

# INVESTMENT CLIMATE IN PRACTICE

## BUSINESS TAXATION

### TACKLING CORRUPTION THROUGH TAX ADMINISTRATION REFORM

A weak tax administration encourages corruption that benefits both government officials and businesses at the expense of overall tax revenue. Collusive corruption is at the heart of most, if not all, problems related to tax administration. This note examines the drivers of corruption and suggests good-practice measures for reforming tax administration. It is one in a series addressing issues that governments of developing countries face in reforming their tax systems.

A well-functioning tax administration is fundamental in promoting formal business activities, investment, and economic growth. In many countries, however, tax administration is rated by businesses as a key constraint to doing business. A malfunctioning tax administration raises the cost businesses incur in complying with the government's tax requirements. This leads to firms and tax officials colluding outside the system at the micro level and a high degree of mistrust between business and government at the macro level.

Corruption is often viewed as a predatory act: government officials prey on businesses that become the victims. However, tax corruption is a win-win situation for both tax officials and firms. A bribe is not necessarily an administrative extortion, but rather a business transaction yielding a lower tax payment for the company and unofficial, "tax-free" income for the tax official at the expense of national income. Collusive corruption among firms is exhibited in non-compliance of tax payments, misreporting of business activities, informal negotiations on tax obligations, unofficial payments to the collectors, and revenue loss for the government.

Tax corruption raises "black money," hidden income used for bribes related to other government regulations, procurement, and informal economic activities.

#### WHAT DRIVES THE DEMAND FOR TAX CORRUPTION?

A business is willing to bribe if it reduces the tax payment and saves the time involved in tax audits. For instance, in Yemen, businesses report that paying a bribe of 25-40 percent of the tax assessment can lower the assessment by 50 percent. In many developing countries, large firms take this opportunity (and exploit the loopholes in tax laws) to informally negotiate and file tax returns under the presumptive regime designed for small businesses, without disclosing the accounts.

Weak enforcement often means there is no significant risk of detection and punishment, which further encourages corrupt behavior. A high tax burden and compliance cost can exacerbate the situation. Moreover, the inevitable question remains: "Why would I pay tax?" In the absence of any tangible benefits of public

AMINUR RAHMAN

Aminur Rahman (arahman@ifc.org) is an investment policy officer in the World Bank Group and a member of the Investment Climate Department (CIC) business taxation product team. He advises client governments in developing countries on implementing tax reforms that will reduce barriers to compliance, investment, and economic growth.

This note, one in a series on business taxation reform, was developed as part of a joint program between the United Kingdom's Department for International Development (DFID) and CIC. The program focuses on operational issues in tax reform, particularly those related to micro-enterprises and small businesses.

The IN PRACTICE note series discusses practical considerations and approaches for implementing reforms that aim to improve the business environment. IN PRACTICE is published by the Investment Climate Department of the World Bank Group.

spending, taxpayers in many countries do not feel a civic obligation to pay tax, believing their income is taxed to pay the salaries of corrupt public officials.

### WHAT DRIVES THE SUPPLY OF TAX CORRUPTION?

Despite the often robust demand, the key drivers of tax corruption are on the supply side. In many countries, offering a bribe is the only way to avoid harassment from tax officials. Refusal to pay bribes may result in endless inspections (and requirements) that can last for months and waste significant senior management time.

Similarly, while appeal procedures exist in many countries, they are not credible. Firms usually do not try to appeal; they view the decisions in most cases as favoring the tax authority and penalizing businesses with heavy fines and imprisonment. During the long period of settlement, the firm may also face pressure from tax officials to informally settle with a bribe. Consequently, companies often decide not to enter into a dispute.

The underlying causes that drive corruption among tax officials include: complex and unclear tax laws

and procedures; non-transparent hiring and reward mechanisms; a low level of skills; a lack of professional ethics and integrity; low pay and a lack of incentives; conflicts of interest; the “get-rich-quick” syndrome; and insufficient checks and balances within the administration.

### GOOD-PRACTICE REFORM MEASURES

Tax reform measures should tackle both the demand (businesses) and supply (tax administration) side drivers of corruption. The challenges of weak administration and pervasive corruption are closely related and mutually reinforcing. Thus, good-practice reform measures aimed at tax corruption also reflect the key features of modern tax administration.

