsuperscript{11} On Singapore, see Bhatangar, (2000) and Oldman and Bird (2001)
• Thirdly, the taxes due must be collected. In many countries, this is best done through the banking system: it is seldom appropriate for tax administrations themselves to handle any money directly.
• Finally, adequate service in the form of information, pamphlets, forms, advice agencies, payment facilities, telephone and electronic filing, and so on must be provided to taxpayers to facilitate and make as easy as possible taxpayer compliance with the system.

Underlying all this is the view stated in Part II above, that the taxpayer is a “client” – not necessarily a willing one of course! – whose needs must be met, and not simply a thief to be caught. Unfortunately, the latter attitude seems to prevail in all too many developing and transitional countries.

5. Keeping Taxpayers Honest

Of course, to some extent this attitude is understandable, since in reality not all taxpayers are honest in any country. The second important task of any tax administration is to keep them that way. To do so, one must first have a good idea of the extent and nature of the potential tax base, for example, by estimating what is sometimes called the “revenue gap.” This is not always easy to do, but it is essential if an administration is to have some idea of the size and nature of those not in the tax net. In some instances, the major problem may be that many potential taxpayers are simply not known to the authorities. In others, it may be that many taxpayers who are in the system are substantially underreporting tax base. In still others, both problems may be important. Unless a careful study of the unreported base, and its determinants, is undertaken, no administration can properly allocate its resources to improving fiscal outcomes – whether through “sweeps” to find unregistered taxpayers or the generally more productive, if technically much more demanding, route of auditing.

In addition to exploring the nature of the tax gap and undertaking the often difficult tasks of extending the reach of the tax system into the informal economy to the extent feasible as well as the technically complex task of auditing, close attention must also be paid to the simple tasks of ensuring that those who are in the system file on time and pay the amounts due. Immediate follow-up of non-filers and those whose payments do not match their liabilities is an obvious but too often neglected aspect of good tax administration. Adequate interest charges must be imposed on late payments to ensure that non-payment of taxation does not become a cheap source of finance. Similarly, an adequate penalty structure is needed to ensure that those who should register do so, that those who should file do so, and that those who under-report their tax bases are sufficiently penalized to make the gamble of being caught too risky for most of them.

Enforcing a tax system is neither an easy nor a static task in any country. It is especially difficult in the changing conditions of developing countries, but unless this task is tackled with seriousness and consistency, even the best-designed tax system is unlikely to produce good results.
6. Controlling Corruption

The third major task of tax administration is to keep the tax administration itself honest. No government can expect taxpayers to comply willingly with a tax structure that they consider unfair or when they are unconvinced that any of the money collected is put to good use. But even sound tax structure and sound expenditure policy can be vitiated by capricious and corrupt administration. It took the developed countries centuries to develop and implement sound tax administrative practices to keep the obvious temptations to dishonest tax officials in check (Webber and Wildavsky, 1986). Unfortunately, developing countries currently attempting to sustain much larger governmental structures on equally precarious fiscal bases do not have the luxury of centuries to solve such problems. They must do so now, if they are to survive.

Tax officials must therefore be adequately compensated, so that they do not need to steal to live. They should be professionally trained, promoted by merit, and judged by their adherence to the strictest standards of legality and morality. To remove temptation, the money should be kept out of the tax administration and channeled through banks. Officials should have relatively little direct contact with taxpayers and even less discretion in deciding how to treat them. How they behave in such contacts must be monitored in some way. These are all clichés, no doubt, but they are clichés because they are true and, alas, more honored in the breach than in the observance in all too many developing and transitional countries.

7. Conclusion

Improved domestic resource mobilization is an essential ingredient of the stronger policy framework developing countries need to have in place in order to be able to benefit from the opportunities afforded by globalization rather than passively suffer from the vicissitudes that may otherwise be inflicted on countries with weak governance and policy structures. Money alone is not enough for good government; but it is necessary. Similarly, good tax administration is not sufficient in itself, but it is necessary for effective and efficient domestic resource mobilization.

IV. Some Further Issues

This Part considers some important issues in both tax policy reform and tax administration reform that illustrate the interdependence of both elements in determining tax outcomes. The first two sections consider two common policy problems -- inflation adjustment and presumptive taxation -- and briefly note how their resolution reflects and in turn influences tax administration issues. The next two subsections then look at two more “administrative” matters -- sanctions and amnesties -- that are also critical tax policy issues. Finally, the last two subsections, on organization and computerization, deal with a few aspects of two important administrative questions which again have substantial implications for the design of practical tax policy in developing countries..
1. Inflation Adjustment

In principle, tax systems can largely be insulated against the loss of revenues that would otherwise result from inflation by adopting suitable rules to cope with seven different problem areas: (1) collection lags; (2) delinquent taxes; (3) penalties and interest and additional tax demands; (4) overpaid taxes; (5) tax rate and bracket adjustments; (6) business income computation; and (7) asset valuation or asset income computation. The first four of these items create problems due to the passage of time between the time of creation of the tax base and the time of tax payment or due to time taken in administrative verification. The fifth problem arises due to inflation distorting tax rate schedules, and the last two areas arise due to inflationary erosion of the tax base. Changes in some or all of these areas seem called for if inflation exceeds, say 25-30% annually for any length of time.

