12 Organization of the VAT Administration

The next few chapters more systemically address several major issues in administration of the VAT. They focus on areas where the need for strengthened performance has been identified. There are, of course, other areas, such as taxpayer registration and education, and enforcement of arrears, in which there has been important success and hence there is confidence in the basic reform strategy.

The methodology of the analysis of tax administration differs from that of the tax policy issues. Absent a significant academic literature against which to assess the issues that arise, the tax administration analysis draws especially heavily on the discussions that have taken place between national authorities and IMF staff on tax administration issues. These discussions have attempted to strike a balance between the general principles governing sound tax administration and recognizing the importance of country specific circumstances. Individual chapters assess a number of issues that have emerged in recent years as a result of these discussions, and in doing so drew heavily on the survey results summarized in Chapter 6.

The first such general issue is the organization of the tax administration.

Background

In many countries, the introduction of VAT has been seen to afford an opportunity to improve substantially the general tax administration through the introduction of more effective procedures, which can be extended to the entire tax system. On occasion, however, the introduction of the VAT has actually disrupted the existing administration because of inadequate preparations, including difficulties in establishing a proper VAT organization. For example, in Ghana, where the VAT was repealed in June 1995 three months after its introduction, a *third* Board of Revenue was established for the VAT, in addition to those for the internal revenue service and the customs service; in Kenya and Uganda, where VAT departments were established, the lack of coordination of the revenue services has prevented an extension of modern procedures, developed initially for the VAT, to other taxes.

Clearly, decisions regarding the organization of the tax administration are central to the effective operations of the VAT and to the modernization of the entire tax system.

Domestic Tax Organization: Customs or Separate Agency?

The principle that is followed in virtually all countries is that actual collection of taxes on imports, including VAT, is the responsibility of the customs department.[118] It would make little sense to require the taxpayer, in this case the importer, to prepare different forms (that is, imports declaration and tax returns) for the same goods and to visit different offices to present essentially the same information to two different organizations. The issue is, therefore, who should run the domestic VAT, including accounting for crediting tax paid on imports. The three possibilities are administration by:

- the customs department;
- a separate VAT department; or
- the department responsible for domestic tax operations, particularly personal and corporate income taxes.

The VAT is administered by the domestic tax administration in the majority of the surveyed countries (29 out of 36), reflecting the uncontroversial decision of the authorities to administer the VAT in the same domestic tax department as the previous sales or turnover taxes. In these cases, discussions focused on the respective merits of establishing separate VAT offices or administering the VAT, with the income tax, in function-based offices (that is, tax offices primarily organized around functions (registration, taxpayer education, collection, audit, etc.) instead of being specialized by tax). Although many opted for function-based offices, some introduced the VAT in separate offices (for example, Albania, Bulgaria, and Sri Lanka). This latter approach can be supported as a means for facilitating the administration of the VAT during the first years of its implementation. In most cases, however, a major drawback has been the difficulty of merging VAT and income tax offices in the following years.

[118]In a few cases, FAD successfully advised against assigning these collections to the internal revenue department during the preparations for the VAT.

In the other countries (mainly those with a tradition of administering indirect taxes in the customs department), FAD recommended that the VAT be administered either in the customs department or in a new VAT department. Specific recommendations sought to accommodate local circumstances:

- *Customs department:* in 1990, it was recommended that Pakistan administer the VAT in its customs department; however, in 1993, given subsequent weaknesses in customs' administration of the tax, FAD recommended that a separate department be established (which was done in 1996). The other cases where FAD advised using Customs are Belize and Malawi (neither included in the survey). In both countries, reflecting the absence of hard and fast rules, this recommendation was debated within FAD. For Belize, the reasons cited by the 1994 mission were the ready availability of office space and the expected VAT collection on imports (which, as noted below, is not a convincing argument). For Malawi, a FAD team in 1996 recognized that the VAT should be administered with the income tax in the long term. However, its recommendation to begin administering the VAT in the customs department was based on: (i) the presence of a strong United Kingdom assistance program at customs, (ii) the weakness of the income tax department, and (iii) the existence of a proposal to establish an autonomous tax and customs revenue agency in the medium term.
- *VAT department:* in other countries (Ghana, Mauritius, Tanzania, Uganda, Zambia, and Pakistan after 1993), FAD has recommended that a new VAT department should be set up to manage the VAT. It is now obvious, however, that the establishment of an additional revenue department has in most cases increased the coordination problems of the revenue agencies.

