

TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: THE
CONTROL OF TAX EVASION AND THE ROLE OF TAX
ADMINISTRATION

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TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: THE CONTROL OF TAX EVASION AND THE ROLE OF TAX ADMINISTRATION

by

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Abstract

This paper is part of a wider research on South and East Asia countries' taxation, carried on at this Department, under the direction of L. Bernardi, A. Frascini and P. Shome, and the supervision of V. Tanzi. Tax evasion is explained through individual taxpayer behavior and his reaction to the tax structure, social norms and psychological effects. Tax evasion has become more possible with advancements in technology and with globalization that has witnessed the spread of global economic activity and a rise in the possibility of hiding incomes worldwide. Tax evasion has been measured indirectly and directly, but its measurement remains difficult. Nevertheless, the tax administration has to confront it, reduce it, and enhance the revenue productivity of taxes. There has to be adequate administration resources but, since it typically forms a part of general government administration, it has to develop strategies well within the limited resources that it receives. Typically the cost of tax collection is about 1 percent of revenue collection. Modern tax administrations increasingly use third-party information returns to cross-check returns from large taxpayers, while large taxpayer units allow them to conveniently pay all taxes through one window. Potential taxpayers are required to file returns even if taxable income is zero, as long as they are captured under specified expenditure criteria. Tax deduction at source is another third-party instrument that is used for many sources of income. Tax administrations in Asia have become increasingly cautious about arms length applications in the setting of transfer prices for cross-border and intra-company transactions. Tangibles and intangibles such as price setting in the case of services provided are also being scrutinized. Over and above audit and scrutiny, investigation wings are being mobilized, leading to large tax recoveries. Computerization forms a pillar of support in successful tax administration. The focus has been on cross-checking different sources of information to minimize tax evasion. Rapid technological change in the information technology industry poses a continuing challenge for government bureaucracies to complete projects before new technologies appear, making earlier ones redundant. New tax policy options such as the financial transactions tax and the fringe benefits tax are appearing on the horizon, mainly to combat tax evasion and increase revenue. However, it is important not to design new taxes that are distortionary or inequitable just to enhance revenue in the short run.

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1. Introduction, contents and main conclusions¹

The role of tax administration in maximizing revenue generation and minimizing tax evasion cannot be over-emphasized. These remain challenging tasks at every stage of development of a tax administration. This is because it is not just a matter of maximization or minimization but, rather, one of optimization. Thus, there has to be a genuine threat and actual carrying out of audit, scrutiny, investigation, penalty and punishment for an errant taxpayer while, at the same time, his compliance costs must be minimal, and he should be guaranteed an avenue for redressal of genuine grievances for payment of tax, with robust systems of adjudication, appeal and final decision. And, to minimize lengthy adjudication processes, there should be practical avenues such as advance rulings or tribunals that would cut back on undue delay and facilitate speedy administration decisions.

Computerization has become a mainstay in efficient administration that can successfully curb tax evasion. For example, for income tax, forms should be downloadable electronically. Electronic filing should be made possible. If there is tax deduction at source (TDS), the mechanisms - including filing at banks - and transfer of data and revenue to further points in the system should be computerized. For indirect taxes, for example the value added tax (VAT), there has to be a computerized method for cross checking invoices that is precise and incisive, and certainly not cumbersome, for both domestic and international transactions.

An increasingly recognized element in controlling tax evasion is to reduce, as much as possible, the likelihood of interface between taxpayer and tax administrator. Computer assisted processes have assisted in this objective. Thus, selection of audit or scrutiny cases should be primarily random and computer assisted except in the case of criminal suspicion. The outcome of a fully developed tax administration is, therefore, one that is essentially invisible and that ensures due process of law to the taxpayer, yet fully enables the efficient collection of revenue for the exchequer.

¹ The opinions expressed in this paper reflect entirely those of the author and not of any institution or government unless specified. The author appreciates helpful information support from Monica Bhatia and Chandrajit Singh.

The role of appropriate tax design in assisting efficient tax administration is equally important. A complex tax structure or tax law is difficult to administer and, therefore, easy to evade. For example, if a VAT has three rates but no exemptions, then it should not create too many problems. A taxpayer would just need to subtract total taxes paid by him on his purchases - irrespective of tax rates - from all taxes collected by him on his sales, and transfer the difference to the administration. But as soon as one introduces exemptions for individual goods or services, as most countries do, the VAT structure assumes complexity since it breaks the VAT chain. VAT credit cannot be taken against exempted items. So the administration would have to devise a mechanism to keep track of any excessive credit that may be taken by a tax evader. Similar administrative problems emanating from faulty income tax design arise all the time. It is, therefore, imperative for the tax structure to be comfortably administrable and the tax law to be easily interpretable.

In sum, in order to keep tax evasion in check, the tax administration must: *(i)* incorporate genuine threat of penalty but ensure due process; in order to do this, of course the tax administration should be adequately financed and structured; *(ii)* computerize as many administrative processes as possible to minimize the interface between taxpayer and tax official; and *(iii)* not remain aloof from tax policy but assist in every way possible to help design, in reflection of its field experience, a simple tax structure and its commensurate tax law.

In the following sections, these three major tax administration elements in the control of tax evasion and the generation of revenue are examined individually. Emphasis is on actual experiences drawn from South and East Asia. In particular, since tax administration reform has taken up speed in India, the lessons from this process are universal and are cited where found to be useful. However, first, in the next section, a discussion of the problem of tax evasion - in juxtaposition to its variants, tax avoidance and corruption - is attempted. The final section concludes.

However, before embarking on that journey, we summarize below the main conclusions from the analysis that follows.