To deal with collection lags, for example, payment periods may be shortened, or provisional payments of estimated taxes may be made more frequently. Both these approaches obviously increase the volume of information the tax administration needs to deal with and consequently make additional demands on its capacity. Alternatively, tax liabilities can be indexed using a suitable inflation index. For very high rates of inflation, indexing is the only real option. In principle, not only should delinquent taxes be indexed so that their real value is preserved, but the interest charged should be high enough to make financing of current expenditure by such involuntary loans from the government at least as costly as market loans.

Similarly, since inflation lowers real monetary penalties, it encourages non-compliance. Penalties therefore must either be indexed or, if they are expressed as a percentage of underpaid taxes or undeclared income, then the taxes or income should be indexed. The reverse side of this coin is that refunds and other payments due from the government should also be indexed and, if there is an interest element, linked to market interest rates.

With progressive taxes, or in the presence of a taxable threshold, bracket limits and the threshold must also be adjusted with inflation in order to keep the real tax burden constant. The same is true with respect to deduction and rebate floors and ceilings and bracket limits. Obviously, significant changes in tax law are needed to do all these things. Less obviously, but equally importantly, a fairly sophisticated tax administration is needed to set up, maintain, and run properly an indexed income tax system. As both Brazil and Chile have long shown, this task is doable, but it may well be beyond the reach of less financially developed countries with less sophisticated tax administrations.

With respect to income taxes, partial or ad hoc base adjustments have seldom been very successful. Consequently, where inflation is a significant problem, although there is far from being general agreement on this point, a comprehensive inflation adjustment system along Chilean lines may be useful. The elements of such a system include: (1) asset and inventory revaluation according to a suitable price index, with the increased valuation being considered taxable income; (2) revaluation of net worth and indexed (or foreign currency) liabilities to be deducted from income; (3) adjusting beginning-of-period asset figures for inflation before computing depreciation; (4) adjusting the value of initial inventory before computing expenses connected with sales;
and (5) calculation of capital gain on sale of assets as described earlier. For small businesses, however, as for less developed countries such calculations are likely to prove too burdensome.

Even in the simplest tax systems, however, when commodity taxes are levied on a specific rather than ad valorem basis, the specific rates must be adjusted periodically in line with inflation. Simply replacing specific excises by ad valorem rates often does not accord with the economic rationale for such taxes. On the other hand, the administrative and compliance costs of frequent revision in specific rates may be considered too high to bear in some countries, so the ad valorem approach -- though it too requires a more sophisticated tax administration (one that can do arithmetic and not simply count).

2. Presumptive Taxation

Two types of errors may be made in enforcing taxes. In the language of hypothesis testing, these are called Type II and Type I errors. A Type II error is where a taxpayer is wrongly charged with a tax offence, and a Type I error is where an offending taxpayer is not caught. Given the information on taxpayer affairs possessed by the tax administration, the standard of evidence required to obtain a conviction for a tax offence determines the probability of each kind of error. The “presumptive” taxes (Thuronyi, 1996) found in many countries in a sense represent an extreme solution to this balancing act, one driven largely by perceived administrative problems.

With a presumptive tax, the tax administration in principle uses only “objective” or impersonal criteria to establish tax liability, that is, criteria which do not require any information on the actual tax base of specific taxpayers. Presumptions are administratively much more simple than really attempting to assess a taxpayer’s true tax liability in large part precisely because they have no safeguards against Type II errors. On a year-to-year basis, presumptions are thus clearly regressive among those subject to the same presumptive rules. Furthermore, if the presumptive base is not perfectly correlated with the tax base being approximated, presumptive taxes will violate horizontal as well as vertical equity.

Nonetheless, it is often argued that such considerations are overridden by the practical fact that the presumptive approach is often the only feasible method of taxing “hard-to-tax” groups such as small business and farmers. Moreover, the broader question of equity between the hard-to-tax -- for example, those in the “informal” sector -- and the not-so-hard-to-tax must be kept in mind.

Several variants of presumption exist, with different policy and administrative implications:

- One is the “rebuttable” presumption, under which the burden of proving a tax liability different from the presumption is placed on the taxpayer. With this system, the taxpayer must trade-off the potential of lower taxes against the increased compliance cost due to the need to maintain sufficiently detailed records. Though presumably less regressive (ex ante - in terms of the revealed preference of the
taxpayer) than non-rebuttable presumptions, this approach clearly imposes a larger compliance burden on smaller taxpayers.\textsuperscript{12}

- Since a common argument for such systems is to reduce such compliance costs -- which are known to be relatively more onerous for smaller businesses -- most presumptive systems base tax liability on such “objective” factors as number of employees, size of premises, class or category of business, etc. In economic terms, of course, such system are taxing the factors on which liability is based rather than “income” “sales” or some other alleged tax base. In principle, to calculate the appropriate presumptive amounts assessed with respect to different factors requires a high degree of knowledge of the business and considerable administrative expertise, although once calculated, the rules set out could of course be administered by much less expert personnel. In administrative terms, if the tax liability assessed by such methods is too low (relative to that would be imposed by the normal system), there is a danger of too many taxpayers “migrating” into the more favorable presumptive system. To put it another way, as with “infant industry” protective policies, presumptive systems that unduly favor small business act an incentive never to grow up and may hence check the expansion of the tax base that would normally be expected to accompany economic growth.