Looking beyond the survey results, the operation of the VAT by the domestic tax administration is the rule in a vast majority of countries (see Table 12.1). This outcome reflects the parallel trend in recent decades favoring function-based tax administrations over the traditional tax-based organizations. Out of 108 countries for which information was available, 90 countries have decided that the domestic tax department would administer the VAT; 4 decided that the VAT would be administered by the customs department[119] and 14 have established a special VAT department.[120]

[119]The United Kingdom, Israel, Malawi, and Belize (until that country repealed the VAT in April 1999).

[120]Cyprus, Dominican Republic, Jamaica, Ghana, Kenya, Luxembourg, Tanzania, Uganda, Zambia, Mauritius, China, Egypt, Pakistan (since 1996) and Belgium (prior to the creation in 1999 of a single administration for VAT, income, and other taxes).

Table 12.1. Examples of Organization for the VAT Administration

	VAT Administered by Domestic Tax Department	VAT Administered by Customs Department	VAT Administered by VAT Department
European Union	10	1	2
Other European countries	14		1
BRO[1]	15		
Latin America	18	1	3
Africa	18	1	5
Asia-Pacific	13		
Middle East	1	1	2
North America	1		
Total (108 countries)	90	4	14

Source: IMF staff compilation.
[1]Baltic states, Russia, and other states of the former Soviet Union.

There are variants within each of these models, depending on the degree of integration of the revenue departments:

- In most countries where the VAT is administered by the domestic tax administration, both VAT and income tax are usually handled in the same tax office at the local level. Indeed, many countries where the VAT was initially established in a separate office network have now merged their VAT and income tax operations in the same function-based offices.[121] However, in some countries (for example, Portugal) integration of direct and indirect tax administrations is limited to the headquarters level.
- Most countries where the VAT and income tax are administered in a function-based organization have maintained specific VAT programs in separate units. For example, all EU countries established special VAT registration and audit programs following the reform of the VAT on intra-European transactions in 1993. Special units are also usually required for processing VAT refunds and implementing VAT education programs.
- Conversely, in some of the countries where the VAT is administered by customs and those where a separate VAT department has been imple-

[121]In Europe, France merged the income tax and VAT offices in the early 1970s and Italy has also done so.

mented, some integration of income tax, VAT, and customs operations has typically emerged over time. For example, Canada's implementation of the VAT almost coincided with a move toward integration of the customs, excise, and income tax administrations in the early 1990s.[122] In Africa, countries such as Kenya, Malawi, Tanzania, Uganda, and Zambia have implemented revenue authorities controlled by a single board of directors.[123] So far, however, integration in these African cases has been limited to personnel policies and budget control, with only modest progress toward integration of their operations.[124]

Administration of the VAT by the Customs Department

The most often cited example of VAT administration by a customs department is that of the United Kingdom H.M. Customs and Excise. Historical accident is the main reason for this.[125] Beyond historical accident, two main factors could justify the allocation of VAT administration to Customs. The first is the significance of VAT collected on imports for total VAT revenue (which, as discussed in Chapter 4, frequently amounts to between 40 to 60 percent of total VAT collections in developing countries and transition economies). The second is the experience of customs officials with physical control of goods and issues such as the classification and valuation of goods.

However, these factors are of less relevance in a modern tax system. As an economy grows, the share of VAT associated with the domestic formal economy will typically increase. More important, the new challenges faced by a VAT administration have little to do with the collection of VAT on imports (which does not require skills different from those of collecting customs duties). These challenges include establishing new registration and education systems, controlling the credit mechanism, processing refunds, and developing

[122]The Canadian Taxation Department and the Customs and Excise Department were merged in a single department reporting to a deputy minister in 1994. However, while VAT and income tax headquarters and field offices have been successfully merged, there are still separate headquarters and field offices for the customs administration.

[123]Others, such as Mauritius and Rwanda, have also taken steps to establish revenue authorities.

[124]The most noticeable steps taken in this direction are in Uganda, which recently established a large taxpayer unit, in which VAT, excises, and income tax operations are fully integrated, and in Ghana, where a single taxpayer identification number was introduced.

[125]As explained by Tait (1988), "the United Kingdom case is unusual. The customs administration was assigned responsibility for the operations of the purchase tax that was introduced during World War II, when the tax administration was overburdened and when the Customs was less busy than usual. Because of this accident of timing, the Customs gained in experience in dealing with the purchase tax, and when the time came to introduce the VAT, this experience was a deciding factor in allocating responsibility for VAT administration."

new audit programs, all areas in which domestic tax administrations usually have an advantage.[126]

In addition, although experience in physical controls may be useful, effective VAT administration requires a broader range of skills to administer a self-assessed, accounts-based tax. These skills are usually found in the internal tax administration whose staff are trained in auditing financial transactions and accounting records. Indeed, in countries where the VAT was initially administered by the customs and excise department, experience has shown that customs and excise staff, whose skills focus on physical control, classification, and valuation of goods, are not best suited to the requirements of a VAT administration. The problem is that there is a tendency to administer the tax like an excise tax using complex forms (requiring unnecessary information on the quantities and types of goods produced, raw materials processed, raw materials and goods in inventory).

