



Adapting Tax Systems to Economic and Social Development¹

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“Taxation is the art of plucking the goose with minimal hissing”

Adapting tax systems to social economic development should be a foundation course of ten credits. It is about

- the design of tax systems and tax reform
- the implementation and administration of tax rules

The success of a tax system depends on

- I. General conditions for applying rules in society
- II. The capacity of the tax administration to implement and administer tax rules
- III. The design of tax systems
- IV. Example: adapting tax systems to the challenge of an ageing population

I. The non-tax conditions for applying rules in society

1. Minimal level of economic development. Globalisation has extended economic development

Taxes are possible in a non-monetary society, but their role is very limited (taxes in kind)

- ex:
- supplying military personnel and equipment to the Lord
 - communal work on road building (Burundi)

I. The non-tax conditions for applying rules in society

1. Minimal level of economic development. Globalisation has extended economic development worldwide

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- ex:
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2. Peace and the Rule of Law

- # Not equal to Western style of democracy
- # Not equal to mere absence of social order

The rule of law means that citizens as an organised group or as individuals, voluntarily accept the legal limitations set to their powers and de facto behaviour in the interest of other organised groups or individuals.

Main indicator: the government is abiding by its own rules

Ex.: Darfour - Gaza - East Congo - Iraq

3. Minimal Degree of Social justice

Extreme social inequality undermines the efficiency and legitimation of a tax system

- if number of well to do is very limited, the tax system may not provide enough revenue (efficiency)
- if destitute citizens are taxed:
“it is not possible to peel a stone” social resistance to tax (legitimacy)

Ex: Turkmenistan: oil and gas were the preserve of the president and outside the tax system

4. Specific non-tax conditions

Ex: High degree of illiteracy

Ex: Absence of a reliable postal system or the absence of a reliable system of telecommunications (Turkmenistan)

Ex: Tradition of resistance against foreign occupation (Belgium-Netherlands)

Ex: Tradition of making gifts in Asian society, propensity to make gifts to public officials ---> corruption

II. THE CAPACITY OF THE TAX ADMINISTRATION TO IMPLEMENT AND ADMINISTER TAX RULES

1. General conditions for an effective tax administration
2. The external organisation of the tax administration
3. The internal organisation of the tax administration
4. The numbers: relationship between the number of tax officials and the number of taxpayers
5. The geographical organisation of the tax administration
6. The methods of auditing

1. General conditions for an effective tax administration

- absence of political interference: meddling in investigations and tax collections of political opponents, interference in appointment and promotion of tax officials
- adequate remuneration of civil servants - inadequate salaries
→ corruption
- consistent strong political commitment (not! interference) to the development of the tax administration , → benign neglect

2. The external organization of the administration: the position of the tax administration in the government structure

- (a) one or more administrations?, customs & excises, VAT/GST, income taxes, social security, national, regional, local taxes, gift & inheritance taxes
- (b) federal or centralised structure, regional or provincial auditing and collection of tax

ex: Germany, Czechoslovakia, Belgium: federal structure

People's Republic of China (PRC): strong independence of provincial tax administrations, problems of uniform application and transfer of funds to central authority

(c) taxes vs social security (+payroll)

- in EU different administrations, social security controlled by trade unions and employers organisation
- social security is about spending not about collecting
- weak auditing department in social security --> fraud and avoidance
- when social security = payroll tax, collection by tax administration is self evident and tax base in S.S. = tax base in PIT
- when S.S. is largely collected from employers and S.S. base is different from tax base collection through a separate administration may be tolerated

(d) Organization outside civil service: independent revenue board?