- Another use of presumptive methods is as a back-up system for the normal tax system. For example, this year’s profit taxes must be at least as high as those based on past profit rates declared by the firm previous years, on the basis of profit rates declared by similar businesses in this year, or on the basis of some presumed average return on capital in general or in the particular industry. If the tax base declared by the taxpayer is less than that calculated from such information, the tax assessed is based on the latter. This approach is in a sense actually a combination of the two approaches discussed above.

Given the prevalence of various “presumptive” approaches to taxation in many developing countries, such systems require close attention from both the policy and the administrative perspectives.

3. Sanctions and Penalties

A quite different approach to minimizing the Type I error mentioned above (that is, failing to catch evaders) is to levy penalties automatically for offenses in which it is difficult to prove intent to defraud. Such offenses may, for example, include arithmetic errors in the calculation of taxes; misclassification of goods; or exceeding ceilings for deductions - provided, in each case, that all the relevant information for a correct determination of taxes is actually included in the return. Automatic penalties for hard-to-prove offenses are attractive since negligence is, for such offenses as those listed, of as

\textsuperscript{12} At one time Russia had a particularly egregious system under which taxpayers on the presumptive system were actually required to keep all the accounts needed for the normal tax system. This clearly makes no sense.
much concern as intentional errors and since there appear to be no adverse implications for equitable treatment. Nonetheless, since anything that minimizes Type I errors runs the risk of increasing Type II errors and wrongly punishing the innocent, ideally some safeguards should be in place to reduce such undesirable outcomes. Tax administrations that do not have in place good “error correction mechanisms” for dealing with disputes run the risk of alienating those who feel, with some reason, that they are unjustly taxed. As noted earlier, policies and practices that may tip a generally compliant taxpayers into joining the non-compliant group should be avoided if at all possible.

The structure, severity, and coverage of penalties is an important and unduly neglected question in many countries. Experience suggests that penalties should increase with (1) the potential revenue loss due to the tax offence; (2) the difficulty and cost of detecting the offence; (3) the effect of the offence on other taxpayers; (4) the offender’s state of mind (a higher penalty should apply if the offence is deliberate and pre-planned); and (5) recidivism. In addition, penalties should depend on the similarity of the offence to actions which are punishable under other laws, given the cultural context. For example, penalties for non-compliance should be inversely related to the ease of compliance and the information about obligations which taxpayers may reasonably be expected to have, taking into account such things as the availability of forms, the aid provided to taxpayers in filing returns, and taxpayer education programs.

A few additional considerations may be noted. First, different channels of evasion, although they may legally constitute different offenses, are often substitutes as far as the taxpayer is concerned. Thus, a failure to file is the same (aside from filing costs) from the taxpayer’s point of view as the failure to pay taxes due - provided there is no difference in the probability of being made to pay taxes and the penalty applicable. From the administrative point of view, however, the task of collecting is easier if the offence is further along in the identification/registration-filing-tax determination-tax collection chain. Consequently, it appears reasonable to levy the highest penalties for the failure to register as a taxpayer (e.g. not obtaining a taxpayer number) and the lowest for failure to pay taxes due, in order to tilt taxpayer non-compliance actions to the last stage. The feasibility of implementing this prescription will obviously vary from country to country.

A second issue concerns penalties for technical offenses which do not result in explicit underpayment of taxes. A tax administration is first and foremost an organization dealing with information. Any offence which reduces the information available to the administration, whether from the taxpayer herself or from third parties, has an implicit value in terms of expected revenue lost. Furthermore, some “technical” offenses (e.g. non-maintenance of records) may be substitutes for direct underpayment; at the very least such an offense is often a signal that such activity may be taking place. In fact, for hard-to-tax groups -- where, by definition, underreporting is difficult to detect -- penalties or failure to maintain accounts may have more deterrent effect than penalties for evasion.

Thirdly, in principle, when several different taxes are payable by the same taxpayer, penalties should predispose taxpayers to attempt to evade the most easily enforced taxes, if evasion cannot be completely curbed. For example, if VAT evasion is easier to monitor than (say) corporate income taxes, then penalties for evasion should be higher on the
latter. In particular, it is obviously highly undesirable to encourage taxpayers to go “offshore” (beyond the reach of the taxing jurisdiction) both because such actions greatly increase the difficulty of enforcement and also because in many instances they may also result in real national losses of output and income (whether taxed or not).

Fourthly, with any reasonable interest-cum-penalty structure - especially time-varying penalties - tax delinquency should not pay as a simple financial transaction. In many countries, if any rational taxpayer did the calculations, he would never pay taxes, or pay on time, simply because it is cheaper secure working capital by doing so rather than, say, borrowing from a bank. Delinquency due to financial hardship (cash flow problems/bankruptcy) or because taxpayers are gambling on taxes not being collected should be deterred by properly-designed penalties and interest..

One option to deal with delinquency due to hardship, for example, may be to permit tax deferral. Since verifying hardship can be administratively burdensome, it may even be easier for the government if most such requests for deferral were granted -- provided there was adequate follow-up to ensure the debts are collected in the end. For other delinquents, perhaps the rate of interest might be set at a rate that makes it worthwhile for commercial financial institutions to discount the taxpayer’s “IOU” to the government, thus making the enforced loan commercially worthwhile.

