The Reform of Tax Administration

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The subject of tax administration is extremely important both to those concerned with the key role increased tax yields can play in restoring macroeconomic balance and to those concerned with tax policy and its effects on the economy in general. As Tanzi (1987) has pointed out, tax administration plays a crucial role in determining the real (or effective) tax system, as opposed to the statutory tax system. Indeed, there is a growing conviction among tax policy specialists in developing countries that “policy change without administrative change is nothing” (Bird (1991, p. 39)) and that it is critical to ensure that “changes in tax policy are compatible with administrative capacity” (World Bank (1991, p. 51)). In a very real sense, “tax administration is tax policy” in developing countries (Casanegra de Jantscher (1990, p. 179)).

The “best” tax administration is not simply one that collects the most revenue. How that revenue is raised—that is, the effect of the revenue-generation effort on equity, on the political fortunes of governments, and on the level of economic welfare—may be equally important. A poor-quality tax administration may collect large amounts from easy-to-tax sectors such as wage earners, while being unable to enforce taxes on business enterprises and professionals. The level of collection is therefore a somewhat unsophisticated measure of the effectiveness of tax administration. A more accurate measure is the size of the “compliance gap”—that is, the gap between actual and potential tax revenues—and how that gap varies among the different sectors of the tax-paying population.

Over the last three decades the governments of many Latin American and Caribbean countries, as well as those of the Iberian peninsula, have made considerable efforts to improve the effectiveness of their tax administrations. These efforts frequently took place under unfavorable macroeconomic circumstances. Tax administrators often had to cope with a barrage of tax reforms, interspersed with numerous ad hoc

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changes in tax rates, exemptions, and payment periods introduced largely for revenue reasons. As discussed in Casanegra de Jantscher, Coelho, and Fernandez (Chapter 7 in this volume), bouts of high inflation further complicated tax administration in a number of countries, both because of the adjustments needed to offset the impact of inflation and because of the negative effects inflation has on tax compliance.

In spite of these difficulties, several member countries of the Centro Interamericano de Administradores Tributarios (CIAT)¹ considerably improved the quality of their tax administration, particularly in the 1980s. In broad terms, the 1960s were a decade of hope, when some thought that the introduction of the then new computer technology would solve the problems of tax administration. In contrast, the 1970s were for many countries a decade of frustration, as it became increasingly clear that technology alone could not do the job. Finally, the 1980s—in so many ways a lost decade for a Latin America burdened with external indebtedness and characterized by macroeconomic instability—turned out to be a decade of achievement for the reform of tax administration. In South America, particularly solid achievements were recorded in Bolivia, Chile, Colombia, and Uruguay. Portugal and Spain also made considerable progress during the 1980s. Such successes show that under the right conditions, the efficiency of tax administration can be increased significantly in a relatively short time. Moreover, as these countries have demonstrated, when administration is improved, revenues can be maintained and even increased while at the same time reducing excessively high tax rates and diminishing inequities through more adequate enforcement of taxes across different taxpaying groups (Silvani (1991)).

The progress made during the 1980s in these countries provides an encouraging example to other countries that are now undertaking major tax administration reforms. For example, Argentina, having reformed its tax structure significantly, has turned to overhauling its tax administration, with initially high returns in the form of increased tax collections.² Peru is also engaged in major reforms of both its tax structure and its tax administration. Important structural changes in administration are taking place in Mexico, El Salvador, Jamaica, Paraguay, and

¹The headquarters of CIAT—the Inter-American Center of Tax Administrators—is in Panama. Its members include Latin American and Caribbean countries, as well as the United States, Canada, Spain, and a number of other nonregional countries.

²In Argentina the ratio of tax to GDP rose from 13 percent in 1989 to 20 percent in 1990, with at least one third of this increase being attributable to improved administration, particularly of the value-added tax (VAT). (The remainder is attributable to broadening the tax base and the beneficial effect on collections of the marked decline in the rate of inflation over this period.)
Venezuela are all planning to introduce a VAT and to implement major tax administration reforms. Brazil is also studying the possibility of undertaking reforms in its federal tax administration.