- traditionally within Ministry of Finance because MF is responsible for the execution of budget, needs full authority over revenue collection
- traditional organisation:
 - treasury: tax policy - revenue estimation, simulation and tax reform
 - administration: customs, excises and income tax
 - drafting: treasury, administration parliament

- independent revenue board separate corporate body for tax audit and collection (and revenue spending)

Model: National bank: separate and independent partner of MF

- composition and independence are very important: civil servants, ranking independent citizens or experts
- separate service rules, not subject to civil service rules, hierarchy of public officials, separate and adequate remuneration <--> corruption
- specialisation: no automatic interference from other administrations

Ex.: education/defense → tax administration



Example: inland revenue authority Singapore (IRAS)

Revenue:

- fixed % of projected collections
- bonus/penalty based on excess or shortfall of actual collection

Caveat: Who is calculating the projections? There may be a tendency to systematically underestimate projected collections so that score is always positive

3. THE INTERNAL ORGANISATION OF THE TAX ADMINISTRATION

The organisation of the tax administration is:

- (a) product based per type of tax
- (b) function based per type of activity
- (c) client based per type of taxpayer

(a) Organization per type of tax

The traditional type of tax organization: separate administrations are set up to administer specific types of taxes. Each tax department contains virtually all the functions necessary to administer the tax for which it is responsible: Customs, excises, VAT/GST, Turn over/Sales, PIT, CIT, Inheritance, gift and estate taxes, Social security and payroll.

Each department has its own management and staff, network of offices and carries out full range of functions: assessment, audit and collections.

Advantages product based organization

- clear accountability and responsibility for each tax
- clear lines of command
- allows quick responses to changing circumstances in countries with quick succession of tax reforms
- connects well with different methods of assessment and procedure per separate tax

Disadvantages product-based organization

- duplication of functions and loss of economies of scale
- problems in joint compliance programmes, e.g. joint audits in income tax and VAT/GST
- risk of development of different administrative cultures (different filing forms, procedures, computer programmes!)
- problems of communication between departments and flows of information
- higher compliance cost of taxpayers subject to different taxes
- increased risk of collusion between taxpayers and tax officials, because all functions are closely connected in one isolated department and can easily be linked

(b) Organisation per type of function

Departments are organised per type of essential administrative function or work process: processing tax returns and tax payments, audit, collection, litigation. Each department is directly connected with the central office of the tax administration

Advantages functional organization

- Increased efficiency because of economies of scale
- Comprehensive approach to non-compliance across all taxes, e.g. joint audits VST/GST and income tax and combined efforts of audits and cleaning up arrears in tax payments
- Improved communication, because within one department all the information is available for different taxes. Condition: compatible computer programmes;
- Reduces scope of collusion because different function of different axes are dealt with by separate departments. Condition: a strong separate internal auditing department controlling all different functions and organizing control of one function controlling another function.

Disadvantages functional organisation

- Poor service to taxpayers, because different aspects of the same tax are dealt with by different administrations: ex.: collecting department is enforcing collection of tax which has been protested after audit.
- Each functional department needs to be aware of different rules for different taxes, which results in compartmentalisation of the department and loss of efficiency. This depends of course on the design of the tax system (different filing, audit, payment and litigation procedures for different taxes, or same procedures).

(c) Organization per type of taxpayer

The tax administration is organised in departments providing full range of services for specific groups of taxpayers categorised by size, by legal form of activity or by economic sector.

Two different objectives:

- Improving administrative grip and compliance of specific groups of taxpayers providing the bulk of revenue (e.g. the group of foreign or multinational companies in CIT, or big taxpayers in VAT/GST)
- Servicing the taxpayers as “clients” (e.g. Australian Tax Office: salary and wage earners, small business, big business, and business applying withholding taxes and paying miscellaneous taxes) in order to obtain more cooperation from taxpayers

Advantages client based organization

- improved compliance and taxpayer service, because of direct link between taxpayer and administration and improved ability to match enforcement and education programmes to different compliance patterns
- correct allocation of resources in function of the audit risk and needs of different groups of taxpayers

Ex.: concentration of resources on big taxpayers: department to monitor group of taxpayers providing largest amount of revenue.

Ex.: matching qualities of tax officials with need of big companies --> rulings.