- There are various sources and causes of tax evasion. An inequitable or highly burdensome tax structure will not be tolerated. However, globalization seems to have led to

a growth in tax-evasive behavior, reflecting income sources from many countries and increased possibilities to hide income from any individual country tax administration. Ineffective tax administration will exacerbate tax evasion under these circumstances.

- Tax evasion has been estimated in many ways. An indirect way is to estimate the underground economy since tax evasion directly generates it. A more direct way is to estimate tax potential through a country's input-output matrix and comparing it with actual revenue collection. It could be concluded that in many developing countries, half the income tax may be evaded and one-third the VAT or consumption taxes may be evaded.

- To combat tax evasion, tax administrations should have adequate resources. In most countries, however, they form part of general government administration and must, therefore, compete for scarce resources. Under the circumstances, the literature has discussed the impact of incentive schemes for tax officers. Typically, the cost of collection is about 1 percent of revenue collection. The more inefficient a tax administration is, the less effective would be the use of a dollar in revenue collection.

- A review of Asian countries reveals an increase in administrative action and follow-up in the administration of international taxation. However, tokenism is being avoided and focus is shifting to critical areas of intervention through the development of robust practices in operations, investigation, and judicial processes.

- Thus tax administrations are requiring third-party information returns in which a third party is asked to submit returns on transactions with others, if such transactions are over a certain threshold. The objective here is to cross-check such information with large taxpayer income tax returns. Tax deduction at source is also a third-party device to facilitate tax collection and is increasingly used for many sources of income.

- Large taxpayer units are being used in many countries to reduce tax evasion by requiring all taxes to be paid through one window by large taxpayers. This facilitates cross-checking across all taxes while providing a single window facility to the taxpayer. The small taxpayer is being assisted with the establishment of help centers external to the tax office to reduce his inherent fear of tax officers. The potential taxpayer is being required to file returns even with zero taxable income as long as he is captured under specified expenditure criteria.

- Given the growth in cross-border transactions and the quantum increases in international capital flows involving transfer pricing, tax administrations are increasingly training officers and applying *arms length* rules in the setting of transfer prices by multinational companies in both international transactions and domestic transactions among multiple subsidiaries.

- Joint audits by central and local governments are being carried out to facilitate matching of information across a wide geographical area. Such audits focus on transfer pricing behavior and use a wide variety of indicators for selection and examination. Audits can be of various types: random audits, audits of evasion-prone sectors, in particular, emerging service sector activities, and of high-income individuals identified through information and intelligence. The latter remains limited in scope and is reserved usually for cases of repeat offenders. A review of Asian countries reveals an increase in administrative action and follow-up in the administration of international taxation.

- In an increasingly complex world faced by the tax administration, computerization is of the essence. Experience reveals that computerized systems for tax collection may be successfully put in place; but it remains a challenge to make such systems user-friendly. There are likely to be quite a few initial glitches, but these can be resolved with time and a full understanding of the underlying needs of the tax administration to implement the tax structure.

- It is, therefore, crucial to design tax policy that is implementable. At the same time, innovations in tax design are appearing to buttress tax administration to reduce evasion and improve revenue productivity. Two recent examples are a financial transactions tax and a fringe benefits tax. They have been introduced in Latin America and the Asia-Pacific region. While they have been rather controversial, there is no gainsaying the fact that they are turning out to improve information flows to the tax administration and to assist in additional revenue mobilization.

- Nevertheless, taxes should not be devised merely to accommodate tax administration. For, if they increase inefficiencies in resource allocation and inequity among taxpayers, they will affect economic growth adversely in the medium term and, consequently, be deleterious to revenue productivity.

2. Tax evasion - its forms and effects

Tax administration is closely linked with the three concepts of tax avoidance, tax evasion and corruption. They are sometimes used interchangeably; however, there are essential differences among the three, mainly reflecting the degree of malpractice involved.

Tax avoidance is not illegal in the sense that it usually results from the creativity and planning of tax accountants and lawyers within the gambit of existing tax laws in aiding taxpayers to minimize their tax. Tax avoidance is obviously facilitated by complex tax statutes in which opportunities exist to interpret the tax law in the taxpayer's favor when it was not so intended by the drafters of the law. Therefore, tax avoidance as a matter is mostly addressed in the context of tax policy reform that is the focus in last section.

Tax evasion, on the other hand, is illegal though, if detected, it normally leads to civil rather than criminal penalties. It involves flouting of the tax law. It generates an underground economy in the form of income that is not reported or accounted for in tax returns. As a result, a subterranean economy begins to function in parallel to the organized economy with generally deleterious effects on equity among taxable persons, on the efficiency of resource allocation, and on the stability of revenue collection and the macro economy (Tanzi and Shome 1993).

Some authors whose views have been summarized by Brooks (2001) have, however, claimed that the underground economy minimizes the government's reach over the private sector and, thus, assists in unfettered economic growth. This argument essentially ignores the fact that it leads to distorted growth inasmuch as one part of the economy grows faster at the cost of the other part, and that the latter could have been more efficient and productive in an even playing field.

Corruption goes one step further. It has been defined as the "abuse of power for private gain" (World Bank 1997). Its ramifications are grave since it burrows into the very foundations of society and the institutional framework of government. Unlike tax avoidance and tax evasion, corruption involves collusion and, often, criminal connotations. Thus, bribery is a form of corruption since it involves at least two parties (Asher 2001). In this sense, Transparency International's (2001) Corruption Perception Index (CPI), in vogue for

citation in cross-country studies, is essentially misconceived. It appears to recognize the demand and acceptance of bribes rather than the offer and supply of bribes, thereby missing the quid pro quo nature of corruption. For example, in international contracts, assigning the perception of corruption to one party leads, expectedly, to far higher CPI's in developing countries than in developed countries. A similar fallacy appears when the illegal outflow of money from developing countries is considered corrupt but not its acceptance, banking and use elsewhere. Both arms of corruption are pernicious. Without the adroit cooperation of both providers and recipients of such resources, the web of international money laundering could hardly have spread so far.

