

A Primer on Building Capacity in Tax Policy and Administration

INTRODUCTION: Sound tax policy and administration are essential for managing public finances efficiently and effectively. The purpose of the tax system is to generate revenues to finance the various government services that people demand. This is obviously true, but it must be kept in mind that the tax system has a very important impact on any country's allocation of resources and the accumulation of physical and human capital, and it forms part of the institutional framework in which economic agents must operate. The tax system also plays an important role in determining the "fairness" of a country's economic institutions. Tax policy and tax administration are two sides of a coin, where, jointly, they have profound impact on an economy and a society, and where one cannot function well without the other also functioning well.

TAX POLICY

Making tax policy consists of selecting the kinds of taxes to be used, the rates to be applied and the total revenue to be collected, taking account of the effects of allocation of productive resources across alternative sectors and activities. As has often been observed, decisions as to the allocation of resources to the various departments of tax administration (e.g. collections, audit, taxpayer assistance, investigation) can also be policy decisions. A principle of taxation that is widely subscribed to is that the cost (to taxpayers and to the government) of collecting the amount of tax revenue sought should be as low as possible. And, as noted earlier, "cost" in this context should be understood to include any "leakage" from taxes collected through corruption or mismanagement. Another broad principle of taxation is that the tax structure should not exert unintended influence on the distribution of productive resources across alternative sectors and activities.

What, one might ask, is the best combination of taxes and rates? There is a range of reasonable answers for any real world situation. Each country or region has its own particular economic base, natural resources, customs, standards of fairness, taste for public and private goods, concentrations of wealth and so on. Nevertheless, there are a few relatively straightforward general guidelines that most tax systems could aim for while still honoring their own uniqueness: specifically, taxes should be broadly based with few exemptions and deductions, and few rates, and should meet community standards of fairness.

The rationale for these guidelines is pragmatic. The simpler the tax, the easier it is for taxpayers to calculate what they owe, and for tax administrators to monitor and enforce compliance. A broad base spreads the burden of taxes among more taxpayers and across a large number of economic activities. Consequently, a given level of tax revenue can be had with lower rates than if the tax has a narrow base. By limiting deductions and the number of rates, incentives are limited for taxpayers to waste resources solely to qualify for more deductions or a lower rate. A flat or single rate structure for indirect taxes is preferred to a multiple rate structure, since it will have fewer impacts on the allocation of resources or consumption choices. For instance, some countries have exempted certain products from the Value-Added Tax (VAT) with unexpected impact.

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In El Salvador, for instance, the exemption of medicines from the VAT gave an undue advantage to imported medicines over domestic production, thus harming this important national industry.¹ Exemption of foodstuffs or subjecting them to lower VAT rates has had similar effect and has harmed domestic producers.² Multiple VAT rates, by region, in Mexico have led to fraud and long trips taken solely with the purpose of reducing the final price paid for products.

Tax reforms that USAID has supported in Egypt, El Salvador, Jamaica and Kosovo all contributed to some degree of “flattening” of income taxes by reducing the number of rate brackets.³ Indeed, in Jamaica the personal and companies income taxes each went to a single non-zero rate and the rates were the same. In El Salvador, income tax rates were reduced, the number of personal income tax brackets was also reduced, and the top income tax rate was set equal to the single rate on corporate profits. Kosovo’s income tax so far has remained inordinately narrow, as it applies only to reported wages. Nevertheless, the rates are few, and the Government has drafted a comprehensive income tax law that will include non-wage and self-employed incomes. In each of these cases, argument in support of these tax measures depended heavily on analyses performed by policy analysis units that were established with USAID assistance. The Tanzania Revenue Authority’s Research and Policy Department designed its own comprehensive tax policy reform, focusing on reducing the number of taxes, the number of tax rates, and eliminating exemptions, raising the zero-tax income bracket. USAID assistance helped provide the Tanzanians with the organizational structure and the tools for research and analysis and for developing policy reform proposals, but the Tanzanians developed and marketed the reform program.

Since the 1970s, the VAT has had growing worldwide appeal – after its low cost and broad base were demonstrated in Western Europe. Egypt, El Salvador, Guatemala, Jamaica, Tanzania, and Kosovo have all moved toward use of the VAT or a VAT-like General Consumption Tax. Except for Kosovo, all of these project-assisted policy moves represent a shift away from an array of older indirect taxes that were inefficient, with a wide variety of rates and numerous different bases. Thus, the emergence of these comparatively streamlined VAT-type taxes represents a major improvement of the fiscal systems of which they are a part. An additional advantage of the move to VAT-type taxes is that it is a significant step toward promoting international trade and harmonizing tax systems with those of trading partners and with other domestic policies being adopted to eliminate obstacles to trade. USAID projects in Egypt, El Salvador, Guatemala and Jamaica were explicitly supportive of trade liberalization efforts.

BUILDING CAPACITY

Building the capacity to analyze tax and broader fiscal policy and to propose homegrown reforms is essential for ensuring greater sustainability to tax reform. Every national government needs an office with the responsibility to:

1. Forecast government revenues (annual, multi-annual, and short-term receipts).
2. Simulate revenue, social, and economic impacts of alternative tax policies.
3. Monitor and report on revenue performance of the tax department.
4. Conduct multi-year strategic planning and monitor its implementation.
5. Prepare quality analysis of fiscal policy and tax policy issues, as well as of spending proposals that arise in the budgeting process.
6. Prepare useful statistical reports and databases for economic and policy monitoring.
7. Participate in the preparation of annual budget requests, especially with regard to revenues.

Tax administrations must be able to forecast revenues by tax type and by geographically dispersed collection offices, and monitor their performance within the budget year. This function can be performed using the databases and professionals in a policy analysis unit. Such monitoring can help to detect and remedy local problems before they become more serious.