A typical technical assistance program for tax administration reform addresses several reform measures in strategic sequence. In the short term (within 18 months), the program aims to simplify tax instruments and processes; facilitate underlying legal reforms; consolidate subnational taxes and fees; and provide training and capacity building for tax officials and the private sector to successfully implement the streamlined, consolidated tax instruments and processes. In the medium-term (within 36 months), the program will redesign tax administration architecture that involves institutional autonomy; reorganize the system and services based on types of taxpayers; and implement human resource management policy, automation, incentive mechanisms, and checks and balances.

### SHORT- TO MEDIUM-TERM REFORM IMPLEMENTATION

**Simplify, standardize, and harmonize tax procedures.** A simpler process reduces tax officials’ discretionary power and abuse of tax laws, lessening the burden for firms to comply. For example, Colombia recently carried out a systematic study of important business processes and prepared a map of corruption risks to guide procedural changes. Latvia and Jamaica reformed their tax and customs codes to reduce the discretion of revenue officials and simplify procedures.

### SIX REASONS TO REFORM TAX ADMINISTRATION

- ❑ Tax administration is a critical determinant in the investment climate. Improving it can help attract more investment to increase growth and reduce poverty.
- ❑ Tax reform reduces the compliance cost and broadens the tax net, enabling the government to raise revenue with a lower tax rate and to equitably distribute the tax burden.
- ❑ For any given tax policy, a well-functioning administration raises more revenue than a malfunctioning one.
- ❑ Tax policy reform without administrative reform is not fruitful in an environment of mistrust; the good intentions of either tax officials or businesses are cynically viewed by the other party.
- ❑ Tax corruption propels corruption in other areas; reform is essential to cut the “supply lines” of corruption.
- ❑ A modern tax administration is necessary to keep up with the increasing sophistication of firms’ operations in the era of globalization.

### **Enforce compliance and target corruption with a strengthened legal framework and administration.**

A lower tax burden will not increase compliance without an effective enforcement mechanism. The laws should enforce record keeping, return filing, voluntary registration, and arrears collection. Under self-assessment, compliant taxpayers should be free to conduct business without abusive auditing, and those considered non-compliant should be penalized. The legal framework should reflect “zero tolerance” for corruption. If proven guilty of corruption, the offenders—whether they are tax officials or firms—should be punished.

### **Conduct taxpayer outreach and education.**

Educating taxpayers reduces firms’ misconceptions and confusion about tax policies and procedures, and raises their awareness on the benefits of proper record-keeping, such as quick assessments and less likelihood of being audited (and less intrusively, if audited). It also works to instill trust between the administration and business. In Uganda, Rwanda, and South Africa, outreach activities have included TV and radio coverage, advertising, and tax-themed school programs to help children understand the civic responsibility of paying taxes.

### **Institutionalize an effective control and audit system.**

Experience suggests that most firms will comply in paying taxes if they understand their obligations, and if they see the tax administration is fair in handling non-compliance. The risk-based auditing system enables effective auditing and efficient management of the administration’s resources. A number of countries, including Chile, Colombia, and Hungary, have implemented systems that compile information from various sources to create risk profiles. Hungary has imported a system that guides auditors through the steps of an audit. Other measures include: streamlining the reporting arrangement for audits; rotating auditors to prevent corrupt affiliations between auditors and audited firms; and implementing a system to monitor individual auditors.

## **MEDIUM- TO LONG-TERM REFORM IMPLEMENTATION**

### **Institutionalize e-services and automation.**

Reducing face-to-face interactions between businesses and tax officials limits opportunities for

corruption, as has been demonstrated in the Philippines and Nepal. Automation is a key feature of modern tax administration. It efficiently collects information from taxpayers and other parties (such as banks and government agencies) and electronically supports clerical functions. It enables businesses to file returns and to easily and quickly declare and pay taxes. Automation is also essential for risk-based management approaches.

### **Introduce an effective human resource management policy.**

The administration should have a transparent, fair, and streamlined policy for recruitment, performance appraisal, career development, and compensation including incentives. Staff professional development needs to include an anti-corruption focus, ethics, and code of conduct. Employee achievements in detecting tax fraud, attaining client satisfaction, and improving revenue collection should be recognized. Latvia, the Russian Federation, and Colombia have focused on strengthening their tax administration management. Many countries have used revenue administration restructuring to establish human resource management principles and terminate corrupt officials. In Guatemala, Peru, and Jamaica, a rigorous process of psycho-metric tests, job-specific skill tests, interviews, and personal record reviews was used to weed out corrupt and underperforming employees. To improve tax officials’ pay (thus lowering the incentive for corruption), some countries have disassociated revenue administration staff salaries from general civil service pay. In Guatemala, the salaries of top managers were increased significantly. Jamaica created a separate pay scale for tax administration staff. Russia and Albania allowed managers to give performance-based bonuses.