Disadvantages client based organization

- duplicating activities and loss of economics of scale
- inconsistent application of tax laws over different groups of taxpayers
- risk of collusion and corruption because of the close client relationship (ex.: rulings big multinationals) to be countered by strong separate internal audit unit
- need for higher skilled and paid officials to meet the changing educational and enforcement needs of different groups of taxpayers

4. The numbers: relationship between the number of tax officials and the number of taxpayers

- all tax administrations complain about a lack of manpower. A minimum of manpower is required
- quality and distribution of skills matters

Ex.: excess clerical staff, shortage of auditing staff, manual processing of tax returns



Approximate numbers 2000

	<u>PRC</u>	<u>US</u>	<u>UK</u>	<u>Belgium</u>
Taxpayers (millions)	50	130	35	6
Taxes % GDP	15	30	40	45
Tax officials	500,000	?	65,000	30,000



5. The geographical organization of the tax administration

Organization is determined by

- the geographical extension of the country
- the density and distribution of the population
- rail and road connections and channels of communication

Compare: Estonia - Albania
Philippines - Indonesia

- Estonia - Albania: small countries two levels of offices: central - local
- Russia: 89 regional offices
 2,600 local offices
- Philippines and Indonesia:
communications between islands some of which are very densely populated, others are almost empty
- Span of control for central or regional offices:
there are only so many taxpayers or tax officials that can effectively be followed up by one tax official.

At what level are functions taken care of?

- central office tax policy, tax reform, revenue forecast and simulation
- local offices: implementation-compliance

-- Regional offices

processing tax returns, servicing call centres, selecting taxpayers for audit conditions

conditions: reliable telecommunications, reliable postal service and clear lines of command between central regions and local centres, no multiple subordination

if conditions fulfilled → regional auditing, conditions mostly not fulfilled in developing countries

-- local centres

Problem of multiple subordination

Ex.: PRC

Local offices were accountable to both provincial authorities and central SAT.

SAT was in charge of overall implementation but did not have direct contact with taxpayers. Provincial authorities were in direct contact with taxpayers and would permit different conditions of application

6. Methods of Auditing

In-depth auditing of every taxpayer every year is not required.

- annual compliance with tax returns and payments should indicate regularity of taxpayer's behavior - if possible at all it should computerised
- in-depth auditing is only necessary once every so many years (depending on statute of limitations)

Problem: criteria for selection of in-depth auditing

Many developing countries lack the basic information for risk assessment

Problems of selection for audit

The data which a tax administration needs for the selection of taxpayers for auditing are different from the data necessary to auditor investigate an individual taxpayer.

Procedural rules in tax codes sometimes do not permit the tax administration to collect or search for the data necessary for audit selection.

III. Design of tax systems

- Tax systems need to be tailor-made. General prescriptions are very dangerous and should always be embedded in local reality.
- However, it is always very instructive to look across the border to other systems. This is not always the same as listening to international experts from IMF, WB, OECD or EU.
- Unfortunately national tax reformers are not very much inclined to look across the border. Tax reform should not be imposed by foreign experts but should be “owned by national tax administration”.

1. General design of the system

For developing and transition countries emphasis as revenue raisers should be on

- VAT or GST
- excises
- customs
- corporate income tax on big business
- annual vehicle registration tax
- personal income tax in that order.
- local or regional land or property tax
- no tax incentives, if possible at all

2. Design of specific taxes

VAT/GST

- scope as wide as possible starting with goods and extending tax to services: list of services subject to tax gradually turned into general taxation with list of exemptions for specific services
- introduction at one single low rate (2-5%), if higher rate exempt basic items, or tax at low rate. Do not zero rate inside the country. No luxury rate.
- if input tax on investments cannot immediately be credited, do plan the full introduction of the credit from the start
- put in substantial threshold for small business
- if VAT is regionally organised, use common base and rate for intra-regional transactions

Excises

- if you apply excises on volume or weight (i.e. not ad valorem) be sure that the amount of tax stays in line with inflation
- restrict excises as much as possible to basic supplies (mineral oil, alcohol, tobacco, coal and gas)
- you may want to impose ad valorem excises on bulky/luxury items (yachts, luxury cars, speed boats and golf carts)



