

Improving Resource Mobilization in Developing Countries and Transition Economies



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The term "country" as used in the text of this publication also refers, as appropriate, to territories or areas.

The present report was prepared by Michael G. Mimicopoulos mainly on the basis of selected substantive papers prepared for the meeting of the Ad Hoc Expert Group on Strategies for Improving Resource Mobilization in Developing Countries and Countries with Economies in Transition. Special thanks to Maria Radu and also Marina Mak for providing technical support.

The views expressed are those of the individual authors and editor and do not imply any expression of opinion on the part of the United Nations.

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Foreword

The process of globalization has tended to complicate taxation issues leading to "harmful" tax competition. It has made taxpayers more aware of the differences in tax rates and has constrained the ability of tax administrations to track down trade and investment flows. By increasing significantly the amount and type of income earned abroad, globalization also reduces the ability to verify the accuracy and authenticity of taxpayers' returns. Trade liberalization has also resulted in a considerable loss of revenue as tariffs and other trade related taxes are cut. In addition, tax evasion and avoidance create serious revenue mobilisation problems which have provided the impetus for the improvement of tax administration in developing countries and transition economies. The exponential growth of electronic commerce also poses a daunting challenge to taxing authorities' traditional approaches to both direct and indirect taxation.

The erosion of existing sources of public finance can be resisted and the use of public resources may be more effectively secured for social development through tying revenue to outlay, or at least to the relevant level of government, and through fiscal stabilisation. But many of the ways of securing and retaining additional resources for social development require the help of joint international action.

The economic crises which have affected many developing countries and transition economies since the 1980's have been crises of macro-economic imbalances, resulting in current account and budgetary deficits. The adjustment programmes were aimed at improving the structure and administration of tax systems, in order to enhance efficiency and facilitate revenue mobilization. These programmes typically included tax policy and administration reforms aimed at broadening the revenue base, improving compliance, enhancing equity and reducing distortions stemming from existing complex and inefficient tax systems.

Tax reforms should aim at simplicity, equity and comprehensiveness. They should also aim at raising revenue to finance expenditures without recourse to excessive public sector borrowing. The success of tax reform is predicated upon the existence of an efficient and effective tax administration. Good governance comprises the rule of law, effective state institutions, transparency and accountability in the economic and financial administration, and democratic institutions and traditions. In this context, the effective mobilization of financial resources and their efficient and transparent utilization through sound investments in physical and social infrastructure assumes importance as a means of improving the living standards and welfare of the populations in developing countries and transition economies.

As a contribution to the debate on these issues, the Division for Public Economics and Public Administration is pleased to offer this publication which summarizes the discussion and papers presented at the Meeting of the Ad Hoc Expert Group on Strategies for Improving Resource Mobilization in Developing Countries and Countries with Economies in Transition, which was organized jointly by the United Nations Department of Economic and Social Affairs and the Association de Planification Fiscale et Financière (APFF). The meeting took place in Montreal, Canada, October 2-6, 2000. (The Conference Agenda is reproduced in Annex 1). Approximately 50 people attended the conference from at least 30 countries. The participants

reflected a broad range of views and experience, mainly from the public sector. This report is intended both for those who attended the conference and those who did not, as it highlights key issues discussed and presents an overview of the wide range of approaches suggested. (The list of substantive papers presented at the conference is reproduced in Annex 2). These papers are available at <http://www.unpan.org>. Annex 3 examines the issue of Establishment of Autonomous Revenue Agencies in Sub-Saharan Africa. Annex 4 examines the issue of Implementing the Ottawa Taxation Framework Conditions on E-Commerce. The conference covered a wide range of issues, ranging from the role of tax administration in resource mobilization to tax policy administration and reform, the management of revenue administration, as well as electronic commerce and the challenge for the tax administration. Various instruments and taxation structures were presented, as were different institutional, legal, and regulatory frameworks. More specific country case studies were also discussed. While the conference covered a series of broad issues, it focused on the development of strategies to mobilize resources and to enhance tax policy administration, with particular attention to the lessons and opportunities for developing countries and transition economies.

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I. ROLE OF TAX ADMINISTRATION IN RESOURCE MOBILIZATION

A. Role of Government revenue and their composition

The sources of funds for most governmental budget expenditures and infrastructure financing are income taxes, customs duties, excise duties, and general sales taxes such as VATs. In developing countries, most productive tax bases are taken by the central government.

Fiscal policy constitutes the government's most significant tool for achieving several socio-economic objectives, and for re-distributing income, both in the short and long term. The budget is the medium through which the government can tap two channels for influencing income distribution, namely: taxation and public expenditures. Experience has shown that public expenditure offers better opportunities than taxation to redistribute income. The role of tax policy in re-distributing income has become limited, particularly in the context of a globalized economy. Therefore, tax policy should concentrate primarily on devising an efficient system of taxes, which could be easily administered with broad bases and moderate and reasonable marginal rates. Although equity and efficiency considerations should be paramount in designing the tax system, there is a need to design tax systems which are seen and perceived as consistent with the society's conception of a just and equitable burden *of* taxation. In this context, vertical and horizontal equity are important considerations.

The proportion of public expenditure devoted to social expenditure depends on several factors, inter alia, the tax to GDP ratio, and the resources devoted to other objectives. Tax policy can indirectly contribute to equity by raising enough resources to allow a level of expenditures on public services that is adequate to promote social goals without creating any impediment on economic growth. For that purpose, developing countries and transition economies should endeavour to attain optimum revenue realization potential through the device of "widening of the tax base" which has both legislative and administrative obligations. It may also become necessary to enact retroactive legislative amendments in order to recoup the loss of revenue of several past years. In the absence of a system of indexing, this may also result in collecting the taxes due from many years earlier, in a depreciated currency of a fraction of its true worth. Tax administration must be constantly vigilant to unearth devious schemes of clever taxpayers aimed at avoiding taxes, and to study the impact of any judicial decisions which are prejudicial to the interests of revenue and which may require legislative amendments to clarify the legislative intent.

Another aspect of widening the tax base is its administrative implications. No matter how well designed tax laws may be in theory, they may still fail to achieve their objective in practice unless they are efficiently implemented or administered, and taxpayers can be induced and if necessary, compelled to ensure their compliance. An efficient and effective administration is a pre-requisite if a tax system is to fulfill its revenue producing potential. Even a best designed system is only as good as the administration which implements it. Tax administration is therefore, a major tool in a government's efforts to pursue a sound fiscal policy, achieve an optimum tax effort level and establish an appropriate tax structure. An efficient and effective tax administration may generate more revenue, which may help a government reduce budgetary deficits and curb inflation.

The differences in the various national tax systems and in the tax burdens combined with the progressive elimination of obstacles to the movement of persons and property, as well as the growing sophistication of the techniques used by tax professionals to help their clients take advantage of legal loopholes, have enabled an increasing number of individuals and companies to resort to tax evasion and tax avoidance.

Tax evasion and avoidance have serious implications for fiscal policy. They violate the principle of fiscal equity and distort allocative behaviour, imposing an unfair tax burden on taxpayers who cannot shift their tax liabilities. The greater the extent of tax evasion and avoidance is, the more difficult it is to finance government expenditure without inflation, or in other words, to increase tax revenue adequately, with the result that the excess of expenditure over taxation is positively correlated with the tax burden. Tax payment has in fact come to be regarded as unfair, since public expenditure has been increasingly perceived as failing to yield commensurate benefits either to taxpayers personally or to their communities.

Tax administrations have adopted various measures to reduce the opportunities for tax evasion and avoidance. These measures have included reliance on indirect taxes, reliance on declarations and withholding of taxes by third parties, operational efficiency and the cross checking of information, auditing of cases, the unilateral determination of taxable income, the bilateral determination of taxable income (forfeit system), administrative rulings and judicial decisions, as well as the enactment and enforcement of penalties. International tax evasion and avoidance can be combated by the conclusion of bilateral tax treaties providing for mutual assistance and the exchange of information.

A country's tax effort or level of taxation which is expressed as a percentage of GDP, can be affected by a variety of factors, namely, government spending for consumption or investment, the extent and scope for public debt, the inflow of foreign direct and portfolio investment and the extent of income from public enterprises. The aspects of a tax system of particular interest to policy makers in developing countries and transition economies are whether: (1) there is scope for raising the overall tax level (expressed as a ratio of tax revenue to GDP); and (2) whether the existing composition of tax revenue (in terms of income relative to consumption taxation) is appropriate.

In answering the first question, a quick look at the comparative levels of tax revenue in developed and developing countries across two different time periods, as shown in Table 1 below, reveals the following policy implication. A higher level of economic development generates additional needs for tax revenue to finance the rise in public expenditures, but at the same time, it increases the ability to raise revenue to meet these needs. It should be noted here, however, that it is even more important to focus on the ways the revenue is utilized, and perhaps on the tax structure, than on the level of taxation per se. Given the complexity of the development process and the way that taxation might impact on it, it is doubtful, however, whether the concept of an “optimal” level of taxation that is robustly linked to different stages of a country’s economic development could ever be meaningfully derived for any country.¹

Table I. Comparative Levels of Tax Revenue 1985-1997
(In percent of GDP)

	1985 to 1987	1995 to 1997
OECD countries	36.6	37.9
America	30.6	32.6
Pacific	30.7	31.6
Europe	38.2	39.4
Developing countries	17.5	18.2
Africa	19.6	19.8
Asia	16.1	17.4
Middle East	16.5	18.1
Western Hemisphere	17.6	18.0

Source: OECD, Revenue Statistics and IMF, Government Finance Statistics

The question of optimum composition of total revenue revolves around the question of income taxation vis-à-vis consumption taxation and under the rubric of consumption taxation, the taxation of imports vis-à-vis domestic consumption. The choice between taxing income and taxing consumption for developing countries and transition economies, involves their relative impact on vertical equity in view of the unequal income distribution in these countries. The traditional form of the consumption tax, by taxing consumption as it takes place, in the form of a general sales tax, such as a VAT, is far less regressive than commonly thought. Theoretically, consumption can be taxed on the same graduated scale as income by allowing deductions from income of savings. But the experience of some countries, including India and Sri Lanka with short lived expenditure taxes shows that such taxes pose considerable administrative difficulties for developing countries, as net savings must be tracked down and reported to

¹ Vito Tanzi and Howell H. Zee, “Tax Policy for Emerging Markets: Developing Countries” International Monetary Fund, 2000. Working Paper: WP/00/35.

tax authorities. Even in a developed country like Sweden, the Lodin Commission's studies came to the conclusion that a personal expenditure tax was not administratively feasible.

Concerning taxes on imports, the developing countries' reliance on import duties as a convenient tax base has been compromised by their entry into the World Trade Organization, regional trading arrangements, such as Mercosur, ASEAN and NAFTA, or bilateral trading agreements with developed countries, resulting in lower levels of both nominal and effective protection and substantial revenue losses. Research has also shown that if an underlying tariff reform improves production efficiency, replacing the tariffs with domestic consumption taxes would raise welfare in a small open economy.²

Given that economic development tends to lead to a relative shift in the composition of revenue from consumption to personal income taxes, the important tax policy issue for developing countries is not so much in determining the optimal tax mix, but rather in (1) spelling out clearly the objectives to be achieved by any contemplated shift in the mix; (2) assessing the economic consequences of the shift – in terms of both efficiency and equity – in the most objective manner possible; and (3) implementing compensatory – possibly non tax (e.g. expenditure) – measures if those who are being made worse off by the shift are from the poorer docile.

As a general rule, in developing countries the tax efforts are low in relation to the amount of tax revenue that could be collected on the basis of voluntary taxpayer compliance. There is therefore scope for an increase in the tax effort in these countries and also in transition economies. While no rational or desirable magnitude of that increase can be laid down, governments in these countries should endeavour to strike a reasonable balance by setting taxation at levels high enough to generate sufficient resources to meet the necessary public expenditure, but not so high as to discourage investment in business activity, or the propensity to save, or to encourage attempts at tax evasion and avoidance.

Another generalization that can be made is that countries with low per capita income collect more revenue from taxes which are easy to administer, while developed countries can resort to more sophisticated taxes, such as sales taxes, or service taxes. In most developing countries, reliance on taxes which are easy to administer leads to a considerably flawed structure, based mainly on foreign trade taxes, namely, customs duties or export taxes. In fact, administrative constraints tend to determine a country's actual tax structure. These countries should strengthen their administration capacity through intensive training and exposures to modern methods of administration. This would enable their governments to introduce new broad-based income and consumption taxes, thereby reducing their dependence on foreign trade taxes.

² Michael Keen and Jenny E. Lightart "Coordinating Tariff Reduction and Domestic Tax Reform" International Monetary Fund Working Paper, 1999, WP/99/93.

B. Impact of globalization/trade liberalization on tax revenues

1. Globalization impact

The benefits of the process of globalization, namely, a better allocation of world resources, a rise in output and living standards, greater access to foreign goods, technology, capital, technical skills, etc., are widely accepted. Globalization however, carries with it certain negative implications, some of which arise from the fact that certain national policies have an impact beyond national frontiers thus creating frictions, particularly in the area of taxation. Whereas before, the territoriality principle granted countries the right to tax all incomes and activities within their jurisdiction, the progressive integration of world economies implies that the actions of many governments have been greatly constrained or influenced by those of other governments and spillover effects across national boundaries generated by taxation have become common and significant. Some developing countries have sought to take advantage of this situation by attracting a larger share of the world tax base, thus exporting some of their tax burden. So-called “harmful tax competition” between states is now a subject of constant debate at the international level.

On a purely theoretical level, the harmonization of taxes is not a desirable idea, since variations in tax rates across different countries give taxpayers more choice and also create pressure on governments to be more efficient. Faced with a choice of different combinations of tax and government services, taxpayers will choose to be where they get closer to the mixture they want. On this basis, one may wonder whether there is any merit in the phrase “harmful tax competition”. But tax competition may reduce redistribution and thus weaken the social safety net that in a global economy is needed more than ever.

Increasing tax competition is the result of the mobility of capital and industry and the tendency of economic activity to become “footloose”. Since economic activity is no longer motivated by the need to be close to mineral deposits, markets or transport facilities, taxable income can move to the most welcoming jurisdiction.

Although in most developed countries, tax revenues as a proportion of GDP have risen over the past 30 years, with the share of taxes on corporate profits remaining rather stable, falling corporate tax rates around the world, would indicate that governments have embarked on an effort to lure foreign investors by offering lower taxes. One qualification to this would be the fact that tax rate cuts have oftentimes been accompanied by a widening of the tax base through the scrapping of corporate tax exemptions, which have offset to a certain degree the impact of the rate cuts. As the efforts to attract capital, on the part of developing countries shows however, such attempts by offering low taxes, have been mirrored by other developing countries offering even lower rates.

Globalization and the accompanying capital mobility have created opportunities for potentially harmful tax competition among countries eager to attract foreign direct

investment (FDI). Transnational firms (TNCs) can reduce their tax burden by relocating mobile capital. A recent empirical study on FDI and Corporate Tax Revenue of OECD countries, covering the period 1988-1997 has found that the countries experiencing revenue declines also offer the least attractive corporate tax regimes within the OECD.³

Although part of the decline can be attributed to business cycle variations or changes in tax codes, its extent and persistence suggest that additional factors may be at work, including the direction and size of FDI flows. If a country's domestic tax base is high relative to other countries, the tax base may shift to countries with a less burdensome tax regime, implying outward flows of FDI. Taxes may also play a major role in a transnational's decision about where to declare profits. In fact, TNCs spend considerable revenues on transfer pricing including cross-border transactions in an effort to minimize tax liabilities. FDI affects corporate tax revenue through transfer pricing. For example, a TNC in a high tax country which produces a good with inputs from a branch in a low-tax country, has an incentive, to overstate the price of inputs because this would increase the profits in the low-tax country, while reducing the profits in the high tax country, thus minimizing worldwide tax liabilities. In theory, the transfer price is supposed to be the same as the market price between two independent firms, but often there is no market, so the real market price is unknown. This is particularly true in the service economy or of firms supplying intangible goods. The manipulation of transfer prices has led to the erosion of the tax base.

If the force of globalization is combined with technology, namely, the Internet, the issue of tax management is elevated to the top of the agenda for all governments. Whereas until now profits could fall for taxation purposes only outside the physical boundaries of the jurisdiction, now they can also fall within the unregulated dimension of cyberspace.

Increasing tax competition has come at a time when most western governments loathe to raise taxes for political reasons. These governments are having a hard time protecting existing tax bases as tax rates are falling while spending needs to be maintained or even increased. It is this juxtaposition of factors which is behind increased fiscal vigilance on transfer pricing. Multimillion dollar transfer pricing disputes are now common. Transfer pricing rules have been tightened up as a result.

Many countries are trying to lure foreign consumers to do their shopping in their territory by offering low rates of sales and excise taxes on easily transportable and expensive commodities, thereby exporting their tax burden which results in reducing other countries' tax revenues while increasing their own. For most of these countries, the elasticity of tax revenue with respect to changes in their tax rates may be particularly high because of the possibility of cross-border shopping, which has increased due to more open borders, better information, more international advertising, lower transportation costs, greater mobility of persons, mail order and Internet shopping, technological and policy developments and advances, and a greater use of credit cards to pay for cross-

³ Reint Gropp and Kristina Kostial, "FDI and Corporate Tax Revenue: Tax Harmonization or Competition?", Finance and Development, June 2001, pp 10-13.

border shopping. The extent of cross border shopping caused by tax rate differentials is growing in importance.

Many individuals derive substantial incomes from investments or business or professional activities carried out in other countries, mostly due to increased personal mobility, technological advances and increased facilities to save and invest abroad. Most such individuals under-report such foreign income with the firm belief that the local tax administration has neither access nor the ability to discover such income. Unfortunately, the exchange of information among tax authorities of different countries is limited and incapable of preventing the non reporting of such concealed income or detect tax evasion. Many times, the non-existence of bilateral tax treaties requiring co-operation in exchange of information or even where treaties exist, conflicting objectives of tax administrations in different countries, prevent access to vital information which can establish tax evasion. In recent years, there has been a proliferation of countries and territories known as “tax havens” imposing low or even no taxes encouraging individuals and enterprises to channel their incomes earned in other countries, often with provision of total immunity regarding banking transactions information, thus facilitating tax evasion and avoidance. The countries from which these incomes or capital originate experience serious revenue losses and a decreased control of their tax bases. Many hedge, investment or mutual funds have shown their residence status as located in the tax haven jurisdictions. It is indeed doubtful whether the persons who invest in these funds do make proper declarations of their income from these funds to their own tax authorities. It is becoming increasingly evident that many tax evaders, smugglers, drug traffickers and other money launderers have utilized the services provided by the tax havens. The total deposits reported by some of these tax havens far exceed their GDP and are disproportionately large compared to their economies and the number of their inhabitants. The flood of laundered cash is estimated by the International Monetary Fund at anywhere between \$590 billion and \$1,500 billion.

In addition, the increasing and widespread use of financial instruments, such as derivatives have created complex problems for tax administrators and further possibilities for tax competition. It is becoming increasingly difficult to trace the income generated by these financial instruments, their location or source and the identity of the taxpayer who has earned such income.

As a result, tax administrators the world over have experienced considerable difficulties in identifying such income, allocating it to specific countries and bringing such income to tax. There have been very few initiatives in crystallizing the legal position concerning the taxation of income attributable to new financial instruments. Policies are lagging behind technical developments.

Lost tax revenue is one of the main reasons why the developed countries are taking action to deal with citizens and corporations hiding their money. As a result, these countries are cracking down on tax evasion aimed at forcing big changes in industrialized countries and offshore financial centers. Recent parallel initiatives launched by the OECD and the European Union are increasing the pressure for improvements in financial

transparency worldwide. The two efforts respectively aim at bringing tax dodgers to account and improving the exchange of information between tax authorities.

The OECD published in June 2000, a list of 35 tax havens that faced economic sanctions unless they took remedial action. It is targeting systems that allow individuals and companies to evade tax due in their home countries. The European Union reached an outline agreement also in June 2000 on a system of information exchange to ensure the taxation of non-resident savings in the 15 member states. The pressure for action on tax evasion has never been greater.