The role of tax administration in curbing corruption is through its investigative wings but it has to be supported by the crime control wings - such as intelligence, enforcement and internal security - of government. This paper does not attempt to go further into the criminal aspects that are centered around the issue of corruption.

2.1 Sources and causes of tax evasion

Tax evasion is the outcome of individual taxpayer behavior and social norms on the supply side, and shortcomings in tax administration on the demand side. To begin with, the tax structure has to be perceived as equitable across various groups of taxpayers. Also, if marginal rates are too high, taxpayers are likely to find ways to evade tax. Across the world, these aspects are well recognized today, and the outcome of international tax harmonization has been a lowering in the rate structure (to improve incentives) and attempts at broadening the tax base (to reduce inequities).

Nevertheless, tax evasion tends to arise also from other factors. Individual behavior in certain sectors is known to be highly tax-evasive. These include professional services including the usually highly paid medical profession, and the construction industry, to name a few. They tend to receive fees and make payments in cash, fuelling the underground economy. Even in developed countries such as the United States, medical practitioners, in particular, comprise a difficult sector to tax. Indeed, a number of Western authors have dubbed the individual income tax a voluntary tax. Difficult-to-tax taxable

persons may even include large corporations that typically contract out - through work contracts - to smaller units.

With globalization, this phenomenon has assumed challenging dimensions. As capital becomes increasingly fungible, sources of income and expenditure are spread across the globe and difficult to track or even identify since they often leave little trace in any one national tax jurisdiction. Increasingly, therefore, the globalized economies of East Asia are demonstrating their conservatism in international taxation rules and practices (Pricewaterhouse Coopers 2003).

Social norms have been changing in many economies. Since the 1990s, as large public corporations have been privatized in Latin American and South Asian countries, the small service sector - one that is traditionally difficult to tax - has grown. With the emergence of East Europe and the former Soviet Union (FSU), and their entrance into the international market economy, the taxpayer roll has multiplied but revenue intake is not reflected commensurately. In traditional economies, if eminent persons do not pay their fair share to the exchequer, that becomes an example to be emulated by all and sundry. An assessment that the use of revenue is inefficient or ineffective or, worse, suffers from unacceptable leakages, provides grounds for society to evade tax.

Ineffective administration can exacerbate tax evasion. For example, extremely punitive penalties encourage taxpayers to appeal tax demands easily since it gives them time until final determination of the tax. By that time, the real - as opposed to nominal - value of the revenue in the hands of government is likely to diminish. Bureaucratic lethargy in applying the law - perhaps in reflection of social norms - increases evasion and hurts revenue. Slow development of information technology (IT) due to its complexity, or its ineffective use by the administration, signals taxpayers that tax evasion carries low risk. Indeed, technological advances have, in particular instances, translated into tax evaders' computer capabilities running well ahead of the administrator's, exacerbating the problem.

2.2 Estimating tax evasion

The difference between actual revenue collection and an estimation of potential collection is the *tax gap*. It is an estimate of total leakage, comprising the effects of tax avoidance, tax evasion and corruption. Typically, however, the tax gap is referred to as estimated tax evasion.

Estimating tax evasion can be indirect or direct. The indirect method links tax evasion to the underground economy since the latter could be thought of as the size of economic activity that would be taxed if reported in tax returns. The estimate of the underground economy is essentially indirect in that it is attempted through estimating the demand for currency in the economy, or estimating discrepancies between national expenditure and income statistics, or linking growth in electricity consumption to the growth in economic activity because of their observed close relationship. However, one school of thought is that the tax rate - usually the income tax in this context - to be applied to an estimated underground economy to arrive at an estimate of tax evasion would have to be perspicacious. Otherwise the estimated tax gap may turn out to be too large for corrective policies that are practical and implementable. Authors have discussed the issue of optimal auditing in a context of audit probability and penalty (Mookherjee and Png 1989; Chander and Wilde 1998).

In a recent cross-country survey, the size of the underground economy, Schneider and Enste (2000) have grouped countries into regions and shown that, in a few, the underground economy could be as large as 3/4 of the reported economy though, in the representative Asian, Latin American and FSU countries, it ranges between 1/3 and 1/2. Among OECD countries, southern Europe was at 1/5 and others at 1/10. However, as argued above in the context of the CPI, these analyses tend to reflect some double counting in developing countries and undercounting for others, if one considers how the underground economy is generated in a globalized world economy. Nevertheless, there is no gainsaying the fact that, even if distributional adjustments are made, tax evasion, derived through indirect methods, is likely to yield significant estimates.

A more direct method of estimating the tax gap, in particular for VAT, is to estimate potential VAT revenue from the country's input-output matrix and to compare it with VAT revenue collection. This method was developed for Mexico by Aguirre and Shome (1988) and later applied to other Latin American countries (Shome 1995). These methods have revealed that as much as 1/3 of potential VAT collection and 1/2 of income tax collection may remain uncollected.

Another concept of VAT evasion has emerged in the discussions and practices of international tax experts. This is *VAT productivity*. Thus if a country has a general VAT rate of x percent, it should ideally be able to collect $1/2 x$ percent of GDP in VAT revenue. If it collects less than $1/3 x$ percent of GDP in VAT revenue, VAT productivity is low. The VAT structure possibly suffers from many exemptions and breaks in the VAT chain, and the VAT administration is unlikely to be combating tax evasion successfully (Shome 2002).

