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Designing a Tax Administration Reform Strategy: Experiences and Guidelines

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Abstract

Building on previous FAD work in the tax administration field, this paper defines broad criteria for diagnosing the problems in a country's tax administration and formulating an appropriate reform strategy. To be effective, this strategy should be based on the size of the tax gap and the country's particular circumstances. This paper discusses some guiding principles which have provided the basis for successful reforms, including: reducing the tax system's complexity, encouraging taxpayers' voluntary compliance, differentiating the treatment of taxpayers by their revenue potential, and ensuring the reform's effective management. Also discussed are specific bottlenecks that hinder the effectiveness of the tax administration's operations.

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SUMMARY

Tax administrators in developing and developed countries face the challenge of modernizing tax administration so it can operate effectively in an increasingly global economy characterized by difficult-to-tax sectors and by sophisticated computer and communications technology. Experience has shown that a reform strategy over the long-term is required to significantly increase the effectiveness of the tax administration's operations. Short-term measures to remedy tax evasion rarely bring about substantial improvements.

To design an appropriate tax administration reform strategy, the paper suggests that countries may be divided into four groups according to the tax administration's effectiveness, that is, the level of taxpayers' noncompliance or the "tax gap". As a rule, the larger the tax gap, the more radical are the changes needed. Countries with a smaller tax gap would need to adapt to changes in the tax system and the taxpayer population in order to maintain high compliance levels and lower the costs of collection and compliance.

Considering the size of a country's tax gap and the tax administration's particular circumstances, the paper discusses several guiding principles, based on country experiences, which have provided the basis for successful reforms. These include reducing the complexity of the tax system, encouraging taxpayers' voluntary compliance, differentiating the treatment of taxpayers by their revenue potential, and ensuring the effective management of the reform.

Crucial to designing a tax administration reform strategy is the identification of bottlenecks that hinder tax administration operations. The paper discusses bottlenecks in the following areas which have been observed while assisting IMF member countries: taxpayer registration, returns and payment processing, computer operations, stopfiler detection and arrears collection, delinquent taxpayers, audit, sanctions and penalties, taxpayer services and publicity, management and organization, and personnel.

I. INTRODUCTION

In many developing countries, tax administration reform has been part of a broader fiscal reform effort aimed at restoring macroeconomic stability and at restructuring tax systems so that taxes are more efficient, less distortionary of market forces, and easier to administer. In countries with economies in transition, the impetus to modernize tax administration has also come from the need to establish a tax administration that can respond to the demands of a growing market economy and the resulting increase in the number of taxpayers.² Tax administrators in both developing and developed countries also face the challenge of modernizing the tax administration so that it can operate effectively in an increasingly global economy characterized by the growth of difficult-to-tax sectors such as the financial and other services sectors and by the rapid expansion of sophisticated computer and communications technology which could be used by taxpayers to conceal economic transactions.

The purpose of this paper is to build on previous FAD work in the tax administration field³ and to reflect on experiences in assisting IMF member countries in designing and implementing tax administration reforms. Based on these experiences, broad criteria for diagnosing the major problems of a country's tax administration are defined, and guidelines are discussed for formulating an appropriate tax administration reform strategy. However, it should be noted that to design a specific strategy for a given country, the country's particular circumstances need to be taken into account.

As a first step in determining an appropriate tax administration reform strategy, it is suggested in this paper that countries may be divided into four major groups according to the tax administration's effectiveness, i.e., the level of taxpayers' non-compliance.⁴ As a rule, countries with a larger tax gap will need to consider more fundamental changes in tax administration. Countries with a smaller tax gap will need to keep up with changes in the tax system and the taxpayer population in order to maintain high compliance levels and lower the costs of collection and compliance.

Depending on the size of a country's tax gap and its specific tax administration problems, there are a few general guiding principles which have provided a sound basis for

² In this paper, the term "countries with *economies in transition*" refers primarily to the Eastern European and Baltic countries, Russia, the other countries of the former Soviet Union (FSU), China, Laos, Cambodia, Vietnam, and other countries with economies in transition.

³ See, for example, Bird and Casanegra de Jantscher, eds. (1992), Tanzi and Pellechio (1995), Tanzi and Shome (1993), and Mansfield (1987).

⁴ Effectiveness is frequently measured by the tax gap, which is the difference between the tax that should be paid according to the tax laws and regulations and the tax which is actually collected.

several successful reforms, and which may assist tax administrators in defining a tax administration reform strategy.⁵

As experience in several countries has shown, fundamental administrative reform is possible; the tax administration can be modernized and its effectiveness improved. The most obvious result of this is an increase in tax collection. Less visible, but equally important, are the economic efficiency gains obtained from reducing the tax gap and unfair competition resulting from an uneven tax burden among businesses. Improvements in tax administration, however, are never final, and reform efforts need to be continuously updated. Otherwise, gains in effectiveness can be easily reversed.

This paper is organized as follows: Section II discusses criteria for diagnosing existing problems and for selecting an appropriate tax administration reform strategy. Against this background, Section III presents an overview of ten guiding principles which have proven useful in defining the general framework for a tax administration reform strategy across a broad range of countries. Once the general framework for the tax administration's reform strategy has been defined, tax administrators must identify specific bottlenecks that impede the development of an effective tax administration. Section IV contains a discussion of frequently observed bottlenecks in major areas of tax administration.

II. DIAGNOSING EXISTING PROBLEMS AND SELECTING AN APPROPRIATE STRATEGY

One of the first steps that reformers need to take in initiating a tax administration reform is to diagnose existing problems and to develop an appropriate strategy. *The diagnosis is in itself an important exercise, as the reformers must identify the administration's key problems and define its key goals, as well as the options for achieving these goals.* Even in countries that already have an effective tax administration, in order to maintain a high level of effectiveness given constant changes in the economy, the tax system, and the taxpayer community, tax administrators need to review periodically the strategy that is being followed.⁶ Of course, the measures included in this strategy will depend on each tax administration's particular circumstances.

To design a strategy, it is important to have a clear idea of the tax administration's overall effectiveness. The size of a country's tax gap, despite the fact that it is only an indicative measure often based on estimated data and on sampling techniques, has come to be widely recognized as an important measure of the tax administration's effectiveness. The tax

⁵In addition to the tax gap, there are a number of different methods which have been discussed in the tax administration literature to evaluate and guide tax administration reforms. For an overview of the potential use of economic analysis in guiding and assessing tax administration reform, see Bagchi, Bird, and Das-Gupta (1995).

⁶For example, in 1992, the U.S. Internal Revenue Service (IRS) formulated the "Business Vision" plan. The plan set forth how the U.S. tax administration would operate in the future and analyzed the changes which would be needed in existing operations to achieve its future goals.

gap, which, as defined previously, is the difference between the taxes actually paid and the taxes which should be paid according to the existing laws and statutes, includes taxes not paid due to tax evasion, tax arrears (taxes declared but not paid), the shortfall in taxes due to taxpayers' misunderstanding of the tax laws, and any other form of non-compliance. While a precise measure of the tax gap is normally difficult to obtain due to the lack of accurate and up-to-date statistics needed to estimate the potential tax base, a general notion of the tax gap's order of magnitude and its trend is needed for tax administrators to determine the general strategy to follow.⁷ Usually, the larger the tax gap, the more radical the changes that need to be considered in the strategy. In what follows of this section, countries have been grouped into four broad categories according to the degree of tax administration effectiveness. Table 1 shows figures of taxpayer non-compliance for selected countries.

Table 1. Non-compliance in Selected Countries
(Ranked by Per Capita Income)

Country ⁸	Year	Tax	Non-Compliance Coefficient
Country 1	1992	VAT	35.4
Country 2	1990	VAT	43.9
Country 3	1992	VAT	40.8
Country 4	1992	VAT	52.5
Country 5	1991	Income Tax	25.0
Country 6	1991	VAT	38.2
Country 7	1991	VAT	35.8
Country 8	1992	Personal Income Tax	52.0
Country 9	1994	VAT	38.0
Country 10	1994	VAT	44.6
Country 11	1991	VAT	53.3
Country 12	1991	VAT	18.2
Country 13	1989	Corporate Income Tax	64.0
Country 14	1992/93	VAT	14.6
Country 15	1991	VAT	36.3
Country 16	1991	VAT	29.7
Country 17	1992	VAT	37.1
Country 18	1991	VAT	14.0
Country 19	1994	VAT	31.5
Country 20	1992	VAT	7.8
Country 21	1992/93	VAT	5.1
Country 22	1989	VAT	26.0
Country 23	1991	VAT	23.0
Country 24	1992	Income Tax	17.3
Country 25	1992	VAT	5.4

Sources: Bogetic and Hassan (1996); Medina (1990); Shome (1995); Silvani and Brondolo (1993); U.S. Internal Revenue Service (1988).