In conclusion, globalization has increased the scope for tax competition since it enables countries to export a part of their tax burden to other countries. Tax competition creates difficulties for countries by eventually leading to lower tax revenues, by changing the structure of tax systems in directions not desired by policy makers and by reducing the progressivity of the tax systems, thus making them less equitable.

2. Trade Liberalization Impact

In a globalized economy, many developing countries and transition economies, have initiated tariff reforms, dismantling trade barriers, lowering import tariffs and opening their economies to international competition. Although trade liberalization leads to economic efficiency and as a result to a higher level of economic growth, freer trade does result in loss of considerable revenue as tariffs and other trade related taxes are cut. Since tariffs (designated as trade taxes) constitute a major source of revenue for most fiscally stretched countries, many of which are developing countries and transition economies, for countries embarking on a liberalization of their tariff structure, concerns arise as to how to recover from other sources the revenue loss that entails from the lowering of tariffs. In a small economy, a small and radical contraction of tariffs combined with equal but opposite changes in consumption taxes, leaving the consumer prices unchanged, does increase both welfare and public revenues. In other words, by simply offsetting tariff reductions point by point, with increases in destination based consumption taxes, leaving consumer prices unchanged, no loss of revenue occurs. Given that the underlying tariff reform improves production efficiency, coordinated reforms of this kind for a small open economy are certain to increase both welfare and public (tax plus tariff) revenues. This outcome clearly shows the importance attached to the development of domestic sales taxes, notably the VAT, in accompanying a tariff reform.

Two major problems faced by administrations dealing with trade related taxes are: (1) A proper system of classification of goods and merchandise entering the national territory and the application of the *ad valorem* principle for the calculation of import duties; and (2) The problems faced by the smuggling of goods from across the borders and the stricter enforcement associated with these problems. There is therefore a need to adhere to an internationally accepted classification of goods and merchandise in order to thwart the attempts of unscrupulous importers to misclassify goods in order to pay a lower rate of duty, most often with the connivance of customs assessing authorities.

There is also a need to constantly examine the schedule of classification of goods and to issue administrative instructions to subordinate authorities about the scope of entries which are likely to create confusion and ensure that the possibilities of miscalculation are minimized. While the imposition of an import duty on the basis of physical volume or weight of imported goods has the merit of simplicity and ease of operation, the *ad valorem* method is more scientific and seeks to automatically enhance the collection of import duties with the rise in the price of imported articles.

In some developing countries there are multiple rates of exchange of foreign currencies, known as “official”, “government” and “market” rates of exchange applicable in different circumstances. Most often, the conversion price of imported goods expressed in foreign currency into national currency takes place in an official rate of exchange which is far below the “market” rate of exchange, thereby giving an unwarranted subsidy to the importer who proceeds to sell the imported articles in the domestic market on the basis of the market rate of exchange. In such cases, it is advisable for customs authorities to adopt the market rate of exchange for conversion of foreign currency into national currency for calculation of the import duty in order to avoid loss of revenue.

High tariffs and trade barriers create opportunities for widespread smuggling of dutiable goods across national frontiers, in developing countries and transition economies. The customs administration should be given a greater role in policy-making, so that a rational tariff structure is formulated. The customs authorities should obtain effective logistical support in the form of modern electronic and communication devices to intercept smugglers, fast moving vehicles, speed boats, the latest versions of computers, and scanners to detect contraband goods, in an effort to enhance the efficiency and effectiveness of the customs administration in combating smuggling activities. Since customs administrations are often hampered in their efforts by the lack of sufficient financial and physical resources and a shortage of manpower, equipment and other logistical support, adequate provisions should be made for the allotment of financial resources, earmarking a specified percentage of import duties for such requirements, with no cuts factored in during periods of financial stringency. Customs administrations, should also enjoy complete autonomy to prepare and execute their activities.

C. Additional and Innovative Measures

The erosion of existing sources of public finance can be resisted through various ways of scanning and retaining additional and innovative resources for social development in many cases with the help of joint international action. The approaches outlined in this section are innovative in the sense that they are not yet practiced in many of the situations in which they might be useful. Some are additional in the sense that they could well be applied without reducing any other measures for tapping or securing resources for social development. The erosion of existing sources of public finance can also be resisted through tying revenue to outlay or at least to the relevant level of government and through fiscal stabilization.

The additional and innovative measures recommended are broadly the following: (1) measures involving international co-operation; (2) measures aimed at reducing corruption and international crime; (3) self-financing measures and intermediation; (4) levies on land and natural resources; (5) valorization and development charges; (6) reforming public enterprise policy and management; and (7) stabilizing fiscal expenditure.

1. Measures involving international co-operation

a. Conventions to limit tax erosion arising from “tax competition”

International competition for inward investment encourages tax degradation in the form of (a) the lowering of rates of corporate tax; (b) statutory direct tax concessions to inwards investors; and (c) “flexible” provisions allowing for executive discretion to offer further concessions. The last of these provides a fertile field for corruption and is considered below under the subheading “Transparency and the rule of law”. All three act to “compete away” tax revenue. This process is not economically efficient. There is no reason to think that the jurisdiction that gives away most to the investor is allocatively the best. Nor is there any strong reason to think that a lower tax all round will enhance production in such a way as to increase the revenue collected at any given tax rate. Where the taxes concerned are based fairly accurately on the economic rent of the natural resources used, there is no presumption at all that reducing them will increase economic efficiency in any way. So there may be gains in revenue all round if each government takes action (a) to restrict as far as possible executive discretion in the awarding of tax concessions to investors; (b) through international agreements reducing the nature and extent of the direct tax concessions; and (c) through setting a lower limit to effective corporate tax rates.

b. Reform of taxation of transnational income

The present system for taxing transnational income is wide open to avoidance and evasion, as it is full of holes. However, there are simple ways in which the system might be reformed provided there were enough agreement among the major economic and financial powers. There is no reason that the tax revenue of any country (other than possibly some of the present tax havens) should be reduced as a result of the suggested reforms. At the same time these reforms have the potential at least of transferring revenue differentially to poorer countries.

To minimize evasion, (1) income should be taxed as far as possible in the first instance at source; (2) where two tax authorities have claims on the same income, each should inform the other what has been declared about that income in order to minimize avoidance; and (3) the jurisdiction under which income is to be taxed should be determined by clear objective tests. None of these conditions is fulfilled at present.

(1) The basic model underlying the present treatment of transnational income from capital and knowhow (interest, dividends, royalties, and management fees) is that it should be taxed in the country of the income-earner's residence. There are large exceptions to this practice; but much income, especially interest, remains untaxed in the source country, and much of the rest is subject there only to withholding taxes at low rates. It is likely that much income not taxed in the source country is not declared in the country of residence and hence not taxed at all.

(2) There is very limited exchange of information among national tax authorities about individual taxpayers.

(3) Corporations that derive their income from more than one country are supposed to divide it among jurisdictions for tax purposes according to the proportions generated in each country. But this leaves large scope for judgment on the part of the taxpayer; one tax authority normally does not know what has been declared to the others. And there is evidence that the discretion thus given to the taxpayer is a means of considerable avoidance and possibly some evasion.⁴

These deficiencies might be overcome by international agreement to the following six reforms.

(1) Income should be taxed in the first instance as near to the source as possible.

(2) Hence withholding taxes on interest, dividends, royalties, and management fees, if these payments are to cross inter-jurisdictional borders, would be collected universally, at a set of uniform rates internationally agreed. At the same time, there might be or might not be conventions providing for the transfer of some of the withholding tax so collected to the relevant country of residence of each taxpayer.

(3) Each jurisdiction should allow credit for taxes paid in another jurisdiction, rather than allowing for deductions or exemptions.

(4) Transnational corporations' incomes could be allocated according to an internationally agreed formula that relied as far as possible on objectively verifiable indicators such as proportions of work force, wage bill, or capital assets, in various countries.

(5) There would be an international system of coded identification for all individual and corporate income taxpayers. The code would not only refer to the jurisdiction in which the taxpayer resided or was registered but also be extended to record all those from which she, he or it derived income. Knowledge of the identity of the taxpayer attached to each code number would be confined to the tax authorities of the jurisdictions referred to in the code number, but information relating to the taxpayer's income would be shared among them – in certain circumstances automatically, and in certain circumstances on request.

⁴ V. Tanzi, Taxation in an Integrating World, Brooking Institution, 1995, pp.101-103.

(6) A tax report to any tax authority of the income of a corporation would be required to give information on the total world income of the transnational and the revenue distribution among jurisdictions would be considered.

Though the above six arrangements are intended to fit together, they do not depend entirely on each other for their value. Any one of them individually, if universally adopted, would constitute an improvement. Some of these elements would serve to a point as substitutes for others.

A further longer term objective would be to negotiate towards common definitions of income for tax purposes. This would simplify and facilitate transnational arrangements for taxing profits. Inevitably, international compliance with any such set of rules would be incomplete. Most of the existing tax havens in a narrow sense (microstates that derive a large part of their national incomes from being tax havens) would probably remain outside. So long as those remaining outside were confined to the existing tax havens in this narrow sense, the capacity of such tax havens to reduce the tax revenue of the rest of the world would probably be curtailed by the new arrangements. But most of the world economy would need to be in if the system were to be reasonably watertight.

With a reasonably high agreed rate of withholding tax, say of the order of 20 per cent, the afore-mentioned reforms would almost certainly initially move substantial taxable capacity to developing countries. They are predominantly source countries rather than residence countries for direct investment. They would also recover some revenue losses that would otherwise have been experienced through transfer-pricing executed by means of royalties or management fees. At the same time, governments which had previously not done so, would now be taxing the interest from nonresident bank deposits. Indeed some developing countries might gain in the share they retained of their own residents' deposits through the reduced attractiveness of moving funds to major financial centers.

It is true that a large shift to withholding tax at source might be agreed to only on condition that some of the withholding tax collected would be subsequently transferred to the country of residence. This might reduce any new advantage initially accruing to developing countries. But, because of the reduction in evasion, considerably more revenue in total is likely to be collected, so that there would be room for a deal that on the whole more than recompensed countries of residence for the shift while leaving source countries also with substantially more revenue than before.

The chances of agreement to a new regime for the taxation of transnational income along these lines would be much enhanced if there were an international tax organization, parallel to the other multilateral organizations and especially comparable to the World Trade Organization, that could act as a source of information, and a champion for promoting such mutually advantageous deals. To avoid undue delay, a start might be made with a small secretariat to promote cooperation in tax matters, which might

gradually take over responsibility for various international tax conventions and their further development.

c. Internationally coordinated taxes

A number of forms of tax have been proposed that would inevitably or most naturally, be imposed by international agreement, for reasons of enforcement, or to prevent any one country from being disadvantaged if it were to tax alone. In some cases these are taxes on activities considered in general harmful or to have negative externalities. These have included taxes on arms exports, on international airfares, on hydrocarbon use, and on foreign exchange transactions. The first three of these can probably be ruled out for various reasons as subjects for uniform, internationally coordinated taxes though the second and third have been quite successfully applied by certain countries independently.

A uniform, globally coordinated tax on foreign exchange transactions, however, may still be seriously considered. The case for it is that the annual value of foreign exchange transactions is so high (over \$450 trillion) that a tax on them at a very low rate (say 0.1% or less – of the order of the rates charged by banks for most of their currency exchanges), though it would have a negligible effect on trade and long term capital flows, would even on the assumption of a quite high responsiveness of the level of transactions, yield substantial amounts. Projections of \$150 billion to \$225 billion global revenue from a 0.1 per cent tax would assume – surely conservatively – that the level of transactions would fall by 50-67 per cent in face of the 0.1 per cent tax. It is accepted that a part of these proceeds would have to accrue to the authorities that collected them – as an incentive to do so and a recompense for the cost incurred. But the balance would be distributed among governments, or retained for strictly global purposes or for use in anti-poverty programmes in developing countries.

But how promising would a (possibly universal) tax on foreign exchange transactions be as a source of revenue for social development? Inevitably, it would not only impose a burden (reduce disposable income) like all taxes, but also compete with other sources of revenue. Its collection can be expected to reduce other tax bases – though not to such an extent as to eliminate the net increase in tax revenue, even if all the competing taxes would have been effectively collected, as they may not have been.

Until now, the main doubts that have been expressed about such a foreign exchange tax are: (1) that consistently collecting it may not be administratively possible; (2) that it entails inequitable cross-country burdens, since it would bear more heavily on countries with more open economies than on those of comparable average income whose economies are less open, and (far more important) that revenue would accrue quite disproportionately to countries hosting the main foreign exchange markets or (depending on the method of collection used) issuing the major “vehicle” currencies; and (3) it is held to need the cooperation of governments whose jurisdictions covers at least all significant foreign exchange markets.

In answering some of these concerns, the equity problem could be remedied by subsequent redistribution of some of the revenue. As regards the administrative feasibility of the tax, the tax's enforceability has been carried forward by a recent persuasive argument that, if the tax were to be collected through the settlement system for foreign exchange trades, rather than through the trading markets themselves, it could be made administratively watertight, regardless of the form of the financial instruments used, the location of the parties, or the site in which the payments were made.⁵

The overwhelming bulk of foreign exchange trades necessarily go through a system of netting and settlement among the banks, and this has become increasingly organized, centralized, and regulated. The need of traders to avoid settlement risk (the risk to one party that the other will not honor the agreement) requires that both sides of any trade should be settled simultaneously. It has recently become possible, through technological developments to achieve such simultaneous settlement universally, and central banks have required banks within their jurisdiction to use the netting and settlement system that has been developed. This requires that all the original gross foreign exchange trades should be recorded. It is probable that even foreign exchange trade carried out through exchange of securities will seek to go through the system because that is the cheapest way of avoiding settlement risk. A fee is collected on transactions that use the system. A tax on the same transactions could be collected as an addition to this fee.

In conclusion, if the political obstacles in the way of a universal foreign exchange tax (albeit nationally imposed and collected) could be overcome, the potential payoff – in terms of revenue readily available without significant allocative distortion – would be high.

2. Measures aimed at reducing corruption and international crime

Governmental corruption has a number of ill-effects. Statistical studies support the belief that it reduces expenditure on education and health, reduces the productivity of public investment and infrastructure, and reduces public revenue – as well as reducing foreign direct investment and the rate of economic growth.⁶ Three types of measures are suggested here: (1) transparency and the rule of law; (2) removal of tax allowances for foreign bribery; and (3) action on money-laundering.

a. Transparency and the rule of law

Corruption of tax authorities is regarded as one of the main reasons why many taxes in developing countries realize so much less revenue than knowledge of the tax bases suggests they should. Much of the opportunity for corruptly reducing the tax due would be removed if taxes were fixed rigorously by law so that no executive discretion

⁵ R. Schmidt 1999, "A feasible foreign exchange transactions tax", Paper presented to the North-South Institute, Ottawa, June 1999.

⁶ V. Tanzi, "Corruption around the world." IMF Staff Papers, 45, 4 December 1998 pp.585-586.

was possible. Since it will not be possible to remove executive discretion entirely, at least it should be minimized (confined to the interpretation of clear rules), and any significant decisions, and reasons for them, should be recorded and the record be made publicly available (so-called transparency). If the government and senior officials are permissive about tax corruption, there is not much choice that it will be curbed; but if there is a will to reduce it, transparency and minimal administrative discretion will help by making the concealment of corrupt arrangements much more difficult.

Even when there are no corrupt payments, discretion over the granting of tax concessions can easily erode revenue for no sound reason. Officials wanting (with the best of motives) to attract foreign investments may be led to give away too much because they are likely to know less about the investing firm's real intentions than the investing firm itself. Strict limits to the concessions fixed or allowed by law can overcome this effect of relative weakness.

b. Removal of tax allowances for foreign bribery: criminalization of foreign bribery

An important part of the demand for illegal favours in developing countries arises from OECD country investors. There are new resolutions, under OECD auspices, for governments to penalize any of their own residents who contribute to it. OECD countries agreed in a recommendation of April 1996 that members should not allow bribery of foreign officials to be a tax deductible expense. By late 1999, 18 countries had legislated accordingly. In 1998, the OECD agreed to a Convention on International Bribery that required signatories to establish that bribery of a foreign public official was a criminal offense under their own law and to take other action to make such criminalization effective. Though there are the usual arrangements for the Convention to come into force after so many countries of significant weight in international transactions have formally accepted, approved or ratified it, there is no good reason, why any country, OECD member or not, signatory or not, should not take the recommended action unilaterally.

c. Action on money-laundering: information requirements and confiscatory provisions

Money laundering refers to the use of financial intermediaries for disguising the origins of earnings from criminal activity. What it protects typically are earnings from extortion and illegal drugs, sex and firearm sales, and income seeking to evade tax. It depends on secrecy, among banks and other financial institutions, about customers' accounts.

The first task is to reach international agreement on rules for financial institutions that would give reasonable confidentiality to depositors and borrowers on matters relevant to their position as commercial competitors, while at the same time allowing their governments, and foreign governments with a legitimate interest, access to information with a bearing on criminal activity or on the liability of taxpayers within their jurisdictions.

It is extremely likely that some countries that have made a reputation from banking secrecy would resist any such provision even if there was wide agreement upon it in the rest of the world. It would be important to look for ways of inducing them to cooperate or else of neutralizing the effect of their non-cooperation.

Similarly, there should be international agreement on guidelines for laws that would permit a government to confiscate after due process, from a financial institution within its jurisdiction, sums corresponding to amounts passing through the institution that could be shown to be the proceeds of crime. Laws might also be agreed to permit governments to stop foreign exchange transactions on the part of institutions that are on good grounds suspected of handling of earnings of illegal activity. There might be a resolution to direct any confiscated funds to social purposes.

3. Self-financing measures: Intermediation

Here are included ways of obtaining funds, either specifically for the benefit of the poor or in ways by which numbers of the poor are likely to benefit, through financial intermediation rather than through taxation. It is a question of removing blocks to certain types of loan transactions that would be of value to both lenders and borrowers – with very poor people benefiting directly or indirectly. These methods have the great advantage that they can be employed without the need to raise or commit public funds, or at least without the need to do so after an initial period.

a. Commercialized micro-finance

Micro-finance covers lending in very small amounts to the “entrepreneurial poor”. It has been introduced in a number of countries in South and Southeast Asia, Latin America and the Pacific, following approaches pioneered most famously by the Bangladesh Grameen Bank. These ventures have shown that lending to the poor is possible, with high recovery rates on the loans, and at rates of interest that can be high enough eventually to cover the full costs, and furthermore that by these means the incomes of many poor families can over a period of years be substantially increased – provided certain rules of good practice are observed. The rules of good practice have been well documented based on abundant experience.

It is important for governments to deal with micro finance at arm’s length; through NGOs or else through autonomous state owned institutions, either set up specifically for micro finance or operating for the purpose through specialized firms. Grant finance provided by the state from its own resources or aid funds should be treated as seed corn to cover the initial high cost period of lending in any locality and thus to finance expansion, but not to finance continuing operations, which should be put into a commercial basis as soon as that can be done. The reasons for this, given that it has been shown to be possible, is that, though it is vital that there should be continuous availability of new loans for past borrowers, public and charitable funds cannot be relied upon to flow indefinitely; and that the more existing lending operations can be made self supporting, the further can finance for the poor be extended.

Once operations are fully self supporting, covering market interest rates as well as the relatively high administrative costs of maintenance and expansion that are necessary in this type of lending, potentially vast resources of commercial loan capital are available.⁷ For governments, it is a matter of (a) persuading commercial banks to set up special departments to deal with micro borrowers directly, or else (b) equipping (or creating) other lending borrowing agencies to act as intermediaries between the ultimate customers and the banks, and ensuring that these agencies have the expertise needed for them to be regarded by commercial banks as reliable borrowers. In addition, adequate training of managers is crucial.

b. Intermediation in housing finance

The durability of housing means that, when middle income people build new houses for themselves in order to upgrade their accommodation, they release other dwellings for those below them on the income scale, which as a result tend to fall in price. The process continues down the housing and income ladder. More middle-income housing – built commercially or by households for themselves – means more low cost housing. So whatever facilitates unsubsidized private house building will increase the supply and reduce the market price of accommodation for the poor.