4. Tax Amnesties

Tax amnesties merit special treatment both because of their complex effects on taxpayer behavior and because of their popularity. On the whole, the evidence is clear: tax amnesties should be avoided. Amnesties guarantee immunity from punishment for evasion declared during the amnesty. General amnesties can be given, for example, by specifying a period during which no penalty will be levied on delinquent taxes; or by floating a bearer tax exempt bond scheme which pays a low or negative interest rate thus collecting taxes implicitly. The advantage of the latter scheme from the taxpayer’s point of view is that her name continues to be outside tax department records while her wealth is tax paid. To be effective, the taxpayer must be certain that money declared during an amnesty does not lead to investigation of tax evasion in years not covered by the amnesty and does not make her liable for technical penalties for not maintaining accounts and so on.

Partial amnesties to particular groups or for particular portions of the tax base (e.g., foreign income, smuggled goods of particular kinds) are also possible. A related practice is to provide for immunity from prosecution for detected evaders. Such amnesties - like “plea bargaining” in the U.S. court system or “compounding of offenses” in India - may be justified if the cost of prosecution of tax evaders is high.

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13 For a detailed analysis, see Das Gupta and Mookerjee (1998), chap. 5.
14 Presumptive taxes, when rebuttable, resemble a pre-announced amnesty since in effect they guarantee immunity from investigation on payment of a pre-announced fee.
Analytically, besides conferring immunity from sanctions, general amnesties are a combination of three factors: an opportunity for tax deferral or a lowering of penalties; a government-provided opportunity to launder tax-evaded money; and a signal of future enforcement by the government (whether positive or negative). In practice, some amnesties also involve lowered tax rates. A taxpayer’s response to an amnesty will depend on the extent to which disclosures affect the taxpayer’s ability to evade taxes in future, which depends on the efficiency of record keeping and whether past records are examined for current audits. Consequently, the influence of an amnesty on taxpayer behavior is complex.

Governments desperate for quick funds sometimes turn to amnesties as one way out. Sometimes the immediate revenue results are impressive, although of course it is seldom clear what the real present value of any net revenue increment may be. Perhaps the most effective amnesty is one that is given to, so to speak, “wipe the slate clean” of old offenses in order to launch a new era of tough tax enforcement. Unfortunately, all too many countries have given periodic amnesties, and hence lost all credibility. If amnesties are given periodically by governments (e.g. India granted 7 over a 35-year period, while Argentina has had 21) they soon come to be anticipated. Anticipated amnesties, especially if repeated, generally signal that the government is unable to enforce taxes effectively. Such amnesties will have effects during both the years preceding the amnesty and in the amnesty year. While a general fall in taxpayer compliance can be expected, even with such bad amnesties in some instances the timing of tax payments will be affected so that revenue in the amnesty year may actually increase as people pay deferred taxes and “launder” illegal money. Even such limited positive effects of an amnesty, however, become increasingly unlikely as compliance gets further eroded.

Administrative discretion to waive penalties has effects similar to permanent amnesties, unless the conditions under which such discretion can be exercised are very carefully specified. Moreover, discretion inevitably opens up an avenue for corruption. Discretionary amnesties are best avoided as they do not enhance revenue or equity. In cases of tax evasion due to extenuating circumstances, leniency, if called for, may better be shown through provision for special judicial - not administrative - petitions.

5. Organizing to Tax

Tax policy reform strategies properly vary from country to country, but one constraint is usually common in all developing countries: the scarcity of tax administration resources. Despite the high potential pay-off in terms of increased revenue, it is usually difficult, and often impossible, for tax departments to obtain more staff, to raise wages to attract (and retain) highly-qualified staff, or even to meet such basic material needs as office space and computers. Tax administrators are civil servants and hence subject to all the constraints affecting civil services in developing countries. Reform strategies that require substantial additional administrative resources - particularly staff - are hence usually

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15 For a useful recent discussion of money-laundering and tax evasion, see Alworth and Masciandaro (2003).
doomed to failure, because the resources that are needed will not materialize fully or in a timely fashion.

In recent years, an increasingly popular way around this problem has been to set up independent revenue authorities. While there are wide variations from country to country, in general such authorities are to some extent freed from civil service restrictions on hiring and pay and may also be given access to some earmarked source of revenue. In sub-Saharan Africa, for example, a revenue authority was established in Ghana as early as 1985, in Uganda in 1991, and subsequently in Zambia, Kenya, Tanzania, and Rwanda, with others in process. Other examples may be found in Latin America and elsewhere. Experience with this approach to by-passing at least some of the normal problems of administrative reform in developing countries have been mixed. In some instances (e.g. Peru) at first matters seemed to go well, but then they deteriorated quickly. In others (e.g. Tanzania) it is not clear to at least some observers that much has changed for the better. In other instances, however, considerable improvements do seem to have occurred. Although this question cannot be discussed in detail here, a tentative conclusion might be that, to put it in perhaps rather extreme terms, those countries that – as noted in Part III – have the will, strategy, and resources to reform tax administration do not need independent revenue authorities and those that lack these critical ingredients are unlikely to be successful even if they create such an authority.

Even when there is a independent authority, there is seldom much, if any, additional funding. As a rule, successful administrative reform strategies – with or without revenue authorities -- have therefore generally been based on better allocation of available resources rather than on accretions of major additional resources. Examples are cutting down unproductive tasks like processing the returns of wage earners and devoting the resources thus freed to more productive work, as in the cases of Chile and Colombia.

