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Smart Tax Administration

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The “smartest” development policy needs to be underpinned by “smart” tax policy. However, the best tax policy in the world is worth little if it cannot be implemented effectively. What can be done, to a considerable extent, inevitably determines what is done. Increasing tax revenues requires an effective tax administration: new taxpayers must be identified and brought into the tax net, and new collection techniques developed. Implementing such changes invariably takes time.

Three ingredients are essential to effective tax administration: political will, a clear strategy, and adequate resources.

If the political will exists, the blueprint for effective tax administration is relatively straightforward. The tax administration should be given an appropriate institutional form—which may (or may not) mean a separate revenue authority, as discussed later. It should be adequately staffed with trained officials. It should be properly organized, which usually means an organizational structure based on function or client groups (for example, large and small taxpayer offices) rather than on a tax-by-tax basis. Computerization and appropriate use of modern information technology are important, but these improvements must be carefully integrated into the tax administration. Putting all this into place takes time, resources, direction, and effort. But it *can* be done, and it pays off, as demonstrated by countries from Singapore to Chile.

Why Tax Administration Matters

How a tax system is administered affects its yield, its incidence, and its efficiency. Administration that is unfair and capricious may bring the tax system into disrepute and weaken the legitimacy of government. For instance, in many transitional countries in the 1990s, the failure to improve tax administration

when new tax structures were introduced resulted in very uneven tax imposition, widespread tax evasion, and lower than anticipated revenue. In some developing countries, corporate tax liabilities are often negotiated rather than calculated as set out in the law. In some countries, bribery is so common that it is considered a regular part of the compensation of tax officials. Such corruption undermines confidence in the tax system, affects willingness to pay taxes, and reduces a country’s capacity to finance government expenditures. *How* revenue is raised—the effect of revenue-generation effort on equity, on the political fortunes of the government, and on the level of economic welfare—may in some ways be equally (or more) important as *how much* revenue is raised.

Tax administration is a difficult task even in the best of times and in the best of places, and conditions in developing countries seldom match these specifications. Assessing the relationship between administrative effort and revenue outcome—let alone other possible policy objectives such as procedural fairness or strengthening state legitimacy—is by no means a simple task. One cannot assess how well a tax administration is functioning, let alone suggest how to improve it, without taking into account not only the environment in which it has to function, but also the laws it is supposed to administer and the institu-

tional infrastructure with which it has been equipped. Complexity and its implications for tax administration have long been a concern even in the most developed countries. Even the most sophisticated tax administration can easily be overloaded with impossible tasks. Such concerns are critical in countries in which inevitably less than perfect administrators are asked to tackle inherently complex tasks in a generally hostile and often information-poor environment. The life of tax administrators in many countries is made even more complicated by the propensity of governments to alter tax legislation annually, or even more frequently.

Simple exhortations to “do better” are of little use to resource-strapped administrators faced with difficult tasks. Nor are the various gimmicks or quick fixes that seem to come easily to the minds of clever policy designers of much use in resolving tax administration problems. Experience around the world demonstrates that the single most important ingredient for effective tax administration is clear recognition of its importance at high political levels and the willingness to support good administrative practices—even if it is politically difficult to do so. Few developing countries have been able to leap this initial hurdle. At times, urged by international agencies or simply desperate to get more revenues, countries have launched frantic efforts to corral defaulters or to rope in new taxpayers without hurting politically powerful interests, and without providing the time, resources, and the consistent long-term political support needed to support and administer an effective tax system. The widespread reluctance to collect taxes efficiently and effectively may be understandable in countries that are fragile politically, but without such efforts, 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.

Tax Administration Tasks

The three major tasks of an effective tax administration are facilitating compliance by ensuring that individuals obligated to pay taxes are doing so and to try and make compliance easier for the taxpayer; enforcing compliance and reducing tax evasion; and improving governance to keep tax officials honest and reinforce the legitimacy of the tax system.