This book discusses which solutions have worked and which have not worked in the field of tax administration reform. Why have some countries been successful in their efforts to improve their tax administration and others have not? The five chapters in Part I of the book outline and assess in detail recent major administrative and policy changes in Bolivia, Colombia, Guatemala, Jamaica, Spain, Trinidad and Tobago, and Uruguay. Part II of the book then considers specific aspects of tax administration reform, drawing both on these country case studies and on the experiences of other countries such as Argentina, Chile, Mexico, and the United States. The commentators on each chapter also draw on experiences in each of these countries, as well as in Brazil, Costa Rica, Peru, Venezuela and, indeed, in most other countries of the Latin American and Caribbean region and in a wide variety of other developing and developed countries.

I. Lessons from Experience

One of the most important lessons emerging from the experiences set out in this book is that, as a rule, an essential precondition for the reform of tax administration is the simplification of the tax system to ensure that it can be applied effectively in the generally "low-compliance" contexts of developing countries. The experience of Bolivia, which introduced a major simplification of its tax system in 1986, is instructive in this respect. As Silvani and Radano (Chapter 2 in this volume) show, much of the success achieved in reforming the tax administration in Bolivia can be attributed clearly to the extensive simplifications made in the tax system. Indeed, as Bahl and Martinez-Vazquez (Chapter 3 in this volume) argue in the case of Jamaica, it seldom makes sense to try to reform tax administration without simultaneously reforming the tax structure so that it is both sensible and easy to administer. Of course, as experience in both Chile (Harberger (1989)) and Colombia (McLure and Pardo (Chapter 4 in this volume)) demonstrates, it is possible to improve administration with less drastic but nonetheless effective simplifications in tax policy. The reduction in the number of income tax deductions, for instance, permitted these countries to eliminate filing requirements for most wage earners, thus greatly reducing the administrative burden since withholding alone then sufficed to enable most income tax payers to fulfill their obligations.
Another important lesson suggested by experience is the need for a strategy for the successful reform of tax administration. “Strategy” in this context simply means a comprehensive plan that assigns clear priorities to the tasks that must be performed, tailored to the available resources. As the case studies show, no single strategy is appropriate for all countries and under all circumstances. In Bolivia, for example, where huge macroeconomic imbalances had practically destroyed the tax system and its administration, shock treatment was called for. In other countries, such as Colombia and Uruguay, a more gradual approach to reform has been successful. In still other countries, such as Trinidad and Tobago (Due and Greaney (Chapter 5 in this volume)), the introduction of a major new tax—generally the VAT—has required meticulous planning and implementation in order to ensure success.

The third ingredient for successful reform of tax administration is a strong commitment to reform at both the policymaking and managerial levels, as well as a certain degree of technical competence. The best reform strategy applied to the most simplified system will fail if there is a lack of political will to implement it. While some crucial initial technical support can sometimes be obtained from foreign experts, a critical core of local expertise is needed to take full advantage of such assistance. Even more important is the presence of a managerial team fully committed to taking the steps necessary to improve the quality of tax administration, with the full political support of the highest authorities. Without such commitment and support, even the best-designed reform efforts will not be successful in the end.

Successful tax administration reforms thus have these three main ingredients in common—simplification, strategy, and commitment. There is, however, no single set of prescriptions—no secret recipe—that, once introduced, will ensure improved tax administration in any country. Developing countries exhibit a wide variety of tax compliance levels, reflecting not only the effectiveness of their tax administrations but also taxpayer attitudes toward taxation and toward government in general as well as many other factors. Attitudes affect intentions and

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3For another example of a country in which similar shocks eventually induced major changes, see the discussion of Argentina in World Bank (1990) and Bird (1992).

4The case of Uruguay is discussed in Silvani and Radano (Chapter 2 in this volume) and Harberger (1989); the Colombian case is discussed in McLure and Pardo (Chapter 4 in this volume) and Bird (1992).