⁷Methodologies for estimating the VAT gap are described in Aguirre and Shome (1987) and Silvani and Brondolo (1993). A methodology for estimating the income tax gap is presented in "Tax Gap Briefing", U.S. Internal Revenue Service Research Division (1993).

⁸Country names have been omitted to preserve confidentiality.

One category of countries would include those administrations that are very effective and the tax gap is very low, in the range of 10 percent or lower. This category would include countries such as Denmark, New Zealand, and Singapore. In these cases it would be difficult to increase effectiveness significantly: there is a good system of self-assessment based on taxpayers' understanding of the tax system and their tax liabilities; systems and procedures in all areas of tax administration are well-defined and used effectively by trained personnel; the organization is well structured, managed, and financed; taxpayer services are available to a high proportion of the taxpaying population; sanctions are adequate and systematically applied; audit activities are properly planned and targeted; computer technology effectively supports the tax administration's operations and is continuously updated; and, tax administration staff are professional and held to a high standard of behavior. In these cases, the strategy would have as its main goals to maintain a high level of compliance while trying to increase efficiency by reducing the cost of collection and taxpayers' cost of compliance. The tax administration of countries in this and the second group (discussed below) will also need to continuously adjust their organization and procedures to meet the challenges posed by the growing number of taxpayers in the service sector, the globalization of trade and capital flows, and the revolution in computer and communications technology.

A second category would include countries where tax administration is relatively effective but the tax gap is in the 10 to 20 percent range and therefore there is room for improving their effectiveness. This category would include countries such as Canada, the United States, some Western European countries, and Chile. For countries in this category, the general approach to tax administration may be adequate and the attitude of the taxpaying population towards compliance positive. Nevertheless, the strategy should have as its goal to increase compliance levels by: (1) modifying the structure of the tax department to provide better taxpayer services and reduce operating costs; (2) redefining or introducing specific procedures to take advantage of new technology; (3) strengthening enforcement activities to control large, small, and unregistered taxpayers; (4) expanding the use of technology, for example, to permit an increase in the number of electronically filed returns; or (5) devoting more human and physical resources to tax administration to narrow the tax gap.⁹

A third category would include the vast majority of countries (including both developing and developed countries), which have relatively ineffective tax administrations and a tax gap in the range of 20 to 40 percent of the potential tax. In these countries improving the effectiveness of the tax administration should be a major concern, and the general approach to tax administration should be critically analyzed. Some of the tax administrations in this category have abundant material resources, relatively good systems and procedures, and qualified staff; yet paradoxically, a broad range of problems exist which prevent the tax administration from operating as effectively as it could. Such problems may include: weak management of the organization, inappropriate use of available technology, ineffective use of available information to control non-compliance, design of computer systems without taking

⁹For example, the U.S. Internal Revenue Service is very efficient because it spends only \$0.5 per \$100 collected; the question is whether increasing this cost may result in a significantly greater effectiveness.

into account the needs of the end-users, weak collection enforcement, poor coordination between the tax administration and other agencies involved in tax administration, unclear priorities (i.e., the arrears collection program does not target outstanding obligations by their amount, beginning with the largest), and the existence of corrupt practices. For countries in this category, the major objectives of the tax administration reform strategy should be to significantly improve the effectiveness of tax administration operations, to change the behavior of the average taxpayer, and to raise the compliance level of the general taxpayer population. To achieve this, major organizational, procedural and management reforms are required to be carried out by the tax administration. To address high noncompliance levels, programs with the broadest possible coverage of taxpayers are also needed.

Recent efforts undertaken by one country illustrate the kind of strategy which countries in this grouping may follow to address key tax administration problems. The tax administration's senior staff established a work plan to achieve a few strategic goals: (1) designing different systems to monitor taxpayers according to their size; (2) reducing the time span for the "amicable" collection of delinquent accounts; (3) speeding up the judicial collection of arrears by the Controller General's Office; (4) streamlining the appeals process; (5) increasing audit effectiveness; (6) simplifying and reducing the number of tax forms; (7) strengthening the tax administration's information systems operations; and (8) improving the accuracy of the taxpayer master file.

The fourth group consists of countries with a highly ineffective tax administration and a tax gap in the range of 40 percent or more of the potential tax. Among the major problems which may characterize tax administrations in this grouping are: (1) the lack of financial and material resources; (2) poorly qualified and trained staff; (3) extremely ineffective procedures; (4) failure to implement measures that will reduce non-compliance; (5) the absence of effective taxpayer services; (6) a high turnover of technical staff and management; and, (7) corrupt practices. In these countries, the strategy needs to be quite comprehensive and a complete revamping of the tax administration is called for. Thus, the design of a strategy needs to consider the phasing out of obsolete tax administration concepts and practices and the adoption of a completely new foundation.

A separate group of countries whose tax gaps vary considerably are the countries with economies in transition. These countries present specific problems that require specific solutions because their tax administration operations are not fully based on generally-accepted principles recognized by most tax administrations today, such as voluntary compliance, the self-assessment of tax obligations by taxpayers, and clearly defined rights and obligations of the tax authorities and the taxpayer.

China's recent tax administration reforms provide a good example of a strategy to implement a comprehensive reform in a transition economy. To guide the tax administration reform, the State Tax Bureau defined a number of strategic goals, which were: to achieve uniformity in applying tax laws; to establish a National Tax Service to collect central government taxes; to organize offices according to the basic functions of tax administration which include taxpayer information, accounting and data processing, collection enforcement, and taxpayer inspection; to expand self-assessment of liabilities and payment of taxes; to

improve taxpayer information programs; to encourage the establishment of non-governmental tax agents to assist taxpayers in fulfilling their tax obligations; to develop targeted audit programs; to provide significant computer support for tax administration operations; to designate the district and county level offices as the basic operational units where computerization efforts are principally focused; and, to adopt a step-by-step approach to tax administration reform using pilot projects to test the reform measures.

III. GUIDING PRINCIPLES IN DESIGNING A TAX ADMINISTRATION REFORM STRATEGY

Once the general diagnosis for a particular country has been made based on the criteria discussed in the previous section, tax administrators need to determine the tax administration reform strategy's main goals. Depending on the size of the tax gap, these goals could be primarily: (1) to maintain the existing compliance level while reducing the cost of compliance and of tax collection;¹⁰ (2) to obtain moderate gains in compliance by improving key procedures; (3) to obtain significant gains in compliance by considerably modifying the approach to tax administration; or, (4) to obtain significant gains in compliance by revamping the current tax administration procedures. The relative importance which should be given to each of these principles will depend on each country's particular circumstances and the main goals of the tax administration reform. Experience has shown that there are a number of guiding principles which can provide a sound basis for a successful reform. This section discusses ten guiding principles that will need to be considered in designing an overall reform strategy.

A. Political Commitment to and the Sustainability of the Reform are Crucial

To significantly improve the effectiveness of tax administration, the government must be politically committed to the reform. Explicit support of the tax administration reform effort and the tax administration's management from the country's top government officials is of fundamental importance to every tax administration reform. The government's political commitment should be visible to the public and expressed in various ways, for example, by ensuring the rapid approval of tax legislation and regulations, by the active support of proposed changes in tax administration by Ministry of Finance officials, and by public information and public relations campaigns informing taxpayers of the new procedures, as well as the consequences taxpayers are likely to face if they do not comply with the tax laws. Without this kind of political commitment and special programs to inform and garner support from the taxpaying public, the package of tax administration reform measures may not be politically sustainable and improvements in tax compliance will be unlikely. Successful implementation of changes in the tax structure and in systems and procedures also requires a committed management team. The management team in charge of the tax administration and of the tax reform should be headed by a highly motivated and trained group of professionals at

¹⁰See Jenkins and Forlemu (1993).

tax administration headquarters backed by the Government's strong political will to introduce change.¹¹

In addition, the reform measures must be politically sustainable. There are two aspects of this issue, one related to the political sustainability of the reform within the tax administration, and one to the reform's sustainability outside the tax department. In order for the tax administration reform project to be politically sustainable, the management and staff of the tax administration must be involved in the design and implementation of the reform project from the outset; that is, the tax administration must have "ownership" of the project. Tax administration reform projects which do not sufficiently reflect the concerns of the country's own tax administrators and which are "imposed" by outsiders will not succeed. The political sustainability of the tax administration reform measures may also depend on factors such as the public's perception of: the equity of the tax system, the productivity of public expenditure, and the impartiality with which tax laws are applied.¹²

B. Simplify the Tax System to Facilitate Administration and Reduce Compliance Costs

One of the most important lessons learned from experience, and which has been discussed at length in the tax policy and tax administration reform literature, is the importance of simplifying the tax system in order to enhance the effectiveness and efficiency of the tax administration.¹³ *That is, a tax system with few taxes, a limited number of rates for each tax, limited exemptions, and a broad base has proven, in the context of many developing countries, to be much easier to administer and to result in higher compliance levels than a complex tax system.*¹⁴ Complex and opaque laws also make it difficult for taxpayers to comply and raise compliance costs.