Facilitating compliance

The first task of any tax administration is to facilitate compliance: ensure that those who should be in the system are in the system, and that they comply with the rules. To do so:

1. *Taxpayers must be found.* If they are required to register, the registration process should be as easy as possible. Systems must be in place to identify those who do not register voluntarily. Tax authorities should adopt an appropriate unique taxpayer identification system to facilitate compliance and enforcement.

2. *The administration needs a process to determine tax liabilities.* This may be done administratively (as with most property taxes) or by some self-assessment procedure (as with most income taxes and value-added taxes [VATs]; see box 1 for more information on VATs). Recently, as discussed later, in some countries, really “smart” administrations have changed the game substantially by increasingly prefilling tax returns with information obtained from reliable third-party sources.
3. *Taxes must be collected.* In many countries, the best solution is collection through the banking system. It is seldom appropriate for tax officials to handle money directly.
4. *The authorities should provide adequate taxpayer services* in the form of information, pamphlets, forms, advice agencies, payment facilities, telephonic and electronic filing, and so on, to make taxpayer compliance as easy as possible.

This approach rests on treating the taxpayer as a client to be served and not a thief to be caught. Unfortunately, the latter attitude still prevails in many countries.

Enforcing compliance

Of course, some taxpayers are not honest, so enforcing compliance and reducing tax evasion are also important tasks. To enforce compliance and reduce evasion, the administration needs to understand the extent and nature of the potential tax base to estimate the tax gap, preferably by sector and type. Without at least some idea of the number and type of individuals and firms not complying, no coherent enforcement strategy can be devised. Sometimes the problem is that large groups of prospective taxpayers are simply not known to the authorities. Or it may be that many taxpayers who are in the system are substantially under-reporting. Without some knowledge of the unreported base, and its determinants, no administration can properly allocate its resources to improve tax collection and ensure everyone bears at least a roughly fair share of the tax burden.

In addition to exploring the nature of the tax gap and extending the reach of the tax system into the informal economy to the extent feasible, close attention must also be paid to such simple tasks as ensuring that those who are in the system file on time and pay the amounts due. Immediate follow-up to contact nonfilers and taxpayers whose payments did not match their liabilities is often neglected. Adequate interest charges must be imposed on late payments to ensure that nonpayment of taxes 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 deter tax evasion.

Improving governance

A third major task is to also keep the tax collectors honest. No government can expect taxpayers to comply willingly if tax-

Box 1. An Example: VAT as a Self-Assessed Tax

The VAT is often described as a self-assessed tax because once established, it becomes part of standard business operations and runs itself. The task of the tax administration is thus not to assess who owes what, but instead to guard the “borders” of the system and verify that those who should be self-assessing are behaving responsibly.

For such a self-assessed tax to function properly, seven preconditions must be in place:

1. a simple, clear, stable law,
2. a good taxpayer service,
3. simple procedures,
4. effective enforcement,
5. reasonable audit,
6. strict penalties, and
7. a good administrative review system.

In reality, of course, many developing countries that have VATs do not satisfy many—or sometimes any—of these preconditions. One cannot take a tax administration out of its environment, and such factors as the level and distribution of income and wealth, the importance and pattern of international trade, the relative size and nature of the informal sector, the relative importance of final and intermediate sales, the prevailing level of trust in government, and taxpayer morale all enter into understanding both the present administrative situation and the prospects of improving its outcomes. To implement a modern VAT successfully, a country needs not only the right tax structure, it also needs both the right tax administration and the right clientele (taxpayers).

To get to this happy position, however, some very fundamental changes in underlying economic and political conditions may first be necessary—and perhaps unlikely, at least in the short run. Nonetheless, even with a relatively weak administration in an unfavorable environment, with the right VAT, a country may be better off. Almost every country needs a general consumption tax, and since the VAT is the best form of such a tax—the one with the fewest bad effects—the case for a VAT is strong almost everywhere on administrative grounds. For example, in a poor country with a high import component in its taxable consumption tax base, the tax office no longer has to prove that a duty-free import had been improperly claimed. Instead, taxpayers have to demonstrate, by filing returns, that they were entitled to offset the VAT on imports against the VAT on sales.

