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Tax myths: Dispelling myths about tax transformation in rapidly growing economies

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Tax myths

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Taxes play an important role in every country. Sustainable sources of revenue are critical for financing infrastructure, healthcare, education, and other public services. In rapidly growing economies, tax revenues are increasing as a percentage of GDP: In Latin America, for instance, the average tax-to-GDP ratio rose from 14 percent in 1990 to 21 percent in 2013[1].

Many governments recognize the mission-critical nature of tax collection, and in turn are implementing projects aimed at transforming their tax systems and tax administration. These transformation programs address a range of topics, such as optimizing tax collection, redesigning the tax system for increased tax fairness, fighting the informal economy, increasing taxpayer registration, and using new technologies to improve compliance and taxpayer services.

In conversations with public sector leaders globally, we have uncovered several misconceptions about tax transformations. Many leaders believe, for instance, that it takes up to 10 years for a tax transformation effort to produce visible and lasting results. But our research shows this isn't always the case. Countries like Mozambique, Morocco and Georgia have quickly and significantly increased tax revenues—up to 5 to 10 percent of GDP in less than five years, in fact. One African country increased non-oil tax revenue by more than $4.5 billion in just three and a half years—a 5 percent increase on top of baseline growth. Another African country captured an additional $750 million in tax revenue in the first year of its transformation program.

Reality can sometimes be at odds with conventional wisdom, raising important implications for policy makers and tax administrations.

Based on our experience working with tax administrations in rapidly growing economies, we have identified five striking myths about tax

Myth:	Reality:
1. **Going digital is challenging**	Digitizing taxpayer services and back-office processes in phases can be a cost-effective way to overcome high infrastructure costs and concerns about equality of access. As e-filing rates approach 100 percent, submission processing costs can be reduced by an average of 45 percent.
2. **Risk-based compliance tools are always complex**	Taxpayers at high risk of noncompliance can be identified and targeted using data that are already available, with a very basic approach. A simple segmentation approach helped one country generate approximately 1 to 2 percent more revenue in just 12 months.
3. **The informal economy is a problem to be addressed in the future**	Governments don't need perfect information to fight the $5 trillion[2] informal economy. There are targeted and cost effective initiatives that can reach part of the informal economy—and it should be a priority.
4. **Boosting the agency's capabilities takes at least 10 years**	Field-and-forum training for critical positions, combined with training-at-scale for the rest of the organization, can significantly upgrade skills within 1 to 2 years. Improving auditor's skills in this way led to an audit-related collections increase of fifty-fold in an African country, in just 6 months.
5. **Educating taxpayers to address the culture of non-compliance comes as a second priority**	Communicating the transformation program is crucial. For one tax administration, communicating the benefits of the transformation generated approximatively up to 1 percent tax revenue increase in as little as 12 months.

transformation programs. We believe these myths pose a very real risk of misinformed decision making for governments. Here, we present those myths, as well as strategies for overcoming them.

Myth 1: Going digital is challenging

Reality: Digitizing taxpayer services and back-office processes in a phased and segmented approach can be a cost-effective way to change the taxpayer experience from a time-consuming paper obligation, to a user-friendly electronic experience. A modular approach can help tax administrations overcome high infrastructure costs and help mitigate any lack of access to electronic channels the population may have.

For tax administrations, electronic channels have a wide range of purposes and can be used to educate taxpayers, provide off-the-shelf tax information, allow interactions between taxpayers and tax agents, as well as facilitate e-filing, e-invoicing and e-payment. Tax administrations can leverage this infrastructure by introducing electronic channels such as Internet portals, and mobile filing and payment options, as a powerful lever for improving service levels.

However, many governments and tax administrations remain hesitant to invest in technology for various reasons. Some assert that investments in technology are worth the effort only if they produce economies of scale. Indeed, cost savings from electronic filing are only realized when over 90 percent of taxpayers have subscribed. It is no wonder that many discuss digital services and technology investments as an "all or nothing" policy, where they either mandate all taxpayers to comply or none at all. Others argue that offering digital services would violate the principle of equity, because many of their citizens still do not have access to the Internet. Some countries may simply not yet have the right telecom infrastructure network to use e-services at a national scale.