¹¹Tanzi (1996) has recently defined "political will" as "the awareness of the need for change and determination to bring it about." In addition, he points out that "In a pluralistic society, this political will clearly cannot be limited to the economic team or even to the executive branch of the government alone. It needs to be widely shared within the legislative and judicial branches and among 'opinion makers' in the society at large, including the media."

¹²See Asilis and Milesi-Ferretti (1994).

¹³This literature includes Bird, Richard (1990a); Mansfield (1987); Tait, Graetz, Eichengreen (1979); Tanzi (1981); Richard and Casanegra de Jantscher, eds. (1992).

¹⁴Many countries have introduced or are in the process of introducing fundamental tax policy and/or tax administration reforms aimed at simplifying the tax system and improving compliance levels during the 1980s and 1990s, including practically all the Latin American countries, many African countries (Benin, Chad, Côte d'Ivoire, Gabon, Guinea, Mali, Niger, Senegal, South Africa, Togo, Uganda), and Korea, the Philippines, and Indonesia, among others.

The tax administration should also be simple from the customer's (taxpayer's) point of view. Tax forms and procedures should be as simple as possible to encourage compliance. To help simplify tax administration, the information required on the tax forms should be kept to a minimum and be readily available from the taxpayers' books and records.¹⁵

There are a number of administrative benefits which can be derived from a simplified tax system. For example, establishing a reasonable income tax filing threshold would limit the number of taxpayers obligated to file returns and simplify administration. By not requiring salaried employees to submit tax returns and by requiring small businesses to submit VAT returns only quarterly, the tax administration could reduce the number of low-yield returns received and concentrate on programs which will improve the effectiveness of tax administration, for example, collecting tax arrears and expanding the audit program.

Simplifying the tax system will also lead to a reduction in taxpayers' costs of complying with their tax obligations. Compliance costs, like administrative costs, can be reduced by such measures as imposing a single rate (in the case of the VAT), defining a reasonable registration threshold and reducing exemptions. Exemptions increase bookkeeping requirements and raise the cost of compliance. In some cases, compliance costs can be reduced through final withholding on transactions like payment of interest, dividends, and salary bonuses. The data required for businesses to comply with the tax laws should be obtainable from their own accounts. Taxpayers should not be asked to present data which would require them to keep special records for tax purposes.¹⁶

C. Encourage Voluntary Compliance

A broadly accepted principle in tax administration is that the ultimate goal of any tax administration is to promote voluntary compliance.¹⁷ Penalizing tax evaders and pursuing delinquent taxpayers to collect tax arrears are not in themselves the main objectives of the tax administration, although voluntary compliance may be encouraged if the tax administration is successful in making the taxpayer community realize that non-compliance will be detected and effectively punished. Thus, management of the tax administration is the art of achieving a proper balance between service to the taxpayer and enforcement of the tax laws and regulations to promote voluntary compliance.

Tax administration should encourage voluntary compliance and address the obstacles that prevent voluntary compliance. Important obstacles to taxpayers' compliance are: the

¹⁵Denmark, Canada, and New Zealand are among the many countries which have introduced simplified tax return forms in order to facilitate their use by taxpayers.

¹⁶See Cnossen (1994) and Pyle (1991).

¹⁷Voluntary compliance is the timely filing and reporting of required tax information, the correct self-assessment of taxes owed, and the timely payment of those taxes without enforcement action.

perceived inequity of the tax system; the complexity of the tax laws; the lack of fairness of the penalty system; weak taxpayer education programs; low levels of integrity and professionalism of the tax administration's staff; the tax administration's inability to ensure impartiality in the appeal process; and weak audit programs. Well-designed preventive actions, such as the establishment of withholding schemes and the development of preventive audit programs¹⁸ which will demonstrate to a significant number of taxpayers that the tax administration will use relevant data to detect evasion, may also foster voluntary compliance.

Voluntary compliance goes hand in hand with a system of self-assessment. Under a self-assessment system, taxpayers are responsible for determining their own tax liabilities and for the accurate and timely reporting and payment of their taxes.¹⁹ Given clear information, proper education, simple procedures, and sufficient encouragement, there is a greater possibility that taxpayers will calculate and pay their tax liabilities on their own. In this way, the tax administration can concentrate its resources on identifying and dealing effectively with those taxpayers who fail to comply properly with their tax obligations. Extensive reliance on a self-assessment system combined with targeted enforcement would allow the tax administration to effectively administer the tax system. Among the key elements which must be in place for a self-assessment system to operate effectively are: (1) good taxpayer services programs to facilitate taxpayers' understanding of their obligations and entitlements; (2) simple procedures; (3) a strong but fair penalty system; and, (4) effective verification and enforcement programs. These two broad principles, voluntary compliance and self-assessment, are the foundation of modern tax administrations.²⁰

D. Formulate a Clear Strategy

In order to fundamentally reform the tax administration, a clear strategy is required. Before beginning the reform, tax administrators need to diagnose the tax administration's principal problems, design a strategy for actions to be taken, and agree on the strategy's scope and timing. Given that many countries embarking on such a reform have limited resources, experience has shown that the reform should be implemented through practical and

¹⁸Preventive audit programs are designed to show taxpayers that the tax administration has the information and the operational capacity to detect evasion, and to convince taxpayers that evasion will have bad consequences for them.

¹⁹When self-assessment is applied it is usually applied to the major taxes, and not to the property taxes. Several countries with effective tax administrations, however, do not have a self-assessment system for some major taxes, including, for example, Sweden, where the tax administration calculates individuals' income tax liability based on information received from third parties (employers, banks, etc.). The United Kingdom's Inland Revenue Department has recently launched a major program to introduce self-assessment in 1997 for 9 million individual and corporate income tax payers.

²⁰For a discussion on the importance of self-assessment for increasing taxpayer compliance and for the future of tax administration, see James and Wallschutzky (1995).

manageable steps, that is, it should be gradual. During the transition period, however, revenues should be secured through measures that can be implemented with the limited resources available.

To gauge the progress of the tax administration reform strategy, attention must be given to the design and implementation of standards for management evaluation and control, or performance standards. Most modern tax administrations have clearly defined strategies that are linked to their major functional operations and aim to improve revenue collection, process information more rapidly, increase the coverage and quality of audits, and deliver services to taxpayers more effectively. Improving the effectiveness of these key functions should be the basis for defining performance standards in tax administration.²¹

E. Identify the Tax and Accounting Laws that Require Change

Reforming the tax administration is a complex process which generally requires changes in many related areas, beginning with the tax laws. *As a first step, reformers should determine what new tax and accounting laws and regulations are needed, then the timing and appropriate channels for introducing the legislation.* Introducing new procedures may require the drafting and legislative approval of a new tax code and regulations. Legal changes are frequently required to introduce modern accounting standards and invoicing requirements as well as complementary measures related to the rights and obligations of taxpayers and tax officials. Will legislative changes be made by executive decree, which tends to be faster, or will they require legislative approval? Will business groups need to be consulted, and, if so, at what stage? Will the changes be discussed in the media? How will they be presented to the public, and who will make these presentations? These questions need to be answered at an early stage of the reform process in order for the reform proposals to be widely understood and eventually supported by the public, both essential prerequisites for introducing legislative changes in the tax system.

F. Take an Integrated Approach to the Tax Collection Process

To be effective in the medium term, the general strategy should also have as a guiding principle an integrated approach to the tax collection process, and consider each of its elements—registration, collection, collection enforcement, audit, legal affairs, taxpayer services—essential to the strategy. *To achieve a significant improvement in the overall effectiveness of the tax administration each element of the tax collection process needs to be improved.* Tax collection can be viewed as a chain in which each stage of the collection process is linked directly or indirectly to another stage; thus, problems in one stage of the process are likely to adversely affect other areas. For example, improper taxpayer registration or failure to assign a unique taxpayer identification number (TIN) to taxpayers will complicate processing of returns as well as detection of stopfilers and delinquent taxpayers. Failure to process tax returns and payments will hamper detection of taxpayers in arrears and prevent the tax administration from correctly targeting taxpayer groups for auditing.

