

INTERNATIONAL

Administrative Dimensions of Tax Reform*

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1. INTRODUCTION

The best tax policy in the world is worth little if it cannot be implemented effectively. Tax policy design in developing and transitional countries must therefore take the administrative dimension of taxation carefully into account. What can be done to a considerable extent determines what is done in any country. In many developing countries, for example, there is a large traditional agricultural sector that is not easily taxed.¹ Often there is also a significant informal (shadow) economy that is largely outside the formal tax structure.² The tax base that is potentially reachable in such countries thus constitutes a smaller portion of total economic activity than in developed countries.

To some extent, the size of the "untaxed" economy is itself 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.³ The resulting lower tax revenues often lead governments to raise tax rates still further, thus exacerbating incentives to evade taxes. Unfortunately, all too often when a country's real tax base, i.e. the base its tax administration can effectively reach, is small, so, almost by definition, is the administration capable of reaching it effectively.

Section 2. of this paper 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 can both policy and administrative agendas be advanced together? Section 3. sketches the broad outlines of administrative reform, i.e. the essential conditions for such reform, its principal components, and its limits as a way of solving critical tax problems. Section 4. then reviews several key issues in tax administration with particular attention to their implications for successful tax policy reform and implementation. Finally, Section 5. concludes the discussion, adding a few new elements to the opening discussion of policy and administration in Section 2. and illustrating them with some examples from tax reform in Poland.

2. 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 in practice. Experience suggests that it is not a good idea to ignore the administrative dimension of tax reform. One cannot assume that whatever policy designers can think up can be done or that any

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1. The special problems of taxing agriculture are not discussed here; see M.H. Khan, "Agricultural Taxation in Developing Countries: A Survey of Issues and Policy", *Agricultural Economics* 24 (2001), pp. 315-328, and I. Rajaraman, "Taxing Agriculture in a Developing Country: A Proposal for India", Paper at Conference on The Hard-to-Tax, Andrew Young School of Public Policy, Georgia State University, May 2003, for two useful recent reviews. The administrative aspect of agricultural taxation is discussed in R.M. Bird, *Taxing Agricultural Land in Developing Countries* (Cambridge, MA: Harvard University Press, 1974) at Chap. 11.

2. See Friedrich Schneider, "The Size and Development of the Shadow Economy around the World and the Relation to the Hard to Tax", Paper at Conference on The Hard-to-Tax, Andrew Young School of Public Policy, Georgia State University, May 2003, for a comprehensive review of the size of the shadow economy in many countries.

3. In many countries, a number of agencies in addition to the tax administration are involved in revenue administration, such as the social security administration and the customs administration and in some countries the financial police. In Bosnia, for example, two thirds of the revenue of the Entities (the main governmental level) is collected by the customs administration.

administrative problems encountered can be easily and quickly remedied. The real tax system people and businesses face reflects not just tax law but also how that law is actually implemented in practice. How a tax system is administered affects its yield, its incidence, and its efficiency. Tax administration is too important to policy outcomes to be neglected by tax policy reformers.⁴

Unfortunately, tax administration is a difficult task even at the best of times and in the best of places, and conditions in few developing countries match these specifications. Moreover, administration 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 non-compliance; 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".⁵ 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.⁶ How revenue is raised, i.e. 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 as *how much* revenue is raised. Private as well as public costs of tax administration must be taken into account, and due attention must be paid 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).⁷ 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 Vito Tanzi has noted, tax administration has a crucial role in determining the real (or effective) tax system, as opposed to the statutory tax system.⁸ There is a growing conviction among tax policy specialists in developing countries that it is "misguided ... to reform tax structure while largely ignoring tax administration"⁹ and that it is critical to ensure that "changes in tax policy are compatible with administrative capacity".¹⁰ But how much is actually known about the experience of countries that have reformed or tried to reform their tax administration?