There appears in many countries to be a latent demand for improved housing that requires only the supply of finance, in suitable form but at full market rates of interest, to become effective. Spending on housing has the advantage in countries with abundant unskilled labour that it is highly labour-intensive in the inputs that it demands and so it can generate national income with a low import component. A switch of spending towards house building is likely to be a switch towards local inputs and to mean therefore that more national income than before can be sustained from a given level of foreign exchange earnings. Linking the supply of funds to the latent private demand for housing will thus tend to increase potential national income as well as the market price of accommodation for the poor. An attempt to make full use of this opportunity was the experience of Colombia in the early 1970s.⁸

c. Indexed bonds in small denominations

If a government wants to discourage the funds of private savers from moving abroad and to attract them for public purposes, it is reasonable to issue bonds whose value is fully indexed to inflation and at rates of interest comparable with current world rates. Small lenders might be further attracted if the government agreed to buy the bonds back at any time at their indexed values with only a small discount.

⁷ According to a study covering East Asia and the Pacific (See R. Goodwin-Groen, The Role of Commercial Banks in Microfinance: Asia-Pacific Region, Foundation for Development Cooperation, Brisbane, 1998, pp. 3,8), virtually all successful microfinance institutions charge commercial rates of interest.

⁸ L. Currie and L.E. Rosas, UPAC: A Theory Converted into a Successful Reality, Instituto Colombiano de Ahorro y Vivienda, Bogotá, 1986.

4. Levies on land and natural resources

Levies on the possession or use of natural resources have several advantages. One is that the entities on which they are based cannot move from one jurisdiction to another. A second is that in principle taxes can be imposed upon them up to just short of their full user value (their “resource rent”) without discouraging effort, saving, or enterprise, and generally without any distortion, in resource allocation. A third that often applies is that, where the state is the owner of the resources and a private person has acquired their use in full knowledge of the conditions, there is no objection in equity to taxing their use up to their full user value.

Governments do often collect taxes that fall more or less on national resource use, but fail to take full advantage of the opportunities offered because the taxes fall on other activities or factors as well. If very high rates are to be imposed without economic loss, the taxes must be closely targeted to the value of the resources rather than falling also on labour, capital, or enterprise.

For the use of most natural resources other than land (minerals, hydrocarbons, water sources, forests, fisheries, broadcasting wave lengths), there is no publicly known market price that can readily be applied to estimate the user value or rent in each case. There are broadly two approaches to taxing them that may be efficient: *ex-ante* and *ex-post*.

a. *Ex-ante*: auctioning of rights

Auctioning of rights in advance of any development expenditures has been applied to offshore hydrocarbons in producing fields by the United States federal government since 1954 (“cash bonus bidding”) and by some other authorities and landowners in North America. The successful oil company pays only what it has bid. Since the sum is paid before any development can begin, decisions on exploitation (extent, speed, timing) cannot be affected by it, so that the tax cannot generate any misallocation. Moreover, the method has the advantage that, as well as collecting revenue, it also allocates the use of the resource to one firm by a method that can readily be protected from favoritism or corruption. The United States has taken sealed bids for oil and gas leases in order to minimize the chances of collusion among bidders. Evidence from the early period of United States experience with the auctioning of oil and gas leases suggests that what was collected by the authorities in bids actually exceeded what could reasonably be considered the true rent of the resources.⁹

Auctioning may be applied also to forests, water, fisheries and wave lengths. It does not seem to have been used for deposits or metal ores. The reason for this exclusion, relates to the fact that the mining company needs to have an assured right to exploit if it should choose to do so – in light of the considerable outlay needed to assess the value of the deposit – not a claim that will depend on whether it later bids the most.

⁹ W.J. Mead, “Cash bonus bidding for mineral resources”, in M. Crommelin and A.R. Thompson eds., Mineral Leasing as an Instrument of Public Policy, University of British Columbia Press, 1977.

b. *Ex-post*: taxing discounted cash flow or equivalent

The approach characteristic of Papua New Guinea since the late 1970s, and of Australia for offshore oil and gas since 1985, has been one in which the economic rent of the resource has been estimated, progressively as exploitation proceeds, on the basis of cash flows actually associated with the extraction, which are then discounted (accumulated) at an interest rate that is supposed to approximate to the cost of capital for the activity concerned. As positive net cash flows over the life of the operation to date are realized, they are taxed at a proportional rate. So the base on which the tax is calculated has had the cost of capital, as well as the costs of other inputs deducted. The tax – a so-called “revenue rent tax” – is applied before corporation tax is assessed and becomes an expense for corporation tax purposes. Since the resource rent tax approaches neutrality in that only the surplus (representing the value contributed by the natural resource), not the normal reward of any other input, such as labor or capital is taxed, the rate of the tax may be high without serious loss of efficiency. However, in order that a resource rent type tax should come close to falling exclusively on the economic rent and so avoid distorting effects, the rate at which the discounting of cash flows is applied for purposes of estimating the tax base should be close to the rate likely to be applied by the extractors in their own decisions.

In conclusion, it would seem that some form of prior auctioning of rights will be appropriate for water, fishing, forestry, and radio wave lengths – in all of which some reasonable estimate can usually be made in advance of the quality of the resource and the returns to be expected on it – and also (at least in some circumstances) for oil and gas. For metals, prior auctioning may not be appropriate, and in these circumstances a resource rent type tax may give the best approach to a charge falling exclusively on the economic rent. If even where auctioning seems appropriate, there is any likelihood that the price reached by auctioning may fall seriously short of the true economic rent of the resource, a resource rent type tax may and probably should be applied as well as the auctioning of rights. With renewable resources, there should of course also be conditions imposed on the user to maintain or restore the value of the resource, and the lease should have a fixed period. These guidelines apply most directly to new allocations of rights. Where extracting firms have acquired rights under one set of fiscal rules, any change in the rules applying to them has to be considered carefully for its possible unfairness and for the uncertainty that it may generate among future firms considering the acquisition of rights.

c. Taxes on rental value of land (“unimproved” land value)

Taxation on real property, especially for local government purposes is common. But, in order to avoid distorting effects such as the discouragement of building, such taxes should be based on the rental value of the natural resource exclusively, that is on the unimproved or site value of the land: what the value of the price of land would be if it had no buildings on it but its circumstances were otherwise unchanged – its value solely on account of its size, natural quality, and position. It is true that much of this value will commonly be due to developments of human origin around it but these are just

as much a gift to the holder of the land as is the land itself. This form of local government tax is normal in Australia and has been applied elsewhere.

Land's (unimproved) value may be raised considerably by developments (such as urban expansion or changes in land use planning) that occur quite independently of any sacrifice or other decision on the part of the owner or user and are often, in part least, publicly funded. There is a strong case in equity for diverting at least the value of such gains to the public rather than leaving such gains with the lucky owner who happens to be holding the land when they occur. An *ad valorem* tax on the annual unimproved value of the land that is revised as the market value changes goes some way to meeting this requirement. Where the State is already the landowner but contemplates privatization of the use of the land, there is a great advantage in not alienating it to private buyers permanently but instead making it available under a lease – on the understanding that the bulk of the payment for the lease will be assessed *ex-post*, that is annually or more often on the current use value of the land. Unlike an oil-producing block, a piece of land is likely to be permanently valuable, and in many urban settings increasingly so as time goes on. A lease for a rolling period of years can give the user considerable security of tenure and there can be formalized provisions for giving a developer the full value of improvements if the land is ever withdrawn from his use.

However, it is obvious that, where land is the principal property of many poor people, any general tax on land that aims to tax part of its economic rent must be applied with extreme moderation. One solution is to exempt from taxation individual holdings of land below a certain value. Also, where land has been bought on one set of assumptions about the taxation that will fall upon it, for the State to increase the burden on it without similarly increasing the burden on other assets might be regarded as unfair and should therefore probably be done only very gradually.

Land as a tax base has the further advantage in terms of the issue of tapping resources for social development since revenue derived from it is generally the practice of subordinate or local governments and these often have the responsibility for major social expenditures.

5. Valorization and development charges: linking payments to local benefits and costs.

a. Valorization

Relating local tax measures closely to benefits received has been advocated as a way of reducing the political objections. A method of doing this was undertaken very seriously in Colombia from the late 1950s. It was used as a way of financing a number of urban improvements, notably roads, pavements, and sewers. It was known as *valorization*¹⁰. The charges for any particular work were divided among the owners of

¹⁰ W.F. Doebele and O.F. Grimes Jr., Valorization Charges as a Method for Financing Urban Public Works: the Example of Bogota, Colombia”, World Bank Staffing Working Paper No. 254, World Bank, Washington, D.C. 1977.

properties held to be favorably affected by it. The total charges were not higher than the cost of the improvement, but they were allocated among property owners in proportion to the assessed benefits that each received in enhanced value. They were in principle lump sum levies but their payment was spread over a period of up to five years. The ratio for each paying household between the sum due and its income determined the length of spread, so that no one had to pay in a year more than a certain proportion of income.

The problem of timing – that the works inevitably took place before much of the levies were paid – was met by various devices. There was a revolving fund, apparently with some initial direct state or municipal finance. Also contractors could be paid in bonds, which they could sell. Property owners were allowed to pay their dues in these bonds, with discounts for paying early.

b. Development charges

A different application along somewhat similar lines is to charge urban property developers in advance an estimate of the *pro-rata* share of the public sector cost of providing additional public facilities (such as water, drainage, sewerage, policing, road maintenance) that their development will entail. This type of device has been used in North America and in the Republic of Korea.

6. Reforming public enterprise pricing and management.

The reference here is to the pricing and management of infrastructural services – power, water, sanitation, transport, communication – but what is said refers also to public enterprises in general.

There are two separate issues. Very large additional resources in many countries could be found for public purposes – with additional advantages – by charging for public utilities at their full cost. Also inefficiency and waste in the delivery of infrastructural services leads to considerable reduction of real incomes; the gains from eliminating this waste could be either passed on to the consumers or retained by the government.

This is potentially a huge well of additional resources. Removing subsidies and correspondingly expanding services may work strongly to the net benefit of the poor, who would often willingly pay the full average cost, rather than be without the service. Management may be improved by a variety of devices, of which straight privatization is only one. Removing subsidies (and the corresponding need to ration services) removes a fertile field of corruption, and for many services it is conducive to environmental improvement.

7. Stabilizing fiscal expenditure

Securing resources for social development is likely to depend on medium term fiscal planning. This involves both stabilizing the overall level of fiscal expenditure as far as possible and setting constant price or proportional limits to the various major categories of expenditure. If the first of these tasks can be achieved, the second is

comparatively easy – a matter of internal policies – and the purposes of fiscal planning can be fulfilled.

In stabilizing fiscal expenditure, what is needed is: (a) both a consistent attempt on the part of the government to relate fiscal outlays in each period to trend or “expected” revenue (after allowance for planned borrowing or repayment of lending); and (b) protection of insurance against extreme exogenous fluctuations in fiscal revenue and national income. The second (b) gives the first (a) a much enhanced chance of success, and it may also be used as an incentive for attempting (a).

There are two main exogenous sources of extreme instability to which developing countries may now be subject. One is the instability arising principally from fluctuations in primary export earnings but capable of being aggravated by other changes, for example in prices of food and energy imports, in world interest rates, and in absentee worker remittances. It is the instability against which the IMF’s Compensatory and Contingency Financing Facility (CCFF) and the European Union’s STABEX and SYSMIN schemes have been directed.

The other type is the instability characteristic of the 1990s and tending to affect semi-industrialized or industrializing middle income countries. This is the instability resulting from massive capital flight and capable of occurring even when macro-economic variables seem satisfactory.

a. Cushioning primary export economies

Where crop earnings vary greatly, the traditional approach has been to use national producer price stabilization schemes. These (though technically quite capable of contributing considerably to stabilization both individually and nationally, as has been shown by certain countries such as Papua New Guinea) have come into disrepute because of their abuse by governments. In response a recently formed International Task Force on Commodity Risk Management, staffed by the World Bank has been investigating the possibilities of using market devices, such as forwards, futures and options, in order to provide individual crop producers, and individual purchasers of imported food and energy commodities, with a measure of stability in the prices they receive or pay. This project has large implications not only for national stabilization but also for the welfare of the individuals concerned, potentially very large numbers.

An additional measure that is proposed here for cushioning primary export economies is an insurance fund to which participating countries make non-repayable contributions when exogenous factors are favourable in relation to trend and receive non-repayable transfers when they are unfavourable. The relative magnitudes of the two for comparable deviations would be determined by projections of the relevant exogenous factors across the system in order that the scheme can expect to be self-financing. To this end, for each country a composite indicator of exogenous factors affecting income, publicly translated into a common measure according to their impact on external power is suggested. Provision by the international community for backstopping of the insurance

fund is also suggested, in case in spite of reasonable planning for self-sufficiency, it should run out of resources.

b. Curtailing rapid speculative capital flights

Ensuring that rapid capital flight cannot pay is an approach which is exemplified by the suggestion made earlier that if the machinery were in place for collecting a universal tax on foreign exchange transactions, such a tax at a prohibitive rate might be temporarily imposed (cued by an objective indicator) on transactions out of any currency whose effective exchange rate had fallen more than a certain amount below “trend” (as defined say by a moving average)¹¹.

This measure would have the advantage over the usual form of restriction of capital outflows that it would come into force only temporarily, that it would not require regulatory distinctions among different forms of capital outflow, and that the announcement that it was in readiness might remove the necessity of its ever actually being applied.

II. TAX POLICY, ADMINISTRATION AND REFORM

¹¹ P.B. Spahn, “The Tobin Tax and Exchange Rate Stability”, Finance and Development, 33; June 1996, pp.24-27

A. Interlinkages, mutual effects and corrective policies

While there may be some disagreement on the extent to which government should be involved in attaining economic objectives, its overall desirability is generally accepted to be crucial. The government's role requires both that it is able to finance its activities in a non-inflationary way through compulsory extraction of resources from households, as well as that the resultant distortions constituted by taxes as wedges that influence relative prices are minimized. Herein lies the primacy of tax policy in helping to attain economic policy objectives. More importantly, in the same way that tax policy should have a dynamic orientation to respond to changing economic circumstances, tax administration must itself evolve an internal dynamic to promote the effective application of tax policy. For the design of tax policy to be successful, it must also pay due attention to administrative constraints; and measures to improve tax administration should help to make the implementation of designed tax policies move effective. Put simply, idealistic tax policy can complicate tax administration, while ineffective tax administration can undermine tax policy. Hence, failure to coordinate these activities is likely to affect adversely the pace and sustainability of the tax reform process. Moreover, it is wise for modifications to current regulations or the introduction of new concepts to be based on their transparency¹². The most important property of all taxes, is their ability to be collected.

It is widely recognized that tax policy and tax administration are intrinsically linked. In this interrelationship, however, tax policy formulation is generally seen to precede tax administration. This is because only when a tax structure is legislated does tax administration come to play its role in the implementation of policy. In developing countries, however, the direction of the link may not be quite so apparent. Indeed, the proposition has been put forth that in developing countries tax administration is tax policy¹³. This would imply that, however fine the design of the tax structure might be in a representative developing country, it is the interpretation and implementation of the law that counts. These elements reflect the need for adequate capacity of the tax administration in place to implement the law.

Indeed, policy failures in the choice of tax system components and poor administration of taxes are to be found in many developing countries. Inappropriate tax systems have a variety of unwanted consequences including: (1) Uncertainty about public services due to taxes being unreliable sources of revenue; (2) Tax systems imposing significant costs in terms of lower economic growth and inefficient resource allocation, particularly in countries that can ill afford the additional burden; and (3) Arbitrary and inequitable economic transfers between different groups.

¹² Transparency levels in various countries have tended to correspond closely to the levels of economic growth over the past decade. The fast growing members of the transition economies group have higher transparency standards than Russia, Ukraine and other members which have experienced slow growth.

¹³ Richard M. Bird and Milka Casanegra, Improving Tax Reform in Developing Countries, International Monetary Fund, Washington, DC, 1992

For developing countries, the effort to introduce effective and efficient tax systems, involves some formidable challenges¹⁴. The first is the structure of their economies, which makes it difficult to impose and collect certain taxes. The second is the limited capacity of their tax administration. The third relates to the poor quality of basic data and also to the fact that in many developing countries the political sector is less inclined to apply a rational fiscal policy or less responsible in doing so than in the developed countries.

Tax revenue yield is influenced by both tax policy and tax administration. The concern of tax policy is to ensure the elasticity of responsiveness of potential revenue to overall economic growth and this depends on how the tax bases, and the tax rates applied to them are established. For example, if tax bases are eroded because of tax exemptions and deductions for achieving various social and political welfare objectives, tax rates would have to secure a given level of potential revenues. There is, however, a limit to which tax rates can be raised before they begin to affect adversely the behaviour of economic agents, in particular, as regards their decisions to work, consume, save, and invest.

Tax administration assumes that tax bases and rates are appropriately established and seeks to secure as much as possible of the resulting potential tax revenue effectively and efficiently. The more complex it becomes to administer taxes because of the need to ensure the correct application of numerous exemptions and deductions and multiple tax rates, the less effectively will the tax administration collect the potential tax. At the same time, its efficiency will also be diminished because the costs of such collection will rise.

In sum, an appropriate strategy for tax reform would first involve studying the tax structure and setting appropriate policy goals, and then modifying these in the short-term by taking cognizance of the associated administrative problems. If the ordering were reversed and administrative considerations became the binding constraint in a tax reform, which by its very nature is a longer-term process, the tax system is likely to play only a very limited role in achieving economic policy objectives.

The design of tax policy is of paramount importance for tax administration. In developed countries, the complexity in their tax structures has necessitated increasing international cooperation on exchange of taxpayer information, transfer pricing and arms length rules, and attempts at the development of harmonized rates, accounting rules and executive statutes and action¹⁵.

Tax policy formulation and reform should aim at simplicity, equity and comprehensiveness of tax law and taxpayer related procedures. If efficient and feasible administration is an objective, the structure of all taxes should comprise common

¹⁴ Vito Tanzi and Howell Zee, *op.cit.*

¹⁵ International Fiscal Association, Visions of the Tax Systems of the XXIst Century, 50th Congress in Geneva, Kluwer, The Hague, 1996.

elements: low rates, few nominal rates, a broad base, few exemptions, few incentives, few surcharges, few temporary measures, and where there are exceptions, clear guidelines. This is because a simple tax structure induces better tax administration.

In developing countries, tax reform strategy should also aim at rationalizing tax and tariff structures and making greater use of broad based consumption taxes, such as a modern VAT with ideally a single tax rate of say 17.5% as in the case of Zambia, a threshold to exclude small business, and the broadest possible coverage of goods and services.

Reforms of tax administration have reinforced the introduction of more modern tax structures in many developing countries. In some countries, a first step in the reform of the tax administration was to simplify taxes, a step that was complemented by administrative reforms. More generally, reforms of the tax administration typically included elements such as wider registration of taxpayers, the simplification of procedures for taxing the informal sector, the establishment of large taxpayer units, and staff training and computerization. Tax administration reforms typically have long gestation lags, and, therefore, cannot be utilized as short-term revenue measures. For example, the introduction of a VAT in Benin was implemented over an extended period and was the catalyst for other reforms in tax administration.

Appropriate sequencing of tax reform is important for the overall success of the reform strategy, especially given the limited administrative capacity of many developing countries. In this connection an early focus on implementing a VAT, beyond its importance for revenue, can be justified in terms of motivating necessary improvements in overall revenue administration. Benin, Kenya, and more recently, Uganda and Zambia have used the introduction of new systems and procedures for the VAT as a catalyst for reforming the administration of other taxes. A successful VAT comes with a package of new administrative systems and procedures that replace existing and often, antiquated policies and practices. These new procedures include the reforms mentioned above and, more specifically implementing unique taxpayer identification number, introducing self-assessment, and developing audit plans and procedures. These reforms are often reinforced, or followed, by the introduction of new systems and procedures for taxing small businesses and the informal sector, including the possible introduction of presumptive taxes on these sectors. Once the VAT system is operational, new systems and procedures for administering the tax are often then extended to other taxes such as the business income tax and withholding taxes on wages and salaries.