Administration of the VAT by a Separate Department

Most of the countries that had a tradition of administering excises and sales taxes in the customs department recognized that the VAT requires organization, procedures, and systems different from those in customs administrations. As a result, specific VAT departments were typically established in these countries. This provides the opportunity for a clean break with the potentially flawed procedures of existing revenue agencies. In theory, the recruitment of staff exclusively trained in the VAT should also provide the specialized expertise needed for an effective VAT administration. However, there are also shortcomings. These include:

- Establishing a separate administration in countries with scarce skills and training facilities can be difficult. For example, when Pakistan established its new VAT department, the recruitment of new staff from outside the administration proved difficult. Furthermore, many of the VAT officials, who were recruited from the customs administration and trained for the VAT, returned to their former administration in the months following their assignment to the new VAT department.
- Establishing a new administration is often resisted by the staff of existing revenue agencies. For example, in Ghana, where a new VAT administra-

[126]One advantage of an integrated VAT and customs administration is that it should facilitate exchanges of information on imports and exports, a requirement for effective processing of refunds. However, this is essentially an information technology issue—not an organizational one—that should be resolved by the implementation of appropriate computer systems using a single taxpayer identifier for both tax and customs administration purposes.

tion was created in 1995, a number of customs officers openly opposed the establishment of a new revenue service.

- The creation of a separate VAT department can also lead to fragmentation of the tax administration if there is no comprehensive strategy to promote coordination of the operations of the various revenue agencies. For example, in Ghana (in 1995, at the first introduction of the VAT there) and Uganda, where the VAT registration process was carried out by new VAT agencies, different taxpayer identification numbers were used for income tax, excise, and customs administration purposes, with an additional number being introduced with the implementation of the VAT. Moreover, there has been no cross-checking of information between the revenue departments since the introduction of the VAT in many of these countries. (The lack of coordination can reflect political realities. In one of the surveyed countries, an important reason for the resistance of traders to the VAT was the fear that reconciliation of purchase and turnover data by the VAT and the income tax departments would provide the income tax administration with additional information to assess their tax liabilities. Opposition to the VAT is sometimes really opposition to an effective income tax.) Indeed, despite the recommendations of FAD to promote close cooperation between the income tax, VAT, and customs administrations, there is little apparent appreciation among the staff of these administrations that cooperation is critical to successful enforcement programs.
- Separate VAT departments also increase tax administration costs due to duplication of resources (for example, duplication of taxpayer identification systems, office facilities, equipment, and computerization resources). For taxpayers, the need to carry out their tax obligations in separate offices, the possibility of being audited by different departments (which do not coordinate their enforcement programs), and risks of inconsistent treatment under the VAT or the income tax also contribute to complexity.

Administration of the VAT by the Domestic Tax Administration

As noted, this form of organization has been adopted by a vast majority of the countries where a VAT has been introduced over the past 20 years. It was the organization used by the French tax authorities when their VAT was introduced in the 1950s. Indeed, major steps in the transformation of the organization of the French tax administration coincided with the gradual introduction of the VAT in that country from 1948 to 1968 (Box 12.1).

Box. 12.1. Introduction of the VAT and Reform of the French Tax Administration

The different phases of the introduction of the VAT have coincided with three major steps in the reform of the French tax administration Direction Général des Impôts (DGI):

In 1948, the authorities introduced a sales tax with an invoice-based credit mechanism that applied at the manufacturing-import stages (the *taxe unique à paiements fractionnés*).	The DGI was established during the same year by merging the departments in charge of direct and indirect taxes.
In 1954, the authorities extended the coverage of that tax to the wholesale stage and replaced several indirect taxes. The new tax was called the VAT.	At the same time (1950–55), the DGI was gradually implementing new audit techniques, based on joint audits of the taxpayers' liabilities by specially trained auditors (*les vérificateurs polyvalents*). Also, in 1955, the DGI began experimenting with function-based tax offices (to replace the former tax-based offices).
In 1968, the authorities extended the VAT to the retail stage.	At the same time, the DGI began the implementation of a comprehensive plan of modernization of the tax offices. The objective was the reorganization of the tax offices based on both function-based and taxpayer-based principles (for example, the establishment of separate units to audit small, medium, and large taxpayers).