2.1. Keep it simple

One of the most important lessons emerging from experience in various countries¹¹ is that an essential precondition for the reform of tax administration is to simplify the tax system in order to ensure that it can be applied effectively in the generally low-compliance contexts of developing

and transitional countries. The experience of Bolivia, which introduced a major simplification of its tax system in 1986, is instructive in this respect. 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-Vazquez¹² argue in the case of Jamaica it seldom makes sense to reform tax administration without simultaneously reforming tax structure to be both sensible and administrable. Of course, as experience in both Chile¹³ and Colombia¹⁴ demonstrates, considerable improvements can be made 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

4. As John McLaren (ed.), *Institutional Elements of Tax Design and Reform*, World Bank Technical Paper No. 539 (Washington, D.C., 2003), p. v), puts it: "... optimal policy requires simultaneous consideration of the design of the tax code and of the administrative structure created to enforce it."

5. Milka Casanegra de Jantscher, "Administering a VAT", in M. Gillis, C.S. Shoup and G.P. Sicat, eds., *Value Added Taxation in Developing Countries* (World Bank, 1990), p. 179.

6. For example, although many tax administrators understandably cite the relatively low average costs (often around 1% of revenues) of collecting revenue in developed countries, the costs may be considerably higher in some developing countries (Arthur J. Mann, "Estimating the Administrative Costs of Taxation: A Methodology with Application to the Case of Guatemala", DevTech Systems, Arlington, VA, August 2002). In any case, even low costs do not prove that additional funds allocated to tax administration will be returned a hundredfold. 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 (Jaime Vazquez-Caro, Gary Reid, and Richard M. Bird, *Tax Administration Assessment in Latin America*, Regional Studies Program Report No. 13, Latin America and the Caribbean Technical Department, World Bank, 1991). Finally, theoretical arguments (Joel Slemrod and Shlomo Yitzhaki, "Tax Avoidance, Evasion, and Administration" in Alan J. Auerbach and Martin Feldstein, eds., *Handbook of Public Economics*, vol. 3 (New York: Elsevier Science, 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.

7. In one of the few books on how tax administrations actually function in developing countries, Alex Radian, *Resource Mobilization in Poor Countries* (Transaction Books, 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 tax administration "telling" as opposed to "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. Of course, as discussed later the facilitating and monitoring of such "quasi-voluntary" compliance (Margaret Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988)), are important tasks for any tax administration.

8. Vito Tanzi, *Public Finance in Developing Countries* (Aldershot, UK: Edward Elgar, 1991).

9. Richard M. Bird, "The Administrative Dimension of Tax Reform in Developing Countries", in Malcolm Gillis, ed., *Tax Reform in Developing Countries* (Durham NC: Duke University Press, 1989), at 315.

10. World Bank, *Lessons of Tax Reform* (Washington, 1991), at 51.

11. For various country experiences, see Richard M. Bird and Milka Casanegra de Jantscher, eds., *Improving Tax Administration in Developing Countries* (Washington: IMF, 1992) and Arindam Das Gupta and Dilip Mookherjee, *Incentives and Institutional Reform in Tax Enforcement* (Oxford, 1998).

12. Roy Bahl and Jorge Martinez-Vazquez, "The Nexus of Tax Administration and Tax Policy in Jamaica and Guatemala", in Bird and Casanegra de Jantscher, op. cit., note 11.

13. Arnold Harberger, "Lessons of Tax Reform from the Experiences of Uruguay, Indonesia, and Chile", in Gillis, op. cit., note 9.

14. Santiago Pardo and Charles E. McLure, Jr., "Improving the Administration of the Colombian Income Tax", in Bird and Casanegra de Jantscher, op. cit., note 11.

since withholding alone then sufficed to enable most income taxpayers to fulfil their obligations.