Best-in-class tax administrations are taking a different approach to digitization. Going digital is no longer about making digital channel usage mandatory for 100 percent of citizens—it is about improving the taxpayer experience one segment or service at a time. Using a segmented or phased approach makes digitization more cost-effective, by staging the investments needed instead of requiring a single lump sum upfront. One agency in Asia registered 1 million taxpayers for electronic filing services in just 9 months by targeting civil servants and employees of state-owned enterprises. This allowed the agency to test its e-filing systems before launching it to the rest of the country. This type of approach can bring substantive

As e-filing rates approach 100 percent, submission processing costs can be reduced by an average of 45%

How to dispel Myth 1

1. **Tax administrations can start with discrete taxpayer segments before launching programs more broadly.** To ensure high rates of return, agencies can focus first on large taxpayers, who represent up to 90 percent of tax revenues in some countries. An African tax administration launched e-filing and automatic audit checks for the largest companies as a first digitalization phase, ensuring high returns on investment.
2. **Agencies can differentiate their digital offering and leverage alternative channels, such as smartphones.** For example, the Government of Mexico City and the Mexican Ministry of Finance have made available a smartphone app that allows users to pay property or payroll taxes, traffic fines, water bills, and driver's licenses fees, up to $5000.

results in both the short- and long-term; as e-filing rates approach 100 percent, submission processing costs can be reduced by an average of 45 percent[3].

While new e-government solutions such as smartphone applications are economically attractive, there is also an opportunity to reach a wider range of the population. Concerns about accessibility might be overstated: Internet access and mobile penetration in emerging markets are growing exponentially—Internet users in developing Asia increased more than twelvefold between 2004 and 2014, and more than half of African countries will likely reach 80 percent mobile penetration by end of 2015. Best-in-class tax administrations are taking advantage of these trends. Taxpayers in South Africa are now able to complete and submit their annual income tax returns quickly and easily on their smartphones, as well as on their tablets. They also receive their assessments electronically.

Myth 2: Risk-based compliance tools are always complex

Reality: High-risk taxpayers can be identified and targeted using readily available data, with a simple but effective approach.

Most rapidly developing economies don't have the type of advanced analytic tools that can automatically detect suspicious taxpayer behavior. They may lack the digital data required to run such sophisticated analysis. Take countries where financial statements are submitted in paper form, or where these financial statements are scanned but are not in a standard format that can be easily analyzed. At best, these administrations rely on labor-intensive analyses to identify high-risk taxpayers.

How to dispel Myth 2

1. **Tax administrations can create a centralized compliance center** for building risk-based tools, conducting risk analysis, and identifying high-risk taxpayers for audit. Centers can include multiple teams; each one can be responsible for a different high-risk segment. Each team should have a cell leader and 6 to 8 auditors. Ideally each auditor would have expertise in a specific taxpayer segment.

2. **Agencies can consider segmenting taxpayers in a high risk sector.** Size and sub-sector are typical dimensions to consider. For example, an African tax administration decided to focus efforts on small and medium size taxi service providers.

3. **Tax administrations can digitize existing information and build simple heuristics to determine outliers.** They can identify 2 to 3 risk predictors, based on the audit team's input. Typical predictors for the trade sector include gross margin, annual revenue increase and cost of goods sold. They can conduct simple regression analyses to detect outliers and to define rules-of-thumb for identifying high-risk taxpayers. It can take 4 to 6 weeks to establish a data repository, and up to 6 months to get a risk model up and running.

4. **They can also consider working with tax intermediaries to identify high-risk taxpayers.** Tax intermediaries such as audit firms and tax consultants can be valuable partners in detecting non-compliance.

Simple segmentation can identify opportunities to increase tax revenues by 1 to 2 percent in just 12 months

Many administrations are embarking on multi-year efforts to upgrade their data and risk systems to address this data analytics gap. Some already have centralized centers that scan tax forms and supporting documents, which can then feed into a risk model. Others are linking the tax system to external sources of data for validation. For example, an Asian tax administration has a 3-year road map to create a sophisticated risk engine that is linked to the national ID system.

While the design and roll out of a full-fledged risk engine will yield substantial gains in the long term, a simple heuristic-based approach can also be launched in parallel to get big results, and fast.

By using a simple segmentation of taxpayers according to size, sector, and past behaviors (among other attributes), tax authorities can quickly perform a risk analysis that flags any unusual discrepancies between one taxpayer's behavior and that of his or her cohort. By applying this risk analysis and segmentation technique to approximately 500 taxpayers, one African country was able to identify a small number of taxpayers who together owed 5 percent of the country's total uncollected tax debt.

Not only is the approach doable, but it brings major outcomes in the short term for tax administrations: we estimated a simple taxpayer segmentation to identify larger revenue opportunities can generate approximatively a 1 to 2 percent revenue increase in 12 months.

Myth 3: The informal economy is a problem to be addressed in the future

Reality: Gathering perfect information to tackle the US$5 trillion[2] dollars informal economy in the developing world can be time consuming and costly, but a few targeted and cost-effective actions can go a long way to reach part of it.