Administering the VAT in the department responsible for administering domestic taxes has several advantages:

- Integration of the revenue departments can underpin a more effective tax administration, in which a function-based organization can be implemented from the top (headquarters) to the bottom (field offices). Such an organization enhances efficiency and reduces compliance burdens. For example, a single registration system and a single accounting unit to process all returns and payments for all taxes will simplify taxpayers' obligations and reduce tax administration costs. Similarly, an integrated collection enforcement unit for all outstanding taxes helps improve effectiveness, as the same accounts are likely to be in arrears for several taxes.

- The self-assessment embodied in a VAT (discussed in the next chapter) requires close coordination between the VAT, income tax, and customs administrations, including automatic cross-checking of data (for example, on turnover, purchases, imports, and exports) and implementation of effective enforcement programs based on both physical and accounts-based controls.
- Integration can also facilitate a major improvement in income tax procedures and systems. For example, modern collection and enforcement procedures designed for the VAT should also be used for personal income tax and the corporate tax. In the same way, the registration thresholds under the VAT can assist the income tax administration by providing a basic approach to classify taxpayers (for example, simplified income tax systems can be used for taxpayers below the VAT threshold, while compliance work can be directed primarily toward those above the threshold to maximize income tax performance). Integrating the VAT and income tax administrations can also energize taxpayer education and income tax enforcement (both in dealing with noncompliance with filing and payment, and in pursuing underreporting of sales, use of fake invoices, as well as under or overpricing). Clearly, implementation of effective VAT enforcement and audit programs helps improve income tax compliance.

This list of advantages prompts one to ask why VATs administered under this model have sometimes been associated with weak performance. There are several reasons:

- The design of several of the VATs implemented in the 1970s and 1980s was too complex. Some of these, for example, were in Africa[127] and their VAT legislation included multiple rates (for example, four rates in Côte d'Ivoire and Senegal, five in Morocco). In most cases, there were no registration thresholds, and small taxpayers (with a turnover below a certain amount) paid VAT based on the *forfait* system, a complex presumptive tax ill-suited for countries with a limited administrative capacity. Moreover, VAT forms were unnecessarily complicated (four pages in certain countries). Thus, in

[127]For example, Côte d'Ivoire in 1960, Morocco and Niger in 1986, and Tunisia in 1988.

Table 12.2. Advantages and Drawbacks of the Different Models for VAT Administration

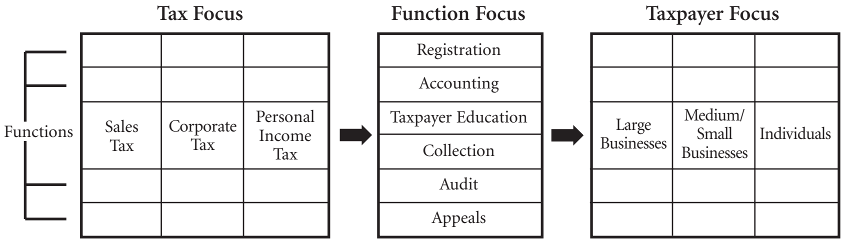
	Advantages	Drawbacks
VAT administered by the customs and excise department	Facilitates exchange of information on imports and exports	Customs and excise procedures and systems are not suitable for VAT administration Customs staff may not have appropriate skills Impedes coordination of VAT and income tax administration
VAT administered by a specific department	Allows a clean break with existing procedures when the VAT is implemented Helps focus on VAT administration	Establishing a new revenue department in a developing country with weak administrative capacity and scarce skills requires a strong political commitment Staff of the existing revenue departments often resist the establishment of a new department Increases the fragmentation of the tax administration and impedes coordination of the VAT, income tax, and customs operations Increases tax administration costs
VAT administered by the domestic tax administration	Provides for a more modern, effective (function-based), and efficient tax administration Facilitates coordination between VAT and income tax administration, and therefore supports better VAT and income tax compliance	Risks insufficient focus on the specifics of the VAT administration

Source: IMF staff compilation.

several countries, the advantages of a sound organization (VAT administered with the income tax in a function-based tax department) were offset by excessively complex legislation and weak procedures.[128]

[128]There has been a subsequent improvement in many of these countries—for example, Côte d'Ivoire and Senegal now have only two VAT rates, and all other WAEMU countries have a single VAT rate; moreover, businesses below the registration threshold are now exempted. In recent years, most of these countries have also embarked on reforms to improve their tax administration (including the establishment of large taxpayer units, simplified collection procedures, and more effective collection enforcement programs).