There is no single set of prescriptions that, once introduced, will ensure improved tax administration in any country. Developing and transitional 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 general. Attitudes affect intentions and intentions affect behaviour. 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. 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, i.e. architecture, engineering and management.¹⁵ 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. 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 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.¹⁶ Even the most sophisticated tax administration can easily be overloaded with impossible tasks.¹⁷ Such concerns are obviously even more important in developing and transitional countries in which less well-equipped administrators are asked to tackle inherently complex tasks in a generally hostile and often information-poor environment. The life of the tax administrator is made 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). Simple exhortations to "do better", while cheap and always popular, are of little use to resource-strapped administrators faced with impossible 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.¹⁸

Some such gimmicks, e.g. lotteries in which tax invoices constitute lottery numbers, have long been properly derided by experts as costly and of dubious effectiveness.¹⁹ 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 also no panacea.²⁰ The tax administration must be able to control withholders 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 have in fact been withheld. The mere expansion of withholding will not improve compliance unless the administration is able to control both withholders and taxpayers subject to withholding.

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. 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.

2.2. The taxpayer as the "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

15. This analogy draws on one set out in Carl S. Shoup, "Melding Architecture and Engineering: A Personal Retrospective on Designing Tax Systems", in Lorraine Eden, ed., *Retrospectives on Public Finance* (Durham, NC: Duke University Press, 1991).

16. Internal Revenue Service (IRS), *Income Tax Compliance Research* (Washington, 1988).

17. Christopher Hood, *The Limits of Administration* (New York: Wiley, 1976).

18. For discussion of a number of such schemes, see Bird, op. cit., note 9.

19. Richard Goode, "Some Economic Aspects of Tax Administration," *IMF Staff Papers* 28 (June 1981).

20. Pirooska Soos, "Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues", 24 *UC Davis Law Review* 1 (1990).

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 4.). Ideally, such measures should be combined 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 non-compliance, and finally to applying penalties. Successful reform strategies require an appropriate mix of all these approaches.

Improving tax compliance is not the same as discouraging non-compliance. 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.²¹ While most tax compliance in most countries most of the time can perhaps best be characterized as “quasi-voluntary compliance”²² 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.²³ 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 to be 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. Generally, 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,²⁴ the evidence from studies in developed countries²⁵ 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 commonly found in some developing countries, e.g. stamp taxes and the variety of minor excises, suggest that compliance costs may well be very high. 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 many developing and transitional countries than in the high-compliance environment of the few developed countries in which 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 has been the subject of a large formal theoretical literature on the economics of tax evasion.²⁶ 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 Shaw²⁷ calls that portion of tax rev-

21. Joel Slemrod, ed., *Why People Pay Taxes* (Ann Arbor: University of Michigan Press, 1992).

22. See Levi, op. cit., note 7.

23. James Alm and Jorge Martinez-Vazquez, “Institutions, Paradigms, and Tax Evasion in Developing and Transition Countries”, in Martinez-Vazquez and Alm, eds., *Public Finance in Developing and Transitional Countries* (Cheltenham, UK: Edward Elgar, 2003).

24. A recent study of compliance costs in India (S. Chattopadhyay and A. Das Gupta, “The Compliance Cost of the Personal Income Tax and its Determinants”, National Institute of Public Finance and Policy, New Delhi, 2002) suggests that such costs may be considerably higher in some instances than in most developed countries.

25. Cedric Sandford, ed., *Tax Compliance Costs: Measurement and Policy* (Bath, UK: Fiscal Publications, 1995).

26. See Frank Cowell, *Cheating the Government: The Economics of Evasion* (Cambridge MA: MIT Press, 1990) and Slemrod and Yitzhaki, op.cit., note 6.

27. Graham K. Shaw, “Leading Issues of Tax Policy in Developing Countries: The Economic Problems”, in Alan Peacock and Francesco Forte, eds., *The Political Economy of Taxation* (New York: St. Martin’s Press, 1981).

enues 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 3.

In addition to this serious gap in the existing formal analysis, the literature has not as yet managed to effectively model 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.²⁸ 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 centred on some form of computerization. While it is difficult to conceive of a modern tax administration that can perform its tasks efficiently without using some form of computer technology, in many instances the expectation of greater effectiveness from computerization has not materialized. As discussed further in 3., the more successful reforms did not merely involve computerizing antiquated processes but rather also redesigned and streamlined basic systems and procedures, e.g. 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 sidestep such needed reforms. Even the best computerized system will not produce useful results unless there are real incentives for tax administrators to utilize the system properly.