In the final analysis, tax structures have to reflect what is administrable, minimizing the number of tax concessions, incentives and tax rates and ridding the tax system of taxes, which have outgrown their utility. The success of revenue mobilization over the medium term depends significantly on the implementation of comprehensive reforms in revenue administration, through the strengthening of institutional capacity, the improvement of systems and procedures, and giving greater authority to revenue administration. Revenue administration occupies a pivotal position in the overall financial administration in terms of the collection of optimum revenue at a minimum

cost. If it is to fulfill its potential, the tax system must be simple, equitable and neutral, with an emphasis on its role in the pursuit of a sound fiscal policy, the achievement of optimum tax effort levels and the establishment of an appropriate tax structure with a view to fostering economic growth.

A significant feature of tax administration reform in many developing countries was the establishment of an autonomous tax administration separate from the finance ministry or treasury and, in some cases outside the regular civil service (for a discussion of this issue in reference to Sub-Saharan Africa, see Annex 3). Separating tax administration from the regular civil service and thus providing more flexibility in setting salary levels of tax officials and in hiring and firing staff, if supported by political commitment and reinforced by organizational reforms, has been found to enhance productivity and contribute to substantial revenue gains, although there are cases in which the initial granting of autonomy was withdrawn (Ghana). Along with granting the revenue administration greater autonomy, the change often created opportunities to make organizational changes that supported implementation of more efficient, modern procedures. In the case of Zambia, it led to the modernization of Direct Taxes.

Technical assistance, when well designed and implemented in line with growth in local capacity, can play an important role in tax administration reform. Indeed, technical assistance from the International Monetary Fund and other providers such as the United Kingdom's DFID (Department for International Development) has been proven to be a catalyst for authorities to undertake fundamental tax administration reform in a number of developing countries). It has focused particularly on building institutional capacity aimed at increasing voluntary compliance and self assessment, expanding the use of final withholding taxes, improving collection procedures, developing audit plans and procedures, and reorganizing the tax administration along functional lines, generally with positive results (Albania, Benin, Bolivia, Guinea, Mongolia, Mozambique, Uganda and Zambia).

B. Ramifications of tax policy for tax administration

In many developing countries, tax laws may be extremely well designed and detailed. But unless the accompanying tax administration is able to handle these laws in terms of having the appropriate staff to interpret and implement them, the field level reality of the actual incidence of the tax system may be quite different from the original objectives.¹⁶ The taxes may be passed on to those on whom they are not meant to fall, and the distribution of the burden may turn out to be indiscriminate. Economists will have a field day carrying out exercises regarding the "time incidence" and "efficiency costs" of various taxes, lawyers will have to litigate tax matters because of the difficulties

¹⁶ Angelo Faria and Yucelik Zutu, "The Interrelationship between Tax Policy and Tax Administration", in Parthasarathi Shome (ed), Tax Policy Handbook, International Monetary Fund, Washington, DC pp.267-272.

in interpreting complex tax laws and, accountants, ploughing through a myriad pages of the tax code, will successfully advise clients in careful tax planning so that their tax burden is minimized.

The introduction of effective and efficient tax systems in developing countries, involves some formidable challenges.¹⁷ The first is the structure of their economies, which makes it difficult to impose and collect certain taxes. The second is the limited capacity of their tax administration. The third relates to the poor quality of basic data and also to the fact that in many countries the political sector is less inclined to apply a rational fiscal policy or less responsible in doing so than in the advanced countries.

Reform strategies should also seek to modernize tax administration, keeping in mind however, that such institutional reforms take time to produce needed revenue gains. The modernization strategies of such tax administration institutions should amongst other things include: legal provision to govern the administration, administrative autonomy, budget determination procedures, well defined organizational and tax structure and divorced from political interference in administrative decisions.

Generally, developing countries with low revenue to GDP ratios (around 10 per cent) should emphasize, efficient revenue mobilization as a key element in rectifying fiscal imbalances. At much higher revenue to GDP ratios (generally more than 20 per cent), persistent macro-economic imbalances would call for shifting fiscal consolidation efforts towards containing expenditures.

In developed countries, the roles of tax and fiscal policies follow from the view of the role of government in organizing economic activities. The activist role for governments appears to be giving way to a more restrictive view that in a market economy, governments exist essentially to promote the development and efficient functioning of market forces over the longer term. In this context, “tax neutrally” has been invoked by fiscal experts as the prime guide for a tax system designed to work with market forces.

Where however, “market failure” is manifested because of public goods, externalities, natural monopoly and asymmetric information, state intervention is observed to be warranted. In these cases, however, the state is called upon to facilitate the provision of, rather than to produce, such goods and services, thus necessitating an explicit transfer of financing resources between the private and public sectors. Hand in hand with this shorter term revenue enhancing role of tax policy is its perceived contribution to short term economic stabilization. There remain, however recognized longer term functions for the tax system represented by its allocative function, primarily in influencing the consumption/investment resource balance through tax/price wedges and, to a lesser extent, its redistributive function in reducing socially skewed distributions of income and wealth. A more recent emerging role for tax systems – at least in some industrial countries – is through adjustment of energy taxes to reflect environmental concerns. However, the need to finance burgeoning government expenditure without

¹⁷ Vito Tanzi and Howell Zee, “Tax Policy for Emerging Markets: Developing Countries, *op. cit.*”

recourse to inflationary bank financing or augmenting the government debt burden means that, in the short-term, the revenue enhancing objective is more important than other objectives.

By contrast, in developing countries and transition economies, the role of taxation hovers uneasily between its former function as a passive system of predetermined transfers and a more modern role as an instrument of macro-economic policy that influences the behaviour of economic agents. The public sector still effectively controls virtually the whole economy, and enterprise activity and employment are largely public in character, with output and prices at both the sectoral and individual firm level only gradually being freed from centralized controls. In this system, taxation of employees has taken the form of withholding taxes on individual earnings, and of payroll based social security contributions, in a controlled wage setting environment. For enterprises, a system of regulated volume, price and profit differentials operate, with the result that no tax laws had to be legislated and that a wide variety of arbitrarily established nominal – and more important effective – tax rates operated in practice. In place of compulsory explicit transfers between the private and public sectors through taxation, as in market economies, there was a centralization of revenue and its subsequent allocation or earmarking through transfers to other levels of government and to state enterprises.

All transition economies have accepted the need for a fundamental restructuring of their tax systems as they evolve from being controlled economies to becoming market economies. This restructuring is necessary to take account of the micro-economic efficiency effects of taxation applied to newly independent economic agents. Also, in the short run, macro-economic considerations call for maintaining fiscal stability in the face of contracting tax bases and rising demand for significant social welfare and public infrastructural outlays.

While tax reform in transition economies to be effective cannot be long delayed, it also cannot precede underlying structural change. The central dilemmas for policy makers are how to balance longer-term concerns of equity and allocative efficiency with the shorter-term concern with declining revenue and whether to go for a “big bang” comprehensive approach in adopting a western type tax structure or to proceed more gradually. In practice, they have adopted elements of both approaches, in the process saddling themselves with complex distortionary features.

The overall record in transition economies is, at best, mixed. Transition economies' VAT systems remain complicated to operate because of the retention in the countries of the origin principle and a cash rather than accrual basis of assessment; multiple rates, excessive exemptions, and mixes of invoice and accounts based methods of establishing tax liabilities. Similar multiple rates and excessive exemptions, especially for agriculture characterize the schedular income tax and profits tax. Land taxes remain primitive, in part reflecting the uncertain situation regarding land titles and thus land values.

It can be argued in general, that reformed tax systems are difficult to legislate, and once legislated, even more difficult to implement unless complemented by institutional administrative (including legal), and attitudinal changes within the tax administration and taxpayers. Clearly, the normally difficult and drawn out process of tax reform is likely to prove even more so in transition economies.

1. Customs tariff structure and exemptions

In the 1960s, it was characteristic of developing countries to have high and multiple tariff rates in a wide array of customs classifications. These also tended to differ across countries. Slowly, most nations regularized them under the CCCN classification system that made them comparable across countries. Often the twin objectives of customs reform were rationalization of the rate structure as well as the restoration of a clean, viable customs administration. Indeed, the administration was made easier as the classification system became standardized, as the challenges to identify imports and exports according to classification codes became less arduous simply because the number of tariffs were reduced, and as the need for one-to-one encounters between tax official and tax administrator diminished, reducing the likelihood of corruption. In the most extreme case, Chile introduced a uniform tariff for all commodities so that the tariff structure could have no detrimental influence on customs administration.

Box I. Reform in the design of custom duties in India in the 1990's

In India, during the 1990's, significant improvements were made in the design of taxes. The number of customs tariff rates was reduced significantly; the structure was rationalized in that input tariff rates were made significantly lower than output tariff rates; and the rates themselves were markedly lowered, so that the average tariff rate was reduced from 55 percent at the beginning, to a little over 25 per cent at the end of the decade. These changes in the structure of customs tariffs that resulted in reducing the number of customs classifications, in turn leading to greater transparency made customs administration much simpler and less prone to corruption. But while the rate structure was thoroughly reformed (and further reductions are contemplated), the customs tariffs remain burdened with exemptions with a wide coverage and such detail that they have a toll on the efficiency of the administration. To take a specific example, there is a customs tariff exemption that allows a lower duty to the import of resin that is used to manufacture shoe soles. However, it may be quite difficult to convince appraisers in the customs department as to the purpose of the resin imported since it may always be argued that resin has many uses. The probability of the issue getting resolved in an informal basis is high, therefore.

The minimization of exemptions is a very important objective. In the early design of tax policy, exemptions tended to play an important role, whether they be in the area of customs tariffs, the value added tax, excises, individual income tax or the corporate income tax. Even smaller taxes such as the capital gains tax, wealth tax, and inheritance tax at the federal level, or the property tax, motor vehicles tax, professions tax and the

like, at the local level, were typically replete with exemptions. Not only was the number of taxes affected by exemptions very large, but the conditions under which the exemptions were applicable were very complex. In such unreformed tax structures, exemptions and reliefs added to the discretionary power of lower level tax administrators. Most countries reforming their tax structures, whether they are in East Asia, such as Singapore and Thailand or in Latin Americas such as Argentina, Brazil, Chile and Colombia have made serious attempts to curb the spread of tax exemptions and reliefs, though not always with complete success. Only the abolition or a major scaling back of exemptions that would almost completely remove discretion, except where absolutely justified, would help restore transparency and honest administration.

2. Domestic consumption tax rate structure and exemptions

In the area of domestic consumption taxes, early post World War II years witnessed the imposition of domestic taxes on production and consumption that were finetuned to assumed elasticities of demand, to differentiated social considerations and purely revenue considerations that typically led to a multiple rate structure. At the same time, these taxes cascaded, with no offset or credit being given for taxes paid at various stages in the chain of production and distribution¹⁸. They were inefficient in that they affected production decisions adversely and led to misallocation of resources.

Interestingly most unitary governments had such distortionary turnover taxes at the federal level (including advanced countries in Scandinavia) while decentralized nations imposed them not only at the central level but also at the level of states or provinces such as in Argentina, Canada and India. Reforms appeared generally at the federal level first, with the introduction of a value added tax (VAT) that gives credit for input tax earlier paid, with the twin objectives of administrative efficiency and minimizing tax induced distortions. The administrative improvement emanates from the built-in cross verification advantage of the VAT since VAT paid on inputs is not credited to a producer in the absence of an input invoice. The structural improvement takes place in that the VAT eliminates distortion as represented by misallocation or redirection of resources from one economic activity to another. Therefore, it does not alter producers' decisions to produce particular commodities that, in general should reflect the demand from consumers. However, for this benefit to occur, the VAT must give credit for raw materials and capital goods. Only this form of VAT is a consumption-type VAT and is equivalent to a retail sales tax. Many countries have, however, taken long or have flip-flopped in their decision to introduce a consumption-type VAT including Brazil, Colombia, India and Turkey to name just a few.

¹⁸ Typically, a tax that is collected on inputs is fed into the price of the output. That is the purchaser who uses inputs and produces the output keeps the value of the input tax that he paid within the pricing of his output. Therefore, when the output is taxed, not only the value added of the output is taxed, but also its input, together with the tax on the input that had been earlier paid (because the input tax is incorporated into the output price). This has the unintended effect of: (1) taxing an output (together with its input content) more than once; as well as (2) applying a tax on the earlier paid input tax. This tax on tax is called cascading. It should cause producers to move their capital or resources away from the production of this output to another one which does not suffer from cascading. Parthasarathi Shome (ed), Value Added Tax in India: A Progress Report, Centax Publications, New Delhi, 1997.

Today, more than a hundred countries have introduced the VAT. In keeping with the importance of simplicity in tax structure, the VAT should have as few rates and exemptions as possible. Information collected from the International Monetary Fund for about sixty of those countries revealed that about half of them have single rates even though many of them began with more than one rate. This would tend to indicate that it is quite possible to progress towards a simple VAT rate structure. However, many countries do have more than one rate. They tend to have differentiated lower rates for essentials such as clothing, medicine, books, electricity, public transportation and water¹⁹. But few have more than three rates.

While the number of rates in most VAT structures is small, many countries have a multiplicity of exemptions thereby not only eroding its base but complicating tax administration. This is because exemptions break the debit-credit chain so that the built-in verification advantage of the VAT is jeopardized. In Costa Rica, for example, construction materials used for popular housing were exempted, though they were not for commercial construction. Since the same company may undertake later activities, it was impossible for the tax administration to authenticate the rightful use of this exemption. Thus, this type of selective exemption can only lead to inefficiency if not corruption. Unfortunately, many countries are unable to control the creeping in of exemptions. Therefore, VAT reform to clean up exemptions may be required every five to six years.

Box II. Reform in the turnover (excise) tax in India.

In the case of India, the central government's turnover (excise tax) reform began in 1986. Though its progress has been relatively slow, more than a hundred excise rates have been reduced to three main rates, and credit is given not only for tax paid on raw materials but also for capital goods. The tax is called central VAT (CENVAT). Distortions, however, remain within the overall VAT structure that tend to adversely affect resource allocation and efficiency of administration. One type of distortion arises from the fact that after having introduced and implemented immediate VAT credit on capital goods for four years, in 2000, the credit was scaled back to be given over two years. This was apparently done for recouping revenue but this type of modification affects business planning. Further, while three main rates have been announced and it is claimed that over 85 per cent of the goods are taxed at the main rates (and most of these at 16 per cent), there are other rates at which the remaining goods are taxed. The lack of clarity in the classifications for which the rates apply can cause administrative problems.

Box II. Continued

A major problem is the continuance of exemptions from the CENVAT. Though the exemptions number about 70, each exemption has many entries so that the actual coverage is more extensive. Thus, there are 259 "entries" under exemptions with 52

¹⁹ It is not at all clear, however, that exempting essential commodities benefits the poor in relation to the rich. In South Africa, for example, it was found at the time of the introduction of VAT, that the rich spent more in absolute terms on bread than the poor. Thus exempting bread implied greater tax expenditure (or sacrifice of tax revenue) on account of the rich than the poor. This type of fallacy is often encountered in the design of the VAT. Importantly, having more rates also erodes the administrative advantages of the tax.

“conditions” and 7 “lists”, including hundreds of items in each list. For textiles alone, there are 90 exemptions; for exports, 209 for small-scale industries, 5; and for contracted work (“job work”), 4. Apart from these broad categories, exemptions are given for particular items. Aside from the overall number, their descriptions tend to amplify their scope, for example, when exemptions are made conditional, such as “for use in leather industry”, thereby adding to the discretion of administration staff, just as in the case of customs tariffs.

The pernicious role of exemptions in making transparent administration well nigh impossible is magnified when such exemptions are made subject to qualitative conditions, as is the case in India, such as the consideration if the exemption under question should be strictly interpreted or liberally given. In effect, that decision is left to junior officers such as the appraisers, superintendents and assistant commissioners. Needless to say, continuing problems in the overall structure tend to have a multiplier effect in rendering a simple tax such as the VAT relatively complex to administer, under which corrupt officials and tax evaders could thrive comfortably. Thus, the impact of tax structure on tax administration cannot be minimized.

Most developing countries that have seriously undertaken reform of domestic consumption taxes at the federal level such as Argentina, Bangladesh, Bolivia, Chile, Colombia, Indonesia, Nepal, Republic of Korea, South Africa and Thailand to name a few have endeavored to introduce a simple VAT with a broad base and a few rates, and a simple law with little confusion or complexity in interpretation. And most have achieved their goals relatively successfully.

Box III. Brazil’s VAT structure

Brazil is one country that attempted early reform of domestic consumption taxation at all levels of government by introducing a comprehensive VAT in the mid-1960s. While taxation using the VAT principle was introduced at all levels, the mainstay of the VAT structure (ICMS) was at the level of the States, covering a wide base of goods and services at a general rate of 17 per cent. The federal government’s tax base, included selected industrial products (IPI) that were taxed at various rates, while the municipalities were given local services as a base (IS1).

Over the decades, however, the Brazilian ICMS structure became complex and cumbersome, as many special dispensations crept in. Exports from developed states to developing states were taxed at a lower rate of 12 per cent, lower rates of 5 per cent and 17 per cent were applicable for selected items, and special exemptions were steadily introduced under the authority of CONFAZ, a body of state finance secretaries chaired by the federal taxation minister that meets intermittently and decides on such matters.

Structural changes that have emerged from these deliberations have led to administrative challenges in the states in ensuring the intent of the ever-changing VAT structure. A desire to reform such a complex VAT structure has become inevitable

especially at the level of the federal government that finds itself bailing out poorer states that are unable to meet their needs through own resources or from regular central transfers. Understandably, such fundamental structural reform is not necessarily in the interest of all states, especially those states that see the current ICMS, based on the origin rather than the destination principle, as serving their interest. States that are net exporters to other states gain under the origin principle, since VAT revenue is retained by the states at the point of export. In general, it is the richer states such as Sao Paulo and Rio de Janeiro that gain from the prevailing system and it is unlikely for them to agree to modifications that would reduce their own revenue capacity in favour of other states or the federal government

Box IV. Efforts at reform of consumption taxes by Argentina and India

Two federally decentralized and geographically large countries – Argentina and India – are currently making strenuous efforts in reforming domestic consumption taxes at the sub-national level. In both Argentine provinces and Indian states the main revenue source is a variety of turnover taxes (with no credit or input taxes paid) on production. In effect, they are unharmonized cascading taxes that lead to tax competition among provinces/states, low revenue productivity and an erosion of tax revenue in real terms or in terms of state domestic product. In both countries, the federal government is pressing the provinces/states to reform their tax structures along VAT lines.

There is no doubt that fundamental tax reform is likely to require considerable lengths of time. In India, discussions and associated pronouncements regarding states introducing the VAT have been made several times over recent years. The reality is that, though most Indian states have agreed to eliminate tax competition by announcing minimum rates clubbed in four groups of commodities, little coordinated effort is yet taking place among states for a state level VAT. In Argentina, though there seems to be an understanding that taxation of interstate trade in any provincial VAT should ideally be based on the destination principle, under which the importing state keeps the revenue from the good imported in keeping with the premise of the VAT being a tax on final consumption. The debate, however, seems to have stalled over the actual mechanism that should be put in place – a clearing house mechanism in which provinces themselves play the main role or direct participation by the federal tax administration in processing provincial tax returns relating to interstate trade. The level of simplicity in the final design will certainly determine with what degree of efficiency these taxes can be administered. In the meanwhile, it is common knowledge that, except in the most advanced and reforming provinces/states, the prevailing turnover tax structures have resulted in major lacunae in both taxpayer compliance and clean administration, apart from economic distortions.