2.3 Growth in tax evasion

There is a prevalent view that tax evasion has grown in recent years and is growing. Many factors account for it. The role of tax administration in the control of tax evasion is, therefore, not a static one but one that is dynamic and remains ever challenging. Among the significant reasons is that, first, in the last two decades the volume of internationally mobile global capital has increased by leaps and bounds and its flows keep increasing. Its dimensions - both direct investment and financial capital in the latter's many diverse forms - also transmute and grow. Opportunities for tax evasion abound and increase before even well developed and astute tax administrations can understand or confront them. A next section will draw upon the experience of Asian countries in addressing tax evasion in international taxation.

Second, the services sector has been growing phenomenally in many countries, in particular in the Asian region, as agriculture loses its comparative advantage, manufacturing faces stiff international competition under new World Trade Organization rules and swift economic growth shifts the comparative balance towards the specialized

services sector. The services sector is often represented by micro units whether they are business processing offices (BPO's) covering a host of service oriented activities, highly skilled medical practices catering to a primarily foreign clientele, or high class restaurants serving the *nouveau riche*. These new types of economic agents are notoriously difficult to tax. And, if they have emerged as colossal public sector units - producing deficits but having nevertheless been a source of guaranteed revenue for government - have disappeared, then the loss to revenue collection could be significant. The challenge for the tax administration here is to develop precision instruments that are able to aim directly at newly emerging revenue sources. Such instruments comprise third-party information sources, compulsory return filing, and other methods, that will be addressed further in this paper.

Third, a mix of sociological and psychological hypotheses of tax evasion has received some attention. Among the sociological are factors such as the premise that the younger generation are less concerned about social or national responsibilities, necessarily the outcome of increased global mobility, the arrival and advancement of the information super-highway, and a common global cultural denominator represented by Music Television (MTV), fast foods, and the fashion ramp. The psychological takes off from there, in that the new generation is perceived to possess utility functions that are more individualistic - the go-getter - that is explicable in the context of a much faster moving world in which there is cut-throat competition and where they have to run to be at the same spot, their goal increasingly represented by the famous metaphor, "famous for fifteen minutes." While fascinating to the economist and posing a challenge as to how to incorporate such factors in economic analysis (Roth and Scholz 1989; Slemrod 1992; Cullis and Lewis 1997), for the tax administrator it adds another dimension to his work in the control of tax evasion.

2.4 Effects of tax evasion

Despite erring on the side of brevity, there need to be some mention of the negative effects of tax evasion on the economic environment. Its most important adverse effect is perhaps on equity. A wage earning factory worker pays tax. A restaurant worker whose income is the same but who receives part of his income in tips does not reveal it for tax purposes. Thus, one blue-collar worker gains at the expense of the other. This is *horizontal inequity*.

A barrister charges his fees, in part, in non-pecuniary terms, for example, a foreign trip for his family, all expenses paid. This is not reported on his income tax return. A salaried employee in the organized corporate sector earns the same reported income as the barrister. Their incomes appear to be the same for tax purposes. This is *vertical inequity* since the barrister's actual taxable income is higher (it should have included the value of his foreign trip). In sum, for both forms of inequity, the higher-taxed person pays for the lower-taxed person since, had there been no tax evasion, the tax rates would have been lower under the premise of revenue neutrality.

Second, tax evasion distorts economic efficiency. In sectors that are less subject to the administrator's scrutiny, there will be more investment. That may be one reason why certain service sector activities - for example, the construction industry - have grown so phenomenally as companies move across national barriers in a globalized world economy. Similarly, the unorganized sector may evade taxes much more easily than the organized sector. It is no wonder that, in the VAT where there is usually a threshold level below which taxpayers are not expected to keep detailed accounts, allowing them to pay a small percentage of their turnover as tax (termed *compounding*), there is a clustering of registrants just below this threshold. Small taxpayers have remained very difficult to tax and maintain a constant presence in the list of administrative concerns (Shome 2004). Based on a theoretical model, Sanchez and Sobel (1993) conclude that only incomes below some threshold level should be audited with a probability that is positive and less than unity.

Third, as both inequity and inefficiency lead to lower revenue intake for government, its functional capacity, efficiency and effectiveness suffer because of tax evasion. Capacity

suffers due to lower availability of resources. Efficiency declines since important functions may have to be given less priority than others. And effectiveness declines as compliant taxpayers realize that government is unable or unwilling to take corrective action and, therefore, feel increasingly comfortable in joining the rest in the act of tax evasion.

The result could very well be an increase in tax rates, or the imposition of distortive taxes, thereby initiating a vicious cycle of inequity and inefficiency. Clearly, the escalation in property tax rates or the imposition of entry taxes by many municipalities, turnover taxes in addition to the sales tax at the level of states or provinces, or inventive surcharges and cesses at the level of the central government are cases in point.

Fourth, tax evasion being under-reporting of income, implies under-estimation of GDP and all its commensurate macro-economic ramifications. Since the denominator is under-estimated, the ratios of tax to GDP, the fiscal deficit to GDP, and public debt to GDP are all under-estimated. The *perceived* higher tax/GDP ratio leads to false comfort, but exaggerated deflationary action may be taken to rein back an exaggerated fiscal deficit or public debt ratio. Policy could thus turn pro-cyclical, leading to suppression of the organized economy and exacerbating a vicious cycle of less revenue generation and higher tax rates. If the underground economy absorbs labor, then the adverse impact of unemployment - by focusing primarily on the organized sector - will also be over-emphasized. Inflation estimates would be similarly distorted unless care is taken to include all segments of the market economy, both organized and underground.