The informal economy can create a huge tax gap in any country, but that gap is often bigger in developing economies. Defined as any unreported economic transaction, the informal economy in developing markets is typically driven by millions of small "mom-and-pop" firms. These businesses are often dispersed throughout the country, making them difficult to reach. However, their economic contribution cannot be ignored: businesses in the informal economy can account on average for 35 percent of emerging markets' GDP[4]– or up to US$5 trillion[2].

Tax authorities have programs to reach the informal economy, operating on the principle of tax fairness. These programs aim to register all taxpayers to demonstrate that the tax system is similarly enforced to all, not just the large firms or the formally employed. However, we have observed that there is often limited follow through once these firms are registered—a tax authority in Asia registered over 1 million new taxpayers within one year, but was able to collect from just 30 percent of them. Often, tax agencies argue that potential tax revenue from these informal firms is so small, and the cost of enforcement so high, that further action can't be justified. Some also insist that informality is a government-wide problem, not just a tax problem, requiring large-scale, long-term and costly initiatives, such as a national ID system, or comprehensive financial inclusion frameworks.

While it is true that comprehensively addressing informality can be time consuming and costly, we believe that targeting hotspots, making it easy to comply, and reallocating existing resources can be cost-effective ways to maximize compliance within the

The informal economy in the developing world represents approximately US$5 trillion

How to dispel Myth 3

1. **Tax administrations can target informal sector hotspots.**
   - **Tax administrations can go to geographic areas with highest levels of informality and collect taxes on-the-spot.** In an African country, the State tax authority decided to target sectors with high levels of informality. Tax agents went to wholesale markets where many such firms operated, and then immediately enforced tax payment. Agents conducted a simplified taxes-due assessment based on average product sales (with no need to fill in a tax form), and collected cash directly on site.

   - **Tax administrations can deploy mobile tax offices to more remote areas** where it is not cost-effective to staff a full-fledged tax office. South Africa deployed buses with staff to rural areas who conducted the full range of services from completion and submission of personal income tax returns, to updating registration and banking details.

2. **Governments can make it easy to comply.**
   - **Some governments simplified the tax system to cater to firms that have poor book-keeping,** such as a reduced tax schedule for small taxpayers, as well as simplified balance sheets and tax declaration forms. They can also simplify the processes associated with registering a business or applying for a commercial license.

3. **Tax administrations can use existing resources to reach taxpayers.**
   - **They can get staff in tax offices to go around the community and register taxpayers.** An Asian administration, for example, launched a “tax census” day. Tax officers, together with community authorities, visited residences and workplaces to collect tax-related data. They collected taxation data, including the taxpayer’s personal information, electricity customer account numbers, the number of family members, the date of the last personal annual income tax return filed, the level of annual income and number of employees including personal drivers and domestic helpers.

   - **They can also crowd-source.** In Puerto Rico, cash receipts are issued with a government number, which citizens can submit to a government-sponsored lottery to win US$1,000 or a car. This encourages all citizens to ask for and submit receipts, while encouraging businesses to report and pay taxes.

informal economy—and to encourage formalization. Our experience suggests that targeting informal sector hotspots can increase total tax revenue up to nearly 1 percent over a 12 month period. To identify these hotspots, tax authorities can use quantitative assessments that combine internal data and third-party information; qualitative intelligence gathered "on the ground" and random audit program risk profiling.

Myth 4: Boosting the agency's capabilities takes at least 10 years

Reality: Targeted training for critical positions, combined with field-and-forum training for the rest of the organization, can significantly upgrade skills within 1 to 2 years.

Having the right mindsets and capabilities is instrumental for tax administrations to improve their performance, but many organizations are resigned to the idea that these capabilities take a long time to build. Some governments face the additional challenge of being unable to manage underperformers. For example, individual tax debt collected per FTE can range from US$0.3 million to US$17.2 million[5] from one tax administration to another, depending on the efficiency of its staff.

That's not always the case. When they target their efforts toward critical positions within the agency, tax administrations can quickly make measureable gains. One administration launched a program to improve its auditing performance; the organization installed a dedicated auditing lead group of approximately 50 dedicated auditors, while at the same time training about 100 tax examiners. Simultaneously, it implemented a rigorous performance management system and developed some new tools. Within 6 months the auditors' productivity raised more than tenfold, audit-related collections increased fiftyfold, and voluntary compliance increased substantially, due to the perception of increased controls. As a result, the revenue from corporate income tax has risen by over 30 percent year-on-year.

