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Unlocking tax-revenue collection in rapidly growing markets

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Unlocking tax-revenue collection in rapidly growing markets

Introduction

The locus of growth has shifted. Many of the world's most dynamic economies are not found in Western Europe or North America but in countries with younger populations and newer horizons. The rapid growth seen in the BRIC¹ countries is now common knowledge. Maybe less known is that many other countries have seen similarly rapid growth: for example, Qatar saw close to 14 percent compound annual growth over the ten years leading to 2011, Angola over 11 percent a year, Ethiopia in excess of 8 percent, and Panama and Vietnam well over 7 percent.²

Such high levels of growth present countries' administrations with their own problems. The dynamism and youth of such economies is often accompanied by numerous challenges, ranging from the need for better regulation and job creation to demands for improved health care and education. Left unchecked, these challenges can overwhelm a country and undo the benefits of rapid growth.³

There is an oft-overlooked key for realizing the potential of rapidly growing markets—that of improving the effectiveness of the tax administration. Doing so will not only provide the increased financial resources required to tackle the underlying challenges but will also ensure that the revenue flow is stable and longer lasting.

This paper looks at what it takes to ensure that such tax-administration reform is effective. Its recommendations derive from our experience in more than 120 public-finance projects in over 20 different countries over the past five years, supplemented by information from our proprietary global tax-benchmarking database that contains the details of over 100 tax practices from more than a dozen countries (ranging from submission processing to examination and from collection to service processes).

Our focus here is on a set of initiatives designed to achieve significant revenue impact within a year of their introduction—what we call “quick wins.” Although this quick-win approach is frequently part of a longer-term strategic plan, the quick wins are designed as self-contained but lasting interventions that will not only realize impact in the short term but will also continue to deliver improvement

Longer-term impact of quick wins

The ten quick-win initiatives can unleash significant impact over the long term as well as in the short term. For example, we recently helped an African tax authority implement a series of initiatives that introduced more effective auditing procedures, improved collections, and increased compliance controls, as well as closed selected tax loopholes. This led to a 6 percent increase in tax revenue in less than 12 months—without increasing tax rates. Tax-effectiveness programs such as these are also important in reducing the level of informality over the long term, bringing many into the tax net for the first time and thus generating increased tax revenue, which will enable the country to promote its economic-development goals. Our projections show that over a 5-10 year period the increased revenue from these initiatives would enable the doubling of expenditure on education and a 50 percent increase in investment in health care (3 to 5 percent of GDP).

over the longer term. For instance, one sub-Saharan country introduced a package of quick wins that has managed to increase revenues by 6 percent above the baseline in just a year and has started using this revenue to increase spending on vital areas such as infrastructure, health care, and education.

The emphasis in this paper on the short-term impact of tax-administration initiatives is deliberate: while it is true that large-scale structural reforms can sometimes be essential, our experience shows that such reforms are also extremely challenging to implement. Structural reforms frequently lead to increased resistance from stakeholder groups and the public at large. The ground needs to be well prepared if such reforms are to be successful. The quick-win approach highlighted here is designed not only to enhance the tax administration's effectiveness and to address its most pressing needs but also to provide a powerful “proof of concept” that will help combat skepticism about any larger reform efforts.

1 Brazil, Russia, India, and China.

2 Norbert Dörr, Charles Roxburgh, et al., *Lions on the Move: The Progress and Potential of African Economies*, McKinsey Global Institute, June 2010.

3 François Bouvard, Robert Carsouw, et al., *Better for Less: Improving Public-Sector Performance on a Tight Budget*, McKinsey Center for Government, July 2011.

Ten ways to achieve quick wins

Rapidly developing economies have many challenges in common in improving tax administration—frequently the authorities in such countries need to implement tax collection in an environment characterized by a high degree of informality and concomitant tax avoidance. Often this challenge is compounded by too much complexity in taxation approaches, insufficient resources and organization, inappropriate collection approaches, and inadequate support systems and tools.

Since all economies are in constant change, the journey of all tax administrations around the world is necessarily one of continuous improvement—one that starts from weak and moves to great. While many systems in today’s rapidly developing economies are weak or at best sound, very few anywhere in the world are great. Most are seeking to move from weak to sound or from sound to good (Exhibit 1).