3. APPROACHES TO TAX ADMINISTRATION REFORM²⁹

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 behaviour 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.³⁰ Nonetheless, although the role of societal and cultural factors cannot be denied, com-

pliance is unlikely to be high if the belief prevails that evasion can be practised 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.

Since resources are always limited, 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, i.e. "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.

3.1. The environmental context

Among the "cultural" factors that affect tax administration 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 in particular, 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.

28. See, for example, the historical discussion in Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon and Schuster, 1986).

29. Much of this section is based on Amaresh Bagchi, Richard M. Bird, and Arindam Das Gupta, "An Economic Approach to Tax Administration Reform", University of Toronto Faculty of Management, International Centre for Tax Studies, Discussion Paper No. 3, 1995. See also Jit B.S. Gill, *A Diagnostic Framework for Revenue Administration*, World Bank Technical Paper No. 472, Washington, 2000.

30. For a recent study emphasizing the social dimension of compliance, see Alm and Martinez-Vazquez, *op. cit.*, note 23.

For a law to be enforced properly, it should both be appropriate to the environment and enforceable: good enforcement requires good tax law. If too many objectives of social and economic policy are incorporated into tax law, the result may be a level of complexity with which neither taxpayers nor tax administration 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) is difficult when the tax base is ill-defined or when there are many exemptions and deductions.

Tax enforcement is also strongly influenced by administrative law, i.e. 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.

The economic environment may also have an important bearing on the effectiveness of tax administration. For example, as discussed further in 4., when inflation is high, the tax structure must be altered 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 payment 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.

3.2. 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. Only a few key aspects are discussed here.

- First, a tax administration must of course have adequate resources in terms of manpower, infrastructure and an appropriate organizational structure. Section 4. touches on the organizational issue; only resource employment decisions are discussed here.
- Second, a tax administration needs an information system to ascertain the existing and potential tax base. An ideal system consists of five subsystems:
 - (1) a system to assess the potential tax base for the aggregate economy;
 - (2) a system to identify potential taxable entities and estimate the amount of the tax base for each of these entities;
 - (3) a system to classify 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 to monitor and provide 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 4., 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 legal context of the country.
- Fourth, a tax administration must select strategies and set out administrative rules to counter each type of non-compliance by different groups of taxpayers e.g. by 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 labour 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.

3.3. The key ingredients of reform

Approaching tax administration reform from a different perspective, experience suggests that 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 2., it helps if the tax system is well designed, appropriate for the country in question, and relatively simple, but even the best-designed tax system cannot be properly implemented in the absence of these three conditions. Much attention is frequently and correctly paid to the resource problems mentioned above, i.e. 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.

Experience around the world demonstrates 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.³¹ Unfortunately, few developing and transitional countries have so far proved able to leap this initial hurdle. 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 favour is understandable in countries which are fragile politically. Without such efforts, however, 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 4.). It must be adequately staffed with trained officials. It should be properly organized, which until recently in most countries meant on a functional rather than tax-by-tax basis.³² 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) but little long-term gain can be expected 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 these steps is easy, and few of them are simple. On the other hand, reforming tax administration is not rocket science. 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.³³

Once the three central ingredients discussed above are in place, one can then think about designing and implementing an 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 administrative reforms are developed in more detail in 4.

3.4. 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:

- firstly, taxpayers must be found. They may be required to register. Whether compulsory or voluntary, 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, 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;
- thirdly, the taxes due must be collected. In many countries, this is best done through the banking system: to reduce corruption opportunities, tax administrations should generally not handle 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 2. above, that the taxpayer is a “client” who is not necessarily a willing one but whose needs must be met, and not simply a thief to be

31. See Bird and Casanegra de Jantscher, op. cit., note 11.

32. Organization by client groups – such as large taxpayers (Katharine Baer, *Improving Large Taxpayers' Compliance: A Review of Country Experience*. Occasional Paper, International Monetary Fund, Washington, 2002) – is becoming common, but it is never sensible to assign specific taxpayers to specific officials for prolonged periods of time.