²¹See Crotty (1996).

G. Differentiate the Treatment of Taxpayers by Size

One guiding principle behind several successful tax reforms has been that different size taxpayers require different administrative arrangements. As Table 2 shows, in many countries, a small number of taxpayers contribute a large percentage of taxes collected.

Table 2. Concentration of Domestic Tax Collection in Selected Countries

Country	Large Taxpayers at National Level		Percent of Total Collection
	Number	Percent of Total Taxpayers	
Peru	1,600	0.14	58
Argentina	2,450	0.25	51
Brazil	30,000	0.33	92
Colombia	4,922	0.41	65
Angola	250	0.44	80
Hungary	300	0.50	50
Nicaragua	400	0.67	75
Bolivia	1,350	1.35	66
Paraguay	1,000	1.67	60
El Salvador	1,005	1.68	75
France	52,000	2.00	50
Sri Lanka	2,024	2.02	92
Mali	53	4.80	60
Congo	50	5.00	65
Gabon	350	5.80	91
Uruguay	11,000	9.00	83

Source: dos Santos (1994).

In many cases, five percent of taxpayers may account for 75 percent or more of the total tax collection. *Special units to monitor, audit, and enforce collection for the largest taxpayers have often yielded significant results in terms of revenue.* In most countries which have established large taxpayer units the compliance of this taxpayer group has improved. In Uruguay, Bolivia, and Sri Lanka, for example, where the large taxpayers represent a high percentage of total tax collection, the percentage of stopfilers (registered taxpayers who do not file a tax return) among the approximately 1,000 largest taxpayers dropped from ten percent to one percent with the establishment of large taxpayer units during the period from 1987 to 1991. At the same time, in many countries payments from this group of taxpayers increased significantly (about 20 percent in real terms) after they began to be monitored by a large taxpayer unit.

In Hungary, the cornerstone of the tax administration reform project has been the implementation of a large taxpayer unit to monitor these taxpayers. In Argentina, a special system to monitor the largest taxpayers (the Two Thousand Taxpayer System, or DOSMIL) was established in 1991, and began monitoring the 900 largest taxpayers in the Buenos Aires metropolitan area. The system was subsequently extended to other offices and, by 1994,

operated in about 130 offices throughout Argentina and covered about 2,450 taxpayers.²² During the period 1990–1994 VAT collection rose from 2.1 percent of GDP to 6.3 percent of GDP, an increase which can be partially attributed to the implementation of these reforms.²³

Arrangements to monitor large taxpayers should be accompanied by special programs for controlling medium-size and small taxpayers, who represent the largest proportion of taxpayers. In the case of medium-size taxpayers, monitoring them with special systems and procedures has also proven to increase their compliance.²⁴ In Uruguay, the monitoring of 5,000 medium-size taxpayers with a new computer system beginning in 1990 resulted in a 22 percent real increase in the taxes collected from this group in the same year. In Paraguay, the control of 1,000 medium-size taxpayers with new systems resulted in a 36 percent increase in real tax collection from 1994 to 1995 for this taxpayer group, and a 22 percent increase in total tax revenue.

In several countries the combination of setting a reasonable registration threshold and introducing simplified schemes for tax payment by small businesses has encouraged their entry into the tax net and encouraged compliance. These schemes include the use of presumptive types of taxation, which are based on indirect means (for example, net worth, a percentage of gross receipts or assets) of establishing tax liability. Establishing reasonable registration thresholds that will require regular filing and payment of the major taxes for the large and medium taxpayers, coupled with simplified schemes for the smallest taxpayers, will not only reduce the tax administration's workload and make it easier for these taxpayers to meet their obligations, but also facilitate the introduction of a comprehensive tax administration reform which would encourage higher compliance rates.²⁵ Hungary's recent experience is instructive in this respect. In 1995, the VAT registration threshold was raised from Ft 500,000 to Ft 1 million. In addition, the filing and payment requirements for businesses with an annual VAT liability of less than Ft 1 million were changed from a monthly to a quarterly basis. These measures significantly reduced the number of VAT returns filed monthly and eliminated the filing requirements for more than 100,000 small businesses which accounted for insignificant amounts of VAT revenues. As a result, the tax administration's paper workload was reduced and the tax administration was able to devote more resources to controlling noncompliance.

²²This system now includes about 300,000 taxpayers, although the largest 2,450 of these account for approximately 51 percent of the total tax revenue. The large taxpayer system in its entirety handles approximately 77 percent of the total revenue.

²³See dos Santos (1994).

²⁴In many cases, these special systems are very similar to those used for controlling large taxpayers, although more flexible payment arrangements would be provided to facilitate payment of taxes by these taxpayers at different bank branches.

²⁵See Tanzi and Casanegra de Jantscher (1987).

In Bolivia, an important aspect of the 1985 tax reform was the introduction of a special regime for small taxpayers. In order to bring a large sector of informal, small retail businesses into the tax net, three different simplified schemes were established which allow small business to comply with the VAT and income taxes in a very simple manner. Under these schemes, small taxpayers go to any bank and pay a lump sum according to the specific category under which they are registered. These taxpayers do not need to fill out any tax return forms. In 1990, more than 200,000 taxpayers, equivalent to more than 50 percent of all taxpayers, were registered under these simplified schemes. In administering the kind of simplified schemes such as the one in Bolivia, however, care must be taken to ensure that there is systematic auditing of taxpayers registered under these schemes in order to prevent their abuse.

H. Ensure the Effective Management of the Reform Process

A strong management team committed to the tax administration reform is essential to the reform's success. In charge of the reform program from the outset and all throughout the reform's duration, the managerial team should have the political support of the highest political authorities. Without such commitment and support, there is a risk that the tax administration will not obtain "ownership" of the reform and that reform efforts will fail. While some external technical assistance may be helpful, a critical core of local expertise and management's commitment to carry out the reform are indispensable to take advantage of such assistance.

A central element of the tax administration reform effort should be to ensure that tax officials are accountable to both the Government and to the taxpayers. Special policies to encourage accountability and discourage corrupt activities should be a cornerstone of the tax administration reform strategy.

I. Set Priorities and Establish a Timetable

Whatever a country's particular conditions, to design an effective reform strategy priorities need to be defined and a timetable prepared, taking into account available resources. Many times, in the rush to obtain concrete results in the short term, reformers try to introduce all the planned changes simultaneously. *It is important to keep in mind, however, that the reform's direction is more important than the speed.* In some cases, the best strategy is to carry out few but effective actions in the short-term, such as quick audits accompanied by wide publicity, while at the same time developing new systems and procedures that will become the tax administration's foundations. This approach may produce immediate positive results in terms of revenue, while allowing time to develop permanent systems. As experience shows, no single strategy is appropriate for all countries and under all circumstances. Each country should formulate its own strategy and set the timetable for its implementation based on the political situation, the structure of the economy, and macroeconomic conditions. The timing will also depend on, inter alia, the tax system's particular characteristics, the tax administration's capacity, available staff and financial resources, and revenue requirements.

J. Begin Fundamental Reform with Pilot Projects

Successful tax administration reforms often begin with pilot projects. Pilot projects do not require a lot of material and human resources, yet they allow the tax administration to design and test new procedures for taxpayer identification, registration, collection, enforcement, and audit before expanding these to the rest of the tax administration. One option several developing countries have chosen is to introduce pilot reform projects to administer the largest taxpayers. *A successful pilot project will help convince skeptics both inside and outside the tax administration that reform is possible. In addition to raising revenue in the short term by improving large taxpayer compliance, a successful pilot project can serve as a blueprint for overall tax administration reform.* Pilot projects are particularly suitable for computerizing tax administration procedures, since large-scale computerization is generally not feasible at the start of the tax administration reform process. Pilot projects should help monitor major taxes paid by large businesses and should support a decentralized computer operation, whereby computerized processing of taxpayer registration, tax return processing, etc., is carried out close to the taxpayer. At the pilot sites, computer systems should be tested for the registration and collection procedures, the generation of integrated master files (computerized files with taxpayers' payment and debit information for all taxes) to produce statistics, the selection of taxpayers for auditing, and the production of information to support audit work. The goal should be to design an effective tax administration system at the pilot site—one that can be extended to other offices.