5The planning and strategy required to introduce a VAT successfully is discussed further in Casanegra de Jantscher (1990) and Tait (1988, 1991).
intentions affect behavior. Attitudes are formed in a social context by such factors as the perceived level of evasion, the perceived fairness of the tax structure, its complexity and stability, how it is administered, the value attached to government activities, and the legitimacy of government. Government policies affecting any of these factors may thus influence taxpayer attitudes and hence the observed level of taxpayer compliance. Measures sometimes recommended for countries with low compliance levels—for example, massive application of such administrative penalties as temporary closures of businesses that fail to issue VAT receipts—may be inappropriate for countries with higher compliance levels, in which a targeted application of stricter penalties may be more effective in enhancing voluntary compliance.

Finally, it should be emphasized that "gimmicks" or "quick fixes" are not of much use in resolving tax administration problems. Some such approaches—for example, lotteries in which tax invoices constitute lottery numbers and tax amnesties—have long (and properly) been derided by experienced tax administrators as being costly and of dubious effectiveness (Goode (1981); Casanegra de Jantscher (1990)). Even the more appropriate approach of 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—is not without dangers. Although undeniably useful in immediately strengthening collections, such widespread withholding does not obviate the need to strengthen the tax administration itself. The tax administration must, for example, 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 as taxes withheld have
in fact been withheld. As the earlier Colombian experience (see McLure and Pardo (Chapter 4 in this volume)) suggests, although withholding constitutes an important element in a successful income tax, withholding alone will be insufficient unless the administration is able to control both withholders and taxpayers subject to withholding.

II. Paths to Reform

Reform strategies vary from country to country, but one constraint is usually common: the scarcity of resources for tax administration. Despite the high potential payoff 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. Since tax administrators are civil servants, they are subject to all the constraints affecting civil services in developing countries. Reform strategies that require substantial additional administrative resources—particularly staff—are hence usually doomed to failure, because the resources needed are unlikely to materialize fully or in a timely fashion. Successful administrative reform strategies 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 such as processing the returns of wage earners and devoting the resources thus freed to more productive work, as in Chile and Colombia. Other examples of more productive ways to use existing resources are set out in Schlemenson (Chapter 10 in this volume) and Silvani (Chapter 8 in this volume). 10

An interesting example of internal reorganization that has been successful in some countries (for instance, Uruguay) in recent years has been the creation of special units to monitor the compliance of large taxpayers with filing and payment requirements. Since it is not uncommon for as much as 60 percent or 70 percent of collections to come from the top 1 percent of taxpayers (that is, a few hundred or at most a few thousand firms, with the number depending largely on the size of the country), it is critically important to ensure that these taxpayers file and pay on time. 11

In addition, in some instances it may make sense also first to introduce, for example, modern techniques of information management in

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10See also the classic, and still largely valid, recommendations in Surrey (1958), as well as many of the papers in Joint Tax Program (1965).
11See, for example, Casanegra de Jantscher and Silvani (1990).
such special “large taxpayer” units, which are usually well managed and relatively efficient to, as it were, work out the bugs before extending such procedures to taxpayers more generally. On the other hand, it is important not to use the existence, and success, of such units as an excuse for neglecting other taxpayers. For instance, if auditing resources are unduly concentrated on large taxpayers, compliance levels among small and medium-sized firms may actually decline, with the result that total revenue from all taxpayers may be lower.

12 Some countries have introduced measures designed to “privatize” certain tax administration activities traditionally performed by government (Ramirez Acuña (Chapter 11 in this volume)). Countries such as Bolivia, Brazil, Chile, Colombia, Ecuador, and Uruguay have assigned a major role to banks in tax collection. This decision has generally been taken both because of insufficient resources in the tax administration and because these countries recognize that banks are already specialized in the handling and control of payments. Here again, however, the mere fact that banks are entrusted with the tasks of receiving payments, returns or even, in some countries, processing returns, does not assure success. For the collection function to work well, proper systems must be designed, the tax department must exercise adequate supervision, and the remuneration paid to the banks must be appropriate. 13 Much time and effort has been spent on these matters in those countries in which collection through the banking system operates successfully.