33. On Singapore, see S. Bhatnagar, “Modernizing Tax Administration in Singapore”, World Bank, December 2000, and Oliver Oldman and R.M. Bird, “Improving Taxpayer Service and Facilitating Compliance in Singapore”, PREM Note 48, World Bank, December 2000.

caught. Unfortunately, the latter attitude seems to prevail in all too many developing and transitional countries.

3.5. 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 thus to keep them as honest as possible. To do so, one must first have a good idea of the extent and nature of the potential tax base, e.g. by estimating what is sometimes called the "revenue gap". This is not always easy to do, but it is essential if the 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 under-reporting. 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 (and 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 but critical 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 thus neither an easy nor a static task in any country, especially in the changing conditions of developing and transitional countries. Unless this task is tackled with seriousness and consistency, however, even the best-designed tax system is unlikely to produce good results.

3.6. 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 developed countries centuries to develop and implement sound tax administrative practices to keep the obvious temptations to dishonest tax officials in check.³⁴ Unfortunately, develop-

ing and transitional 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.³⁵ They should be professionally trained, promoted by merit, and judged by their adherence to the strictest standards of legality and morality. To remove temptation, payments 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. Of course, these statements are in a sense all clichés, 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.

3.7. Conclusion

Improved domestic resource mobilization is an essential ingredient of the strong policy framework developing that transitional 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.

4. SOME FURTHER ISSUES

Several issues that illustrate the interdependence of tax policy reform and tax administration reform are considered here. The first two sections consider two common policy problems, i.e. inflation adjustment and presumptive taxation, and briefly note how their resolution both reflects and influences tax administration issues. The next two subsections then look at two administrative issues, i.e. sanctions and amnesties, that are also critical tax policy issues. Finally, the last two subsections, on organization and computerization, deal with two strictly administrative matters that also have substantial implications for the design of practical tax policy in developing countries.

4.1. Inflation adjustment

In principle, tax systems can largely be insulated against the loss of revenues that would otherwise result from infla-

34. See Webber and Wildavsky, *op.cit.*, note 28.

35. For an interesting discussion of reward systems, see Emilson C.D. Silva, "Incentive Effects of Performance-Based Rewards in Tax Administration", in McLaren, *op. cit.*, note 4, and "Salary Supplements and Bonuses in Revenue Departments, Final Report", World Bank, Washington, August 2001. A useful overview of anti-corruption measures is *An Anticorruption Strategy for Revenue Administration*, PREM Note 33, World Bank, Washington, October 1999.

tion 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.³⁶

To deal with collection lags, for example, payment periods may be shortened, or provisional payments of estimated taxes may be made more frequently. Both approaches 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, indexation 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 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. 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 can be done, but the task 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 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, 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 may be preferable, though it too requires a more sophisticated tax administration (one that can do arithmetic and not simply count).

4.2. Presumptive taxes

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" taxes³⁷ 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 simpler 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 businesses and farmers. Moreover, the broader question of equity between the hard-to-tax, e.g. 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 "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

36. For an excellent discussion, see Milka Casanegra de Jantscher, Isaias Coelho, and Arturo Fernandez, "Tax Administration and Inflation", in Bird and Casanegra, op. cit., note 11.

37. See Victor Thuronyi, *Tax Law Design and Drafting* (Washington: IMF, 1996), Chap. 14 for a good discussion.

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.³⁸

- 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 factors as number of employees, size of premises, class or category of business, etc. In economic terms, such a system taxes the factors on which liability is based rather than income or sales. In principle, to set the presumptive amounts to be attributed to each factor 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 that too many taxpayers will migrate into the more favourable presumptive system. To put it another way, as with infant industry-protective policies, presumptive systems that unduly favour small businesses provide 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.³⁹
- 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's 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 such presumptive approaches to taxation in many developing and transitional countries, such systems require close attention from both the policy and the administrative perspectives.