Because in many countries the informal sector is “fed” largely by the diversion of tax-free imports, stopping this leakage would constitute a major step toward restoring the competitive balance between formal and informal sectors. So long as it can identify and track VAT registrants, the country thus can both have more revenue and at the same time stimulate a sounder pattern of development. Tax administration can often be a serious constraint on tax reform, and countries should be both encouraged and helped to improve their administrations as much as reasonably possible. With just minor changes in tax structure and administration, significant improvements in outcomes may be achieved even in very poor countries.

payers believe the tax structure is unfair or that the revenue collected is not effectively used. But even a sound tax structure and sound expenditure policy can be tarnished by a capricious and corrupt tax administration. Developed countries took centuries to develop and implement systems to prevent dishonest tax officials from corrupt practices. One key factor to reduce corruption is to adequately compensate tax officials so that they do not need to steal to live. Ideally, tax officials should be professionally trained, promoted on the basis of merit, and judged by their adherence to the strictest standards of legality and morality. Temptation should be reduced by limiting direct contact between officials and taxpayers and increasing supervision when there is direct contact. Developing countries trying to sustain relatively large governments on precarious fiscal foundations find it hard to deal with these various issues.

Lessons from International Experience

There is no single prescription—no secret recipe—that, once introduced, will ensure improved tax administration in any country. 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 government in general. 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 influence taxpayer attitudes and hence the observed level of taxpayer compliance. Countries and circumstances differ, but some basic points seem universal.

Keep it simple

One important lesson suggested by experience is that before reforming the tax administration, simplify the tax system so that it can be applied effectively in a low-compliance context. It seldom makes sense to reform tax administration without simultaneously reforming tax structure to be both sensible and administrable. Considerable improvements can often be made in administration by small simplifications in tax policy. Reducing the number of income tax deductions, for instance, may permit countries to eliminate filing requirements for most wage earners. In addition to giving the administration simpler and more enforceable laws to administer, it is equally important to simplify procedures for taxpayers, for example, by eliminating demands for unnecessary information in tax returns and consolidating return and payment forms. Once procedures are simplified, the tax administration can then concentrate on its main tasks: facilitating compliance, monitoring compliance, and dealing with noncompliance.

The taxpayer as client

The prevalent attitude in many tax administrations appears to be that all taxpayers are potential criminals. The key administrative problems are then identifying and controlling taxpayers and catching those who cheat. These tasks are indeed important, and this emphasis is understandable in a country undergoing rapid transition, but 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 taxpayers more as clients—perhaps not very willing clients, but still clients—than as would-be criminals.

As mentioned earlier, *facilitating* compliance requires 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, management information systems that cover both ultimate taxpayers and third-party agents (such as banks) involved in the tax system, and appropriate and prompt procedures to detect and follow up on nonfilers and late payments. *Improving* compliance requires a judicious mix of both these approaches as well as additional measures to deter noncompliance, such as establishing a reasonable risk of detection and the effective application of penalties. Successful reform strategies require an appropriate mix of all these approaches.

Of course, rewriting reality so that citizens are induced to comply with tax laws voluntarily is difficult in countries that face severe institutional limitations arising from large informal sectors, poor salary structures for public servants, ineffective and uncertain legal systems, and an entrenched distrust of government. Nonetheless, services to taxpayers that facilitate reporting, filing and paying taxes, or that impart education or in-

formation among citizens about their obligations under the tax laws are often as or more cost-effective in securing compliance than measures such as auditing and penalties, which are more directly designed to counter noncompliance. The taxpayer service perspective emphasizes reducing taxpayer uncertainty by clarifying legal ambiguities, often about issues as simple as the tax rate applicable to certain transactions, communicating clearly what the law is, and ceasing to change it so often that no one quite knows what it is. Taxpayer compliance costs and convenience should also be taken into account in designing legal and administrative procedures: for example, some countries require excessive numbers of tax payments to be made in inconvenient places.