Recommendations and findings gained currency with policy makers, civil society, and the private sector, when they were based on empirical or quantitative analysis. In El Salvador, the ability to demonstrate not only the revenue impacts of VAT implementation, but also the sectoral impacts was essential to passage of the VAT law. In Tanzania, one study profiling the “Tanzanian Taxpayer” successfully demonstrated that raising the zero-tax bracket would reduce by half the number of taxpayers subject to income taxation, but would result in almost no revenue loss. Another study in Tanzania demonstrated how income tax bracket simplification would affect taxpayers at various income levels. Both of these studies were essential elements not only in the design of the Tanzanian reform, but also in generating support for the reform.

In addition to building the requisite analytic capacity, managing a tax system effectively requires a large volume of high-quality tax and general economic data. The facilities, equipment, organization and systems for collecting, storing and analyzing these data are essential for steadily improving performance and efficiency of the tax system. In the comprehensive tax reform project in Jamaica, a modern and streamlined facility and systems were developed jointly with a number of other donors.

TAX ADMINISTRATION

It has been said that tax administration *is* tax policy. While this was obviously the point of view of a tax administrator, a few truths are definitely worth pointing out. The first is that good tax policy poorly administered is not good tax policy. Conversely, poor tax policy administered well is still poor tax policy. A well-administered tax system is one where compliance costs are low, and taxpayer compliance is high; where the tax administration is able to collect about all the revenues it should, given tax law; and where corruption does not impede these objectives. To attain the well-administered tax system, one needs a good legal and institutional framework, capable and well-remunerated and managed tax administrators, and automated systems and processes with a solid taxpayer database. In addition, a well-administered tax system is one where the tax administration:

1. Enrolls all entities subject to the taxes according to the law on master files.
2. Monitors filings against the master files.
3. Ascertains liability according to the law.
4. Monitors, records, and controls payments in a timely manner.
5. Compares payments at decentralized payment sites with forecast payments.
6. Selects and performs audits and collections activities fairly and effectively.
7. Assists taxpayers with compliance.

A fairly common problem with tax systems is their incomplete registration of taxpayers, which may be hampered by confusing or unduly complicated tax law. This increases the burden of taxes on those who are enrolled and raises questions about the equity of the tax system

The cost per dollar of revenue collected, another important measure of tax system performance, can often be reduced significantly through consolidation. Centralization can also facilitate such measures as establishing uniform Taxpayer Identification Numbers, and testing for compliance on all taxes at once. This is one of the potential payoffs from simplification of personal and companies

income taxes and replacing myriad indirect taxes, bases and rates with a value-added tax. The tax administration projects reported here illustrated the potential efficiency gains from introducing a VAT, albeit to widely varying degrees of success.

Audit can be misused for inappropriate, non-tax purposes including score-settling, political gain and corruption. Substantially removing discretion from the process makes it more difficult to use audit for corrupt or inappropriate purposes, and should yield more revenue. The tools to accomplish this have been developed with help from the projects in Egypt, El Salvador, Guatemala, Jamaica, Kosovo and Tanzania.

Periodic reviews of the tax system sometimes reveal that some particular taxes are not worth the cost of administering them. Early remedies of such problems can boost the system's overall efficiency. This technique has become standard in projects that include a policy analysis and forecasting component.

Institutionalized training capacity is particularly important in the tax services. In most countries, it is natural that as individuals gain expertise in taxation, many of them are enticed away from the government to higher-paying jobs. Moreover, there can be very rapid changes in accounting and other specialized areas that call for continuous training throughout one's career. The Jamaica and El Salvador projects, among others, placed major emphasis on the training function. In Jamaica, an elite tax service professional corps was created under the "Revenue Agent" program, and has been very successful in attracting and retaining tax professionals.

TO LEARN MORE ...

To learn more about the above issues, USAID/EGAT's Fiscal Reform in Support of Trade Liberalization Project has developed a benchmarking methodology for assessing tax systems. This methodology includes indicators of tax structure, tax system performance, and tax administration capacities. It can be downloaded from:

http://www.fiscalreform.net/research/pdfs/assessing_tax_systems_using_a_benchmarking_methodology.pdf

ENDNOTES:

¹ Exempting a product from VAT is not the same as applying a "zero rate" to the product, as is generally done for exports. Producers of exempt products do not charge VAT on the products they sell, *per se*, and are not entitled to recuperation of the VAT they paid on their inputs, whereas producers of zero-rated products, such as exports, are entitled to a refund from the tax authorities for all the VAT paid for the purchase of inputs. In El Salvador, the domestic pharmaceuticals industry was harmed when its products were exempted rather than zero-rated. For example, assuming that the production of aspirin, prior to the imposition of a 10% VAT, required the producer to spend about fifty dollars on the purchase of inputs, such as packaging, chemicals, fuel for transport, etc. for every \$100 in sales. Imposing a VAT of 10% on these inputs that will not be rebated to the producer, raises input costs to \$55, but because competing imports are not affected by the imposition of VAT due to the exemption, the price of these products will not rise. In this case, the Salvadoran drug company's margin over input costs has declined from \$50 per \$100 in sales to only \$45. This can be enough to wipe out a company's entire profit.

² The same effect that was illustrated for drug production can be found for the production of beans. VAT paid on inputs such as fertilizers, fuel, electricity, water, and packaging materials will not be rebated, yet imported beans are entirely exempt from the VAT, at all stages of production.

³ Case studies on these tax reform efforts, supported by USAID technical assistance programs, can be found at: www.fiscalreform.net/usaidtha/usaidtha.htm