Corporate income tax

- one single corporate income tax on all income including capital gains
- be sure that the rate of the corporate income tax always stays in line with the top rate of PIT
- if the preceding condition is fulfilled you can submit any legal entity to CIT (whatever its form and including partnerships)
- if you want to restrict CIT to big companies set conditions on size, exclude possibility to opt out or in
- allow loss carry covers indefinitely or for very long periods (+ 10 years)
- tax total or partial (liquidating) distributions as a dividend /or as a capital gain to substantial individual shareholdings

Personal income tax

- impose PIT as much as possible by way of withholding tax at source, on salary and wage earners, on interest, on dividends, on royalties and on pensions
- except for pensions and wages, tax the first dollar of income
- impose PIT with no more than one or two brackets (rate CIT) and a substantial threshold excluding the low income earners. Tax capital gains on business assets at ordinary rate with roll over relief
- do not tax couples or families on combined income, tax all taxpayers as singles

- if you want to modulate your tax base to family needs, extend the tax threshold to the spouse and add a tax threshold for dependents
- make no attempt to reduce or eliminate double taxation on dividends from companies, but impose a low withholding tax on dividends on top of CIT
- no general capital gains tax except on real estate (exclusion personal dwellings) and substantial shareholdings

General tax law

- provide for a general tax code with basic definitions and concepts (general anti-avoidance rule)
- provide single procedural rules for filing tax returns, tax protests, litigation, procedures, liens and payment rules for all or most taxes. Litigation can be done by a special tax litigation unit
- provide a general tax identification number that can also be used for social security purposes
- provide for an adequate and fully independent administrative tax procedure of review before allowing the taxpayer to go to ordinary courts
- provide for a clear distinction between the conditions of application of administrative and criminal penalties

- administrative penalties are intended to keep the taxpayer in line. They should be moderate and be applied also on unintentional infringements of the tax rules
- criminal penalties should be used sparingly and only when the criminal intent of the taxpayer has been established beyond any doubt
- preferably criminal investigations should not be done by the tax administration but consider the independent state of the judiciary in the country

IV. EXAMPLE: CHANGING TAX SYSTEMS FOR AN AGEING POPULATION

1. The ageing process:

Population +65

	<u>2000</u>	<u>2025</u>	<u>2050</u>
Japan	17%		36%
Singapore	7.1%	19%	23.6%
EU	16.4%		28.2%
US	13%		20%
Republic of Korea			
(Korea)	6.7%	14.7%	23.1%
Indonesia	4.7%	8.3%	15.8%

Old age economic support ratio: number of 15-64 supporting one elderly over 65

	<u>2000</u>	<u>2025</u>	<u>2050</u>
Singapore	9.8	3.5	1.5
Ireland	3.9	2.9	1.5
Greece	2.1	1.7	1.0
EU	2.6		1.3
Indonesia	13.3	7.3	3
PRC	9	4.6	2.2

In 23 years Singapore will be in the position of the best EU countries today, e.g. 23 more years to resolve the problem. PRC has ten years more time and the Philippines still more.

3. Pension situation in SE Asia

- defined benefit pay as you go for public pensions in Korea, Taipei, China universal coverage
- mandatory defined contribution schemes, Malaysia; Singapore; Hong Kong, China.
- other Asian countries
 - public pensions for civil servants and private pension funds for big business in the formal sector
 - i.e. much of the Asian population will depend on family support and inter-household transfers and private savings, to bear the financial risk of a group representing more than 25% of the population

4. Issues of adaptation to ageing population

(a) choice between PAYG and contribution schemes

(b) design of PAYG schemes

(c) design of contribution schemes

(d) taxation of pension schemes

4(a) Choice between pay as you go and contribution schemes: description

Pay as you go

Contributions → benefits

Taxes →

Equilibrium is determined by balance between

- number of contributors and retirees (demography - employment rate - retirement age)
- balance between amount of contributions and amount of benefits

Contributory schemes

Contributions → Benefits
Taxes →

Defined benefits scheme:

amount of benefit is fixed and contributions + investment yield cover amount of benefit. When financial input is insufficient to cover benefits: additional contribution (employee-employer or taxes)

i.e. contributions are determined by amount of benefit.