IV. IDENTIFYING KEY BOTTLENECKS

Taking into account the guiding principles for tax administration reform which were discussed previously, tax administrators will need to define a detailed strategy. Specific bottlenecks need to be identified and concrete measures formulated to address problems identified in the following areas: (1) taxpayer registration; (2) tax returns and payments processing, including the transfer of payments collected through the banking system to the treasury account; (3) computer operations; (4) detection of stopfilers and collection of arrears; (5) delinquent taxpayers; (6) audit; (7) the sanctions and penalty system; (8) taxpayer services and publicity; (9) management and organization; and (10) personnel.

In what follows of this section, the key questions which need to be addressed in order to design a more detailed reform strategy are discussed.

A. Taxpayer Registration

To assess the situation regarding taxpayer registration, the following questions should be addressed: What type of controls are established to check that no TIN is assigned to more than one taxpayer, and that each taxpayer is assigned only one TIN? Which taxpayers must be registered? What measures are in place to register businesses in the informal sector?

A frequent problem that has been observed in this area is that there are no strict controls regarding the issuance of TINs. Also, in many countries of the former Soviet Union and in China, TINs are issued by government agencies other than the tax department.

Other problems include the over-registration of taxpayers, with only a small percentage of registered taxpayers actually filing and paying taxes. This makes it more difficult to identify and monitor taxpayers who should contribute a significant amount of revenue, and creates an unproductive workload for the tax administration. A reasonable registration threshold should be established to avoid over-registration. In the case of the VAT, registration is usually required for businesses with a significant volume of annual sales. In several countries, for example, an annual turnover in the range of US\$12,000 to US\$25,000 is a threshold below which VAT registration is not required.

In the case of countries with large informal economies or with economies in transition, which have a growing number of private entrepreneurs, the tax administration will need to make efforts to incorporate businesses in the informal economy into the tax net. Unregistered taxpayers may be detected chiefly by two means. The first approach is to audit registered taxpayers in order to detect their unregistered suppliers or customers. If a VAT is in place, this may be done by checking that purchase invoices on which VAT credits are claimed and sales invoices show a valid TIN; detection of an invalid TIN may lead to the detection of unregistered taxpayers. The second approach involves searches or inspections in which a group of officials goes door-to-door within a particular geographical area, checking that all persons or establishments engaged in a taxable business activity in that area are properly registered.

B. Returns and Payment Processing

In assessing the system for processing tax returns and payments, tax administrators should determine whether the accuracy and timeliness of the information obtained from the data processing systems are appropriate. *If the information that the systems produce is not timely or accurate, the cause of these problems needs to be determined. This may require a review of tax returns to see if the information requested meets the tax administration's needs. Often these reviews result in a drastic simplification and redesign of tax forms. Experience has shown that the tax administration should request only the data that it can process in a timely fashion.*

For countries with adequate return forms, improvements in the timeliness and accuracy of information can be obtained by introducing filing via diskettes, electronic filing, or telefiling. In Latin America, Brazil is the leader in this area. More than 20 percent of its taxpayers use some kind of electronic filing.²⁶ In the United States, nearly 15 million returns

²⁶See Silvani (1993).

(or about 10 percent of total returns) were filed electronically in 1995.²⁷ For the tax administration, electronic filing means a reduction in cost (electronic filing costs one tenth of what it costs to process hard copies) and significant gains in the timeliness and accuracy of tax information.

It is important for tax administrators to keep in mind that taxpayers should not be penalized by having to submit unnecessary data which will not be used for taxpayer control. The U.S. Internal Revenue Service has estimated that it receives an average of 40 million forms annually that it does not use; these forms are never processed.²⁸ Many countries have improved the quality and timeliness of the information obtained from their computer systems by drastically simplifying their return forms and eliminating unnecessary attachments. Among the various countries which have simplified their forms as part of a broader tax administration reform are Australia, Benin, Chile, Peru, the Philippines, Spain, Sri Lanka, Togo, and Uruguay. In China, at the outset of the tax administration reform some forms required excessive information while others did not require enough to verify key data. The Chinese tax authorities are now redesigning, simplifying, and standardizing the tax forms.

Regarding the accounting of tax revenues, tax administrators need to evaluate what controls are established to ensure that taxes collected (monies received directly or through banks) are properly posted in the corresponding taxpayer account and into the treasury account. Frequently, payments processing systems do not produce reliable information because validity checks are non-existent or poorly designed. As a result, taxpayers' compliance cannot be monitored and banks making delayed deposits to the Treasury cannot be detected. Moreover, if validity checks are not properly designed a teller may keep the money he/she received from a taxpayer or a taxpayer may falsify a payment receipt—the system would not be able to detect this kind of fraud.

Validity checks should also verify the computation of the tax declared by the taxpayer. In designing the system for controlling arithmetic errors, it should be kept in mind that controls should be designed in such a way as to prevent the occurrence of a problem observed in some countries whereby thousands of warning or additional assessment letters for minimal amounts of tax are sent to taxpayers.

C. Computer Operations

Computerization is an essential element for modernizing tax administration. For the tax administration to perform its functions effectively, it must keep up with the pace of computerization in major economic sectors, including banking, trade, and communications. This is especially the case in countries where the collection of tax revenue is primarily through the banking system, and proper revenue accounting and appropriate taxpayer control depend on accurate daily reconciliation of the tax administration's and the banks' computerized records. Despite the advantages that could be obtained from computerizing the tax

²⁷U.S. Internal Revenue Service (1996).

²⁸U.S. Internal Revenue Service (1992).

administration's work, including, for example, increased capacity to process return and payment forms, compile statistics, and improve revenue forecasting, the pace of computerization in many countries has been slow. In some countries basic functions which must be performed on a massive scale, such as the printing and distribution of taxpayer warning letters and notices, are still performed manually.

In the process of computerizing the tax administration, reformers must ensure that development of the tax administration's computer technology is carried out in tandem with appropriate changes in the tax administration's key procedures, including registration, collection, audit, and enforcement. Without this parallel development of computer technology and tax administration procedures, there is a risk that computerization will not result in greater effectiveness in the tax administration's operations because inadequate procedures may have been computerized.²⁹ Reformers must be careful in defining the scope and pace of computerization so that it supports the work of a modern tax department beyond merely computerizing manual systems. This will entail evaluating whether procedures will be computerized on the basis of a pilot project, which will require reduced resources and less staff, or whether they will be computerized in a large number of tax offices, which will require more resources and staff.

The organization of the tax administration and the degree of centralization or decentralization of operations will determine the kind of computer systems which will be required and the appropriate location of the computer systems that compile and store detailed information on taxpayers' accounts. For example, some countries which have developed pilot projects to modernize the tax administration's procedures start off with a relatively centralized approach to computerization; a central pilot office may be receiving and posting on a daily basis detailed data on tax returns and payments from local offices, and re-transmitting this information to the same offices. However, in addition to being slow, such a routing of computerized information may require greater computer capacity at the pilot office than what is really needed. Instead, a more efficient approach may be to decentralize functions such that the entry and storage of detailed data on taxpayers accounts is done at the local tax office, which is nearest to the taxpayer, and only summary data for purposes of reporting and management is transmitted to the regional and central tax offices. Excessive centralization of systems usually results in rigidities, lack of user participation, delays in detecting and correcting input errors, and a reduction in the usefulness of computer systems. Extremely decentralized systems are also difficult to administer because training of staff and maintenance of hardware and software become costly and demand great efforts.³⁰

²⁹See Corfinat (1985).

³⁰China started focusing on improving computer systems at the lowest operational level (30,000 collection stations). Because training and maintenance of software on this scale became very difficult, the main computerization efforts were shifted to the district level (3,000 stations).

Experience has shown that it is extremely important for the tax administration to maintain a degree of autonomy in designing its own computer systems. For this to be possible, it is more convenient for the computer department to be part of the tax administration rather than part of a separate government agency that may also be responsible for providing computer services to other public sector agencies. Frequently, in countries where computer systems have been developed in a separate government agency, the tax administration has been prevented from having in-house, specialized computer systems needed to carry out specific tax administration functions, such as recording and posting of tax payments in the computerized taxpayer masterfile. The development of computer systems outside the tax administration has also resulted in significant inaccuracies in computer-generated information and prevented headquarters from effectively using the computerized information for management purposes.