Improving auditors' skills can increase audit-related collections fifty-fold

How to dispel Myth 4

1. **Tax administrations can develop intensive "bootcamp"** training for critical, revenue-generating departments like audit and tax collections. These "Centers of Excellence" can gather the best technical experts to develop knowledge and best practices which can then be disseminated throughout the entire organization.

2. **Tax administrations can consider creating dedicated staff training facilities,** which can have concrete impact quickly, such as a Tax College to improve general education levels, as well as basic mindsets and behaviors. Or taking a field-and-forum approach: an African tax administration provided a field-and-forum training to more than 400 tax officers on filing and audit toolkits, which led to ~75 percent reduction in the number of stop-filers.

3. **Some tax authorities have also hired externally to complement skills.** For example, an African tax administration set up a technical support team for tax examination primarily consisting of external hires, but with a target of reducing the private share by around 20 percent per year.

Adopting a field-and-forum approach to existing trainings can also significantly improve effectiveness. One African tax administration, over a 3-month period, held regular in-house collective trainings on tax filing and audit tools. This was supported with individual staff reviews and coaching on the ground to ensure a best-in-class learning and use of tools.

Myth 5: Educating taxpayers to address the culture of non-compliance comes as a second priority

Reality: Communication is *sine qua non* to successful tax transformation, and must be done in parallel with other transformation initiatives.

In theory, most tax authorities recognize the importance of communicating to taxpayers, but such communication is often treated as a secondary priority or as something to be simply tacked on to transformation initiatives. To be effective, taxpayer communication should be considered a priority, and just like any other initiative, should receive adequate investment and program management.

Effective communication can have a drastic impact on taxpayer compliance by creating a deterrent effect among the general population. A study highlights that communicating audit results can encourage broader compliance. Specifically, every dollar collected as a result of audits can yield 6 additional dollars in voluntary compliance among taxpayers who might not otherwise have paid[6].

The communication approach should encompass three areas: motivating taxpayers about the benefits of paying taxes; educating taxpayers on how to comply; and increasing the perception of risk for noncompliance by publicizing improvements in auditing, collection, and other controls. For example, one African country organized three stakeholders forums across the nation's three biggest regions, gathering a panel of tax representatives with CEOs and CFOs of the largest companies in those regions, to share direct questions and answers. This was broadcasted live on TV, and 20 newspaper journalists were invited to attend.

Launching targeted communication initiatives is crucial and can generate major return: our estimates suggest it can increase tax revenue up to 1 percent in as little as 12 months.

Communication initiatives can increase tax revenue up to 1 percent in as little as 12 months

How to dispel Myth 5

1. **Tax administrations can set up a team of communication specialists** and involve them in the transformation early on.

2. They can also consider working with an external **professional advertising and public relations firm** to manage the communications program.

3. **Some tax agencies have adopted segmentation principles** (similar to audit and collections), differentiating communication objectives and strategies based on profiles of different taxpayer groups. For example, basic information and emotive campaigns should reach as many taxpayers as possible; while forums that allow for "questions and answers" can be made available to large taxpayers and SMEs with more complicated tax filing requirements. A Mexican tax administration launced YouTube channels to reach a wider and young audience, explaining the use of tax services. In less than 7 months, the YouTube views doubled[7].

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Leaving these myths aside and adopting practical counteractions in their wake is absolutely necessary for informed and appropriate decision-making in tax transformation. Transforming the tax administration and system requires a mix of short- and long-term initiatives, many of them already tried-and-tested, that can bring outstanding results in citizen participation and satisfaction, improved compliance, and ultimately, tax revenue increases. With a precise and well thought out aspiration and action plan, the time is now for rapidly growing markets to tackle tax transformation challenges.

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Endnotes

1. According to *Tax revenue trends 1990-2013*, Latin American Economic Outlook

2. 2012 McKinsey estimates for 98 developing countries, based on the sizing estimates of the shadow economy from the *Shadow Economies All over the World, New Estimates for 162 Countries from 1999 to 2007*, The World Bank Development Research Group Poverty and Inequality Team & Europe and Central Asia Region Human Development Economics Unit, July 2010

3. McKinsey tax performance benchmark analysis

4. Average for a selection of 98 developing countries, leveraging the document *Shadow Economies All over the World, New Estimates for 162 Countries from 1999 to 2007*, The World Bank Development Research Group Poverty and Inequality Team & Europe and Central Asia Region Human Development Economics Unit, July 2010

5. McKinsey tax performance benchmark database, collections per FTE data for 9 selected countries

6. Econometric study using U.S. state-level reporting data for the years 1977 to 1986 by Dubin, Graetz and Wilde, 1990

7. According to *Social Media Technologies and Tax Administration*, OECD, 2011

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