As emphasized earlier, simplicity is an important element in any successful administrative reform. The administration must be provided with simpler and, hence, potentially enforceable laws to administer. In addition, it is equally important to simplify procedures, 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

12 A quite different example of the application of special rules to particular groups is the use of presumptive techniques of assessment to reach such hard-to-tax groups as the self-employed (Bird (1983); Tanzi and Casanegra de Jantscher (1987)). Such techniques may, if carefully developed and applied, be useful in extending the reach of the tax system into the less formally organized sector of the economy and indeed may be essential in many countries if widespread application of direct taxes is desired. A good presumptive system, however, is one that does not remain a permanent part of the tax system but rather withers away over time as taxpayers “graduate” to the normal tax system.

13 There is considerable divergence in how banks are paid for their services. In Bolivia, for example, banks are allowed to keep 0.8 percent of the revenues they collect; in Mexico, in contrast, they are paid a fixed amount for each tax return processed. As noted below, this is one of a number of areas where further research in “tax technology” (Bird (1991)) seems necessary.
tasks: facilitating compliance, monitoring compliance, and dealing with noncompliance.

Facilitating compliance involves such elements as improving services to taxpayers by providing them clear instructions, understandable forms, and assistance and information as necessary (LeBaube and Vehorn (Chapter 9 in this volume)). Monitoring compliance requires establishing and maintaining current accounts of taxpayers and management information systems covering both ultimate taxpayers and third-party agents, such as banks, involved in the tax system (Vázquez-Caro, Reid, and Bird (1992)), as well as appropriate and prompt procedures to detect and follow up on nonfilers and delayed payments. Deterring noncompliance requires both establishing a reasonable risk of detection and applying penalties effectively (Silvani (Chapter 8 in this volume)).

The ideal approach is to combine these measures so as to maximize their effect on compliance—as it were, to move a country from a “low-compliance” to a “high-compliance” environment. For example, when introducing a VAT or other new tax, emphasis should first be given to assisting taxpayers to comply with the new tax—see, for example, the Trinidad and Tobago case discussed by Due and Greaney (Chapter 5 in this volume)—then to detecting noncompliance, and finally to applying penalties. As a rule, successful reform strategies require an appropriate mix of all these approaches.

The taxpayer’s decision to comply, or not to comply, with his fiscal obligations is of course the subject of the large formal theoretical literature on the economics of tax evasion (Cowell (1990)). While some progress has been made both in incorporating the “strategic” aspects of the evasion decision in a game-theoretic framework and in modeling it in principal-agent terms, much remains to be done before the results of such analysis are likely to have much to say about the real world “game” in developing countries. For example, apart from a pioneering paper by Virmani (1987), virtually the entire economic literature on tax evasion assumes that tax officials are completely honest. If not all officials are honest (and in the expected utility framework used in most of the theoretical literature it is not clear why they should be expected to be), the game is very different than that usually modeled. “Leakage costs,” as Shaw (1981) calls that portion of tax revenues that flows into the pockets of officials rather than into the coffers of government, may simply be transfers in economic terms but they may nonetheless

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14 Of course, it is also important to ensure that judicial procedures and institutions are such as to facilitate the proper application of tax laws and penalties.

15 See Graetz, Reinganum, and Wilde (1986) and Reinganum and Wilde (1985).
result in significant distortions as new taxes are introduced and tax rates are increased in attempting to make up for the revenue loss.

In addition to this serious gap in the existing formal analysis, the literature has not as yet managed to model very well either the long-term, repetitive nature of the tax game or the role of "norms" in determining how people play the game. Consideration of the temporal dimension of tax administration stresses the importance both of the interaction of officials and taxpayers and of changes in "tax technology" and taxpayer attitudes to government.\(^\text{16}\) This dimension is especially important in the context of the present book since 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 (such as computerization), and changing the allocation of administrative resources.