D. Detection of Stopfilers

In many countries, the ratio of stopfiling taxpayers to total registered taxpayers is in the range of 20 to 40 percent. These ratios are far higher than desirable, and may be due to several factors: (1) the taxpayer register is out of date and includes many taxpayers who are no longer in business; (2) some returns are filed with errors in the TIN, and as a result, persons who have filed appear as stopfiling taxpayers; and (3) the tax administration does not deal systematically with stopfiling taxpayers.

The first two problems, which reflect weaknesses in the registration and returns processing system, may be solved by properly updating the register and distributing preprinted identification labels to taxpayers. To address the third problem, that is, actual stopfiling, the tax administration would need to design an adequate strategy. A first step is to rank stopfiling taxpayers by size and by business activity. *Priority should be given to monitoring stopfiling taxpayers with the highest income or the largest sales volume.* For smaller taxpayers, control over this group could be exercised every six months or every year.

E. Delinquent Taxpayers³¹

In assessing the situation regarding the monitoring of delinquent taxpayers, it is important that tax administrators consider the following questions: What is the stock of arrears (reported but unpaid taxes) as a percentage of tax collections? What is the proportion of uncollectible arrears? What is the distribution of arrears by age (e.g., the tax period in which the arrears were incurred)? How long does it take to detect a stopfiler or a delinquent taxpayer? Once a delinquent taxpayer is detected, how long does it take to collect the overdue tax? Thirty days? One or two years? What is a "reasonable" collection time?

Priorities should be established for controlling delinquent taxpayers much in the same manner as described above for the case of stopfilers. *The tax administration will need to take swift and effective action on delinquent taxes in order to make it clear that tax delinquency is*

³¹ Delinquent taxpayers are those who have reported but not fully paid their tax liabilities.

an expensive source of financing. As a rule, a small percentage of delinquent taxpayers accounts for a high percentage of taxes in arrears. In two Latin American countries, recent statistics on the concentration of delinquent taxes showed that in one country 3.6 percent of delinquent taxpayers accounted for 90 percent of delinquent taxes, and in the second country 12 percent of delinquent taxpayers accounted for 65 percent of total delinquent taxes. In one country of the FSU, the increase in delinquent taxes owed by less than one percent of all taxpayers resulted in a more than doubling of the stock of arrears in a period of four months during 1996. Given the high concentration of arrears in a few taxpayers, it is important to set collection priorities according to the amount in arrears. In addition, priority should be given to collecting newer and undisputed debts since it is usually easier to collect recent debts, before interest and penalties make them too large, and, consequently, unpayable. At the same time, it is advisable to write off uncollectible debt or at least set it apart from files on collectible amounts. Giving priority to collecting newer and larger debt while allocating some resources to collecting smaller and older debt will make it possible over time to reduce the ratio of delinquent debt to total collection.³²

In dealing with delinquent taxpayers, the tax administration will need to consider the types of administrative arrangements available for taxpayers to settle their outstanding tax debts. The guiding principle in designing effective procedures to settle arrears should be to encourage taxpayers to settle their arrears amicably, with least cost to both taxpayers and the tax administration. This may include setting up a program of payment facilities to enable taxpayers to make payments over a specific time period, in accordance with their capacity to pay.

Many countries require that interest and penalties be paid before or simultaneously with the filing of overdue tax returns (for a discussion of interest and penalties, see Section VII). This makes it difficult to regularize delinquent taxpayers and diminishes the effectiveness of tax administration. The proper policy is to accept the amount of money that the taxpayer is ready to pay, billing him later for any balance that might result from a review of the figures.

F. Audit

It is widely recognized that taxpayers' perception of the probability of being audited strongly determines their degree of compliance.³³ Thus, the importance that a tax administration assigns to the audit function greatly affects the ability of the organization to

³²To secure collection of arrears, the tax administration should be allowed to take recourse to precautionary measures. The purpose of these measures is to ensure that taxpayers' income is indeed used to pay taxes, and to preempt the kind of action whereby taxpayers draw down bank deposits or close bank accounts in anticipation of the tax administration's seizure of his assets.

³³A number of studies in the economics literature, including Dubin, Graetz, and Wilde (1987), Pyle (1991), and Witte and Woodbury (1985), have suggested that there is a positive relationship between the probability of being audited and taxpayer compliance.

*enforce compliance. Even if a tax administration is very effective in registering taxpayers and detecting stopfilers or delinquent taxpayers, the administration's overall effectiveness will be low if auditing is not effective in discouraging evasion.*³⁴

During the last decade many countries have successfully modernized their tax collection system, improved the accuracy of the taxpayer register, and computerized much of the tax collection process. However, many do not have effective audit programs to control the underreporting of taxes. Although several countries have seen some improvement—especially in the short-term—in compliance and collection, within a few years after the first drastic changes are introduced a plateau is reached and there are no significant further advances. For example, in Peru, in spite of the fact that the tax administration's effectiveness has continued to increase,³⁵ further increases in collection will depend on the tax administration's ability to focus its efforts on audit. In Denmark, which has a strong and sophisticated audit program, the compliance rate is one of the highest in the world—reaching more than 95 percent for the VAT.³⁶

Unfortunately, in many countries auditing has decreased in importance relative to other tax administration functions, as shown by the reduction in the number of staff assigned to auditing as well as by the decrease in the percentage of taxpayers who are audited. In many countries, the number of audit staff in relation to the number of registered taxpayers decreased significantly between 1975 and 1995, some by as much as 80 percent. Auditors have gradually been moved to tax administration functions that are not directly related to controlling evasion. Moreover, these auditors are rarely replaced. Today, tax auditors account for about 10–15 percent of tax administration staff in many countries, compared to a desirable target of 30 percent which several countries with effective audit operations have found to be necessary to ensure adequate audit coverage.³⁷ As a result of these trends, fewer taxpayers are being audited.

³⁴This is because the tax administration is able to detect stopfilers and delinquent taxpayers largely through computerized, or mechanical, means—by comparing registered taxpayers against tax returns received (stopfilers) and the reported tax liability against the actual tax payment (delinquent taxpayers). By contrast, in order to detect evasion or underreporting of taxes, auditing (intelligence and investigation) is required.

³⁵Tax collection has grown steadily as a percentage of GDP, from 6.0 percent of GDP in 1990 to an estimated 14.1 percent of GDP in 1996.

³⁶In countries like Austria, Denmark, and the Netherlands, auditors' tasks are greatly facilitated by easy access—via laptop computers—to a range of computerized information, including the tax laws and regulations and all data from the taxpayers' accounts. Auditors can access information from the taxpayer master file regarding import and export shipments (volume and value), invoices, sales to customers, and purchases from suppliers.

³⁷See Holland (1988).

Regarding tax evasion, the crucial questions that reformers will need to ask in identifying key bottlenecks and designing corrective measures include:

- What is the audit coverage—or what percentage of taxpayers are audited per year? In other words, what are the chances that an individual or enterprise that is evading taxes will be detected? Frequently, audit coverage is too low, with barely one percent of all taxpayers audited annually, and less than five percent of medium-size taxpayers audited annually.³⁸
- What is the profit to sales ratio reported by taxpayers (e.g., distribution of taxpayers according to the profits/sales ratio)? What percentage of taxpayers reports losses? What is the distribution of taxpayers according to the reported mark-up (sales to purchase) for the VAT? Sometimes, an extremely high proportion of taxpayers reports losses, a very low profit/sales ratio, or a very low mark-up ratio. Also, in some countries a large number of taxpayers reports a gross margin (difference between annual sales and annual purchases) which would be insufficient to pay salaries; that is, underreporting is evident. A breakdown of this statistical data by economic activity and by taxpayer size would help identify the groups of taxpayers that are consistently underreporting taxes (e.g., large taxpayers in the agricultural sector, small retailers, medium-size professionals, etc.) Estimates of the tax gap by major economic sector or type of taxpayers would also provide valuable information to establish audit priorities.
- Does the tax administration have an audit plan? Are different sectors and types of taxpayers targeted for audit? How are taxpayers selected for audit? What kind of intelligence is there to identify sectors and taxpayers which should be targeted for audit? Are there different types of audits (quick, in depth, etc.) to deal with different types of problems? Frequently there is no audit plan, selection of taxpayers for audit does not follow systematic criteria, and the resources allocated to auditing are not productive either in promoting voluntary compliance or in increasing revenue.
- How many staff are allocated to audit? Is there training for auditors? As mentioned above, a current problem in many countries is that 10 to 15 percent or less of the tax department's staff is assigned to auditing. This shortage of auditors is aggravated by the fact that auditors are not properly trained; in many developing countries, they do not perform thorough audits and investigations, and limit their actions to checking compliance with formal reporting requirements.