3. Direct tax rate structure and base

In the area of direct taxes, by the late 1960s and early 1970s, developed countries in Scandinavia and Western Europe including the United Kingdom as well as many developing countries had legislated multiple and high individual income tax rates. Among the highest was India's, topping 90 per cent. Such high and multiple rates made administration of the income tax very difficult. Income tax evasion came to be widely accepted as standard behaviour in many developing countries that had high rates. Corporate income tax rates were also very high, with most countries legislating rates at between 50-60 percent. Subsequently, beginning in the 1980s, both the individual income tax and the corporate income tax have undergone major changes in design mainly as ideological objectives were overtaken by considerations of reasonableness and objectivity in the imposition of tax burdens, as well as because it began to be realized that administrative feasibility of a high rate tax structure was very low.

In Latin America, with the advent of the VAT, income taxes received less importance in the 1970s. To ease administration, income tax structures excluded many potential taxpayers, the most extreme being Argentina where the income tax threshold (or personal allowance) was effectively set at 2.5 times per capita GDP.²⁰ Other Latin American countries had comparable though somewhat lower thresholds. Reliance on the income tax for tax revenue decreased and yielded lower proportions of total tax revenue in Latin America, typically between 1-2 percent of GDP, while the VAT's revenue productivity was considerably larger, typically between 4-9 percent of GDP. Mexico, is an exception in Latin America, deemphasising the VAT and focusing instead on the income tax as a major revenue earner, even legislating a minimum contribution to the corporate income tax based on gross assets.²¹

The first step in reforming the income tax structure was to reduce the number of rates as well as the level of rates. By the mid-1990s, many developing countries had emerged from the reform process having legislated individual income tax structures – comprising much lower and fewer rates typically 15-25-35 percent. A late comer was India, legislating comparable rates in 1997. Similarly the corporate income tax rates were slashed, sometimes being halved from the prevailing rate as in Brazil, from over 50 percent to 25 percent in 1996. The move to scale back the corporate income tax rate reflected not only the twin objectives of administrative feasibility and better tax compliance but also the forces of globalization and the increased international movement

of capital that necessitated keeping the tax rate low and competitive in line with global trends.

²⁰ By contrast, it has remained at approximately one tenth of per capita GDP in the United States.

²¹ This focus may reflect North American trends to some extent since Canada and the United States have emphasized the income tax as a major source of revenue. Both also have their own versions of the minimum alternate income tax that ensures a minimum income tax contribution from those investment intensive sectors such as mining and oil exploration in which regular depreciation allowances would tend to yield little tax revenue.

It would perhaps not be wrong to say that, with lower tax rates, the administration of the income tax tended to become somewhat simpler. The administration's resources could be spent in alternative investments such as modernizing the tax administration through computerization including electronic filing, more careful data processing, and production of better statistical output. These could be more usefully employed both in tax policy formulation as well as in administrative functions such as audit selection. Clearly, this is an example of how simplification in tax policy can lead to better use of tax administration resources with long run benefits.

Expectedly, one negative ramification of the early high marginal tax rates was that the income tax became replete with exemptions, allowances, deductions and incentives. Exemptions and allowances were also seen to represent the use of a tax policy instrument to achieve particular social or development goals. Thus, over and above the personal exemption or threshold, the individual income tax base became eroded by explicit deductions for household size (which has been used both as an allowance in some countries and as a disincentive in others), education expenses and loans (as a social objective), life insurance (both for social security and savings objectives), and particular savings instruments such as government securities or small banks such as post office savings banks. It also excluded implicit income from owner occupied housing, sometimes income from second homes, agriculture income, and so on, across the world. In some Asian and Latin American countries, certain sources of income such as interest, dividends, and gains from capital were exempted altogether. Understandably, in not a few countries individual income tax came to be known as a "voluntary tax".

The corporate income tax base also became eroded by accelerated depreciation for select activities over and above the depreciation rates applicable to regular taxpayers, incentives for employment generation of capital equipment not produced in the country, export oriented industries, backward region development, small-scale industry, and environmental investment. Sometimes it led to inequitable taxation, for example, the jewelry industry that produced large revenues in small scale production, contributed little revenue. Or it led to excessive imports of unused accessories such as windmills or solar energy panels. In many developing countries, the Board of Investment that drew up lists of "preferred" industries that received incentives became a powerful institution as for example, in the Philippines and Thailand. An activity that was not "preferred" could not easily attract investment. In the Philippines, incentives for employment and capital formation contradicted each other in the same industry, affecting optimal factor proportions adversely. In India, "reservation" for small-scale industry implied quantitative restrictions on the imports of a range of consumer products and an effective policy of protecting low quality products in many industries.

While some countries attempted to narrow the scope of incentives, many have failed to carry out comprehensive reform in this area. This has usually reflected the political difficulties associated with removing the spectrum of incentives since the removal of any small part may nevertheless adversely affect an influential lobby. In a democracy, this becomes an especially hazardous task for policy makers since decisions to remove an incentive may boomerang at the ballot box. This is despite the common

knowledge among most policy makers at this point in time that scaling back tax incentives and exemptions has various positive ramifications for both tax policy and tax administration.

First, since there is no evidence that tax incentives increase investment or savings for which they may be devised, tax experts have invariably taken the position that their removal tends to decrease the distortion caused by the tax system. Second, decreasing the intensity of tax incentives translates to a lower loss of government revenue i.e. to lower tax expenditure. Third, tax administrators have discretion for interpretation of the law or executive statutes, the fewer are tax incentives. This last factor improves fiscal transparency when such reliefs are scaled back thereby simplifying the overall tax structure. In this connexion, one observer has emphasized the “control over the provision of tax incentives to particular investors” by government officials as a “major instrument that makes corruption possible”, making arms length transactions difficult and increasing unwarranted discretion in the hands of officials.²² In the more complex structures, several officials have such a discretion over a single decision.

The result of income tax laws that continue to harbor a range of allowances, exemptions and incentives, both in the individual income tax and in the corporate income tax, despite the reform in their rate structures has been two-fold. On the one hand, for honest taxpayers, filing the income tax return continues to be an annual exercise in complexity and uncomfortable anticipation of the assessment by the tax administrator that is to follow. On the other hand, a direct result of the complexity in the tax structure is also the difficulty faced by administrators in carrying out initial assessments for which the taxpayer may even have to wait a number of years (as is the case in India), as well as to carry out the selective audit function. The simplification of the income tax through cutting back multiple forms of base erosion, therefore, remains a major challenge, with the objectives of reducing economic distortions caused by the tax structure and making the structure administratively feasible.

C. Impact of tax administration on tax policy

While the ramifications of tax policy for tax administration are well known, there has been relatively little discussion of the influence of tax administration on effective tax structure. Yet, given that tax administrators apply the tax law in the field, it is only to be expected that the intent and nature of tax administration give the final tone and flavour to the tax policy mix that is actually implemented. Experience reveals that, in most countries simplification in the application of the legal tax structure is needed as a practical necessity.

In their desire to focus on revenue production, tax administrators have increasingly focused on large taxpayers, tax deduction at source, single tax (in Latin America known as “*monotributo*” and “*impuesto unico*”) that allows so-called small

²² Vito Tanzi, “Corruption, Government Activities and Policy Instruments” in Parthasarathi Shome (ed.), Fiscal Policy, Public Policy and Governance, Centax Publications, New Delhi, pp.27-35.

taxpayers to opt for combining payments for all taxes under one head, distortionary taxes that are simple to collect such as a tax on financial transactions, or recommending non-distortionary taxes that are simple in construct but have negative distribution effects such as the head tax, or little revenue potential such as the cash-flow tax. In reality, therefore, tax administration policy can and does have important effects on the nature of tax structure that is implemented. Indeed the effective tax structure can turn out to be quite different from the original intent of the law.

1. Distinction between large and small taxpayer

Almost all modern tax administrations in Asia and Latin America have moved towards establishing large taxpayer units since often a small number – anywhere between 1000 to 5000 – of large taxpayers contribute between 80-90 percent of the tax revenue collected. While this is a practical device in securing tax revenue in a stable manner, the stability that is generated should not eschew attention given to other taxpayers. Special care has to be taken to ensure that expanding the universe of taxpayers does not receive low priority. An incisive examination of the individual income tax in India, for example, found that the number of assesseees has not been an effective constraint on tax revenue collection.²³ Focusing a highly significant amount of resources on large taxpayers may be an efficient strategy in the immediate run but, in the medium term, it comprises an insufficient approach.

Tax administrators do tend to agree that all taxpayers should ideally be targeted. Nevertheless, they are more likely to implement a strategy to control and expedite the flow of revenue from large taxpayers. In the absence of constant alertness, a disproportionate amount of administrative resources may be spent on the large taxpayer unit.²⁴ The explanation that tends to be given is that such a unit covers not only the income taxes, but also the VAT, selective excises and all other taxes that large taxpayers are liable to.

Tax administrators tend to justify the policy of focusing on large taxpayers on grounds of their yielding a high proportion of revenue. Interestingly, however, calculations in both Asian and Latin American tax administrations have revealed that, in many of those countries, small taxpayers do possess significant revenue contribution potential not uncommonly around one-third of total potential from a tax (depending of

²³ This is not to say that the number of registered taxpayer can grow at a pace regardless of administrative resources. In India, for example, their number increased from about 12 million (10 million net of nonfilers) to about 25 million between 1997 and 2000. It is unlikely that any administration could cope with such an elevation in number within such a short period on time, given that the administration's resources have not increased significantly. Further advancement towards computerization of the income tax department has been characteristically slow.

²⁴ Resources allocated to large taxpayer units for registration, collection, assessment and audit typically take up a significant majority of administrative resources.

course on where the line is drawn between large and small taxpayer). At an extreme, this leads to the conclusion that the high significance of large taxpayers in revenue collection should be taken as a temporary shortcoming, albeit understandable, in tax administration, rather than as a rationale for the tax administrator to continue to pour more resources into that activity in the long run.

By contrast, small taxpayers are made subject to simplification schemes that tend to erode their tax contribution phenomenally on grounds that they are likely to evade taxes in any event. Across Latin America, such simplification schemes have been enacted. In Argentina, for example, the *monotributo* introduced in 1999 for small taxpayers – those who have a defined low turnover – requires them to pay a maximum of 1 percent of turnover in all taxes combined. Interestingly, after the experience with *impuesto unico*, a similar scheme introduced in Bolivia with fundamental economic reform in 1986, the authorities concluded by the mid -1990s that the system was not only inequitable but also that it encouraged evasion since it made possible potentially large taxpayers to continue under the umbrella of the scheme. Thus there is clear incentive for the typically large self employed sector around the margins of the threshold to continue to under-declare their incomes even in the long run to circumvent graduation from the scheme. In addition, a reversal of vertical equity tends to occur in such cases since any loss of revenue has to necessarily be made up by those who are not under the threshold, leading to their tax burden being higher than what it would be in the absence of the simplification regime.

In sum, the divergence in the treatment of large versus small taxpayer contradicts the concept of equity in taxation. Vertical equity is affected in the reverse direction if small taxpayers are not expected to pay their dues (properly defined, rather than just reflecting some simplification scheme) even in a long run. Even horizontal equity suffers when a wage earner in a factory is subjected to a tax (typically through tax deduction at source) that is not collected from a wage earner in a restaurant, or self-employed worker with the same income. From a tax policy point of view, differential effective treatments to facilitate administration may be acceptable only in the short run for, otherwise the design of the tax structure based on principles of equity would be rendered powerless. This can be ameliorated by designing and implementing a tax administration strategy devoted towards closing the gap between the large taxpayer and the small taxpayer in the foreseeable future.

2. Self-assessment by taxpayers

Self-assessment is assumed to imply that a taxpayer – individual, factory or business enterprise – files the tax return on his/her own with the probability of a face encounter with a tax official being reduced only to the occasion of a detailed audit. It is usually recommended for the facilitation of both the tax administration as well as for fostering taxpayer responsibility. Tax administration resources, it is said, could be utilized in more useful functions than in physical control methods for revenue collection.

Self-assessment is said to reduce the probability and incidence of corruption. However, it assumes a population of mature taxpayers which, it must be recognized does not exist in all cases. Changing habits may involve significant planning and effort in

taxpayer education. If self-assessment is imposed in an environment in which tax evasion and avoidance are normal, then the implications for revenue collection could be detrimental.

There certainly are instances in which more rudimentary administration methods based partially on physical checks and controls are necessary in order to ensure equity and efficiency from a tax policy viewpoint. These are situations where tax administrations have neither adequate resources nor the professional wherewithal to follow up with techniques for adequate taxpayer control including assessment and selective and incisive audit. For example, at the time of the break up of the ex USSR, the emerging countries there as well as in other East European countries had almost no prevailing framework infrastructure or even understanding of financial control methods. Yet external assistance based on experience from advanced countries regularly recommended a quick switchover to financial control methods. Certainly there was a virtual collapse in revenue collection in the Russian Federation in the ensuing years, Not only did revenue suffer, but it also meant that the effective burdens of taxation were distributed unequally and the allocation of economic resources continued to be very inefficient.

Other countries that have been slow or conservative in accepting technical assistance based on developed country experiences blindly have tended to preserve their revenue position better. This is of course not say that, with time and serious pursuance of taxpayer education, training of tax officers and computerization, there should not be a steady movement towards financial control methods. But certainly such techniques that simply facilitate practices from the point of view of the tax administrator, should be eschewed without important due consideration of their impact on revenue productivity, efficiency or equity of a tax structure in a particular case.

3. Tax deduction at source (TDS) or withholding

While the 1960s and 1970s could be said to have firmed up the conceptual basis of taxation in the Haig-Simon tradition, the late 1980s and the 1990s began to question the feasibility and administrative implications of the tax structures that emerged from purist concepts of equity, efficiency and stabilization as objectives. Objectives based on equal tax treatment of equals (horizontal equity) and unequal treatment of unequals (vertical equity) as well as of neutral treatment of different economic activities, generally led to the basis of global taxation with a progressive rate structure. All sources of income were to be “globalized”, i.e. pooled together, and taxed under the same rate schedule, thereby ensuring equity as well as stabilization over the business cycle.

In practice, collection and audit of a global income tax turned out to be cumbersome, often infeasible and slowly, withholding mechanisms at low rates began to be used, ensuring a minimum contribution from income sources such as wages and interest. Withholding requirements were often written into law, to facilitate collection at an early stage (in a manner similar to the usefulness of a VAT for collecting revenue in steps, rather than only at the final stage at which the likelihood of tax evasion is higher).

Support for the proposition that TDS reduces evasion, has come from a review of several country experiences – Australia, Egypt, Indonesia, Ireland, Japan, Pakistan, the Philippines, United Kingdom, and United States – have concluded that “a carefully structured system for withholding on business income reduces tax evasion by self employed individuals and promotes other tax policy objectives”²⁵. Nevertheless, a stage has arrived at which withholding taxes are being levied at higher rates and as *final* taxes and mainly for administrative reasons. Conceptually, correct global taxation seems to have given way to a more administratively feasible means of taxing all major sources of income such as wages, interest, dividends, business income and payments to small suppliers in a number of developed and developing countries.

4. Taxes merely to suit tax administration

Sometimes, poor taxes are designed to suit the purpose of easy administration. One such is a tax on financial transactions that has become popular in many Latin American countries. Argentina experimented with it in the early 1990 but eventually removed it. But tax administrations in other Latin American countries, which have imposed such a tax have felt that it is a revenue productive and easily recuperable tax since it falls mainly on bank cheques. Yet no analysis has been made of the tax’s long-term effect on the health of financial transactions or on increasing cash transactions. In light of the fact that most Latin American countries have liberalized capital accounts in their balance of payments, financial transactions could suffer to the extent that such transactions could be carried out abroad in order to avoid the tax.

The cash-flow tax is another example cited for its property of simplicity. It is favoured by some over the corporate income tax since the structure of the latter has become complex and cumbersome in many countries. It is claimed that the cash flow tax is easy to design in a way free of the complexities inherent in the design of the corporate income tax. Mexico uses the concept of cash flow as a tax base for small taxpayers in order to facilitate tax administration, and other countries are examining it. Fortunately, the tax has not been enacted to replace the corporate income tax given its low revenue potential. The cash flow tax’s narrow base which comprises “pure profits” of a firm as opposed to its “income”, would make it an unpopular tax since for revenue neutrality with the corporate income tax, its rate would have to be very high.

Finally, examples of peculiar taxes, enacted for purely revenue reasons, are occasionally encountered. Such was the instance of the head tax or poll tax which was introduced in the United Kingdom in the 1980s, on every adult – even the unemployed – for purely revenue reasons. The introduction of such a regressive tax was unique in a developed country in modern times. Not surprisingly, it led to violent reactions that resulted in its quick removal. Another is the case of the “statistical tax” in the early 1990s found in selected Central American countries. It was a surcharge on customs

²⁵ Piroška Soos, “Self-employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues”, University of California – Davis Law Review, vol.24, No.1, 1990, p.109

duties to circumvent existing customs tariffs agreements among themselves. Such taxes vitiate the intention and progress of international tax reform and have the force of increasing distortions in international trade.

To conclude, the objective of facilitating tax administration or revenue collection should not spearhead the introduction of poorly designed taxes. This should be avoided even in the short run since the economic impact of such taxes may be brisk. They could also be extremely detrimental both in terms of equity and efficiency. Such taxes are either removed in a hurry or tend to remain on board once legislated. Experience with such taxes especially reveals the importance of correctly designing an overall tax structure.

III. THE MANAGEMENT OF REVENUE ADMINISTRATION

A. Taxpayer education, information and assistance

The relationship between the tax administration and taxpayers is a crucial element for an effective functioning of the tax administration, as well as for an optimum tax collection capability. Currently, the relationship existing between the state and the taxpayer is objectively of an authoritarian nature. The tax administration's challenge is to soften its image of an authoritarian entity to an image of an entity having simply authority.

Good taxpayer services and well designed and targeted publicity campaigns are crucial elements in encouraging taxpayers to comply voluntarily with the legislation. To facilitate voluntary compliance, the tax administration should provide taxpayers with consistent, impartial, courteous and prompt service. In many developing countries and transition economies, relatively simple measures, such as, providing taxpayers with tax return forms, eliminating fees for the receipt of tax payments by the banks, a common practice in some transition economies, and establishing taxpayer assistance counters in easily accessible locations would significantly improve taxpayer services.²⁶ Effective taxpayer services include such programmes as developing clear forms and instructions, providing points of contact to the public so that people can request and secure information about tax obligations, and developing educational programmes to inform existing and potential 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 is easily comprehensible 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 judicial decisions, rulings, regulations and other notifications in order to foster a higher level of compliance and minimize misunderstandings of the tax laws and regulations²⁷. In certain transition economies which have launched a reform without first having established effective taxpayer information and service campaigns, taxpayers have misunderstood new taxes and procedures, and this fact has hindered the reform process.

Publicity campaigns through the mass media 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 effective in improving voluntary compliance and increasing revenue in many countries.

²⁶ Carlos Silvani and Catherine Baer, "Designing a Tax Administration Reform Strategy: Experiences and Guidelines", IMF Working Paper, WP/97/30, 1997

²⁷ Robert A Le Baube and Charles L. Vehorn, "Assisting Taxpayers in Meeting their Obligations", in Richard M. Bird and Milka Casanegra de Jantscher (ed) Improving Tax Administration in Developing Countries, International Monetary Fund, Washington, DC 1992

Although developing countries and transition economies should in principle try to ensure that taxpayers are audited, on a systematic basis, in practice, most of these countries do not yet have the requisite number of staff with the necessary skills to carry out extensive audits. These countries also need to strengthen their vigilance machinery and anti-corruption strategies in order to maintain the integrity and reputation of their auditors from being compromised by increased personal contacts between tax auditors and taxpayers. Simultaneously, parallel to these efforts to speed up the detection of non-filers, stop-filers and inaccurate filers, the tax administration should seek to promote greater compliance through improved taxpayer education, information and assistance. Improvement in these areas constitutes the core of the major operational changes made in recent years by the tax administrations of developed countries, such as Australia, Canada and the United States, as well as by some developing countries. With respect to better taxpayer relationships, it has now become increasingly evident that an effective and efficient tax system would depend on the consent and willing cooperation of the general body of taxpayers and employers. A number of countries, including Canada, New Zealand and the United Kingdom have taken the lead by publishing Taxpayers Charters which set out for the first time in public the principles which should be adopted in handling taxpayers' affairs, along with the rights and obligations of taxpayers. Some rights, such as the right to courtesy and consideration, the right to the presumption of honesty, the right to every benefit allowed by the law should not remain as unattainable goals, but as something which both the tax administrations and the taxpayers should strive to achieve as partners in a common endeavour. These attitudes can be positively influenced by the "service" provided to the taxpayers, by placing greater emphasis on viewing the taxpayer as client or customer or as somebody to work with rather than against. This is not a utopian ideal, but a practical possibility.