The journey any tax-administration-improvement program embarks on should seek to address the three major dimensions common to every tax ecosystem: administration, taxpayer service and communication, and the tax system. The choice of which levers should be pulled in each of the

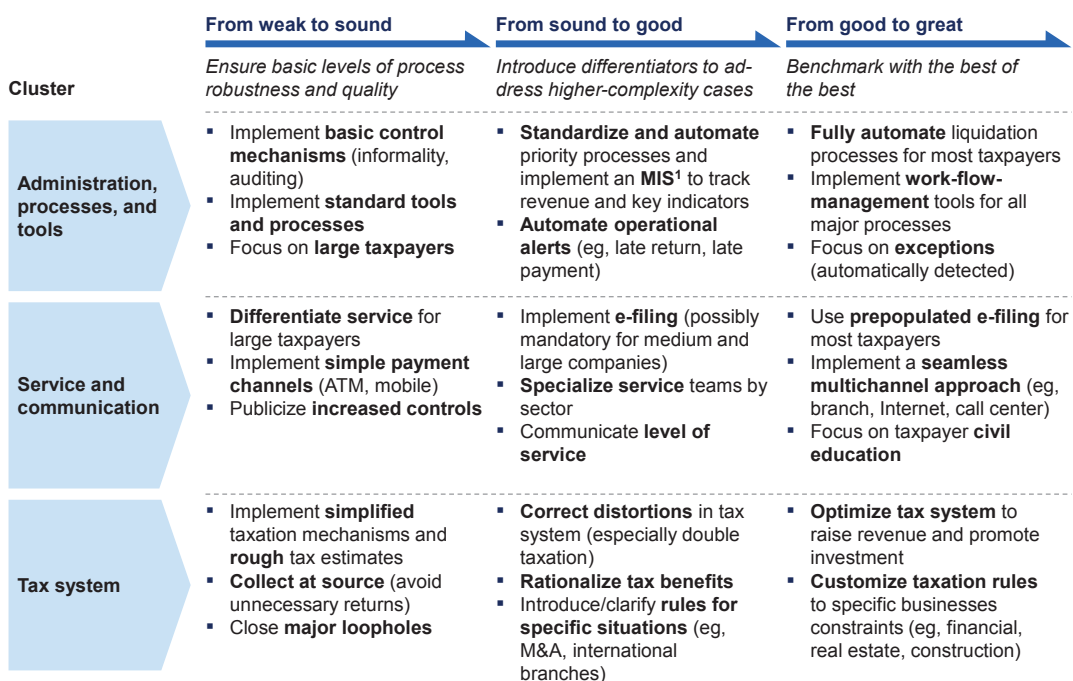
three dimensions depends on the level of development of the individual country and the particular needs of its tax system.

The following ten quick-win initiatives, each of which has yielded significant impact in one or more fast-growing countries, fall into the same three clusters: initiatives designed to enhance administrative processes, those focused on improving taxpayer service and communications, and those designed to achieve focused changes to the tax system.

Enhancing tax-administration processes to enforce compliance and increase collections Tax administrations are on a journey of improvement in which they face many common operational challenges. A large number of rapidly developing economies are now at the point on this journey where they need to ensure that their tax systems are well focused and efficient, that key processes are robust, that their communications are effective, and that they possess all the necessary skilled talent. We have found five levers to be especially effective in delivering results quickly:

Quick win 1: Focus resources on improved auditing, processes, and tools. In rapidly developing economies, the control tools used to ensure an efficient auditing process are especially important, as the fast-moving growth creates

Exhibit 1 A tax ecosystem must go through a transformation journey.



¹ Management information system.

a major opportunity for tax evasion and can encourage a culture of noncompliance. Auditing is thus not only a way in which to detect and penalize evasion attempts; it is a way to signal the tax administration's intentions to prioritize more aggressive enforcement. Improved auditing will also promote higher levels of voluntary compliance by highlighting the government's efforts in maintaining high ethical standards and thereby improving service levels.

Such improvements yield almost immediate results. One administration, for example, launched a program to improve its auditing approach by installing a dedicated auditing lead group with approximately 50 auditors while at the same time training about 100 tax examiners. It also developed specific audit tools to partially automate the process, thereby simplifying it and improving its overall quality and consistency. At the same time, it implemented a rigorous performance-management system. Within six months, the auditors' productivity rose 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.