Figure 12.1 How the Structure of Tax Administrations Has Evolved



- Some countries, including France and Canada, have tended to neglect the need to maintain specific VAT systems in their move toward a fully integrated, function-based administration. For example, audit methods based only on joint audits of all tax liabilities do not provide for sufficient broad coverage of taxpayers for the VAT. These methods, which are sometimes excessively focused on income tax audits, are often too sophisticated for small and medium-sized taxpayers. Thus, tax administrations that have moved toward more integrated, function-based organization, do nevertheless need to maintain some tax-based components (mainly for VAT and, sometimes, excise administration purposes).

Table 12.2 summarizes the principal advantages and drawbacks of the alternative forms of organization.

Another major trend over the past ten years in the organization of the tax administration has been the development of compliance strategies based on a taxpayer-segment approach (for example, the establishment of special units to control large taxpayers, the implementation of audit units to deal respectively with small, medium-sized, and large taxpayers and the establishment of units to deal with specific industries such as financial services). In some countries (for example, Australia and the Netherlands) the taxpayer segment approach is now the primary criterion for the organization of the tax administration (see Figure 12.1).

Conclusions

Are some types of organization more effective than others in supporting the performance of the VAT and facilitating the modernization of the tax system? The discussion above shows that there is no definitive answer. Clearly, advice regarding the department where the VAT should be administered has varied over the past ten years, and there has been some uncertainty as to what is the most effective and efficient organization for administering the VAT in a few countries. However, discussions have clearly been sensitive to the existing institutional strengths and weaknesses in specific countries. Nonetheless, strong common trends have emerged in the FAD recommendations. In particular, FAD advice now recognizes that, whatever the organization model, the implementation of a VAT should be part of a comprehensive strategy to modernize the entire administration.

To elaborate on the details of the overall strategy as currently practiced:

- Whatever the type of organization adopted, there should be close coordination of VAT preparations with the income tax and customs departments.

- When the decision is to administer the VAT in the domestic tax administration, it is crucial that the basic systems be in place to support VAT operations—including modern registration systems, comprehensive taxpayer education programs, and appropriate collection enforcement procedures (to ensure that VAT defaulters are identified and treated promptly)—and, as needed, to develop specific VAT systems—including effective refund systems and audit programs.

- Where a special VAT department is established, the emphasis should be on strengthening the coordination of the income tax, VAT, and customs agencies:

  (i) In the near term, this involves, among others, a better coordination of the VAT, income tax, and customs operations at management levels, and the development of basic measures to coordinate VAT operations and those for other taxes (including a unique taxpayer identification number, exchanges of information to support enforcement, and programs of joint audits).

  (ii) In the near to medium term, large taxpayer units (LTUs) should be implemented for all taxes. In countries where a special VAT department has been established (such as Uganda), a major objective of the LTU is to support the merging of the income tax and VAT administrations in pilot offices as a first step toward the integration of the VAT and income tax administrations.

  (iii) In the longer term, after a function-based organization has been tested in the LTU, the objective should be to move toward an integrated tax administration organization beginning with the integration of income tax and VAT operations at the headquarters level, and, later at local office level (beginning with the most important centers).

However, it must be recognized that the coordination of different agencies' operations is frequently a source of frustration. In most of the surveyed countries, there are still different taxpayer identification numbers in use in each department, and the coordination of the different agencies is always extremely difficult. More generally, the experience of several of the surveyed countries shows that insufficient attention paid to tax administration organization and management issues may have undermined VAT performance. In addition to the examples mentioned above, this was the case in many CIS countries.

Building on this experience, FAD for its part has increased its emphasis in recent years on addressing specific tax administration issues with a clear preference being expressed for the VAT to be in the domestic tax administration. In all cases, the reform should be prepared by a team of full-time officials, including representatives from the income tax and customs departments. Depending on the tax administration's previous organization and history in administering a sales tax, the organization should then be as follows:

- In countries where there is a function-based, domestic tax department and a strong experience in administering the sales tax in this department, the VAT should be administered in function-based tax offices, in this department. In this case, however, appropriate attention must be paid to the development of special VAT systems for specific functions (especially refund and audit).
- In countries with no function-based organization or/and no experience in administering the sales tax in the domestic tax department, the VAT should be administered in separate offices, in this department. Attention should be paid to: (i) the need to closely coordinate income tax and VAT operations at both headquarters and tax office levels, and (ii) developing a medium- to long-term strategy to merge the VAT and income tax offices (for instance, beginning with the merging of VAT and income tax operations for large taxpayers in a pilot office).