3. Cost and design of tax administration

Having traversed the causes and effects of tax evasion, we now look at particular aspects in the formation and functioning of an effective tax administration. The first ingredient is whether tax officials are remunerated appropriately in order to check the incidence of tax evasion and corruption. This is inherently linked to the cost of tax administration and, therefore, to the cost of revenue collection. Authors have discussed these matters in stylized

frameworks, for example, the issue of increasing inspectors' salaries (and increase in the opportunity cost of firing them for poor job performance) by Vasin and Panova (1998), or giving bonuses to tax officers in relation to their individual tax collections (Bardhan 1997).

3.1 Cost of tax collection

Over and above incentive schemes that could raise revenue collection, a more direct preoccupation is the matter of cost of revenue collection. Overall, the cost of collection seems to vary a good deal across countries. In a recent cross-country study, Highfield (2001) demonstrates that, in 1998-9, the cost of collection as a ratio of revenue has been 0.72 in Thailand, 0.84 in Australia, 1 in the Philippines, 1.04 in Singapore, 1.1 in Hong Kong, 1.21 in Japan, and 1.37 for the UK (Inland Revenue), though, for customs and VAT, it is much lower. Indian data indicate that the cost of collection ratio of customs and excise is about 0.86 while that of the income tax is near 1.

In general, the cost of collecting income tax, as compared to indirect taxes, is higher reflecting the relative complexity of an Income Tax Act, larger number of income taxpayers, far more points at which the income tax has to be collected, and the wider sources of revenue, both domestic and spread internationally. What is certain is that resources for the tax administration should be adequate. More important perhaps, they need to be efficiently spent. This is because the tax administration is usually placed well within the framework for overall government administration expenditure allocations and does not enjoy any special dispensation. Therefore, it has to compete for scarce resources. Attempts to set up tax administrations as autonomous agencies external to the ministry of finance have had, at best, mixed success across the world.

3.2 A framework for administration resources

An essential element in the control of tax evasion is the adequacy of administration resources. A theoretically correct tax policy and expenditure structure may be set up. But,

without sufficient tax administration resources and mechanisms or expenditure management systems, the tax law or expenditure allocations by themselves would not yield the national income or economic growth envisaged (Shome 2002). That framework is delineated below.

The objective of the framework is to demonstrate that there is a binding constraint that tax administration may pose on tax collection over that predicted by the structure of taxes. The same type of constraint applies also to the expenditure side between expenditure policy and expenditure control. Thus the diagrammatic schemata refers to a wider fiscal context, incorporating both tax and expenditure sides. For simplicity, we shall use tp , ta , ep , and ec to denote the tax policy, tax administration, expenditure policy and expenditure control variable, respectively.

Conventionally, if tp is the tax rate and $Y_1 - Y_0$ is income, then

$$tp (Y_1 - Y_0) = TP$$

is the tax revenue that is collected. This is demonstrated in the top left quadrant of Figure 1.

TP can then be consumed or invested by government in its expenditure programs EP, leading to income in the next period of $Y_2 - Y_1$, as sketched in the top right quadrant of Figure 1. The expenditure-income relationship is:

$$TP = EP = ep (Y_2 - Y_1)$$

where ep is the expenditure/income ratio. So far, we have related tax policy and expenditure policy in the top two quadrants of Figure 2.1. There has been no role specified for tax administration or government expenditure control in constraining revenue generation or its expenditure by government. This influence is depicted in the bottom quadrants of Figure 1 and is explained below.

The achievement of Y_2 subsumes a given state of tax administration and expenditure control which is usually not recognized in policy circles to the extent that it should. The underlying tax administration coefficient is ta and the underlying expenditure control coefficient is ec . To make the concept of correspondence clearer, diagrammatically tp and ta are shown to be equal. Similarly, ep and ec are equal. To put it another way, ta and ec are given an equal role in the generation of the economy's income flows. They would simply lie underneath or veiled as it were, just as the oil to grease the wheel of revenue generation

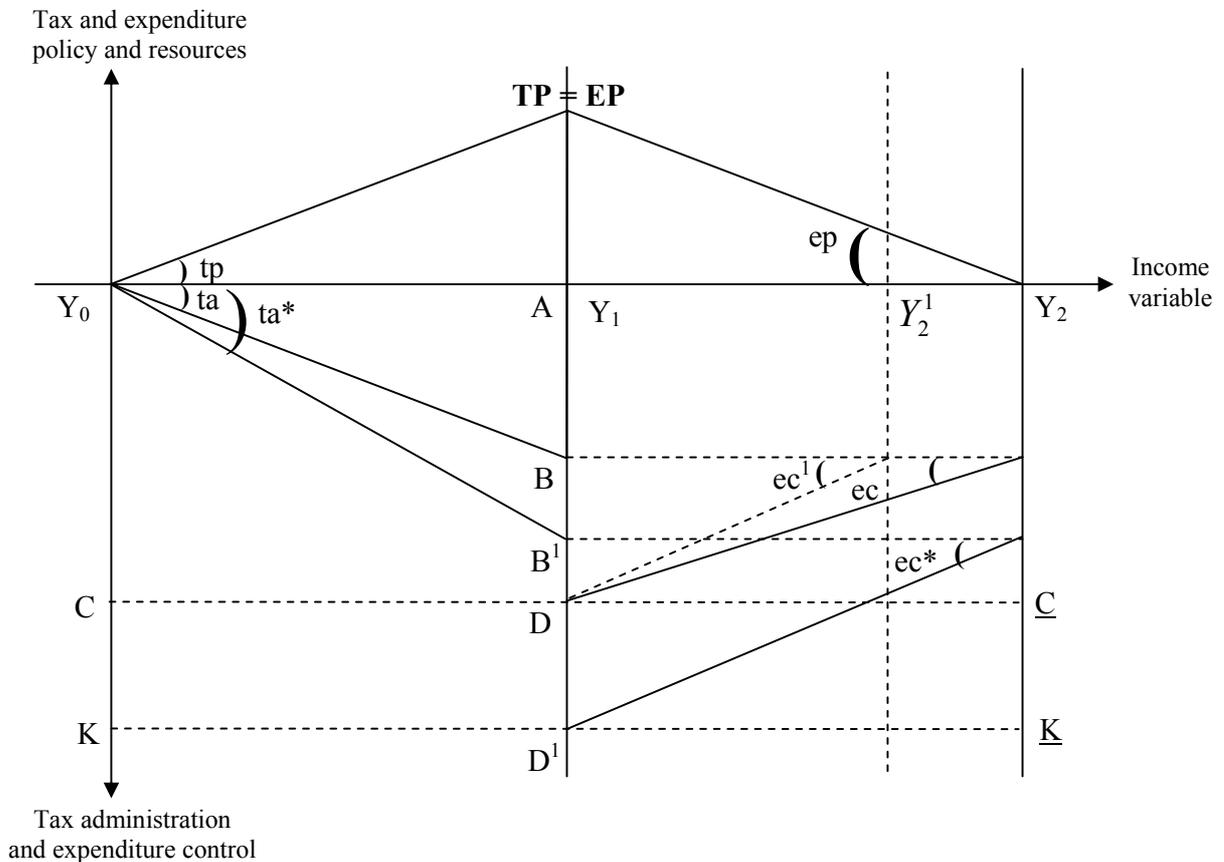
The expenditure control side, ec , follows directly. Essentially, its role is added on:

$$EC = ec (Y_2 - Y_1)$$

This is depicted in the bottom right quadrant of Figure 1 as the distance BD .

Obviously, the overall imputed resources needed for government's tax-expenditure policies as designed and projected, and the resultant sequence of incomes to take effect, are depicted by the distance $AB + BD$. Equivalently, the minimum resource requirement translates to $C = \underline{C}$. This may not represent reality, however, if administrators are simply not able to target the universe of potential taxpayers. Thus, administration has to be enhanced, or greater administrative resources made available to administrators. In that case, a higher underlying requirement $K = \underline{K}$ would apply, to generate the same income flows (Figure 2). \underline{K} is determined as follows.

Figure 2 Tax and expenditure: gaps in administration and control.



Working backwards within Figure 2, it is easy to see how administration practices that is not able to address or cover the complete tax structure, or inadequacies in expenditure management and control, would constrain the result depicted in Figure 1. The constraint can be broken up into tax administration and expenditure control constraints. Say ta is inadequate, resulting in a need for additional administrative resources. Then $ta^* > ta$ would be needed. Similarly, deficient expenditure management implies $ec^* > ec$. Only with these additional resources, $AB^1 + B^1D^1 > AB + BD$, will the same income, $Y_2 - Y_1$, result. Otherwise, with any combination of resources represented by coefficients lower than ta^* or ec^* (such as say ta and ec^l), a lower income than $Y_2 - Y_1$ (such as $Y_2^l - Y_1$) will result. (Note that $ta < ta^*$ but ec^l is set to equal ec^*). Once this happens, future income flows would be similarly adversely affected and, ultimately, economic growth would suffer.

The essential lesson from this simple exposition can be useful. The gaps between tax policy and tax administration (and between expenditure policy and expenditure control), have to be bridged if government's objectives in formulating its tax-expenditure policy mix are to materialize. The difference can take the form of lack of required resources for full implementation, or the inefficient use of allocated resources or, simply, an application of the law that does not completely reflect its original intent and purpose. Next we look further into the role of modern tax administration methods in the control of tax evasion and at particularly designed tax policy measures for the control of tax evasion.

3.3 Design of modern tax administration controls

The basic design of a tax administration is well known and has been widely discussed, whether along a tax administration's functional lines (Bird and Casanegra 1992; Silvani and Baer 1997) or, along economic lines or as a firm maximizing its objective (Bagchi *et al.* 1995; Tanzi and Pellechio 1995). It is not the purpose here to traverse those same grounds. Instead, as indicated in the introductory section, we intend to take up three specific matters in the development of modern tax administrative practices that represent a movement away from tokenism and towards incisive facilitation of the primary operations - assessment, audit, scrutiny, investigation, and judicial - of tax administration.

First, what are some of the incisive instruments that have been developed in terms of taxpayer information flow that could be usefully utilized by the administration to expand the taxpayer base and facilitate additional revenue mobilization? Such instruments include, among others, additional information (third party) returns for large transactions; tax deduction at source (TDS) or withholding; large taxpayer units (LTU's); and compulsory filing of returns to enable non-tax information matching for those who have zero taxable income but fulfill certain expenditure criteria.

Second, with the spread of international businesses across national boundaries, how do tax administrations monitor arms length rules in the setting of transfer prices? Various Asian countries are dealing with it in different intensities but it is clear that they are all tightening their rules and implementing them more strictly. These two aspects will be examined in this section.

Third is the issue of computerization of the tax administration. This has become a mainstay of a modern tax administration. But the design of computerization itself is a challenging task as will be explained in next section. The ultimate success of a tax administration in collecting revenue rests squarely on a well-designed mainframe into which all information flows are channeled and based on which all cross-checks are possible.

3.3.1 Tax administration precision instruments

As modern tax administration has moved to financial - as opposed to physical - control methods, its instruments have become more precise. They are oriented towards cross-checking rather than merely unilinear checks of consignments leaving the factory in the case of domestic production (excises) and consumption (VAT) taxes, or single-file examination of an income taxpayer, where the emphasis is increasingly on third-party information.