4.3. Sanctions and penalties

A quite different approach to minimizing the Type I error mentioned in 4.2. 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 that in each case, 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 for such offenses is of as much concern as intentional errors and since there appear to be no adverse implications for equitable treatment. Anything that minimizes Type I errors,

however, runs the risk of increasing Type II errors and wrongly punishing the innocent, so ideally some safeguards should be in place to reduce such undesirable outcomes. Tax administrations that do not have in place a good "error correction mechanism" for dealing with disputes run the risk of alienating those who feel, with some reason, that they are unjustly taxed. Practices that may tip generally compliant taxpayers into joining the non-compliant group should be avoided if at all possible.

The structure, severity and coverage of penalties are important and unduly neglected questions in many countries.⁴⁰ 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 programmes.

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, from the taxpayer's perspective, the same (aside from filing costs) as failure to pay taxes due – provided there is no difference in the probability of being made to pay taxes and the penalty applicable. From an administrative perspective, however, the task of collecting is easier if the offence is further along in the identification/ registration, filing, tax determination or 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 himself or from third parties, has an implicit value in terms of expected revenue lost. Furthermore, some "technical" offenses (e.g. non-maintenance of

38. 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.

39. This point is stressed in e.g. Richard M. Bird and Sally Wallace, "Is it Really so Hard to Tax the 'Hard-to-Tax'?" Paper at Conference on the Hard-to-Tax, Andrew Young School of Public Policy, Georgia State University, May 2003.

40. The best discussion of this issue remains Oliver Oldman, "Controlling Income Tax Evasion", in Joint Tax Program, *Problems of Tax Administration in Latin America* (Baltimore: Johns Hopkins University Press, 1965).

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, under-reporting is difficult to detect, penalties for failure to maintain accounts may have a 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 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. In some countries no rational taxpayer would pay on time because it is cheaper to secure working capital in this way than by borrowing from a bank. Delinquency, whether 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.

4.4. Tax amnesties

Tax amnesties merit special treatment both because of their complex effects on taxpayer behaviour and because of their popularity. On the whole, the evidence is clear: tax amnesties should be avoided.⁴¹ 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 his name continues to be outside tax department records while his 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 him 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 US court system or "compounding of offenses" in India may be justified if the cost of prosecution of tax evaders is high.⁴²

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;⁴³ 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 his 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 behaviour is complex.

Governments desperate for quick funds sometimes turn to amnesties. The immediate revenue results may occasionally be impressive, although 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 granted regularly (e.g. India granted 7 over a 35-year period, while Argentina has had 21) they soon come to be anticipated. Repeated amnesties generally signal that the government is unable to enforce taxes effectively. Such amnesties 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. As compliance becomes further eroded, such limited positive effects become increasingly unlikely.

Administrative discretion to waive penalties has effects similar to a permanent amnesty, 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.

41. For a detailed analysis, see Das Gupta and Mookerjee, *op.cit.*, note 11, at Chap. 5.

42. Presumptive taxes, when rebuttable, resemble a pre-announced amnesty since in effect they guarantee immunity from investigation on payment of a pre-announced fee.

43. For a useful recent discussion of money-laundering and tax evasion, see D. Masciandro and J. Alworth, "Tax Evasion, Tax Competition, Lax Financial Regulation and Money Laundering: Is there an Overlap?", Bocconi University Paolo Baffi Centre, Working Paper No. 161, September 2003.

4.5. Organizing to tax

Tax policy reform strategies properly vary from country to country, but one constraint is usually common in all 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. Reform strategies that require substantial additional administrative resources, particularly staff, are hence usually 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 has 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 still other instances, however, considerable improvements do seem to have occurred.⁴⁴ Although this question cannot be discussed in detail here, a tentative conclusion might be that, to put it in extreme terms, countries that have the will, strategy, and resources to reform tax administration probably do not need independent revenue authorities and those in which these critical ingredients are lacking are unlikely to be successful even if they create such an authority.