³⁸It should be noted, however, that the quality of audits should not be overlooked in the effort to broaden audit coverage. For example, in many FSU countries, the tax administration is required to audit taxpayers every two years, even though what is referred to as an audit is more of a check of accounting and reporting formalities than an actual tax audit. Such a system prevents the tax administration from effectively auditing sectors and taxpayers with the highest noncompliance rates, and has not been effective.

- Is there a system to monitor taxpayers' monthly or quarterly payments which allows detection of significant deviations? During periods of credit shortages, for example, taxpayers will substantially reduce payments, such as advance payments for the income tax or monthly payments for the VAT. A significant reduction in these payments should trigger a quick audit to determine whether this is due to evasion.
- Is there a program for cross-checking information? In the case of the VAT, under-reporting of sales is a common practice in many countries; experience has shown that cross-checking information between sales and purchases is one of the most effective tools to control the underreporting of sales. In the case of the income tax, for example, cross-checking of information on interest paid by banks to bank depositors with that declared by individuals has helped detect the underreporting of income in the U.S.
- How are VAT refunds to exporters controlled? Fraudulent VAT refund claims by fictitious exporters have been the cause of major tax scandals all over the world, and specific procedures need to be designed to control VAT refunds to exporters. New Zealand, Singapore and Chile have developed highly effective procedures based on comparing refund claims with the historic profile of exporters.³⁹
- How are audit activities monitored? Is there a system in place that allows evaluation of both auditors' productivity and audit program effectiveness? The systematic evaluation of audit activities is an indispensable instrument to improve the quality of audit work. Sometimes, audit results are only measured in terms of additional assessments made by the auditors, without taking into consideration that these assessments could eventually be overturned during the administrative or judiciary process of appeal.

G. Sanctions and the Penalty System

A good system of sanctions and penalties is an indispensable tool for enforcing compliance. As part of the assessment of the tax administration, the effectiveness of the sanctions and penalty systems in encouraging taxpayers to voluntarily comply with their tax obligations should be evaluated.⁴⁰ *A guiding principle in the design of a good system of penalties and sanctions should be to encourage taxpayers to settle their tax arrears quickly and to discourage them from using legal challenges to delay the payment of taxes which have*

³⁹See Silvani and Brondolo (1996).

⁴⁰There is considerable discussion in the economic literature (see Pyle, 1991) of the role of sanctions and penalties in creating incentives for individuals to engage or not engage in tax evasion. According to Pyle, research has shown that lower penalties which are applied more consistently are more effective in deterring evasion than high penalties applied fairly infrequently.

*been correctly assessed.*⁴¹ To achieve these objectives, the sanctions and penalties: (1) should be levied promptly once a liability has been established; (2) should not be excessive; (3) should, however, be higher than the prevailing market interest rates—the prime or LIBOR rate plus a spread.⁴²

Colombia is an example of a country whose tax administration adopted (in the late 1980s) new rules to encourage quicker settlements. The basic sanction was reduced from 200 to 160 percent of the amount at issue, and it can be reduced even further by the taxpayer's quick admission of liability. Taxpayers who discover they have made a mistake before it is detected by the tax administration can correct it by paying only a 10 percent penalty (previously 100 percent). If the taxpayer agrees to settle at the time of the initial field audit, the penalty is 20 percent of the underpaid amount (previously 200 percent). Finally, if before the case goes to court the taxpayer accepts the tax administration's formal demand for a supplementary payment, the penalty is 40 percent; after the case goes to court the penalty is 80 percent.⁴³

To ensure that the sanctions and penalty system is effective, sanctions and penalties should be able to be easily applied by tax administrators to non-complying taxpayers. To achieve this, penalties should be relatively mild, since the application of lesser penalties does not require, as a rule, a lengthy administrative and judicial process. The sanctions and penalties should be designed to change the behavior of the average taxpayer, which requires that sanctions be applied to the largest possible number of non-complying taxpayers. This is particularly relevant for countries with high levels of noncompliance (this would refer to countries with a tax gap of over 20 percent). Care should be taken not to rely on extremely severe sanctions which will affect a few taxpayers in hopes that they will eventually encourage greater compliance. In one country, for example, forty people were recently imprisoned for various types of tax violations. This record number of imprisonments, however, had practically no impact in terms of increasing revenue or improving compliance. One measure which has proven effective in changing taxpayers' behavior and in publicizing the tax administration's enforcement actions is the temporary closure of businesses. The closure penalty is often levied on difficult to control businesses for an array of tax violations, ranging from failure to issue invoices for documenting sales to failure to submit tax returns after repeated warnings from the tax administration.

⁴¹Payment of overdue taxes should include: (1) the taxes due on the unreported amount; (2) the penalty charge, expressed as a percentage of (1); and (3) the interest charge for the use of government funds, expressed as a percentage of (1).

⁴²This assumes that penalties are determined on a percentage basis instead of being a fixed amount. In general, experience has shown that it is preferable for penalties to be defined as a percentage of the total outstanding amount of taxes in order to facilitate adjusting penalty rates for inflation.

⁴³See Ramírez Acuña (1992).

H. Taxpayer Services and Publicity

Good taxpayer services and well-designed and targeted publicity campaigns are crucial elements in encouraging taxpayers to comply with the tax legislation. To facilitate voluntary compliance, the tax administration must provide taxpayers with consistent, impartial, courteous, and prompt service.⁴⁴ Effective taxpayer services will include such programs as developing clear forms and instructions, providing points of contact to the public so that people can request and secure information about their tax obligations, and developing educational programs to inform existing and future taxpayers. A primary objective of taxpayer services is to inform the public of their duties and responsibilities under the tax laws in a way that can be easily understood by even the less educated taxpayers. Thus, it is essential that tax administrators conduct different types of information campaigns for different types of taxpayers (e.g., accountants, special trade associations, the general public) to disseminate information on rulings, regulations, decisions, and other notifications, to foster a higher level of compliance and minimize misunderstandings of the tax laws and regulations.⁴⁵ In countries which have launched a reform without having effective taxpayer information and service campaigns, taxpayers have misunderstood new taxes and procedures, which has hindered the reform process.⁴⁶

Publicity campaigns through the radio, newspapers, and television informing the public of the results of the tax administration's efforts, including, for example, the increase in the number of registered taxpayers, the increase in revenue, the results of audits, and the decrease in tax evasion, have also been extremely effective in improving voluntary compliance and increasing revenue in many countries. Publicizing the results of past enforcement actions carried out by the tax administration has often proven to be more effective than announcements of future actions. Today, taxpayers in countries with a long history of high noncompliance simply do not change their behavior in response to the tax administration's threats of future enforcement actions.

I. Management and Organization

As mentioned previously, a strong management team is essential to guide the tax administration reform effort. In addition, to implement the reform, the tax administration must function as an integrated organization. The managers of the key units in the collection

⁴⁴In many developing countries and countries with economies in transition, relatively simple measures such as providing taxpayers with tax return forms, eliminating fees for receipt of tax payment by the banks (which was a common practice in some Eastern European countries), and establishing taxpayer assistance counters in easily accessible locations in the tax administration would significantly improve taxpayer services.

⁴⁵See LeBaube and Vehorn (1992).

⁴⁶This is particularly true in the countries of the FSU and many Eastern European countries, where taxpayer services and information campaigns are not considered a priority.

process—collection, audit, enforcement and litigation—need to understand the functions and responsibilities not only of their own units but also of the others. In the absence of such trained managers, reformers would need to recruit qualified personnel from other public sector agencies or train existing managers in specialized functions. In some countries, for example, managers of the tax administration were recruited from central bank staff to manage and implement the tax administration reform.

A central question that reformers should address in defining a tax administration reform strategy is: How should the tax administration be organized? Only through the organization will reformers be able to make the core procedural changes that are needed to modernize tax administration. *Before making specific changes in the organizational structure, the reformers will have to address general issues such as the tax administration's: 1) degree of autonomy or dependency from the Ministry of Finance; (2) responsibilities, including the taxes it collects;⁴⁷ (3) type of organizational structure, for example, will it be organized by functions, by type of tax, by type of taxpayer or by some combination of these alternatives.*

To assess a tax administration from an organizational point of view, it is also useful to analyze the turnover of the tax administration's top management, as well as the administrative rules governing the terms of their appointment and employment. High turnover usually results in the absence of strategic plans and clear definition of medium- and long-term objectives. If the tenure of the director of the tax department is seen to be highly unstable, second level managers and the institution as a whole will not pay much attention to the instructions or directives coming from the top (in Argentina and Brazil, in some periods the tenure of the head of the tax department has lasted one year or less; in Chile, since the creation of the tax department the average tenure of its director has lasted six years).