An interesting example of internal reorganization that has been considered successful in some countries (for instance, Uruguay) has been the creation of special offices to deal with large taxpayers. There are three broad ways in which one might attempt to run a tax administration: First, establish a set of rules and apply them in the same way to everybody. Second, establish special rules for some but apply other rules to others. Third, establish general rules which are applied initially only to some but with the clear idea and obligation of extending those rules subsequently to all. The first procedure is desirable in principle but it is seldom practicable in developing countries. The practical choice is therefore between the second and the third procedures. If one considers special tax offices for large taxpayers in this light - as it were as a "pilot" for the extension of similar procedures as widely as possible as and when it becomes feasible to do so - this approach may well make sense as a way of beginning to reform tax administration in many countries. On the other hand, if the sole aim of the change is to maximize revenues, the result in the long run may be deleterious both because other essential administrative tasks may be unduly neglected and because in effect an extra tax "penalty" (tighter control and enforcement) is put on more successful firms.

16 For further discussion, see Jenkins (1994), Verhorn and Bondolo (1999), and Estela (2002), and Fjeltstad (2002).
Other countries have introduced various measures designed to "privatize" certain tax administration activities traditionally performed by government. Countries such as Bolivia, Brazil, Chile, Colombia, and Ecuador, for example, have assigned a major role to banks in tax collection. This decision has generally been taken both because of insufficient resources in the tax administration and because these countries recognize that banks are already specialized in the handling and control of payments. Here again, however, the mere fact that banks are entrusted with the tasks of receiving payments, returns or even, in some countries, processing returns, does not assure success. For the collection function to work well, proper systems must be designed, the tax department must exercise adequate supervision and the remuneration paid to the banks must be appropriate. Much time and effort has been spent on these matters in those countries in which collection through the banking systems operates successfully.

As a final example, of the importance of organizational matters, in 1994, only 135 of the 5500 employees of the State Tax Inspectorate (STI) of Belarus were located in the headquarters office. Moreover, of this rather small headquarters staff, some 44 were in an essentially separate tax investigation service that had been created from the former internal security and state security agencies. Such separate “security” employees were formally assigned to the STI (at all levels), but they still retained their special status and were regulated under separate regulations from regular tax office employees. It is far from clear that this kind of “tax police” approach is either desirable or sustainable, particularly in countries in which distrust of government is long-standing and well-entrenched.

6. Computerization

Radical improvement in tax administration calls for a transformation of its organization and methods. Modern information technology greatly facilitates such transformation (Engelschalk, 2000). A recent study on the enforcement efficiency of the income tax department in India, for example, identified the following problems: poor utilization of information collected by the central intelligence branch; ineffectiveness of surveys of business premises; absence of an adequate system of taxpayer identification numbers; absence of an adequate system of third party information collection; and the poor state of records and deficiencies in the record-keeping system. Much the same could be said of most developing countries. Such problems cannot be resolved in most cases without computerizing the information system.

The availability, cost, and accessibility of modern computers make them ideal for the large-scale information processing and coordination problems facing tax administrations in even the poorest countries. The administration of customs duties, general sales taxes like the value-added tax, income taxes, and property taxes can all benefit from appropriate computerization. Another reason for tax administrations to acquire some expertise in computerization is that multinational companies and, increasingly, large domestic firms employ sophisticated computer systems which will be beyond the investigative capacity of technologically backward tax administrations. Nonetheless, it is critical to have a clear strategy and to consider a number of important
aspects of the problem when considering the introduction of technology to upgrade the information handling capacity of any tax administration.

The areas to be computerized fall broadly into four divisions: (1) systems related to taxpayer records and tax collection (taxpayer compliance); (2) systems related to internal management and control over resources; (3) systems related to the legal structure and procedures; and (4) systems to lower taxpayer compliance costs. The first of these areas lies at the centre of any computerization exercise. The most important component within this area is the basic information on taxpayers or taxpaying units, such as a taxpayer master file or registration system for the income tax and the VAT, systems for recording import declarations for customs duties, and cadastral data for taxes on bases related to property.

For example, Singapore has developed a computerized system of handling trade declarations electronically - the TRADENET—that allows filing of declarations by traders through their personal computers and the transmittal of permits extremely rapidly. Indeed, Singapore has gone as far or farther in using IT to modernize and improve its tax system as any country in the world, developing or developed (Bhatangar, 2000). Other notable examples of successful and innovative application in different areas may be found in New Zealand, Canada, Spain, and Chile.

Such experiences have demonstrated that there are several preconditions for the successful application of information technology in tax administration. First, and most important, an appropriate strategy of technology modernization must be developed which takes into account the likely obstacles and the constraints arising from such organizational rigidities as civil service salary structure or procedural hurdles in acquiring the necessary expertise, hardware and software. The susceptibilities of the existing staff and their resistance to change need to be taken into account. Experience in Kenya and elsewhere demonstrates that new technologies can only be introduced successfully if the key players in an administration are brought on side. In a developing country, simplicity is also important. As far as possible, the design, structure and operations of the system should be simple. A complex system is more likely to engender resistance and problems. In some situations (as in Mexico) it may be advantageous to entrust a part of the responsibility for setting up an information system to organizations outside the tax administration or even the government.

Second, as a rule considerable organizational re-engineering is needed to gear the tax administration to a computerized environment. Sometimes, as for property taxes in Indonesia, it may be advantageous to organize tax administration by sector, but as a rule a functional approach is easier to operate when key information regarding a taxpayer’s obligations (like filing of returns and payments) is stored in the computer, with a tax “vector” created for each taxpayer, as in Spain.