Even when there is an 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.⁴⁵ 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 that are applied initially only to some but with the clear idea and obligation of extending those rules subse-

quently to all. The practical choice in many countries is usually between the second and third approach. If one considers special tax offices for large taxpayers in this light, as a "pilot" for the extension of similar procedures 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.

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 or returns (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. More generally, the question of the optimal degree of decentralization of tax authorities has become a matter of considerable importance in a number of countries. Some, such as China in 1994, have moved to centralized administration, but more

44. For further discussion, see Glenn Jenkins, "Modernizing of Tax Administration: Revenue Boards as an Instrument for Change", 48 *Bulletin for International Fiscal Documentation* 2 (1994); Roberto Taliario, "Semi-Autonomous Revenue Authorities: Benefits and Costs", World Bank, April 2003; Charles L. Vehorn and John Bondolo, "Organizational Options for Tax Administration", 53 *Bulletin for International Fiscal Documentation*, November 1999; O.H. Fjelstad, "Fighting Fiscal Corruption: The Case of the Tanzania Revenue Authority", Working Paper 2002:3, Chr. Michelsen Institute, Bergen; and Manuel Estela, "Strengthening Peru's Tax Agency", PREM Note 60, World Bank, Washington, November 2001.

45. See Baer, *op. cit.*, note 32.

commonly countries are considering further decentralization of tax administration in various forms and degrees.⁴⁶

4.6. Computerization

Radical improvement in tax administration calls for a transformation of its organization and methods. Modern information technology greatly facilitates such transformation.⁴⁷ 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 many developing and transitional 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 are 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 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, known as 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.⁴⁸ 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 that 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, considerable organizational re-engineering is usually needed to gear the tax administration to a computerized environment. Sometimes, as for property taxes in Indonesia, it may be advantageous to reorganize 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 and the success of any modernization programme will ultimately depend on human resources, i.e. 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

46. John L. Mikesell, "International Experiences with Administration of Local Taxes: A Review of Issues and Practices", Paper for World Bank, 2002, provides an excellent discussion of the pros and cons of more independent administration of local taxes.

47. Michael Engelschalk et al., *Computerizing Tax and Customs Administration*, PREM Note 44, World Bank, October 2000.

48. For a useful discussion of this area, see Glenn Jenkins, ed., *Information Technology and Innovation in Tax Administration* (The Hague: Kluwer Law International, 1996).

any purpose. As discussed in 5., however, one need not strive for perfection in this respect before attempting to reform tax administration.

5. POLICY AND ADMINISTRATION IN TAX REFORM

Tax policy and tax administration interact at three distinct levels: (1) the formation of policy and the drafting of legislation, (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. A few aspects of this experience are discussed briefly in this section, drawing on experience in a number of countries, 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 possible improvements for other countries undertaking similarly ambitious reforms.⁴⁹

5.1. 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 filed through employers and social security funds). In revenue terms, these 11 million individual returns accounted for at most 20% of PIT collected. But in administrative terms, they constituted closer to 80% 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 avoided by adjusting withholding tables to reduce the need for so many refunds. 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.

Another example is that Poland lowered the VAT reporting threshold in 1995, 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 a revenue or administrative perspective, 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 labour 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, e.g. 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.⁵⁰

As noted earlier, simplification of the tax structure seems a prerequisite for removing one of the major irritants for taxpayers in many countries, which is 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 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 United Kingdom 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 eight additions, one multiplication, two divisions, and one inequality, and no instructions were provided to guide the bewildered taxpayer. What conceivable gain can justify imposing such complexity and compliance costs on taxpayers?

49. This section is based on Richard M. Bird, "Tax Policy and Tax Administration in Transitional Countries", in Gustaf Lindercrona, Sven-Olaf Lodin and Bertil Wiman, eds., *International Studies in Taxation: Law and Economics. Liber Amicorum Leif Muten* (Kluwer International, 2000). Note that it does not purport to provide either a comprehensive or a current account of the Polish tax system.