### **Institutionalize a streamlined and transparent appeal procedure.**

An unbiased, quick, and transparent appeal process helps firms develop trust in the overall system. In shortening the process, the tax authority can limit abuse by firms that appeal in order to defer paying taxes over an extended dispute period. The Revenue Appeals Tribunal, a process widely used in the United Kingdom, Canada, and Uganda, can be expedient in moving trials to conclusion.

**Reorganize tax administration by type of taxpayer.** To increase efficiency and effectiveness, the tax authority headquarters and local office

network should be rationalized and streamlined based on the different sizes of taxpayers. Most revenue administrations are moving toward this sort of institutional restructuring. Segmented service delivery enables the tax authority to better understand each category of firms, allowing for informed monitoring of taxpayers and tax officials. For instance, under a size-specific structure, it is more difficult for larger firms to hide profit or income and file as small firms. A functional organization structure has been implemented in Latvia, Jamaica, and Russia. A large taxpayer's office has been successfully established in South Africa, most transition countries, and in many countries in Latin America.

**Ensure the tax authority's autonomy.** Although the tax authority is often attached to the Ministry of Finance, measures should be taken to strengthen the administrative autonomy of tax services. The effectiveness of the measures discussed above— incentives and penalties, streamlined operations, management and control—crucially depends on both organizational and budgetary autonomy. Autonomy increases the transparency of the tax administration and its budget and the effectiveness and efficiency of its expenses. It is important in promoting merit-based recruitment, performance-based career development, and professional skill development. Autonomy minimizes the chances of the administration's involvement in political corruption and client favoritism.

## CONCLUSION

An important lesson in tax administration reform, as experience around the world indicates, is that undertaking reforms on a piecemeal basis does not yield the desired results because each reform measure is critically interlinked with others. Therefore, designing and enacting a comprehensive reform package requires continued and strong political will over time.

Understanding how reform measures work together is key in addressing challenges on the ground in their implementation. For instance, simplifying

processes does not automatically ensure compliance. Businesses can still evade tax without a strong enforcement mechanism. Enforcement should be matched with appropriate checks and balances in administration or tax officials will abuse their power. Similarly, in an atmosphere of mistrust (and lack of confidence in the judicial system), firms seldom use an appeal mechanism and complaint hotlines because they believe the decisions will penalize them and favor tax officials.

Pay raises and bonuses for tax officials, or institutional autonomy for that matter (which is politically challenging to achieve), are not a panacea to stop tax officials' rent-seeking behavior. As evidenced in Uganda, Ghana, and Tanzania, the initial gain in terms of improved revenue collection due to pay raises or institutional autonomy is not always sustainable without checks and balances and punitive measures against corruption. In an environment where corruption is a way of life and the tax authority's higher tiers share the proceeds of the lower tiers' bribery, these sorts of administration-wide measures against corruption are difficult without support at the highest levels of the government (which is also not prone to election results and changes in political leadership).

The key to sustainable progress against corruption lies in sequencing the measures of an overall strategy for reform. While each measure addresses a specific driver of corruption and a full reform package must be implemented over the longer term (or widespread corruption will prevail through the weaker links in the system), a manageable and logical sequencing first addresses the shorter-term implementation components (tax instruments and processes, taxpayer awareness, and the underlying legal and administrative framework). It does not make sense, for instance, to address human resource policy before an audit and control system is in place. Thus, implementation of the shorter-term measures provides a basis for longer-term structural and institutional reform, such as reorganization of the tax administration architecture.

*Further reading on this topic is available from the author upon request.*

The World Bank Group's Investment Climate Department (ICD) is the operational center for IFC's Business Enabling Environment Advisory Services and FIAS, the multi-donor investment climate advisory service. ICD assists the governments of developing countries and transition economies in reforming their business environments, with emphasis on regulatory simplification and investment generation. The findings, interpretations, and conclusions included in this note are those of the author and do not necessarily reflect the views of the Executive Directors of the World Bank or the governments they represent.



World Bank Group  
Multilateral Investment  
Guarantee Agency



THE WORLD BANK