Taxpayers do not always view the decision to pay or not as a simple gamble. 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 noncompliance. Optimal enforcement strategy anywhere is likely to include both rewards for compliers and penalties for noncompliers. But the correct mix depends on many context-specific factors such as 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 to be socially desirable. This picture is not as simple as the conventional economic model of tax evasion, where penalties and probabilities of detecting evasion are seen as driving taxpayer compliance decisions. Increased enforcement actions, or lessened enforcement such as an amnesty, may have quite different results on compliers than on noncompliers, as may increased efforts at public education about taxpayer rights and obligations or increased efforts by tax authorities to provide improved service to taxpayers.

Salvation through reorganization?

Despite the high potential payoff in terms of increased revenue, it is usually difficult, and often impossible, for tax departments to obtain and retain 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. Reform strategies that require substantial additional administrative resources—particularly staff—are hence usually doomed to failure, because the needed resources will not materialize fully or in a timely fashion.

One way around this problem is to set up independent revenue authorities that 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. Experience with this approach has been mixed. In some instances, the result appears to have been to provide an institutional structure that provides a useful catalyst for deeper administrative reform. In other instances, however, the result looks more like yet another dys-

functional bureaucracy. A tentative conclusion is perhaps that any country that has the will, strategy, and resources to reform tax administration probably does not need an independent revenue authority—and a country in which these critical ingredients are lacking is unlikely to be successful even if it creates such an authority.

Whether there is a semiautonomous authority or not, successful administrative reform strategies must usually be carried out without major additional resources. One approach may be simply to eliminate unproductive activities such as the auditing the returns of most wage earners; another may be to consider outsourcing some of the activities traditionally carried on within the administration; and yet another may be to focus efforts more on the larger business taxpayers, who not only pay taxes themselves (for example, on imports and profits), but also collect much of the revenue in every country through payroll, income, sales, and excise taxes and thus serve a critical function in providing information on their owners, employees, suppliers, and customers. None of these approaches is without its own complications, but all may, if properly employed, improve outcomes without incurring serious revenue risks.

The IT solution

No modern tax administration can perform its tasks efficiently without using modern information technology (IT). Among the areas that may be computerized are: (1) taxpayer records and tax collection; (2) internal management and control over resources; (3) legal structure and procedures; and (4) systems to lower taxpayer compliance costs.

Tax administrations increasingly need IT expertise because some of their most important clients—multinational companies and, increasingly, large domestic firms—employ sophisticated computer systems that are beyond the investigative capacity of technologically backward tax administrations.

Experience provides a number of lessons for the successful application of IT in tax administration:

- Most importantly, an appropriate strategy must be developed that takes into account the obstacles and the constraints arising from organizational rigidities such as civil

service salary structure and procedural hurdles in acquiring the necessary expertise, hardware, and software.

- Considerable organizational reengineering, such as consolidating return and payment forms, eliminating unnecessary and unused information required from taxpayers, and so on, is usually needed to prepare the tax administration for a computerized environment.
- Equipment and software should be standardized and bought off the shelf whenever possible to facilitate operation, networking, and maintenance.
- The pace of change and the success of any modernization program depend ultimately on the training and skills of the people who are expected to use the technology. Appropriate incentives and accountability measures are also needed.
- As mentioned earlier, for IT to work at all, a unique identification number must be assigned to each taxpayer.

Perhaps the ultimate example of an automated, Web-based, IT-driven tax system is one like that introduced by Denmark in 2004. Under the “no touch” system now in place in Denmark, which provides extensively prefilled returns online, most taxpayers—over 90 percent—no longer need to file returns or to have any direct contact with the administration, thus reducing compliance costs and freeing substantial administrative resources to deal with more complex administrative problems such as auditing complex or questionable returns. The future of smart tax administration seems increasingly to lie in this direction. For many poor countries, that future may still lie some distance ahead. However, countries such as the Slovak Republic, Singapore, and Chile have already moved in this direction to a considerable extent, and other middle-income countries may do so in the near future.

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