Enhancing quality through taxpayer education, information and assistance requires a determined effort to address compliance in the context of correcting system deficiencies; simplifying cumbersome and complex tax laws and rules, forms and instructions; presenting the tax laws as fair in their intent and administration; and assisting complying taxpayers who are trying but are unable to meet their obligations. A practical approach would aim at: (1) Enhancing citizen support of the tax system by making taxpayers understand the need for and the value of taxation, and by streamlining tax rules through the reduction of exemptions, exceptions or caveats; (2) Improving the process of developing, producing, and delivering forms and information bulletins which currently are very often so complicated that taxpayers must seek the costly professional help of tax consultants, accountants and lawyers; (3) Evaluating the taxpayers' ability to cope with tax forms and publications by monitoring taxpayers' comments, conducting town meetings, interviewing professional groups, carrying out surveys, and testing tax forms in order to be able to resolve problems and make improvements in design, information technology and communications, and taxpayer behaviour.

Tax administrations should recognize the need for an active taxpayer education, information and assistance programme to educate the public and provide hands-on assistance to taxpayers to help them comply with their tax obligations. Experience has

shown that centralizing the responsibility for education, information and assistance activities in a single department or unit can be an effective measure. These activities would normally include media advertisements, telephone and electronic information exchange, publications, workshops and school curricula enrichment.

Organizing broad education campaigns to explain taxpayers' rights and obligations, is another effective measure. The campaigns should seek to project a positive image of the tax administration itself. To that end, the tax administration may also consider issuing a statement setting out its mission and objectives. It would also be beneficial to include tax education programmes in school curricula and to organize, under the auspices of the tax administration, lectures and workshops on tax matters for smaller groups of taxpayers with shared interests. Education campaigns should make optimum use of the appropriate mass media, and they should be carefully designed with the assistance of communications professionals and tailored to the needs of the target groups.

Assuming that the basic background provided is conducive to voluntary compliance – that is, that the tax laws are equitable, that the tax administration implements those laws fairly and uniformly and the tax courts are impartial – there may still be room for improvement of voluntary compliance through broad education campaigns. These campaigns can be aimed at the public at large and their goal is to seek to raise tax consciousness and compliance by explaining taxpayers' duties and rights, the rationale for paying taxes, the manner in which the tax proceeds are spent, and the advantages which the country and citizens derive from government spending. The link between the payment of taxes and economic progress can be highlighted. These campaigns can also bring to the public's attention the consequences of tax evasion, in the form of penalties and prosecution and should make it clear that those found guilty will be dealt with in accordance with the law. Penalties may not only deter potential tax evaders but also fulfill the function of keeping complying taxpayers satisfied with their compliance.

Broad-based campaigns can also help to project a positive image of the tax administration itself. Many taxpayers consider the tax administration as an impersonal, insensitive, heartless bureaucracy seeking to extract taxes from cowering taxpayers who are treated as evaders until proved innocent. The removal of such misconceptions can promote voluntary compliance. The tax administration can issue a mission statement and objectives, as for example, the United Kingdom issued in 1986 – the Taxpayer's Charter – which defines the rights and entitlements of the taxpayer (which include help and information, courtesy and consideration, and confidentiality). Similarly the United States Internal Revenue Service (IRS), has issued a Mission Statement which states that the purpose of the IRS is to collect the proper amount of tax revenues at the least cost to the public, and in a manner that warrants the highest degree of public confidence in the integrity, efficiency and fairness of the revenue authority. In an accompanying Declaration of Commitment, the IRS states *inter alia*, that it will produce products and services to meet the needs of its customers and will treat them with dignity, respect and professionalism. The campaign may also seek to describe in broad outline, how the tax

administration operates (e.g. how income tax forms are distributed, the general method of selecting returns for audit and the availability of publications on various tax issues).

Educational efforts can focus not only on the public at large but also on smaller groups of people. Taxpayer education programmes in schools, devised jointly by senior tax officials and officials of the Ministry of Education can improve voluntary compliance in the coming generation by instilling in it the idea that paying taxes is a civic duty that benefits all members of society. Similarly, lectures and seminars can be organized for groups of taxpayers with shared interests, such as small entrepreneurs, farmers, fishermen, and members of professional associations. These encounters enable the tax administration to explain the general mission and the rationale for its actions, and give taxpayers an opportunity to voice their concerns.

Information campaigns should make use of mass media through carefully designed and targeted programmes. Some countries have also used mobile units, which tour towns and villages disseminating tax information. Furthermore, intermediaries, such as professional associations of lawyers, accountants, trade associations (businessmen, industrialists, contractors, etc.) and trade unions can be used as a means for informing their members.

Tax administrators may consider the possibility of training approved members of recognized voluntary organizations or other groups to help taxpayers who cannot or do not wish to obtain assistance at tax offices. Audio-visual aids, as well as computer programmes that enable the tax administration staff to provide accurate and uniform answers to taxpayers on the basis of pre-programmed questions, can also be utilized where appropriate and feasible. The assistance provided should cover not only the preparation of tax returns but all tax matters, including the resolution of questions and adjustments that may arise after the tax returns have been submitted to the tax administration.

B. Management of human resources

Enhancing the efficiency and effectiveness of revenue administration management implies personnel management and planning and control policies, which make the best possible use of the available human, financial and material resources. In many cases, radical changes in personnel management are essential to the implementation and sustainability of tax administration reform. Hence, the aim should be to develop and implement an adequate personnel management scheme to remedy the shortage of highly-skilled and professional staff, and of experienced functional administrators or managers. Such a scheme applicable across the board to administrators and managers at all levels, should be flexible enough to respond to realities. Personnel management should be viewed as a package consisting of four components: recruitment, motivation, training and management development.

To be effective, personnel policy should address three interrelated issues: the tasks assigned to each position in the organization, the skills and experience required to carry out the tasks for each position and the appropriate salary.²⁸ There are certain relevant questions in assessing the tax administration's personnel policies, namely: What is the distribution of staff by function? What is the distribution of staff by salary? What are the rules for hiring and firing of personnel? Are there clear career paths and job descriptions? Frequently, an excessively high percentage of staff – in some countries up to even 25 percent of total staff performs administrative functions, rather than core operational functions. Salaries are also considerably lower than those in the private sector for identical skills and responsibilities. Also the rules for recruitment, promotions and retrenchment/dismissal do not provide the right incentives and promote the “sclerosis” of the organization.

Personnel policies will also depend upon 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. It has been observed that although personnel matters are usually given less attention than the technical matters, ignoring the former may handicap other tax administration reforms.²⁹ 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 to know that the organization has fair personnel policies. The requirement of a degree of job security should be weighed against the need for establishing staff accountability and responsibility.

To assess the tax administration from the point of view of an organization, it may be desirable 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 from the absence of strategic plans as well as the absence of a clear definition of medium and long-term objectives. If the tenure of the head of the tax department is perceived as highly unstable, the lower level managers and the institution as a whole, will not pay much attention to the directions and instructions coming from higher authorities.

While considering tax reforms vis-à-vis personnel policies, an important issue to be kept in mind is the degree of autonomy of the tax administration. The more the administration enjoys autonomy vis-à-vis civil service rules and regulations, the more flexibility it will have to make the major organizational and procedural changes needed to modernize the tax administration. Essentially, the 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 likely to respond far more easily to the Government's initiatives to generate more revenue if it is able to make its own decisions regarding the appropriate

²⁸ Aldo Schlemenson, “Organizational Structure and Human Resources in Tax Administration,” in Improving Tax Administration in Developing Countries, *op. cit.*

²⁹ Carlos Silvani and Katherine Baer: “Designing a Tax Administration Reform Strategy: Experiences and Guidelines”, op.cit.

organization, staffing, salary levels, procurement, renting or purchasing office space, etc. In many countries, experience has shown that introducing drastic basic 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.

1. Recruitment

Recruitment strategies should be designed to provide tax administrations with a core of professionals – accountants, computer specialists, economists, lawyers and statisticians. Recruitment and promotion should be based strictly on the principles of transparency and non-discrimination with regard to gender, ethnic background and religious beliefs. The recruitment process should be so designed as to ensure that candidates possess not only the requisite technical skills but also such qualities as a sense of responsibility, moral integrity, and a commitment to public service.

The first step in the recruitment of suitable staff should be the preparation of clear job descriptions: setting forth the nature of the duties and responsibilities involved, the education and experience required, and the salary and benefits offered. Candidates for various positions can be found internally or externally. It would be desirable to establish a roster of qualified persons both within and outside the tax administration who might be able to fill vacant posts. Standard entrance examinations, possibly on a competitive basis, may be appropriate.

The recruitment of suitable revenue administration staff poses special problems in developing countries and transition economies where the number of people possessing requisite skills may be limited and in many cases, the private sector can siphon off desirable candidates because it can offer financial and professional conditions that the public sector with its usually limited resources finds hard to match.

Box V. Recruitment procedures in selected developing countries.

Tax administration personnel are recruited through various institutional channels. For example, in Ghana, the Constitution specifies that the authority to make appointments and promotions within the revenue administration is vested in the President, who acts on the advice of the Board of Service in consultation with the Public Service Commission. Similarly, in India, where the Department of Revenue is part of the Civil Service, recruitment is the responsibility of the Union Public Service Commission, a statutory and independent organization under the Constitution of India. The revenue administrations in Bangladesh, Nepal and Pakistan provide for the direct recruitment of staff at senior levels with a restricted quota of promotion from the lower ranks. In Bangladesh and Pakistan, officers are recruited directly through a competitive examination conducted by the Civil Service Commission and assigned to various services, depending upon the candidates' choices and their rank in the examination. In Nepal, officers are likewise selected through a competitive examination conducted by the Civil Service Commission

and then posted as Tax Officers, Customs Officers, and Excise Officers. Staff at the junior executive levels also have to pass competitive examinations in all three countries. Recruitment at lower ranks is centralized in Bangladesh and Nepal and partly decentralized in Pakistan. In Malaysia, recruitment is also handled by the Public Service Department. In Malta, the Department of Inland Revenue does not recruit its own staff since it is a part of the civil service; recruitment is carried out by the Central Government Agency. Moreover, the Department is subject to the policy prevailing in the civil service whereby government employees may be transferred from one department to another. In Venezuela, recruitment is the responsibility of the General Sectional Directorate of Human Resources of the Ministry of Finance which for that purpose, uses the educational and experience requirements set out in the "Types of Position" description manual prepared by the Central Personnel Office.

2. Motivation

In developing countries and transition economies, the recruitment of suitably qualified staff poses special problems, which include poor working conditions, political interference, low morale and the unattractive low levels of remuneration for professional personnel, compounded by the lack of benefits such as, welfare services. Another problem is the keen competition between revenue administration agencies and the private sector for the services of the limited number of people possessing the requisite skills. In order to attract and retain the qualified personnel, there is obviously a need to provide adequate motivation.

Motivation should be perceived as a major component of the personnel management package and should include such incentives as, adequate remuneration and fringe benefits, job security, general job satisfaction, recognition by the top level of tax administration hierarchy of an employee's contribution to the administration's performance, and career development opportunities. Career development should be viewed as a process enabling employees to look forward to an orderly progress in the performance of their jobs or series of jobs, throughout their working life, with increased job complexity, personal responsibility and benefits. Job satisfaction depends on observance by supervising authorities of sound management principles. Each employee should be able to feel that he is part of a team working on the basis of clearly understood policies and directives towards clearly defined goals for the good of the country. Decentralization of authority and proper delegation on clearly understood policies and specific programs should be based on the basis of qualifications, skills and experience of the staff concerned. Supervising officials should be inclined to imbibe team spirit, providing adequate guidance, assistance and encouragement to subordinate officials.

Staff performance should be evaluated at periodic intervals according to objective criteria and awarded standardized ratings, Excellent performance should be commended while remedial measures for removing deficiencies without sounding unduly critical should be implemented. Promotion to higher posts at special positions of responsibility should be normally based on merit-cum-seniority principles. Promotion prospects, with

suitable training opportunities have considerable impact on staff morale. Staff members should be encouraged to suggest measures for avoiding waste and improving productivity, with the incentive of prizes awarded for best suggestions. Award schemes for outstanding performance should also be instituted for different fields of activities in revenue administration.

Adequate motivation eliminates or greatly reduces the incidence of dishonesty or corruption. Dishonesty is detrimental to a revenue administration not only because of the resulting loss of revenue but also, more specifically, because of the harmful effects on the taxpayers' confidence. It is of course, well recognized that there will be less temptation to engage in corrupt activities if tax officials receive salaries which match those of the private sector. However, most developing countries and transition economies lack the resources to pay such salaries and must therefore rely on the security of employment to encourage honesty. Top officials will be less likely to behave dishonestly if they know that, if discovered, they will lose the guarantee of a secure future for themselves and their families. Other strong motivations for remaining honest are the likelihood of an employee's acts being discovered as a result of internal auditing, and the certainty of criminal prosecution and punishment for those found guilty of corrupt practices. Public esteem and approbation of honest officers also constitute an important element in maintaining integrity by revenue officials.

Box VI. Financial incentives for tax administration officials in selected developing countries.

To increase the attractiveness of tax administration posts, certain countries have introduced financial incentives for tax administration officials. For example, in 1986, Uruguay established a Participation Fund financed by 30 percent of the additional collections received by the General Directorate of Taxation as a result of audits, examinations and legal proceedings undertaken by its officials. Tax administration staff receive payments from the Fund. In 1988, in Argentina, the General Directorate of taxation became an autonomous entity, with its own control procedures; and in 1989, the Special Hierarchical Account was established as a means of motivating the staff of the General Directorate. The Account is maintained with up to 0.60 percent of the revenue originating from taxes administered by the General Directorate. Thirty five percent of the funds are distributed among all officials in proportion to their salaries; and fifty five percent are distributed by taking into consideration their position in the hierarchy of functions, performance, attendance and disciplinary record. The balance of 10 percent are devoted to motivating the staff in accordance with the objectives and goals set in each operational area.

In 1991, Peru reorganized the National Superintendency of Tax Administration (SUNAT). Soon thereafter, the SUNAT Employee Fund was established to provide health benefits and loans. Also in 1991, Colombia established the Tax Management Fund within the framework of the Directorate of National Taxes. The Fund's objective is to support the modernization of the tax administration, mainly by promoting productivity training and social welfare programmes for officials and their relatives, and by investments intended to help defray the operating expenses of the tax administration.

Also in 1991, Panama established the Tax Management Fund within the framework of the General Directorate of Revenues. The Fund is financed by one per cent of the excess revenues originating from taxes administered by the General Directorate. Its resources are distributed among the entire staff, in accordance with performance.

3. Training and management development

Training should be broad based and cover all aspects of revenue administration. Whenever and wherever possible, the training programme should cover at least four main areas, namely: (1) Basic training for new entrants in the relevant fiscal laws and operating procedures; (2) Refresher training to upgrade knowledge and skills of revenue administrators; (3) Specialized training in the specific areas of revenue administration; and (4) management training to enable employees to move upwards to supervisory and managerial positions. Wherever possible, the revenue administration should consider the feasibility of establishing its own training center. Revenue administration employees should be given opportunities to exchange technical knowledge and experience with their counter-parts in other countries within the framework of international conferences, workshops and seminars.

Suitable training facilities for revenue administration officials are essential. Newly recruited revenue administration staff are rarely fully prepared for the tasks they are supposed to perform. Moreover, the staff already on board need to be instructed in the administration of new regulations and procedures and be given an opportunity to update their knowledge and techniques, with a view to enhancing productivity and promotion prospects. A well conceived training programme can do much to enhance the efficiency of revenue administration staff and to motivate them by providing opportunities for personal development and career advancement. Training should encompass not only technical aspects but also other aspects of revenue administration, such as communication, as well as public relations skills.

The lack of managerial capabilities seriously handicaps the effective functioning of revenue departments in many developing countries and transition economies. While some progress has been made in developing technical capabilities through entry-level training programmes, insufficient attention has been given to programmes which develop revenue officials into good managers. This situation has resulted from a lack of management training facilities and also from a lack of awareness of the potential of management tools and techniques, with respect to decision making and problem-solving in revenue administration. Every revenue department should develop a training plan spanning the entire service career of a revenue official, including basic training, periodic refresher training and executive and development programmes. Training is an investment which yields substantial dividends if properly administered and regularly provided. Resources permitting, each revenue department should have its own training center or access to a joint training center. At present a number of developing countries have

reasonably good centers for training revenue officials, while some have small training facilities and several have none.

If training is to be effective, there is a need to secure good trainers, and adequate incentives should be provided to attract them. Periodic interregional, regional and sub-regional seminars, workshops and conferences, which enable revenue officials to learn from each other's experience can be extremely useful. The use of a country's training facilities by other countries can also make a valuable contribution to this endeavour, as well as the increased exchange of information on revenue administration between developing countries and transition economies, especially neighbouring ones.

In order to strengthen the infrastructure of management capacities, the revenue administration should emphasize management development, and devise procedures and programmes that make it possible to identify the potential of managerial personnel at all levels and develop it to the fullest. In particular, steps should be taken to ensure that senior managers have sufficient command of the specialized tools of management (including planning, organizing, budgeting, cost accounting, information systems, etc).

C. Management information systems

A management information system is a formal system designed to provide information to managers. The basic idea behind an MIS, regardless of its sophistication, is to provide managers with information in a systematic and integrated manner rather than in a sporadic and piecemeal manner. A good MIS enhances strategic control and strategic planning.

The role of an MIS is to enable members of the administration to carry out their work efficiently and effectively by means of providing a continuous reliable and secure information technology service, in order to: (1) enable access by members of the administration, the senior management of the organisation, and where appropriate other members of the organisation to administrative and management information, and to ensure that such information is reliable and consistent; and (2) ensure that the information technology currently available or planned is used effectively.

The functions of an MIS in the context of revenue administration are: (1) To provide applications for support for the operational and management processes of the tax administration and for the purposes of the institutional plan; (2) To design and develop information systems which promote the efficient and effective operation and management of the tax administration and improve the quality and quantity of management information available; (3) To devise appropriate methods for the dissemination and control of management information within the tax administration; (4) To promote and, as appropriate, provide training in the efficient and effective use of information processing in tax administration.

MISs as applicable in revenue administration operate at two tiers. One tier is the policy formulation level at the Board of Revenue or Revenue Authority, while another

tier is the operational level or the field level where the actual tasks of assessment and collection of taxes takes place. At the policy formulation level, the information required to make management decisions are the figures of total assessments completed and aggregate demands raised, and the collections reported from different centers on a periodic basis which may enable the authorities to compare the annual plan figures of projected assessments and collection targets with the actual performance at the periodic interval. The senior administrators at the Board of Revenue level would be able to assess the performance at the field level and draw necessary conclusions about the meeting of targets by the subordinate authorities, as well as take corrective actions through the proper deployment of personnel, or remove organizational deficiencies by other means.

Another important use of the information received at fixed periodic intervals concerning the collection of taxes, is for transmission to the Budget Division in the Ministry of Finance for their consideration, of the “ways and means” position for incurring necessary expenditure therefrom and to weigh the various options regarding public borrowings. The information made available to the senior administrators regarding the benefits availed of various tax concessions and abatements in actual monetary terms, or regarding the overall impact of tax raising measures, enable the authorities to draw necessary conclusions regarding planned action and future budget proposals.

At the field level, the management information received by the Commissioners of Taxes from the lower formations is primarily in regard to the pace of assessments, the raising and collection of demands, outstanding demands, effects of various judicial decisions and appellate orders, and effects of recovery measures. These details available through computer operated systems enable the Commissioners to assess the strengths and weaknesses of the organisation, the need to take remedial measures, and periodic review of the results achieved. The management of information also highlights the performance of individual subordinate employees entrusted with assessment and collection tasks and provides necessary input for shifting personnel to different positions for obtaining optimum results.