An issue which reformers will also need to address is the tax administration's appropriate degree of autonomy. The more autonomy the organization has vis-à-vis the civil service's rules and regulations, the more flexibility it will have to make the major organizational and procedural changes needed to modernize the tax administration. Essentially, reformers should seek to establish a tax administration that can carry out its part of the country's macro-economic program. The tax administration is more likely to respond more rapidly to the government's initiatives to generate more revenue if it is able to make its own decisions regarding the appropriate organization, staffing, salary levels, procurement, renting or purchasing office space, etc. Spain has been a pioneer in establishing an autonomous tax administration. Peru and Argentina have introduced major organizational

⁴⁷For example, in developing countries that have improved the effectiveness of their tax administrations, the trend seems to be to transfer during a second stage of the tax reform the responsibility for social security tax collection to the tax administration. Argentina transferred social security tax collection to the Tax Department in 1993. This transfer improved the control and enforcement of social security contributions and also helped lower the labor tax rates and broaden the labor tax base.

changes in this area as well. Ghana pioneered the establishment of an autonomous revenue agency in 1985 with the creation of its National Revenue Secretariat, which is independent of the civil service and has its own service and pay policies. Other African countries, including Uganda and Zambia, followed the Ghanaian example and established autonomous revenue authorities with considerable success in 1991 and 1994, respectively. In many countries, experience has shown that introducing drastic changes in tax administration is easier when the organization is relatively autonomous. Conversely, countries whose tax administrations are fully dependent on other government agencies for approval, authorization and staffing have found it more difficult (and therefore have been slower) to introduce major changes in tax administration.

Autonomy should be accompanied by accountability—to the Government and to the taxpayers. An essential element in encouraging accountability is to establish a code of ethics to which tax officials must adhere. To enforce the code of ethics and internal rules and regulations, there should be a strong internal audit unit with a high profile within the tax department.⁴⁸ It is also necessary to have clear rules for the awarding of contracts to the tax administration's suppliers and for other business transactions. Officials in some developing countries have begun to focus on another aspect of staff accountability—corruption. In Peru, the tax administration has introduced an interesting way of addressing issues of corruption; a new requirement for all technical personnel and auditors is a sixteen-hour course in ethics.

Regarding the tax department's organizational structure, clear lines of responsibility should be established between the central, regional and district tax offices; the responsibilities of managers and tax officers at each level should be defined according to national policies and targets. In other words, it is essential to define who is responsible for what and to whom different units should report. Lack of clear lines of authority may seriously complicate the tax administration's operations. For example, China is currently carrying out a major reorganization of its tax administration. One of the most important and difficult problems the authorities face is establishing a national organization, the National Tax Service, to collect taxes. Although China's tax administration was formally separated from the Ministry of Finance in 1994 into the National Tax Service and local tax services, the definition of their respective functions and responsibilities has not yet been completed.

The following issues may need to be addressed in countries with national and local taxes and tax offices.⁴⁹

⁴⁸Internal auditors are often the first to detect instances of corruption in the tax administration, since they are commonly responsible for reviewing departments' compliance with procedures.

⁴⁹This set of questions may vary depending on whether the country is a federation or a unitary state, and how taxing and tax administration responsibilities are assigned between different government levels.

- Will taxpayers use the same TIN for paying national and local taxes, or should different TINs be established? Will taxpayer registration at national and local tax offices be cross-referenced, and information exchanged?
- Will the national and local offices operate a single or two independent computer systems? If a single system, will national taxes be computerized first or simultaneously with local taxes?
- Will the national and local offices process tax returns and payments or will the former receive and process all tax returns and payments? If the latter, will the national office provide local offices with information (electronic or paper), to facilitate monitoring and enforcement of local taxes?
- Will the national and local offices have access to each other's data bases?
- Will the same bank be designated to receive the returns and payments for both national and local taxes?
- Will the national and local offices exchange audit information? Will this be optional or mandatory?
- Will taxpayer services for national and local taxes be provided in the same location for taxpayers who are liable for both taxes?

These issues are examples of issues which, if left unresolved at the beginning, may create major obstacles to reforming the tax administration later on.

J. Personnel

Effective personnel policies are also a key element in allowing the tax administration to progress. To be effective, a personnel policy should address three interrelated issues: the tasks assigned to each position in the organization, the skills and experience required to properly carry out the tasks for each position, and the appropriate salary.⁵⁰ Staff in different positions in the organization should have the skills and experience required to carry out the tasks of each job and be appropriately compensated for that job. If personnel policies do not take into account these variables, staff satisfaction will suffer as will the productivity of the entire organization.

Some of the relevant questions in assessing the tax administration's personnel policies are: What is the distribution of staff by function? What is the distribution of staff by salary? What are the rules for hiring and firing personnel? Are there clear career paths and job descriptions? Frequently, an excessively high proportion of staff—in some countries, up to 25 percent of total staff—performs administrative rather than core operational functions. Salaries

⁵⁰See Schlemenson (1992).

are too low compared to the private sector for similar skills and responsibilities. Also, the rules for hiring, promoting and firing staff do not provide the right incentives and promote "sclerosis" of the organization.

Personnel policies will be determined largely by the kind of organization which is adopted. A tax administration that is dependent on a larger public sector agency such as a ministry of finance or of the economy, will have to follow that agency's personnel policies; a more autonomous organization will have greater flexibility in defining its own. *Although personnel matters are usually given less attention than the technical matters, ignoring the former may handicap other tax administration reforms. For a reform effort to succeed, tax administration staff—from the head of the tax administration to the bottom of the career ladder—need to have a degree of job security, and know that the organization has fair personnel policies.* The requirement for a degree of job security should be weighed against the need for establishing staff accountability and responsibility.

V. CONCLUSIONS

Several countries' recent experience in improving the effectiveness of their tax administration has shown that fundamental reform is possible. This is particularly the case when tax administration reforms follow a major restructuring and simplification of the tax system, when there is a strong political commitment to the reform from the government and from the taxpaying public, when the major obstacles to an effective tax administration have been correctly identified, and when there is a well designed strategy to address them.

The task of reforming the tax administration, however, is not easy. As a first step in defining a reform strategy, tax administrators must diagnose the major obstacles to the creation of an effective tax administration. In the process of analyzing existing problems, it is suggested that countries may be roughly divided into four different groups according to the size of the tax gap and the effectiveness of the tax administration. The size of the tax gap will largely determine the strategy's goals; usually, the larger the size of the tax gap, the more radical the changes in tax administration that will be required.

In the process of defining the reform strategy's main goals, experience has shown that ten guiding principles have been relevant for orienting a number of tax administration reforms: (1) political commitment to and the political sustainability of the reform are crucial; (2) encourage voluntary compliance; (3) simplify the tax system to facilitate administration and reduce compliance costs; (4) define a clear strategy; (5) identify the tax and accounting laws which require change; (6) ensure that there is effective management of the reform process; (7) differentiate the treatment of taxpayers by size; (8) take an integrated approach to the tax collection process; (9) set priorities and establish a timetable; and (10) begin a fundamental reform with pilot projects. The relative weight which is given to each guiding principle will depend on a country's particular circumstances.

A final step in designing a strategy is to identify the specific bottlenecks to the effective organization and operation of the tax administration. In identifying such bottlenecks the following issues should be considered: the existence of an ineffective organization, lack of awareness of and policies for combating corruption, lack of accuracy and timeliness in returns and payment processing, audit programs which are ineffective in posing risks to tax evaders of

being detected and punished, sanctions and penalties that fail to encourage quick settlement of tax arrears and additional assessments.

In designing and implementing a strategy, it is important to keep in mind that tax administration reform is a complex, long-term endeavor; time and resources will be required for the reform effort to yield results. Changes in legislation, regulations, procedures, and staff capabilities cannot be implemented in a short time. Marginal improvements or ad hoc measures intended to reduce tax evasion in the short-term have rarely brought about substantive improvements in the effectiveness of the tax administration and in taxpayer compliance. Instead, countries which have managed to significantly decrease the level of noncompliance have done so by means of implementing a comprehensive reform strategy. In addition, each country will need to formulate its own strategy and define the timing of implementation depending on general conditions such as the political situation, the structure of the economy, and the macroeconomic conditions it is facing. In all cases, the direction of reforms is more important than the speed of implementation.

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