Finally, in recent years virtually all attempts to reform tax administration have centered around some form of computerization. Certainly, it is difficult to conceive of a tax administration that can perform its tasks efficiently without using some form of computer technology. In too many instances, however, the expectation of greater effectiveness from computerization has not materialized. Evidence indicates that the more successful reforms did not merely involve computerizing antiquated processes but also the redesign and streamlining of systems and procedures—such as consolidating return and payment forms and eliminating unnecessary and unused information required from taxpayers. As Corfmat (1985) emphasizes and the study of Spain by Moya and Santiago (Chapter 6 in this volume) shows, successful computerization must be accompanied by a fundamental reorganization of both systems and procedures and cannot be used by itself to side-step such needed reforms.

\section*{III. Agenda for Further Research}

As mentioned above, in recent years there has been considerable research on the theory and, to a limited extent, the facts with respect to tax evasion and tax compliance. Because of such work, much has been learned about taxpayers: why and when they comply and do not comply, what effects various penalties and inducements have on their

\(^{16}\)See, for example, the historical discussion in Webber and Wildavsky (1986), the "predator-prey" analogy in Boyd (1986), and the "Darwinian" analogy in Mayshar (1991).
behavior, and so on (Elffers (1991)). Sociologists, psychologists, economists, and administrators have all contributed to this literature and are likely to continue to do so given the theoretical attractiveness and practical importance of the subject. Unfortunately, interesting and to some extent useful as this work has been, much of it has proved to be of only limited direct relevance to the on-going task of tax administration in developing countries.

One reason for this lack of relevance is the very different environment of tax administration in developing countries than in the developed countries in which this research has been carried out. Another important reason, however, is that there have been almost no studies in any country of tax officials, of why and how they do what they do. Tax administration can be thought of as encompassing both mass (routine) and individual (discretionary) tasks. The former includes functions carried out across a wide range of transactions such as withholding, the maintenance of taxpayer current accounts, and collection; the latter includes audit, investigation of suspected fraud, and so on. As Slemrod (1989) has pointed out, even in developed countries the most neglected aspect of tax analysis is how tax officials act: What are the decision rules they use? What is the evidence on which such rules are based? What is the reliability and validity of such rules? Almost nothing is known about such matters in any country. Governments in some developing countries have little day-to-day control over tax officials, little knowledge of what they do, and, furthermore, no easy way to obtain such knowledge. For centuries, governments in the now developed countries had to spend almost as much time and effort trying to control the peculations and extortions of revenue officials as trying to squeeze more revenue out of an unwilling populace (Webber and Wildavsky (1986)). The circumstances in some developing countries today are not all that different: the need to keep tight control over the handling of cash and to monitor closely the gathering and use of information by tax officials is thus a high-priority task.

As shown in some of the cases discussed in this book, the accountability of officials can be improved both by separating various functions (for example, using controllable third parties such as banks and withholding

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17 For a good example, see Hessing and others (1990) who report that Dutch tax officials examine all income tax returns and select some for further investigation, but that there appear to be no formal selection criteria employed and no system of monitoring and evaluating the performance of different officials except the subjective judgment of their superiors. Such a system may work satisfactorily in the circumstances of the Netherlands. When transplanted to Indonesia, this system left much to be desired, as Gillis (1990) notes.
agents, which facilitates checking and verification) and by instituting systematic internal consistency and security checks (for example, maintaining tight internal security on computerized data bases) to ensure that no improper activities occur in these routine tasks. While much remains to be done along these lines in some countries, what needs to be done is not a mystery. The problem of ensuring accountability is much more difficult, however, with respect to such inevitably selective and discretionary tasks as audit. While there is much still to be learned about this subject, there appears to be no substitute for establishing a group of well-trained and adequately compensated officials, whose work is subject to regular monitoring and review.

Too often when the director of taxes in a developing country is asked for data, it transpires that the only number readily available is the amount of money collected yesterday, last week, or last month. Of course, collection data are highly important, but they are not enough. To run a good tax administration, one must know where the money came from and what the costs and benefits of various possible changes in legal framework and institutional infrastructure might be.