Management information received at fixed periodic intervals can be collated, aggregated, analysed and presented in a form as to enable proper conclusions to be drawn by the senior administrators. For this purpose, it is necessary to select proper hardware and software and to formulate systems which are capable of meeting the demands of the tax administration. While not absolutely essential, most MISs incorporate the use of computers. A frequently used acronym is EDP (electronic data processing). EDP refers to the hardware, software and personnel that process data into information. The personnel in the EDP system fall into three categories: systems analysts, programmers and operators. Systems analysts design an MIS; programmers prepare computer programmes based on the specifications of systems analysts; and operators run or operate computer hardware.

Unfortunately, many MISs have been failures. Careful design and implementation of an MIS is essential. Several crucial factors that determine the success of an MIS are as follows: (1) The information system must be designed and implemented so as to meet the needs of those managers i.e. senior tax administrators who will use it in carrying out their

day-to-day responsibilities; (2) Designing and implementing an MIS is best accomplished through the close cooperation between system analysts and managers; (3) A good starting point in MIS design is an examination of the information systems that currently exist in a tax administration; (4) Flexibility of design is a most desirable characteristic of an MIS; (5) Output from the MIS must be presented in a form that is appropriate for use by managers. Information overload must be avoided. Therefore, an MIS must be designed to meet the needs of the users and must be constantly evaluated in terms of changing users' needs.

D. Electronic service delivery

Revolutionary advances and innovations in information and computer technologies combined with growing domestic and international trade have transformed the global environment. Electronic commerce is the cornerstone of this transformation – a change that is widely regarded as second only to the Industrial Revolution. Electronic commerce can be loosely defined as the delivery of information, products, services or payments by telephone, computer or other automated media. It includes many kinds of business activities that are being conducted electronically – much more than just the purchase of goods and services electronically, as for instance: electronic banking; electronic monies; electronic and inventory systems; electronic payment systems; all commercial transactions conducted by the internet, telephone and fax; and all forms of trade in digitized goods and services. Electronic commerce has been extremely effective in strengthening businesses and stimulating growth in new areas. One recent study shows that the cost-savings from Business-to-Business (B2B) e-commerce alone in five large industrial countries translate into a significantly lower rate of inflation, while efficiency gains translate into higher GDP growth in each of the five countries³⁰.

Simultaneously, a development of governments' own electronic service capacity offers a real opportunity for reinventing governments worldwide. While the private sector in most parts of the world is quickly internalizing the potential advantages of electronic commerce, governments almost everywhere are falling behind in incorporating and developing regulatory systems for electronic commerce and taxation.

Electronic service delivery (ESD) offers Governments new opportunities and ways of doing business. Governments in the developed world have been addressing these issues for the last decade, and yet new technological developments continue to overwhelm their efforts. The knowledge gap between the developed and developing countries is probably greater nowadays than ever. Fortunately, the systems and approaches formulated by the developed world can provide a base from which other countries can begin to coordinate their own approaches.

Experience today suggests that electronic service delivery can provide enormous gains in effectiveness and efficiency for all branches of tax administration. The rapid growth in private sector internet capacity that has occurred in developing countries over

³⁰ M. Brooks and Z. Wahhaj, "The Shocking Economic Effect of B2B", Goldman Sachs Global Economics Paper. No. 37, 3 February, 2000.

the past few years, supported by privatization programmes and the strengthening of telecommunications systems, means that administrations in developing countries need also to begin to address the impact of electronic commerce and potential of ESD.

ESD can help simplify and streamline operations, create more cost-effective administrations, improve compliance and reduce taxpayers' compliance costs, improve accuracy and timeliness, and provide improved and convenient service. Simultaneously ESD provides an open, transparent system, once security concerns are overcome. It is also an effective public relations channel and has enormous potential as a training tool. Direct cost savings for governments and taxpayers also arise from the availability on-line of updated amendments, laws, regulations and forms, increasing accessibility and reducing the need for printing and distribution. Amongst the tax departments, the potential for ESD is perhaps greatest in customs, where technological change is at the heart of business process re-engineering (for instance, risk management techniques, artificial intelligence, bar coding and document imaging, to name a few). Globalization has contributed to increased activity for tax administrations worldwide and ESD offers the means to deliver expanded and improved services at constant or declining real costs. In Canada, for instance, increased levels of returns processed, of corporate filers, and of cross-border commercial shipments, have been realized with stable costs and improved service (reduced turnaround time), in large part because of the development of electronic services. Thus, ESD can be an extremely important means to supporting the basic strategic objectives of a tax administration simplification, efficiency, equity, and accessibility.

In many countries, taxpayers can already receive from their businesses or houses electronically information and assistance; file tax returns; register imports or exports; register a business; and complete financial transactions. In most countries, plans are underway to extend these services, and offer a secure on-line alternative to paper. Canada (The Canadian Customs and Revenue Administration, CCRA) is perhaps the world leader currently with its on-going programme through which all revenue services are to be delivered electronically by 2004. Depicted as the seamless government, Canada's "electronic office" will provide client-focused, fully interactive services conveniently integrated with related services provided by other federal and provincial agencies, and foreign government agencies, accessible anywhere at anytime.

The objective of ESD in tax administrations can be defined as enabling taxpayers to choose from a variety of secure, automated self-service channels to meet their tax and custom obligations, with services packaged to meet the needs of different client groups. Where there is a natural link, services are integrated, often with services from other governmental agencies. Taxpayers should be able to interact directly with the tax administration or via other portals (such as the central government, local government service kiosks, embassies, integrated call-centers and private-sector service points).

While electronic commerce can help increase the effectiveness of tax administrations, it also raises major new issues, and challenges to established tax systems and laws. The potential of electronic commerce for tax avoidance and evasion is a major

challenge and necessitates that countries review their tax policies and administration to ensure that tax laws are applied appropriately. For instance, it is difficult to determine where a commercial activity occurs: since there is no paper trail, problems arise similar to that raised by an underground economy. It also becomes difficult to determine which jurisdiction has the authority to tax incomes and transactions in the case of electronic commerce.

Since 1985 most developed countries have established Advisory Committees on Electronic Commerce under the Minister of Finance to determine the implications of electronic commerce on tax administration. Consistent with the OECD approaches and recognizing that the private sector should lead the way, these Committees' recommendations have tended to focus on:

- Developing a strategy for electronic commerce
- Developing and adopting guiding principles for electronic commerce
- Facilitating universal access
- Building trust in the electronic marketplace
- Defining a legal framework for electronic commerce
- Playing an active role in *international fora* on electronic commerce, in particular, to promote consistency in national policies around the world.

With respect to the tax and regulatory environment, these committees recommend that:

- Governments should create a favourable policy and legal environment for electronic commerce and ensure that the network and physical infrastructure for electronic commerce figure prominently in their policies and programmes.
- Governments should ensure a tax neutral position with regard to electronic commerce transactions so as to avoid new or additional taxes driving business elsewhere. Any new taxes should be based on impact studies.
- All levels of Government and key private sector players should work cooperatively towards building trust in the electronic market place, and in particular, in establishing clear policies in a number of technical areas (for instance, digital signatures, encryption, privacy and protection or consumer rights).

The experience of various developed countries and international organizations, including the OECD as well as the EU, provides a useful base for the developing world. Establishing an Advisory Committee and preparing an ESD Strategy are important first steps.

Aside from benefits and challenges, ESD also introduces some inherent risks for clients, government and officials. These can be summarized as follows:

Risks for Taxpayers:

- privacy and confidentiality on line
- security
- cost (affordable access)
- equity (literacy and accessibility)
- burden of change

Risks for Government:

- risks to programme delivery and continuity (changing technology)
- increased costs from infrastructural overhead, training and updating for technological change
- fraud and misuse

Risks for officials:

- changing work environment and changes in volumes of work
- changes in skill needs (back-office versus front-office).

While there are clear risks associated with ESD, there are also potential risks from failing to innovate. For instance:

- emerging electronic services from the private sector and/or other government sectors will necessitate change in the tax administration
- the cost of maintaining electronic services will become prohibitive
- as will the delivery of traditional labour, intensive services (paper and mail-based processes).

The risks of not innovating easily outweigh the risks of innovating.

1. Tax administration websites: best practices

A survey of existing web sites undertaken reveals that currently approximately 112 countries worldwide have tax administration web sites. These range from comprehensive, all-incorporating systems such as those of the USA, to countries whose web page consists of a photograph of the Ministry of Finance. The survey reveals a number of strengths and weaknesses of existing web sites: key characteristics include being user-friendly, fast, easy to maintain, bilingual where necessary, readily downloadable, integrated with the overall governmental web site, and especially with the other tax departments. Some are extremely detailed and complex. Some have useful links with local or state government (Canada and USA). Many are poorly designed: for instance they fail to return to a home page, do not permit information to be downloaded, or may only be available in the national language (e.g. Taiwan). Perhaps not surprisingly, there is a tendency for countries to develop a web site for customs before their internal tax administration (Indonesia, Isle of Man, Jersey and other island tax havens). Several web sites provide inter-active surveys on-line for taxpayers/practitioners/businesses while other web sites solicit user reactions to developments or new tax proposals by email. Almost all of the larger web sites provide information on employment opportunities – a low cost advertising vehicle – and use them as public relations channels.

Improving the effectiveness and usefulness of developing country web sites can be done at a relatively low cost, and simultaneously, provide an effective vehicle for the interchange of tax information between countries. For Singapore the cost of establishing an e-filing system in 1998 is estimated as less than US\$1.3 million. Similarly, the establishment of a comprehensive city portal for Valencia in Spain is quoted as costing the equivalent of constructing one kilometer of road.

The survey of tax administration web sites reveals two outstanding systems that could be quickly and relatively inexpensively adopted: Singapore and Canada. Both are extremely user-friendly, fast and effectively provide information for tax officials (especially customs) and tax practitioners. In addition, both sites simply permit the downloading of most tax/customs forms that could be needed. Both are outstanding in meeting the needs of importers and exporters on-line. The Canadian system, in particular, has a prototype “Customs Virtual Office” that is a pleasure to use. Both provide information on recent developments, and go to lengths to inform users of challenges and improvements that are being made.

Box VII. Best Practices: The Singapore Web Site

Singapore has separate web sites for inland revenue and customs, accessible directly and through the ministry of finance web site. Both web sites represent best practices for developing countries to emulate. They are comprehensive, user-friendly and speedy. Technological progress has brought sweeping changes to business processes and organizational structure of Inland Revenue and Customs in recent years. Virtually all information needed by taxpayers and traders is on line and downloadable. E-filing is available for income tax and goods and services tax. Initiated in 1998, use of e-filing has grown rapidly and in 2000, 30% of income taxpayers filed electronically. E-payment is also available. A 12-month installment system is available whereby taxes are deducted automatically from taxpayers bank accounts. Revisions to tax liability are automatically incorporated in the installment plan. Payment can also be made through ATM cards. Additional on-line services available include E-stamping, E-Valuation of property, an Interactive Voice Response System for information and a Fax Request system for forms and copies of accounts. Additional services under development include personalized electronic mailboxes for each taxpayer; expansion of e-filing to other taxes; WAP applications on mobile phones, and several others.

Inland Revenue Authority of Singapore (IRAS): www.iras.gov.sg

The Home Page provides the following options:

- About Us
- Tax Information
- IRAS Services
- Downloadable Forms
- Career Opportunities (This also provides detail for staff and clients on agency ethics and staff expectations)

Customs and Excise Departments (CED): www.gov.sg/customs

The Home Page provides the following options:

- Information for Travelers
- Information for Traders: this is comprehensive; all forms are downloadable;
- E-forms
- Notices
- Directory
- Courses
- Careers

Exchange Rates for Customs

- Amendments (for past two years)

Box VIII: Best Practices: The Canadian Web Site

Canadian Customs and Revenue Authority (CCRA) www: ccra-adrc.gc.ca.

The CCRA web site is a model for almost all countries. The merged authority has one integrated web page, which has already set the standards for user-friendliness, ease to access of an enormous information base and is scheduled to become a fully electronic authority by 2004. The system is, in addition, bilingual. Computers are also available in easily-accessed public places for public use.

The following services are already available on-line, broken down by type of taxpayers:

- information and assistance
- e-filing, tele-filing
- business registration
- direct deposit to taxpayers
- Business Information Center (BIC) provides alphabetically a comprehensive information system on all matters relating to customs and taxation
- Seminars for small businesses and traders
- Training Module for Revenue Agents (for instance, Basic Customs)

The Home Page provides the following options:

Information and Assistance
E-filing
TIPS
Direct Deposits

A. Business Registration

The Customs has now introduced a prototype “Virtual Customs Office” (VCO) which will shortly, undoubtedly, become the global standard. Broken down by types of users, the VCO simply and easily provides details on most customs issues, ranging from a tariff wizard, bonded warehouse program, duty drawback program, duty relief program, objections and appeals.

In concluding, ESD offers considerable potential to Tax Authorities to reduce costs, improve efficiency, accessibility, transparency and client orientation, while simultaneously being an effective training and PR tool. The costs of not moving forward on ESD – and e-commerce more generally are considered to be too high to warrant delay. The work of OECD and the EU in formulating frameworks and setting Standards provides a sound base from which developing countries can begin. On the part of Governments it is recommended that:

- An e-commerce czar be appointed – a Government point-man to maintain momentum, coordinate involved players, spearhead the formulation of Government standards, and act as the voice of the Government internationally.

- An Advisory Committee on Electronic commerce be established to determine the implications of e-commerce for Government and on tax administration in particular.
- An ESD Strategy for tax administration be prepared, including launching a national tax and customs web site.

On the part of the international community, it would be helpful:

- To prepare a hands on “Best Practices Manual on e-commerce for developing countries and transition economies, and
- To form a partnership between the international agencies, OECD Governments and the private sector to fund intensive courses and technical assistance on e-commerce and ESD for tax administrators, so as to help bridge the human capital needs and jumpstart the developing countries and transitions economies’ use of the internet.

IV. ELECTRONIC COMMERCE AND THE CHALLENGE FOR TAX ADMINISTRATION

A. Technological and commercial background

The coming of the Internet Age has profound implications for tax administration as it does for just about everything else. The exponential growth of electronic commerce poses a daunting challenge to taxing authorities' traditional approaches to both direct and indirect taxation. The spectre of massive amounts of economic activity conducted through electronic commerce by remote service providers engaged in nontraceable transactions from unidentifiable locations has created concern among fiscal authorities around the world.

“Electronic commerce” refers to a wide array of commercial activities carried out through the use of computers, including on-line trading of goods and services, electronic funds transfers, on-line trading of financial instruments, electronic data exchanges between companies and electronic data exchanges within a company.

Electronic commerce opens up new avenues for the marketing of traditional goods and services directly to consumers. It creates similar opportunities for business-to-business transactions involving both digital and non-digital products and services. Examples of electronic commerce include:

- E-procurement, involving Internet-based sales transactions between businesses, including both “reverse auctions” that facilitate on-line trade between a single business purchaser and many sellers and digital marketplaces that facilitate on-line trading between multiple buyers and sellers.
- On-line catalogs, displaying images of goods, which permit Web users around the world to select and order books, wine, and other products.
- Computer software, which can be transferred electronically to the user's computer;
- Photographs, which can be transferred digitally, and whose price varies with the customer's intended use of the photograph;
- On-line information, such as Lexis, Nexis and other electronic data bases, which are available to users through the Internet and standard telecommunications networks;
- Services such as legal, accounting, medical, and other consulting services, which subscribers can access for a fee using an electronic password to obtain access to the service provider's web site;
- Videoconferencing, which is currently used principally by large businesses and institutions that possess the expensive equipment necessary to participate in a videoconference; but which ultimately may be accessible to many more users with the introduction of inexpensive desktop video-cameras that can be connected to a personal computer;

- Securities trading, which is currently offered by some stock brokerage firms through web sites that permit customers to trade bonds, mutual funds, options, futures and commodities;
- Offshore banking, now being offered at some web sites, including incorporation, banking services, and credit card payment.

Six characteristics of the Internet that will influence the operation of the tax systems can be identified³¹:

1. The ability to establish public and private global communications systems which are secure and inexpensive to operate. The opportunities that this opens up for new forms of commercial activities will not be limited to large companies. Small and medium size enterprises will find it easier to engage in international commerce. Start-up capital requirements on the Internet are typically very low. This, in turn, will lead to a rapid expansion in cross-border activities.
2. The process of “disintermediation” whereby the Internet will eliminate or substantially reduce the need for intermediaries in the sale and delivery of goods and services, and in the provision of information. Commerce which uses the Internet requires a small number of distribution, sales representative, broker and other professional intermediaries. Already it is possible for a producer of software to sell and to deliver its products directly to the final consumer. Similarly, an airline company can deliver tickets directly to passengers. Financial and other information may become available without the intermediation of banks and other financial institutions.
3. The development of encrypted information which protects the confidentiality of the information transmitted on the Internet. Whilst it is possible to detect a message sent by one person to another over the Internet, encryption generally precludes understanding the content of the message.
4. An increased scope for the integration of business functions, e.g., design and production. Private Intranet networks are now widespread in transnational corporations. OECD estimates that at least two-thirds of Internet transactions take this form. This development produces a closer integration of transactions within a transnational corporation and makes it increasingly difficult to separate out the functions carried out by related enterprises. This integration may also produce a dynamic synergistic effect – the sum of the parts being much less than the integrated whole.

³¹ See Jeffery Owens, “The Tax Man Cometh to cyberspace”, paper presented at the Harvard Law School International Tax Program Symposium on Multijurisdictional Taxation of Electronic commerce, April 5, 1997

5. The Internet provides greater flexibility in the choice of the organization form by which an enterprise carries out its international activities.
6. The Internet has led to a fragmentation of economic activity. The physical location of an activity whether in terms of the supplier, service provider or buyer of goods or user of the service, becomes less important and it becomes more difficult to determine where an activity is carried out.

There are several technical features of Internet and Intranet systems that are likely to have significant impact on the operations of tax systems, namely, the lack of any central control; the lack of central registration; the difficulty if not impossibility of tracing transactions; and the weak correspondence between a computer domain name (i.e., an Internet address) and reality (i.e., the actual geographic location of the addressee or the computer equipment used to transmit or receive the information).

Three broad implications of the foregoing developments for territorially based taxing regimes can be discerned. First, there is the sheer magnitude of the increase in cross-border transactions. By significantly reducing the transaction costs of communicating and selling without regard to geographic boundaries or the size of the company, the Internet permits companies that once were confined to local markets to sell goods, services, and information internationally. The resultant increase in cross-border transactions by itself will put greater demands on tax administrations, particularly those already struggling with conventional local commerce.

Second, the digitization of information – the conversion of text, sound, images, video, and other content into a series of ones and zeroes that can be transmitted electronically – creates difficulties in defining the source, origin and destination of both production and consumption. The Internet is a borderless technology. Servers can be located anywhere in the world without affecting the substance of an Internet-based business transaction. From the standpoint of tax administration, the principal challenge is to determine how to implement geographically limited taxing systems in a technological environment that renders geographical borders essentially irrelevant.

Third, the technical features of Internet transactions create enormous problems for taxing authorities in establishing, audit trails, in verifying parties to transactions, in obtaining documentation, and in fixing convenient taxing points. By eliminating the need for intermediaries, particularly financial intermediaries on which governments have traditionally relied to facilitate tax compliance through reporting obligations, the Internet enhances the probability of increased tax avoidance and evasion.

But the implications for tax administration of the growth of electronic commerce are not entirely negative. Specifically, the new technologies create increased opportunities for streamlining tax administrations by replacing paper documentation with electronic data interchange (EDI), by providing for electronic filing of tax returns, and by automating other aspects of tax reporting and compliance. For example, both the OECD's Technical Advisory Group and the Streamlined Sales Tax Project in the United States are

currently focusing on means by which new technologies may be utilized to improve service and efficiency in the consumption taxation of cross-border remote sales.