Quick win 2: Use simple segmentation to identify larger collection opportunities. Most rapidly developing economies lack the advanced analytic tools and databases necessary to automatically flag and follow up on suspicious taxpayer behavior. Nonetheless, by using a simple segmentation of taxpayers according to size, sector, and past behavior, among other attributes, tax authorities can quickly perform a risk analysis that flags any unexpected discrepancies between an individual taxpayer's behavior or payments and that of his or her cohort. This approach, in helping to establish the predicted tax revenue for each cohort, also enables effective monitoring of revenue-collection performance by establishing whether too little or too much tax has been targeted for payment by an individual taxpayer. This segmentation approach has been shown to yield highly accurate results and is being adopted by many (though by no means all) tax authorities in the early stages of improving revenue collection. For instance, by applying this technique to approximately 500 taxpayers, one African country was able to identify a small number of taxpayers who together owed 5 percent of the nation's total uncollected tax debt. The authority expects to collect over half this amount in recovered revenue.

Quick win 3: Target collections in tax offices with the largest outstanding debts. In administrations where tax collection is neither automated nor centralized but is handled on a case-by-case basis by individual tax offices, there is often a low rate of

collection and typically little awareness of how much is owed. This erodes the impact of penalties for noncompliance. In response to this challenge, one customs authority identified which importing businesses owed the most tax, then put in place a technical team to negotiate payment terms directly with the debtors using centrally defined but flexible rules. This program not only helped minimize the opportunities for the importers to continue to accumulate debt but also served to publicize that the customs authority intended to take action against them. Within three months of its launch, this initiative helped collect approximately 15 percent of the outstanding debt (corresponding to approximately 2 percent of the customs department's yearly revenue) and reduced the new-debt-formation rate by more than half.

Quick win 4: Ensure regular updates to the taxpayer registry and follow up. An accurate central taxpayer registry is paramount for ensuring proper management of taxpayer obligations. In many rapidly growing markets, this task can be especially challenging, as much of the economy is likely to comprise "informal" and small-scale businesses, and the tax authorities lack most of the external controls that ensure a taxpayer stays within the system. Given that such administrations do not have the resources to effectively control all taxpayers, it is all too easy for a potential taxpayer to effectively fall off the radar in these circumstances—either by not registering in the first place or by stopping declarations—and to do so without facing any major consequences. To counteract this, registration must be made more rigorous, and feedback systems must be introduced to ensure taxpayers regularly update their information. Additionally, quick and simple controls can be put in place to raise the alarm if taxpayers fail to comply with some of their obligations, focusing administration efforts on the cases that are easier to track and follow up. One tax administration in Africa, for example, launched an aggressive two-week effort to improve its registry. During this period, the authority closed selected branches and sent their officials into the field to identify and register informal businesses in specific, targeted areas. This initiative increased taxpayer registry entries by 20 to 30 percent in each of the targeted districts.

Quick win 5: Introduce account managers to oversee large taxpayers. Increasing tax revenues and compliance is not solely about enforcement: it is also about improving service and making it easier for taxpayers to comply with tax demands. In almost all countries, a very small number of taxpayers account for the majority of tax revenue—typically financial firms, large retailers, construction companies, major manufacturers, large importers, and so on. Although most tax administrations have established large taxpayer units (LTUs), these units often

use the same processes, rules, and resources as general tax offices. This approach more often than not fails to deliver the full potential of the LTU. Introducing “account managers,” supported by a dedicated back office with strong specialists (legal, litigation, tax collection), provides a differentiated service for large taxpayers that will ensure both improved service and increased revenues.

To implement this model, it is first necessary to develop highly skilled, specialized teams to focus on specific sectors or even individual taxpayers. While fully implementing such an approach necessarily takes time, a “crash program” can quickly achieve a large portion of the potential impact in the short term. One sub-Saharan country, on adopting this approach, doubled the number of auditors in its LTU audit teams and implemented an ambitious training program to quickly raise the technical ability of its auditors and the quality of its audits. In parallel, the unit launched a focused effort to analyze and close the small number of high-value, complex collections that had been blocked in appeal. In total, these blocked transactions were worth 2 to 3 percent of the tax authority’s total yearly revenue. Besides bringing in additional revenue, this move greatly improved the LTU’s response times and the quality of its interaction with taxpayers.

Improving taxpayer service and communications

Improving the way in which the tax administrations work with taxpayers not only results in better customer service but also has the potential to increase revenue. We have identified two specific interventions within the broader tax organization that can bring about such improvements.

Quick win 6: Introduce electronic channels for simple transactions. In many rapidly developing economies, mobile and Internet penetration is often comparatively high. Tax administrations can exploit this infrastructure by introducing electronic channels such as Internet portals, mobile payment options, and ATMs as a powerful lever for improving service levels. By using these channels for simple taxpayer transactions, such as tax declarations and payments, the administration can increase the level of voluntary payments while conveying a strong sense of its public purpose. Such approaches not only help reduce the length of queues at tax offices but by so doing remove a barrier to compliance. They also enable the databases to be of much better quality and, as a result, provide the basis for more effective audit and collection processes in the medium term.