50. It might be worth mentioning two special instances where such an integrated approach is needed. The first is with respect to small enterprises (Saul Terpker, "Managing Small and Medium-Sized Taxpayers in Developing Countries", *Tax Notes International*, vol. 29, 13 January 2003) and other "hard-to-tax" groups, where considerable expertise may be needed to develop an appropriately simplified system (Bird and Wallace, op. cit., note 39). The second is with respect to international tax issues, where even the smallest and poorest countries may have to grapple with some of the most complex problems in tax policy and administration. International technical assistance may be particularly relevant in this second case.

5.2. 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 rumours 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 Ukraine still makes it likely that everybody is going to be arguably a little wrong most of the time. 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% "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 taxpayers 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 transitional countries 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. Even after a decade of change some were reluctant to recognize 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. One cannot solve a problem that one does not admit exists.

From an administrative point of view, most taxes collected in developing and transitional countries come from a relatively few tax collecting agents, i.e. customs administration (VAT and excises on imports, import surcharges, and tariffs), 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% 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.

TINs are needed to extend the reach of the tax system 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 behaviour of such taxpayers. Once this is done, attention can be turned to the TIN problem. Even then, however, there is no need for everybody and everything to be numbered. Bringing in potential new taxpayers is of course easier 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.

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 over-ambitious. Clearly, tax administration would be easier if such a system existed. But a new national identification system was not strictly necessary. 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 at one time seemed to come up in every conversation about tax evasion in Poland, are 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. For similar reasons, tax laws change often, and provisions favouring narrow industry interest groups to achieve some very specific policy goal are common. 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%. 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 were inappropriate and undesirable, whether viewed from the perspective of state revenues or enterprise development.

Substantial and frequent changes in tax rules, including discretionary changes to deal with the problems of particular enterprises cause many problems. Frequent changes in tax law are perhaps only to be expected in the circumstances of transition. Some 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 remain far from clear in many countries and hence 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 taxpayers. Neither legislators nor officials should have the latitude for discretionary interventionism that exists in many countries.

The development of the tax system and that of the private sector are mutually interdependent processes. The structure of the tax system must not only be adapted to the new reality of economic activity but this new structure must also be stabilized and made transparent if its full benefits are to be realized. Both tax officials and taxpayers must be able to know with a high degree of certainty what the law is and how it will be applied. Some developing and transitional countries still have some distance to go down this road; others have barely started the journey.

5.3. Reforming tax administration

As noted earlier, the basic tasks of tax administration consist of three distinct (though connected) activities, i.e. 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 some 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 2., these tasks are indeed important, and this emphasis is understandable in a country undergoing rapid transition, but no modern tax system can function on fear alone. Problems of tax enforcement cannot be simply solved 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.

The job of establishing an environment in which citizens are induced to comply with tax laws voluntarily is particu-

larly difficult in developing and transitional countries which 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 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 developing and transitional countries.

A final aspect of tax administration that deserves more attention concerns taxpayer services. Studies on taxpayer behaviour 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 emphasize reducing taxpayer 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 people uncertain as to just what the law is. In addition, taxpayer 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.

5.4. Conclusion

In words echoing some of the points made earlier, Wallschutzsky⁵¹ some years ago 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 clichés to some extent. But they are nonetheless both clearly applicable to

51. I. Wallschutzsky, "Achieving Compliance in Developing Countries", 45 *Bulletin for International Fiscal Documentation* (1989), at 234.

the case of tax reform in most transitional and developing countries and have, equally clearly, sometimes been honoured much more in the breach than the observance.

Leif Muten 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".⁵² Administrative constraints make this equally true in many developing countries. At the very least, it will often take years before such countries 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 sys-

tem 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 more generally, it should come as no surprise that more development is needed in both the same areas.

52. Lief Muten, "Income Tax Reform", in Vito Tanzi, ed., *Fiscal Policies in Economies in Transition* (Washington: International Monetary Fund, 1992), at 187.