Third, equipment and software should of course be standardized to facilitate operation, networking, and maintenance. Experience suggests that, whenever possible, software should be bought “off the shelf” rather than developed internally, both for cost reasons and to more easily accommodate subsequent technological developments.

Fourth, the pace of change, in fact, the success, of any modernization program, depends ultimately on human resources - on the training and skills of the people who are
expected to use and operate the technology. Technical expertise alone is not enough to assure success in application. Appropriate incentives and accountability are also needed, and may not be easy to achieve given the rigidity of civil service establishments in many countries.

Finally, information technology cannot make much headway in tax administration unless a unique identification number is allocated to each taxpayer. In every country in which some degree of computerized tax administration has been successful, allotting a unique identification number has been one of the key steps. Without such a number, information can neither be stored properly nor used for any purpose.

V. Tax Policy and Tax Administration in Tax Reform - the Example of Poland

Tax policy and tax administration interact at three distinct levels: (1) the formation of policy and the drafting of legislation, and (2) the administrative procedures and institutions needed to implement legislation (such as forms), and (3) the actual implementation of the tax system. These matters were thrown into sharp relief in the early 1990s in eastern and central Europe as a result of the major political changes that produced what are commonly called the “transitional countries” out of the former Soviet sphere. Some aspects of this experience are discussed briefly in this section, drawing on experience in a number of countries, but with special attention to Poland. Despite the considerable achievements of Poland in the early 1990s in terms of tax reform, retrospective analysis suggests a number of ways in which all these matters might have been improved.  

1. Policy Formulation

For example, some key tax policy decisions do not seem to have taken adequate account of their administrative consequences. In the case of the personal income tax (PIT), for example, politically convenient decisions to provide deductions for housing expenses and to permit joint filing greatly increased the administrative task while achieving little visible benefit. Close to 11 million Poles were initially required to file PIT returns directly (in addition to another 11 million or so who file through employers and social security funds). In revenue terms, these 11 million individual returns accounted for at most 20 per cent of PIT collected. But in administrative terms, they likely constituted closer to 80 per cent of the workload, particularly since most of them gave rise to refunds. In 1994, for example, about 4 million refunds arose from the housing allowances alone. Much of this huge administrative task could have been handled more simply by adjusting withholding tables to avoid the need for so many refunds.

17 This section is based on Bird (2000). It does not purport to be either a comprehensive or current account of the Polish tax system.
Similarly, there seems no reason to require individual returns to be filed annually for the 11 million persons whose tax liability is adequately handled by withholding. All that is needed in such cases is a list from the withholding agent containing essential taxpayer identification information and minimal base and tax data. In 1995 Poland lowered the VAT reporting threshold, thus bringing additional hundreds of thousands of taxpayers onto the VAT rolls. Although this change might make sense in the long run, it was questionable whether it was either desirable or necessary at that time from either revenue or administrative perspectives, given the huge task already facing the tax administration.

Devising and implementing good tax policy requires careful balancing of many complex issues related to political considerations, distributive and allocative effects, and legal drafting. In addition, considerable attention should be paid to administrative feasibility: can the policy actually be implemented? Lawyers, economists, information specialists, and administrators all need to be drawn into the process of tax policy formation, preferably from an early stage. While some division of labor is of course inevitable, the degree of separation between the various essential actors in the tax policy process appears to be excessive in many countries.

One way to overcome these barriers and to improve tax policy might be to create a small Tax Analysis Unit, probably located in the Ministry of Finance. Such a Unit should consist of a small number of highly qualified specialists — economists, lawyers, and perhaps accountants and administrators. Its most important role would be to support and improve the development of new tax proposals from an economic, legal, and administrative perspective. It could also usefully undertake within a consistent framework systematic analysis of the revenue and economic aspects of the many changes that tend to be proposed in tax legislation as it passes through the legislative process. Working closely with the tax administration, such a Tax Policy Unit could provide useful input not only to tax policy formation at the top but also to tax administrators in the field — by, for instance, helping to develop auditing techniques and providing baseline estimates for use in normal auditing activities.

As noted earlier, simplification of the tax structure seems a prerequisite for removing one of the major irritants for taxpayers in many countries — the complexity of tax returns and requirements regarding filing of supporting documents. While there is obviously need for information essential to determine tax liability, tax forms in many transitional countries are often cluttered with items which are not relevant for most taxpayers. Careful review of existing forms can help identify such items, eliminate them in the interest of simplicity, or at least confine them to separate schedules for those few for whom they are relevant. To improve compliance, for example, the VAT return in the UK was reduced to a single page. In contrast, in Poland in 1995 the monthly VAT form was changed from one with 61 items to one with 105 items (including 37 identification items, 26 on input tax credit, 17 on output tax, and 25 on tax calculation). Moreover, to complete this form required 8 additions, 1 multiplication, 2 divisions, and one inequality.
and no instructions were provided to guide the bewildered tax payer. What conceivable gain can justify imposing such complexity and compliance costs on tax payers?

2. Sequencing Administrative and Policy Reform

A general problem faced initially in many transitional economies was that few revenue administration employees were adequately trained to deal with a private enterprise economy, and staff was being lost to higher-paying activities elsewhere. The experience that tax officials had was primarily with the sort of numerical verification of enterprise accounts that constituted the essence of the tax administrative task under the old central-planning system. Most employees were engaged in checking and verifying the figures submitted by enterprises. Little or no real audit activity was taking place. In addition, tax inspectors were assigned to particular categories of enterprises — a vulnerable system, lending some credibility to persistent rumors concerning the suborning of fiscal officials on the one hand and the arbitrary imposition of penalties on the other hand. Whatever the validity of such stories, the complexity of the present accounting and tax system in countries like Belarus and Ukraine still makes it likely that everybody is going to be arguably a little wrong most of the time, and such ambiguity is conducive to both corruption and extortion.