B. Electronic commerce and income taxation

The most significant issues raised by the advent of e-commerce for income tax regimes are those relating to jurisdiction to tax and the characterization of income.

1. Jurisdiction to tax

Countries generally exercise jurisdiction to tax income on the basis of residence or source. Both of these concepts are likely to become more elusive in the context of electronic commerce. With regard to *residence-based* taxation, an individual or corporate taxpayers' residence – whether defined in terms of domicile, place of incorporation, or seat of effective management – bears no necessary relationship to the electronic commerce in which the taxpayer engages. Accordingly, insofar as the jurisdiction is relying on the residence principle as the basis for taxation, taxpayers will enjoy enhanced opportunities in the context of electronic commerce to move income out of high tax jurisdictions into low-tax or no-tax jurisdictions assuming the taxpayer is properly treated as the resident of such a jurisdiction. Although these opportunities have long existed with respect to conventional commerce, they are magnified in an environment in which the human or legal actors involved can be largely insulated from the electronic aspects of the relevant transactions.

With regard to *source-based* taxation, the jurisdiction-to-tax difficulties confronting taxing authorities relying on residence-based taxation in the electronic commerce context are equaled if not exceeded by the jurisdictional issues confronting taxing authorities relying on source-based principles in asserting jurisdiction to tax income from electronic commerce earned by nonresidents. The United States, for example, generally taxes the U.S. source income of nonresident individuals and foreign corporations. With respect to income that arises from a trade or business, however, the United States generally asserts jurisdiction only with respect to “taxable income which is connected with the conduct of a trade or business within the United States”. Moreover, under income tax treaties which the United States has entered into with 48 countries, the United States generally asserts its right to tax the U.S. source trade or business income of foreign individuals and corporations only when such income is attributable to a “permanent establishment” or “fixed base” in the United States.

The application of these basic principles of U.S. income taxation to electronic commerce creates a number of problems. First, the question of whether a foreign person engaged in electronic commerce is conducting a trade or business “in the United States” is difficult to resolve by reference to the traditional criteria for resolving that issue. The concept of a U.S. trade or business evolved in the context of conventional commerce, which has typically been conducted through identifiable physical locations. As already noted, electronic commerce does not seem to occur in any physical location but instead takes place in the nebulous world of cyberspace. Consequently, even though a foreign

person may engage in extensive transactions with U.S. customers, and thus clearly be engaged in trade or business, it is not at all clear that such a person is engaged in a trade or business in the United States – at least as that concept has generally been understood.

Second, even if a foreign person engaged in electronic commerce with U.S. customers is deemed to be engaged in a U.S. trade or business, it may be even more problematic to suggest that such a person has “a permanent establishment” in the United States in the many cases that will be governed by the U.S. tax treaties. A “permanent establishment” is generally defined as “a fixed place” of business through which the business of the enterprise is wholly or partly carried on”³². Since electronic commerce can (and often will) be conducted without a fixed place of business in the United States, income that might have been subject to U.S. tax were it earned through more traditional commerce may escape U.S. taxation when earned through electronic commerce.

In the end, the principal consequence of defining a server as a permanent establishment may simply be to assure that servers are placed in low-tax or no-tax jurisdictions. Since servers can be located anywhere in the world without affecting the substance of an Internet-based transaction, elementary tax planning considerations would dictate the location of servers in tax havens or in jurisdictions that do not rely on the presence of a server as constituting a permanent establishment.³³

2. Characterisation of income

Electronic commerce raises thorny questions not only with respect to jurisdiction to subject the taxpayer to a tax on its income, but also with respect to the characterization of such income, once it is determined that the taxpayer is in fact subject to tax. Characterisation of income is important because both national and international income rules assign different categories of income to different jurisdictions. For example, under the U.S. Internal Revenue Code, income from personal services is generally sourced in the country where the services are performed; income from rentals and royalties is sourced according to the location of the property or, in the case of certain types of intangible property where the intangible property is used; and income from the sale of purchased inventory is generally sourced in the country where title passes. Similarly, under the OECD Model Tax Convention, and many bilateral conventions, analogous provisions exist that assign income to a contracting state based on the character of the income.

The critical question for electronic commerce is how to analogise digital transactions to transactions in conventional commerce that are addressed in the relevant

³² United States Model Income Tax Convention of September 20, 1996, Article 5, par. 1

³³ At least one company recently learned this lesson the hard way in the context of U.S. state (subnational) taxation. The company located its server at a hosting company’s data centre in the State of New Jersey only to learn that New Jersey considered this to establish a “business presence” in the state. As a consequence, New Jersey required the company to pay New Jersey corporate income taxes and to collect sales taxes on purchases made by New Jersey residents, whether or not those purchases were made on the company’s web site. See Ed Foster, “Exodus into New Jersey Proves to be Very Taxing for One Dot-Com company”. InfoWorld.com, Aug 25, 2000, available at www.infoworld.com/articles.

provisions of national law and international treaties. For example, the purchaser of a digital image arguably is purchasing the services of the enterprise that purveyed the image over the Internet. Under such a characterization, the income ordinarily would be sourced to the country in which services were performed³⁴. Alternatively, the transaction might be viewed as the license to use an intangible, namely, the digitized image that is transmitted over the Internet. Under such a characterization, the income would ordinarily be sourced to the country in which the intangible right was used³⁵. Finally, one might view the true nature of the transaction as the purchase of a photograph, economically identical to the purchase of an item of inventory. Under such a characterization, the income would ordinarily be sourced to the title to the photograph passed³⁶. Obviously, the proper characterization of a transaction will depend on its particular facts. The point is simply that the characterization of transactions in electronic commerce, which have significant implications for the sourcing of income, is a task fraught with difficulties.

The United States Treasury has suggested that the advent of electronic commerce will “accelerate” a trend towards preferring residence-based taxation to source-based taxation due to the difficulty of applying traditional source concepts to link an item of income with a specific geographic location³⁷. By contrast, almost all taxpayers are resident somewhere.

This suggestion is hardly uncontroversial for a variety of reasons. First, the recommendation to tax income from electronic commerce primarily or exclusively on a residence basis is inconsistent with generally accepted international consensus, as embodied in tax treaties and in the United States international tax regime.³⁸ That consensus is based on the principle that the residence jurisdiction has the primary right to tax passive (investment) income, while the source jurisdiction has the primary right to tax active (business) income. Abandoning the source-based principle in favour of the residence-based principle in the context of electronic commerce would therefore violate accepted international norms of tax policy.

Second, it is by no means clear that residence-based taxation provides a panacea for the difficulties of assigning income from electronic commerce on a source basis. While the task of administering a residence-based regime may be somewhat less daunting than the task of administering a source-based regime with respect to income from electronic commerce, many international tax professionals have experienced cases which

³⁴ Internal Revenue Code §861 (a)(3), 862(a)(3). Under the OECD Model Tax Convention, this would depend in part on whether the services are effectively connected with a permanent establishment or are attributable to a fixed base in the country where the services are performed. OECD Model Tax Convention arts. 14,15

³⁵ Internal Revenue Code §861(a)(4), 862(a)(4). Under the OECD Model Tax Convention this would depend in part on whether the royalties are effectively connected with a permanent establishment or arise from a fixed base in the country in which the royalties arise. OECD Model Tax Convention, art.12

³⁶ Internal Revenue Code §861(a)(b),862(a)(b). Under the OECD Model Tax Convention, this would depend in part on whether the “business profits” from the sale are “attributable to” a permanent establishment in the country where title passes. OECD Model Tax Convention art.7

³⁷ U.S. Treasury Department, Selected Tax Policy Implications of Global Electronic Commerce, 1996

³⁸ See S. Avi Yonah, International Taxation of Electronic Commerce, 52 Tax, Law Review.507, 525, 1997

are much more complex, leading to the conclusion that the ultimate solution for electronic commerce will not rely on the “resident somewhere” principle. Moreover, the “relative meaningless of corporate residency”, and the ease with which an Internet-based enterprise may establish a corporate residence divorced from any of its “tangible” activities, suggest that the general adoption of a residence-based regime for electronic commerce could raise as many problems as it resolves.

Third, and of paramount importance to developing countries and transition economies, a residence-based rule raises troublesome questions of international tax equity. A shift to residence-based taxation would be a boon to the United States, the world’s leader in the production of electronic content³⁹. But it is troubling to those who worry about the ability of source countries and countries where consumption occurs – *especially developing countries* – to tax income and consumption. The changes wrought by the Internet which diminish the need for a service provider to have a physical presence in the country where its customer is located, shift the balance of taxing jurisdiction, and revenue, decisively in favour of the country of residence. Since income flows between countries are not necessarily balanced and in the case of flows between developed and developing countries are often severely imbalanced, such a shift could have profound revenue consequences⁴⁰. In short, quite apart from the dictates of sound tax policy or practical considerations about enforcement, one cannot lose sight of the fact that the choice of tax principles may well create winners and losers. Accordingly, when distributional implications are added to the calculus, a residence-based approach to taxing income from electronic commerce may not be particularly attractive.

There is, of course, an alternative approach to “sourcing” income that would avoid some of the difficulties of the existing source rules without wholesale adoption of a residence-based approach to taxing electronic commerce, namely, formulary apportionment. Such an approach would also obviate recourse to complex, painstaking, and often unsatisfactory arm’s-length transfer pricing inquiries as an antidote to price manipulation among commonly controlled enterprises. However, although the formulary apportionment methodology has a long history in the various states of the United States, the prospect of applying it in the international tax arena is extremely controversial and is contrary to international norms accepted by the OECD and United States federal fiscal authorities.

C. Electronic commerce and consumption taxes

In many respects, the most pressing problems of tax administration raised by taxation of electronic commerce are those raised by consumption taxes rather than income taxes. As the number of individual consumers with access to the Internet increases every day, and with more and more products – tangible and digital – being sold over the Internet, the challenges for tax administrations are immediate and real, because

³⁹ See Charles E. McLure, Jr, Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws 269, p.420, 1997

⁴⁰ David R. Tillinghast, The Impact of the Internet on the Taxation of Informational Transactions, 50, Bulletin for International Fiscal Documentation 524, 525, 1996

transactions involving individual consumers tend to be the weakest link in the chain of tax administration.

In examining the impact of electronic commerce on consumption taxes, one should distinguish between national and subnational consumption taxes and, more particularly, between value added taxes (VATs) like those adopted by members of the European Union and the retail sales tax (RST) in the various states of the United States. Although both levies in principle are consumption taxes, and both levies encounter certain common problems raised by electronic commerce, there are also dramatic differences between the VAT and the RST that can lead to confusion and misconception when they are lumped together under the board rubric of “consumption” taxes.

1. VAT issues

To put the implications of electronic commerce for consumption taxation in proper perspective, it is useful at the outset to identify four-categories of transactions which involve electronic commerce: (1) Transactions involving business-to-business (B2B) sales of tangible property consummated through electronic means (e.g., the purchase over the Internet of a computer by a business taxpayer from a remote computer vendor); (2) Transactions involving B2B sales of digital products (e.g., the purchase over the Internet of an electronic data base by a business taxpayer from a data base vendor); (3) Transactions involving business-to-consumer (B2C) sales of tangible property consummated through electronic means (e.g., the purchase over the Internet of clothing by an individual from a remote vendor); and (4) Transactions involving B2C sales of digital products (e.g., the purchase over the Internet of a downloadable video by an individual from a remote vendor. These four categories of transactions may be illustrated as follows:

B2B Tangible	B2B Digital
B2C Tangible	B2C Digital

There is really nothing new about the issues raised by transactions involving sales of tangible property effectuated through electronic means – whether B2B or B2C. Distance selling has existed for many years, and there is no difference in principle between a cross-border transaction in tangible goods effectuated by fax or a telephone call than one effectuated by the click of a mouse. OECD member countries have systems in place to ensure the taxation of imported tangible goods. In the case of the EU, for VAT purposes, electronic transactions are treated in the same way as any other form of distance-sales (e.g. from catalogues, by phone, post, etc). There are well established channels for taxing these transactions – goods purchased from third countries are taxed at import, exported goods are zero-rated and intra-Community sales of goods are taxed

under a special regime for distance sales, either in the member State of the seller or the buyer (dependent largely on the volume of such trade carried out by the seller⁴¹).

Accordingly, it is not B2B or B2C sales of *tangible* products effectuated through electronic-networks but rather B2B and B2C Sales of *digital* products that raise novel and difficult questions for VAT. These questions are in many respects analogous to those encountered in connection with direct taxation, namely questions of jurisdiction and questions of characterization, although they arise in a different context. In principle, of course, there is no question of jurisdiction over the ultimate VAT taxpayer – the consumer – because the taxing authority will always have jurisdiction over the consumer if the tax is imposed by the country of consumption. As a practical matter, however, unless the taxing authority has jurisdiction over the seller, it will not be able effectively to administer a consumption tax on B2C digital transactions. Characterisation is also important because liability for the VAT (at least in the EU, on which the following discussion is based, depends on the place where a supply is made, and the determination whether a supply is one of goods or services is critically important in determining if and when the VAT is due, as well as establishing the party responsible for paying it to the taxing authorities. While the VAT rule for supply of goods is the destination principle, the rule for services is more complicated. The basic rule is that the place where a service is supplied is the place where the supplier has established its business or has a fixed establishment from which the service is supplied. However, there are a number of special rules for particular types of services, e.g., services relating to land, services relating to transport, services involving physical performance, and, most importantly for present purposes, services involving intangibles, consultancy services, and telecommunications. The place of supply for such services when supplied for customers outside the EU or for taxable persons within the EU, but not in the same country as the supplier, is the place where the *customer* – not the supplier – has established its business. In this connection, the reverse charge or self-assessment mechanism is frequently used to collect the VAT from EU customers, and, under a recent VAT Directive involving telecommunications, non EU suppliers of telecommunications services to private individuals are required to register in the EU and collect the VAT.

In approaching the questions raised by the EU, on VAT and other consumption taxes in the context of electronic commerce, the OECD Committee on Fiscal Affairs adopted the following Framework Conditions to guide countries in accommodating their consumption taxes to electronic commerce:

Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.

⁴¹ See Commission of the European Communities, Proposal for a Council Directive Amending Directive 388/77/EEC as regards the Value Added Tax Arrangements Applicable the Certain Services Supplied by Electronic Means, 2000

For the purposes of consumption taxes, the supply of digitized products should not be treated as a supply of goods.

Where business and other organizations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers⁴².

The Framework Conditions have significant implications for the application of consumption taxes to electronic commerce. First, by reaffirming the destination principle of a consumption tax, namely, that taxation should occur where consumption occurs, the OECD has remained faithful to the philosophical underpinnings of the VAT. At the same time, however, its position raises issues of effective tax administration because determining the place of consumption and enforcing collection at the place of consumption can be daunting tasks with digital commerce. Second, by characterizing the supply of digital products as the supply of services rather than the supply of goods, the OECD has sought to provide certainty in the cross-border treatment of digital products for which taxing authorities will be able to develop a discrete set of rules. It also seeks to prevent the erosion that could occur if digital products were characterized as goods but were not susceptible to the collection mechanisms (e.g., customs control) that are appropriate for tangible property but not for digital products or intangibles. Third, by recommending the use of the reverse charge or self-assessment mechanism for B2B digital transactions, the OECD has recognized the propriety – if not the necessity – of developing different collection mechanisms for B2B digital commerce than for B2C digital commerce.

2. United States subnational retail tax (RST) issues

In the United States, forty-five states and the District of Columbia, as well as many of their political subdivisions, have adopted RSTs. Probably the most significant feature of existing state RST laws insofar as they apply to electronic commerce is that state RSTs generally apply only to sales of tangible personal property and not to sales of services or of intangible property. While a few states tax a wide range of services (including information and data processing services), and most states tax some services (e.g., public utility services and hotel and motel services), most state sales taxes are limited to sales of tangible personal property. This makes the state RST a rather imperfect consumption tax – there is no sound reason for distinguishing between household consumption of goods and services for consumption tax purposes.⁴³ More importantly for present purposes, it also makes the state RST an unlikely vehicle for concern about taxation of electronic commerce, since sales of digital products – the only novel issues raised by electronic commerce for a properly structured consumption tax – are largely excluded from the tax base. The unharmonized character of United States state and local

⁴² OECD, Committee on Fiscal Affairs, *Electronic Commerce: Taxation Framework Conditions* 5, 1998

⁴³ The local sales taxes are usually, but not always, identical to the state sales tax and in substance simply increase the rate of tax on the taxable sale.

tax system and the consequent inability of the states (due to constitutional restraints) to require distant sellers to collect taxes on sales to local consumers upon tangible and digital products makes, any interest from an international perspective in the United States model, a misplaced issue.

V. CONCLUSIONS AND RECOMMENDATIONS

Based on the main discussion papers and the conference room papers representing country profiles, as well as a fruitful exchange of ideas, the participants came to the following conclusions:

- Developing countries and transition economies confronting fiscal deficits, unabated debt servicing and declining development assistance, should endeavor to mobilize domestic and external financial resources through tax and non tax instruments that are fair and equitable and which create minimal disincentives for economic efficiency. They should also initiate tax reforms to simplify and rationalize their tax structures;
- A greater emphasis should be placed on improving the efficiency and effectiveness of revenue administration, strengthening the institutional framework through the selection of taxes and duties which are administratively feasible and allow for realistic collections. The tax base should be widened and the informal sector should be progressively integrated into the mainstream of the national economy;
- In the context of international economic relations, there should be an increased stimulus to finalize bilateral tax treaties; protect the interests of national revenue from the operation of transfer pricing mechanisms, tax havens and other tax shelters; and secure tax revenue from income attributable to the new and innovative financial instruments, while avoiding harmful tax competition.

The Meeting of the Ad Hoc Expert Group on Strategies for Improving Resource Mobilization in Developing Countries and Countries with Economies in Transition formulated the following recommendations, which after due deliberation, were adopted by all the participants at its concluding session, namely:

The meeting recommends to the developing countries and transition economies to utilize best practices to:

- *formulate appropriate fiscal policy which will lead to a just and equitable tax burden with a progressive broadening of the tax base and reasonable marginal rates;*
- *improve the efficiency and effectiveness of revenue administration, through the strengthening of institutional and human capacities; upgrade the technical and managerial skills through intensive training, including information technology; and improve infrastructural facilities and employ best practices utilized in successful private sector organizations;*
- *develop enforcement and audit strategies to combat tax evasion, prevent tax avoidance with a view to reducing the utility of tax shelters and tax havens that*

- undermine national tax systems through appropriate administrative and legislative measures;*
- *enhance international cooperation in tax matters through the negotiation of bilateral tax treaties including provisions for the exchange of information, mutual assistance and, among others, methods for eliminating double taxation; and promoting the equitable distribution of taxation among competing jurisdictions; as well as exploring possibilities of multilateral cooperation in information exchanges, legislating minimum rates, and appropriate bases;*
 - *protect national revenues from distorted transfer pricing mechanisms, loss of revenue from e-commerce, new and innovative financial instruments, expanding the tax bases to include the growing service sector with the progress of globalization; and avoid harmful tax competition and ensure a more equitable international income allocation;*
 - *effect the progressive transition of the “informal” economy within the mainstream of the formal sector through appropriate reforms in the legal and regulatory framework, labor legislation, fiscal and financial incentives, reduction of exemptions, allowances and incentives to reasonable levels, and the adoption of presumptive taxation systems, for small enterprises and certain independent activities;*
 - *simplify tax laws and introduce tax administration reforms to reduce the level of taxpayers’ non compliance and develop compliance strategies to provide better taxpayer services and reduce operating costs;*
 - *initiate reform of the systems and procedures relating to the settlement of tax liabilities including the establishment of administrative tribunals or special courts dealing exclusively with taxes, duties, cesses, etc., and institute procedures for an advance ruling relating to tax liability;*
 - *establish verifiable standards of revenue administration performance and implement quality assurance programs that are service and taxpayer focussed;*
 - *encourage dialogue and cross-fertilization of fiscal ideas with the private sector and civil society;*
 - *ensure, to the extent possible, that both the functions of assessment and collection of taxes and duties are concentrated in the same revenue administration.*