Quick win 7: Communicate the benefits of the quick wins widely. Communication is a crucial element in the overall program: good communication will enable the authorities to leverage the initiatives and further enhance tax revenues in the short term. The communication plan should address 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. The communication plan should include both institutional and initiative-specific messages, and can incorporate appeals that have an emotional element (for example, linking the use of tax revenue to the funding of schools or highlighting sanctions for failure to comply), as well as those that are purely informative (for example, explaining changes to tax laws or procedures). Effective communication promotes voluntary compliance. In one country, it is estimated that a communications plan more than doubled the impact of individual initiatives by extending the coverage to potential taxpayers, encouraging them to comply with the tax rules and to pay taxes.

Introducing focused changes to the tax system

Governments also need to think about the longer-term development of their taxation strategy. We have found three areas, independent of policy choices, where governments can introduce focused changes to the tax system. Although dependent on the legislative process, these lend themselves to greater consensus, may be enacted relatively quickly, and can yield immediate and significant impact.

Quick win 8: Close specific tax loopholes. A top-down, granular analysis of each tax type and industry sector, carried out in combination with input from senior tax officials, can enable tax authorities to establish whether or not there are opportunities for quickly closing sector-specific tax loopholes. The analysis should identify whether there are any significant gaps between the expected and actual tax rates. Using this approach, one Latin American country identified two large economic sectors that had, by exploiting loopholes (for example, legacy tax exemptions), been paying effective tax rates a quarter to a sixth of those of the nominal corporate income-tax rate. With only limited legislative changes—and while still keeping the tax rates in the two sectors at a lower level than in neighboring countries—it was possible to bring these sectors more in line with the average effective tax rate. This intervention increased the total corporate income-tax revenue in the country by more than 10 percent in the first fiscal year.

Quick win 9: Simplify the tax system to encourage formalization. The tax systems in most rapidly growing economies are often highly informal and unnecessarily complex. This leads to tax evasion and can also push many otherwise willing taxpayers out of the system entirely. Simplifying the tax code will thus generate additional revenue by encouraging voluntary compliance, while at the same time sending out the message that efforts to formalize the system are a priority within the larger reform program. There are several ways countries have achieved this: some have established simplified taxation methods for small businesses, for instance, or have replaced corporate income tax, value-added tax (VAT), and other specific taxes with one, much simpler system. For example, in 2009, South Africa replaced its corporate income tax and VAT with a simpler “turnover tax” that applies to businesses with annual sales below ZAR 1 million (approximately \$120,000). This provides a much simpler system for small businesses: while it provides no deductions, it improves compliance and involves limited record keeping and a single yearly declaration. The system attracted more than 7,000 taxpayers in the first year of implementation alone, a large portion of whom were converted from the informal economy.

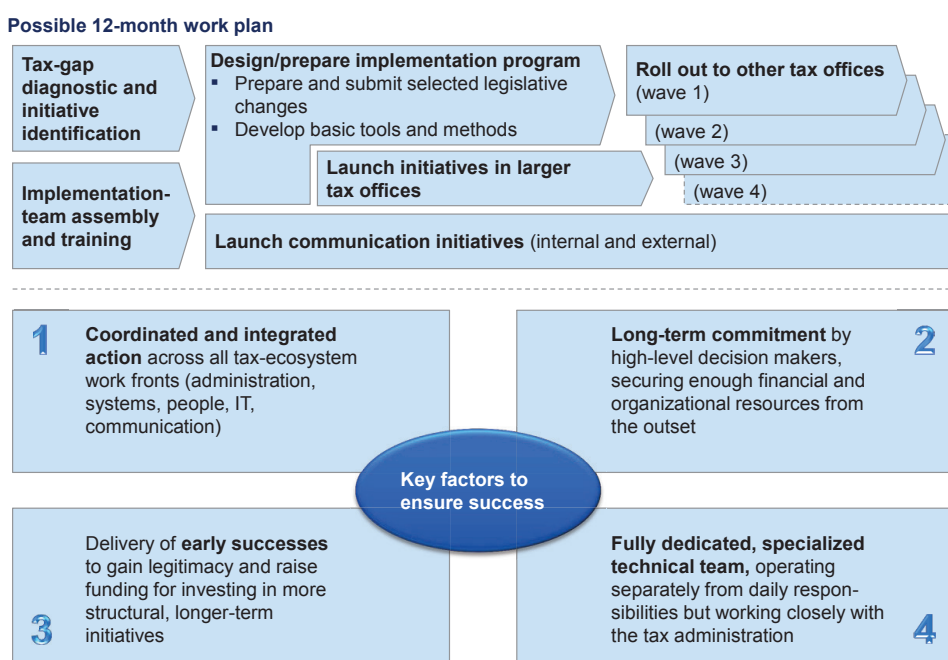
Quick win 10: Enable external checks that enforce compliance. Often informal businesses that operate without paying taxes nevertheless interact with government agencies