In the case of an annual information return (AIR), a taxable person (A) is asked to submit returns on transactions with others (B) over a certain threshold. This allows the administration to cross-check the others (B) whether they have filed returns or, if they have filed, to verify income. For example, in 2005, the Indian income tax authorities have

enacted AIR requiring a number of such transactions with respect to a person in one year, to be reported to the income tax administration: banks on cash deposits of 1 million INR or above in any savings account; credit card companies on payments (0.2 million INR); mutual fund managers on investments (0.2 million INR); company or institution issuing bonds or debentures on investments (0.5 million INR), or shares through public issue (0.1 million INR); registrar or sub-registrar of properties on purchase or sale of immovable property (0.3 million INR); and Reserve Bank of India (central bank) on investment in RBI bonds (0.5 million INR).

This is just to illustrate the long arm of the tax administration that is increasingly intended for use in cross-checking and detecting tax evasion. The challenge remains, of course, in effective utilization of such information for the intended objective, in particular, because the compliance cost for third parties in meeting AIR requirements is unlikely to be insignificant and cannot be ignored.

Among the more traditional instruments involving two parties is tax deduction at source (TDS) that has borne the test of time. It is no longer an issue of its use but, rather, to how many sources of income it is applied. TDS for salary earners is most common in Asian countries. India utilizes TDS for a much wider set of income sources above designated thresholds, for example, rent, interest from banks, securities (though not dividends since they are not taxed in the hands of the shareholder) and inter-corporate interest payments, payments to contractors and sub-contractors, insurance commission to corporations and firms (not individuals), commission and brokerage (other than insurance), payments to non-residents, payments on account of repurchase of Unit Trust of India and other mutual fund units, winnings from lotteries, crossword puzzles and horserace, and commission on sale of lottery tickets. But effective administration of TDS requires the use of computerization, a matter that will be taken up in next section.

Another widely tested instrument is the large taxpayer unit (LTU) through which taxpayers whose tax contributions are above a threshold are required to file. More than 50 countries use this window (Baer 2002). Its advantage from the administration's point of view is that information exchange across taxes is a built-in feature of the framework. From the taxpayer's point of view, the availability of an exclusive window for tax payment and

the likelihood of speedy processing for dispute resolution are important attractions. LTU's have proved to have assisted in facilitating revenue generation and lowering compliance costs, and have become a common feature in Asian countries. In her annual 2005-6 fiscal budget, the India likewise announced her intention to set up LTU's.

On the other hand, 20-30 percent of total potential revenue may be represented by small taxpayers. Thus the best resources of tax administration cannot be focused on large taxpayers alone and small taxpayers cannot be ignored (Shome 2004). Incisive carrot-and-stick instruments are needed for garnering co-operation from the latter. Their fears of the tax administration may be reduced through the establishment of help centers in co-operation with private chambers of industry and commerce. At the same time, small potential taxpayers may be required to file returns even if they self-assess zero taxable income.

Such an instrument requires persons to file returns irrespective of taxable income as long as they meet certain expenditure criteria. India again has utilized such a scheme since 1997-8, in particular with the objective of requiring non-taxpayers to file. Today it is known as the 1 x 6 scheme since, if an individual meets any one of six criteria, he is required to file. These include ownership of property, automobile, credit card, undertaking of foreign trip, annual electricity bill above INR 50,000, and membership of a club with an entrance fee over INR 25,000. Again, even as the taxpayer register and information flows increase remarkably as a result, the utilization of such data to achieve the originally intended purpose remains a major challenge.

For indirect taxes, effective cross-checking forms the crux of modern tax administration based on financial control methods. The most applied method under the VAT is random cross-checking of invoices. Of course computerization is of paramount importance with appropriate systems applications for scrutiny selection based on pre-determined indicators. They usually include input/output ratio, credit availment, export/output ratio, sector-specific characteristics, and others.

But in evasion-prone environments - where multiple account books are likely to be maintained by taxpayers - such cross-checking may not be sufficient since it is not likely to reveal serious evasion (Mukhopadhyay 2005). Here, second generation computer models

that limit the role of cross-checks by the tax administration and roll over the responsibility of credit availment flow within the VAT chain, are being contemplated. Such a method would automatically check availment of input tax credit claimed by a taxpayer (buyer) unless the credit appears on the scroll submitted by the depositor (seller) in the bank where the VAT is deposited. In sum, the role of computer-assisted systems has become imperative in effective tax administration as physical forms have been essentially replaced by financial forms of control.

3.3.2 Tax enforcement in a globalized world economy

If the previous section dealt with the means to improve the tax administration of domestic taxation, an increasingly egregious feature that is discussed in this section is one that deals with emerging administration challenges for international taxation. One important effect of globalization is on taxation. On the one hand, as cross-border related-party transactions overpower domestic transactions, a typical tax director of a multinational company (MNC), tends to claim that geographically split tax attributions, that will completely satisfy a tax administration, have become difficult to achieve. On the other hand, tax authorities that call the splitting “transfer pricing,” maintain that extreme caution is required regarding MNC tax avoidance and evasion because of greater opportunities to hide income across the globe. They have stepped up field audits, visiting business premises and factory sites, and imparting a more visible presence to enforcement activities. Such audits seem to have facilitated the control of both tax avoidance and tax evasion.

Pricewaterhouse Coopers (2003) has carried out an extensive survey of the East Asian region. Some country experiences are summarized here. In 2002, China conducted more than 2 million “tax reviews” that resulted in more than 800,000 audits and a recovery of more than 39 billion RMB. The focus on transfer pricing practices of MNC’s even for intra-China transactions - so much so that these have essentially come to be called “transfer pricing audits” (TPA) - has tended to restore revenue that earlier suffered from cross-border tax avoidance activities. The selection of cases for TPA begins with desk-top analyses based on: low profits for extended periods *pari passu* with company expansion, sizeable

drop in profits after expiration of tax holiday, profit consistently lower than industry average, and inexplicably fluctuating profits. Import-export transactions are, of course, examined but intangible transactions such as licensing, financing and provision of services are increasingly scrutinized.