Many of the taxpayer files maintained in transitional countries under the old tax system were for trivial levies such as the land-use fee or the real estate tax. District tax managers often appeared to consider their task to be to achieve a 100 per cent “audit,” by which they meant arithmetic verification of the figures in the balance sheets and income statements on which tax assessments are based. The most common complaint of tax officials was that an increasing number of tax payers were filing inadequate accounts late — a problem they attributed mainly to the lack of “experience” on the part of enterprise accountants. It was not uncommon for administrators in the early years to deny that there was or would be a serious compliance problem, and they often cited the relatively low amount of tax arrears as evidence that there was not. There appeared to be little recognition in some countries even after a decade of change of the probability that an increasing “tax gap” might open between actual and reported activity or of the numerous opportunities that were already open in the complex tax structure to avoid taxes legally. As was to be expected given the much greater initial degree of change in Poland, Polish tax officials were much more advanced than this in both their recognition of the problems and their efforts to do something about it. But even in Poland not all such efforts were necessarily well directed given problems such as those discussed earlier.

From an administrative point of view, as noted earlier, most taxes initially collected in transitional countries came from a relatively few tax collecting agents — the customs administration (VAT and excises on imports, import surcharges, and tariffs), the social security agencies (social security contributions and PIT on transfers) government itself (PIT withholding on wages), state enterprises (PIT withholding, VAT, excises, and
corporate or enterprise income taxes (CIT), and, perhaps, a few large private enterprises (as for state enterprises, plus perhaps taxes on dividends and interest). Accurate tracking of these fiscal flows, which probably account for 80 per cent or more of current collections in many countries, and keeping these payments current is critical to successful tax administration. Obviously, no elaborate taxpayer identification number (TIN) system is needed for this purpose. Nonetheless, in some countries such as Poland, much emphasis was placed on the need to establish a universal TIN.

What TINs are really needed for is to extend the reach of the tax system out from the existing central core of large taxpayers into the remainder of the potential tax base. Before devoting much effort to this difficult task, however, it is critical to ensure that tight control is maintained over the payments and liabilities of large taxpayers, for example, by setting up a “large taxpayer” unit (as was quickly done in Hungary) and monitoring closely the non-filing, stop-filing, and compliance behavior of such taxpayers. Once this is done, attention can be turned to the TIN problem. Even then, however, there is no need to wait for everybody and everything to be numbered in order to begin this work. Bringing in the potential “new” taxpaying sector is of course be easier as and when all tax data is accessible in computerized form, and a unique TIN is required on various documents. But it can be a serious mistake to wait for that day to come before beginning to develop effective auditing practices on the basis of what already exists — of course in such a way as to encompass new and better sources of information as they become available.

From this perspective, the stated aim of the Polish authorities in the mid-1990s to build a taxpayer register containing information on every legal and physical person in Poland — including an estimated one million undocumented foreigners — and to assign each a unique identification number, seemed overambitious. Clearly, tax administration would be easier if such a system existed. But a new national identification system need not be established to make progress. Simply requiring taxpayers to supply any of the various file numbers that already existed for various purposes in Poland, together with an adequate system of verification (to eliminate duplications, and so on) would capture most of the actual and potential taxpaying population in one form or another. Establishing how much those caught in the tax net should pay is of course quite another question. That part of the potential taxpayer universe that is not encompassed in the existing systems — such as the notorious “foreigners” (mostly from other eastern European countries) who seemed at that time to come up in every conversation about tax evasion in Poland — seem unlikely to be captured in any new system either. Taxing such groups has to be done largely through such well-known, if difficult, ways as reverse withholding and going down the audit trail to check that suppliers and purchasers actually exist and are themselves in the tax system.

In many transitional economies — perhaps as a partial carry-over from the old command system — the tax system continues to be used as an instrument for detailed policy intervention in the enterprise sector. For example, the provision of some form of
relief or advantage to particular enterprises in financial difficulty is not unusual in Belarus and Ukraine. Similarly, tax laws change often, and provisions favoring narrow industry interest groups to achieve some very specific policy goal are common in many countries. For example, in 1995 Poland had accelerated depreciation, special investment allowances for exporters, regional incentives, incentives for financial investment and savings, and various special allowances for enterprise spending on housing and "cultural" purposes. In total, these provisions reduced CIT revenue by around 25 per cent. This system had been improved from its original post-reform structure by replacing tax holidays by investment allowances, but nonetheless both the instability of the tax environment and the proliferation of incentives and reliefs are inappropriate and undesirable, whether viewed from the perspective of state revenues or enterprise development.

A further problem for both tax payers and tax officials in most transitional economies has been the substantial number of changes made in the tax rules, including discretionary changes to deal with the problems of particular enterprises. Frequent changes in tax law are perhaps only to be expected in the circumstances of transition. Some of these changes (such as the introduction in Poland of loss carry-forward provisions and more uniform treatment of foreign and domestic firms) are clearly desirable. Nonetheless, many aspects of both tax law and administrative practice remained far from clear and hence inherently subject to uncertain and variable interpretation. Ideally, the tax structure should, so far as possible, be a fixed parameter which entrepreneurs can factor into their business decisions, not a variable to be influenced by the wishes and needs of particular tax payers. Neither legislators nor officials should have the latitude for discretionary interventionism that initially existed in most transitional countries and still does in some.