or other entities. Putting in place external checks to verify taxpayer status need not be overly intrusive but can prove an effective way to encourage formalization. One rapidly developing economy, for instance, passed a law requiring that authorities check the tax administration’s registry when residents attempt to import goods, send funds abroad, sponsor applications for work visas, or apply for public contracts. The law was then broadly publicized in the media, showcasing the government’s commitment to formalizing the tax system, which ultimately increased voluntary compliance.

How to do it

As a rule, the vast majority of tax-effectiveness programs produce a very positive business case, typically exceeding the required investment by a factor of ten within a 12-month period. With such high returns, it might be expected that every administration would introduce such programs. One reason they may not is that successful implementation requires strong commitment and significant initial investment. With so many other demands on rapidly growing economies, these requirements can pose a stumbling block. Our experience shows that this need not be the case, and that a relatively simple, tried-and-tested approach can help ensure success (Exhibit 2).

Exhibit 2 A tax-ecosystem transformation work plan has four key success factors.



This approach requires putting in place a dedicated unit of senior technicians. The team will be assigned full time to the program: depending on the scope, the required number of dedicated resources ranges from 20 to 100. These resources will be drawn from a variety of specializations—from senior auditors, tax lawyers, and IT technicians to communication experts and managers. This core team will, in turn, be supported by external experts who are responsible for organizing the “intervention teams” for each of the initiatives.

The success and accountability of the transformation program is typically measured by whether it meets key milestones and key performance indicators that focus on areas such as revenue, productivity, and quality, as well as qualitative measures that focus on service delivery.

We have identified four broad success factors that will help ensure the initiatives achieve the desired level of impact. While these success factors are important in all tax-administration-improvement programs, they are especially critical in the ones for rapidly growing markets, where implementation is more challenging.

First, the program needs to be coordinated across all the relevant government functions including IT, human resources, communications, and legislation. Second, governments must secure sufficient long-term commitment from financial and organizational resources at the outset—minimizing the probability of the program being abandoned due to a change in the political actors. Third, the program must ensure that it delivers some early successes, as these will provide legitimacy, and that it funds longer-term initiatives. Finally, a dedicated technical team—operating separately from any political structure but working closely with the tax administration staff responsible for the day-to-day business—needs to be entrusted with designing and implementing the initiatives, establishing clear metrics, and closely monitoring the results.

The ultimate goal of any tax-reform initiative is both to generate additional revenue and to create an organization that

upholds the highest standards of service to taxpayers. This requires, first, appropriate staffing, and second, capability building: both are integral to any successful tax-reform effort aimed at increasing revenue. For the program to be successful, it is critical that the entire tax administration understands and embraces the objectives of the reform, adopts new ways of working, and, if necessary, creates an entirely new culture within the organization (meaning the administration’s attitudes, behaviors, and approaches).

Over the longer term, all tax authorities will need to develop recruitment and training programs designed to assemble and retain the elite tax-leadership team responsible for such reforms. This can be achieved, for example, by offering differentiated career paths for the program team that are linked to a remuneration scheme that is rewarding enough to help reduce the likelihood of bribery. This approach needs to be coupled with performance management and compensation processes that not only ensure that any breaches are dealt with swiftly, transparently, and with the appropriate level of severity but also that strong performance is rewarded appropriately.



Tax authorities in rapidly growing economies face numerous challenges, particularly with regard to reducing the level of informality in the tax system. The tax-effectiveness program of quick-win initiatives described in this paper presents tax administrations an opportunity to increase revenue, build credibility with constituents, and move the administration toward long-term fiscal stability. We believe this approach holds great promise for increasing the efficiency of tax administrations in most rapidly developing economies. Ultimately, even small changes in the way tax authorities operate can provide funding for new roads, hospitals, and schools: for instance, a 10 to 15 percent increase in tax revenues in a rapidly developing economy typically translates into the doubling of spending on health care or education.

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