In the absence of such knowledge, it is difficult to develop an appropriate strategy for the reform of tax administration. The key information missing in most countries includes (1) a detailed breakdown of the uses of administrative resources; (2) information on the results of such uses with respect to the various outputs—revenues, numbers of cases handled, and so on—of interest; and (3) information on tax bases, both actual and potential. The first two of these items are needed for a good management information system in any case; the third is needed both for sound tax policy and sound tax administration policy. As tax administrations throughout the world move into the twenty-first century with computerized data bases, more and more information will be generated. To ensure that this information is both usable and is actually used, however, it is critical that it be both timely and reliable and that both operating administrators and researchers be closely involved in the development of tax management information systems. Computerized information is too important to both tax administration and tax policy to be left to computer specialists alone!

Although, as this book demonstrates, knowledge is gradually being acquired in many countries on many important matters related to the reform of tax administration and tax policy, much remains to be done to systematize and evaluate this knowledge. Some of the topics on which more systematic research seems needed are listed below.

- The measurement of tax "gaps" (between potential and declared taxes, between declared taxes and taxes paid, and between taxes paid and those that reach the treasury).
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- The real resource costs (administrative, compliance, efficiency, evasion) of alternative tax structures and administrative procedures.
- The relative effects of penalties, information systems (reporting), simplicity (of laws), and publicity on compliance.
- The use of presumptive techniques to tax "hard-to-tax" sectors.
- The efficiency with which audit resources are allocated, and possible analytical bases for the administrative rules of thumb and decision rules used to select returns for examination.
- The pros and cons of the "large taxpayer" approach discussed earlier.
- The appropriate compensation system for third-party collection agents (for example, banks).
- The costs and benefits of tax amnesties (see, for example, Stella (1989)).
- The administrative implications of rate differentiation and exemptions (for example, in a VAT; see Tait (1991)).
- The incidence and allocative effects of judicial appeal procedures.
- Possible systems for linking administrative rewards to administrative effort.
- The costs and benefits of alternative refunding procedures.
- The costs and benefits of different degrees of administrative decentralization.
- The role of specialist tax preparers (for example, accountants) in developing countries.

With respect to these and many other possible topics, different results may be expected in different countries for various reasons. For example, different macroeconomic environments (inflation); differences in market structures, risk and time preferences, social welfare functions, information costs and availability, and reaction functions; and different "environments" with respect to relations with government, the nature of government expenditure, "morale," and so on. While many of these terms are rather nebulous and subject to varying interpretations, one cannot form adequate judgments on the many policy issues explicit and implicit in the preceding list without much more careful and systematic analysis than is now available of the relation between such different contexts and the questions raised in the list.

IV. Conclusion

Thus, while much remains to be learned about tax administration reform in developing countries, as this book shows, a great deal is

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already known about the subject and much has been achieved in practice in a number of countries to improve their tax administration. As noted earlier, more could be done to improve tax administration if more people, in both the tax administration and research communities, were interested in it. In effect, the task is to find ways in which to codify the present "expert diagnosis" system of coping with tax administration reform by freeing it as much as possible from the country-specific and time-specific biases we all have. The task is not easy; but it is important, and worthy of much more effort and resources than have so far been devoted to it. Moreover, since governments and taxes seem more likely to grow in importance in most developing countries in the future than to shrink, the problem is not going to go away. The problems are there; the methods and the information needed to tackle them are in their formative stages; what needs to be done is to seize the opportunity to make a more systematic inroad into this important area.

The experiences discussed in this book provide useful lessons regarding tax administration reform. While there is no consensus on a number of issues, it is fair to conclude that most authors and commentators agree that three main ingredients are necessary for a successful tax administration reform in developing countries. First, the tax structure usually needs to be simplified for ease of compliance and administration. Second, a reform strategy suitable to the specific circumstances of each country must be developed; gimmicks or quick fixes are no substitute for a comprehensive strategy. Finally, and above all, there must be a strong political commitment to the improvement of tax administration; otherwise, even the best intentioned and best designed efforts will fail.

REFERENCES