The development of the tax system and that of the private sector are mutually interdependent processes in transition countries. The structure of the tax system must not only be adapted to the new reality of economic activity — a task that was accomplished fairly quickly to a significant extent in Poland if not yet in all such countries — but this new structure must also be stabilized and made transparent if its full benefits are to be realized. Both tax officials and tax payers must be able to know with a high degree of certainty what the law is and how it will be applied. Poland, like many countries in transition still has some distance to go down this road; other countries, such as Belarus, have barely started the journey.

3. Reforming Tax Administration

The basic tasks of tax administration in a transitional (or any) country consist of three distinct (though connected) activities — identification, assessment, and collection. Tax administrations must also ensure that third parties required by law to report transactions or withhold taxes do not default in their obligations. The primary function of tax administration is to monitor compliance and to apply the sanctions prescribed in the
statute against offenders. Even with the best of organization and effort, no tax agency can
detect all offenders. Hence a major plank in the strategy of tax enforcement is to devise
methods to prevent or at least minimize non-compliance at all of these stages.

The prevalent attitude in the tax administration of most transitional countries appears
to be that all taxpayers are potential criminals and that subjecting them to taxation is
fundamentally a matter of identifying and controlling them and catching those who cheat.
As stressed in Part II, these tasks are indeed important, and this emphasis is
understandable in a country undergoing such rapid transition, but no modern tax system
can function on fear alone. Problems of tax enforcement cannot be solved simply by
calling in the “tax police.” Extensive research in a number of countries shows that there is
much to be gained from viewing tax payers more as clients — perhaps not very willing
clients, but still clients — than as would-be criminals.

The job of establishing an environment in which citizens are induced to comply with
tax laws voluntarily is particularly difficult in transitional countries which face severe in-
stitutional limitations arising from large informal sectors, poor salary structure for public
servants, ineffective and uncertain legal systems, and an entrenched distrust of
government — often somewhat paradoxically combined with a habit of excessive
dependence on that same government. The actions open to any tax administration depend
largely upon the environment in which it operates, and these factors are often adverse in
transitional countries.

A final aspect of tax administration that deserves more attention in transitional
countries thus concerns taxpayer services. Studies on taxpayer behavior around
the world suggest that services to taxpayers that facilitate reporting, filing and
paying taxes, or that impart education or information among citizens about their
obligations under the tax laws, may in many circumstances constitute a more cost-
effective method of securing compliance than measures designed to counter non-
compliance. Such a taxpayer service perspective would put much more emphasis on re-
ducing tax payer uncertainty by clarifying some of the present legal ambiguities (for
example, with respect to the VAT treatment of cross-border services), communicating
clearly what the law is, and sticking to it instead of changing it every year (or every
month) and leaving many people uncertain as to just what the law is. In addition, tax
payer compliance costs should be taken into account in designing legal and
administrative procedures. Why, for example, is the CIT in transitional countries often
administered in effect on a monthly rather than annual accounts basis? Such measures
appear to be unneeded and costly carry-overs from the old central-planning system.

The key to success in tax administration reform in any country lies in evolving a
strategy that best utilizes the available resources to minimize the scope for non-
compliance and to maximize the likelihood of detection and punishment of non-
compliance, while simultaneously providing facilities and incentives for compliance at
each stage of the compliance process. No single formula can apply everywhere. Each
country must evolve its own strategy, depending on its own circumstances and background.

4. Conclusion

In words echoing some of the points made earlier, Wallschutzsky (1989) has suggested that the key elements in such a strategy might be summarized as follows:

“- Keep the tax laws as simple as possible; - Aim for a global tax with few exemptions, credits, rebates, or deductions; - Do not try to use the tax system to achieve too many social and economic goals; - Continually monitor the tax system; - Concentrate on basic tasks such as collection of tax at source and an ID number system; - Do not collect more information than can be processed; — Actively encourage good record keeping; and — Aim, as a long term goal, for self-assessment.”

Such words of wisdom are undoubtedly cliches to some extent. But they are nonetheless both clearly applicable to the case of tax reform in most transitional and developing countries and have, equally clearly, sometimes been honored much more in the breach than the observance.

Leif Muten (1992) noted with respect to tax reform in transitional countries that “Rome was not built in one day, nor is a full-fledged modern tax system to be set up within a year or two.” The administrative constraint alone makes this true in many developing countries also. At the very least, it will often take years before such countries will have a fully operative tax administration capable of running a “full-fledged modern tax system” at a satisfactory level. No matter how good a tax policy may be in theory, or a tax administration in practice, both require an appropriate environment in order to produce good results. The transition to a more adequate tax administration and a “state-of-the art” tax system in a country must therefore not only be congruent with each other but with the emergence of the accounting, legal, and economic environment in which a modern tax system can function properly. In countries whose very essence lies in the fact that they are in “transition” between two types of economic systems, it should come as no surprise that close attention must also be paid to the inevitably transitional nature of some key aspects of both tax policy and tax administration. Similarly, in developing countries generally, it should not be a surprise that much more development is needed in both the same areas.
References


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