System may not be sustainable in case of financial crisis

Contributory schemes

Defined contribution scheme

Contributions are fixed and amount of benefit is flexible: depends on contribution + investment yield. Amount of benefits may decrease when investment yield is insufficient, in case of financial crisis.

4(a) Choice between pay as you go and contributory schemes:

criteria for choice

- contributory schemes are only accessible to individuals having excess income. There always remains a category of persons having no means for contributory schemes
- pay as you go schemes are universal and mandatory, with a major contribution of employers, contributions by employees are low
- no risk of loss of investment income for PAYG
- the demographic balance of most South Asian countries (Singapore 9.8-1 or Indonesia 13.3-1, PRC 9-1) allows easy introduction of PAYG schemes with immediate payments of pensions

4(b) Design of pay as you go systems

- no fixed or statutory age for retirement: flexible age of retirement
- adequate duration of contributions: model life cycle employment (40-45 years) depending on schooling obligations(12-15-18-22 years)
- basis of contributions/CAP or no CAP
- amount of benefits/CAP or no CAP
- CAP on benefits < CAP on contributions
- benefits proportional to effective years worked divided by years in life cycle career
- contributions are tax deductible



Example

Mr. Li

studied until 22

entitled to pension at age 67, no pension before that age

career of 35 years

pension at age 67 of 35/45 of capped amount



Mr. Chung

started working at 15
entitled to pension at age 60
works until age 67
pension at age 67 of 52/45
of capped amount

4(c) Design of contributory schemes

Defined benefits schemes:

- defined benefits schemes are not tenable in the long run
- uncertainty of investment yields may cause huge back service or even collapse of the fund
- therefore defined benefits schemes should be turned into defined contribution schemes → UK reform

Defined contribution schemes:

- defined contribution schemes need to mature before they provide sufficient yield for pension → waiting period
- are contributions to/be tax deductible?

4(d) Taxation of pension schemes

- pay as you go: contributions deductible - pensions taxable
- contributory schemes?

4(d) Taxation of pension schemes

Policy choice

contributions

deductible / tax credit

no deduction

pension fund

exempt / special regime

fully taxable

benefits

exempt / special regime

fully taxable



No taxing at any time is extremely favourable. General practice is to defer taxation by allowing tax deduction for contributions.



4(d) Taxation of pay as you go

contributions (capped)

deductible

no credit

benefits (capped)

taxable like earned income



No special tax regime to avoid making (early) retirement too attractive.

Application of general low income threshold.

Because contributions are capped there is automatic limitation of benefit.

4(d) Taxation of contributory schemes

Taxation of contributors:

- policy choice: deduction or credit at time of contribution or exemption or credit at time of benefit general tendency: tax deferral
- even when contributions are not capped, tax benefit should be capped: progressive PIT results in regressive effect to the benefit of high income earners
- depending on concept of distributive justice tax benefit should consist of deduction or tax credit
- system must contain anti-avoidance mechanism, to prevent tax free contributions to be at disposal of taxpayer before retirement



4(d) Taxation of pension funds

Policy choice: full taxation, full exemption, special regimes.
Choice to be determined by tax regime of collective investment funds.

Note: taxation of internal business pension reserves

Some tax regimes permit the pension fund to be kept and managed inside the corporate entity. Exemption of investment may offer huge benefit to corporate fund for business use of pension reserves, such pension reserves are also subject to investment risk of the business. Ex. Germany

4(d) Taxation of pension benefits

When contributions benefit from deduction or credit, pension benefits should be taxable in PIT.

When there is a special beneficial regime for statutory or universal pension schemes benefits should also be available to contributory schemes. Equal tax treatment for equal amounts.