The audits require co-operation between national and local tax authorities. Co-operation enables the latter to establish their own databases for audit targets while being supported by the former on transfer pricing adjustments. “National joint audits” (NJA), featuring simultaneous audits of Chinese subsidiaries of MNC’s are, therefore, made possible. From just coastal areas, audits now extend into the far reaches of the interior. The joint audit approach obliges MNC subsidiaries to improve co-ordination in management and accounting, in particular, transfer pricing. Transfer pricing adjustments can be imposed by the administration within three years (in extraordinary cases, even ten years), resulting in additional taxes payable on the adjusted income. After the TPA, a follow-up review could also be undertaken by the administration.

Controlling individual income tax evasion has been attempted through general investigations, informers - with rewards up to RMB 100,000 for appropriate information - and tax recovery operations on a targeted industry basis. In 2002, for example, executives in the high-technology sector were scrutinized with respect to declarations on offshore stock-option benefits. Such audits tend to adversely affect goodwill of industry. It also leads to financial consequences for industry since the resultant increased tax burden - gross-up tax rates applied to net-of-tax employment contracts - is often borne by the employer, in particular where the employee leaves China.

Hong Kong follows the *territorial* principle of taxation, taxing only Hong Kong sources of income. For companies incorporated in Hong Kong, the territorial principle attempts to tax profits arising in or derived from Hong Kong. Commensurately perhaps, tax evasion is dealt with strictly. Using field audits and investigation to control tax avoidance and evasion, pecuniary punishment - sometimes 100 percent of tax evaded - and prison sentence are both levied. For audit, criteria used include: whether deductions claimed reflect commercial basis, to what extent a Hong Kong company’s expenses are incurred for a related offshore company (hence not deductible), what portion of the profits are

attributable to Hong Kong, and intra-company pricing policies for services provided internally.

In Korea, transfer pricing has occupied center stage in recent years. For administrative support, the tax administration initiated a project to train 1,000 tax officers in transfer pricing during 2002-7. The Law for Co-ordination of International Tax Affairs (LCITA) applies to cross-border transactions since 1996, following OECD guidelines on transfer pricing. Its main objective is to ensure arms length application in price determination. A company has to submit a statement on transfer pricing choices made in overseas inter-company transactions. Additional explanations may be asked for, with replies expected within 60 days, with an extension of another 60 days.

Failure to comply could result in a penalty of up to 30 million W and is likely to lead to a TPA. TPA's are based on a close watch over MNC's and their polices, investments and practices in Korea. They increasingly attempt to cover management service fees that comprise fees for services provided from a central office to subsidiaries. Comparable prices are difficult to find and their benefits not easy to evaluate, thereby carrying the potential for abuse. As a result, an incisive TPA could yield huge amounts through transfer pricing adjustments.

Malaysia uses its investigation and intelligence branches for controlling tax evasion. Officer training has been received from both the United States and Japan. While a field audit unit, established in 2001, usually carries out audits with advance notice - with a target of auditing a company every five years - unannounced visits for tax investigation are also conducted. Visits have resulted in MNC's facing additional taxes and penalties. Malaysia's transfer pricing rules follow OECD guidelines. They apply both to MNC's and domestic companies and include cross border and domestic intra-group transactions affecting profits, such as transfer of tangible goods and assets, and transfer and use of intangibles and services. They require documentation to justify that transfer prices are set at arm's length. Based on a self-assessment system, penalties escalate over the stages of voluntary disclosure, non-disclosure, and repeated offence.

Singapore has typically conducted tax investigation of local businesses. Though random audits - of which transfer pricing examination forms a part - to verify tax returns

are carried out, tax investigation per se remains focused on those suspected to be repeat tax evaders. Voluntary disclosure of evasion reduces publicity, investigation, and penalty. In fact, for unwitting tax evaders, the penalty was lowered in 2000 to 10 percent of underpayment, from a 100 percent maximum earlier. This could be one explanation for the low number of investigation cases. But if evasion is determined, conviction could lead to severe pecuniary and non-pecuniary consequences, since the courts do not shy away from imposing maximum penalties. Punishment escalates - for incorrect return to fraud - to 400 percent of amount evaded with a ceiling of S\$ 50,000 and imprisonment of up to five years. And case details may be put on the authorities' website.

To combat tax evasion, Bangladesh has set up a Central Intelligence Cell (CIC) in its revenue administration. The CIC can investigate income tax files, check financial accounts, gather evidence, and seize suspicious files. It has focused on monitoring large taxpayers, detecting several cases of tax evasion involving significant sums. A recent case of matching credit card expenses with the income tax returns detected huge tax evasion. Examination of tax files of clearing and forwarding agents found that, on average, they had concealed half their income derived from commissions. This resulted in a tax recovery of 20 million BDT from this sector in the city of Chittagong alone in 2003 (Kibria 2004).

It is pertinent to mention, at least in passing, the experience of the developed economies since, in a manner, the Asian economies emulate their experiences. France, Germany and Belgium aggressively investigate and prosecute nationals and residents investing in foreign investment vehicles - life insurance and annuities - to evade tax. France took Pan Euro Life - a subsidiary of Ohio-based Nationwide Global Holdings - to court in 2001, claiming it had been established to evade tax (Zagaris 2001). Given that its chairman was a former head of the European Commission and Prime Minister of Luxembourg, revealed determination and resolve on the part of the tax administration. The United States has also played a role in enforcement efforts in international taxation. In 2001, third party information was stipulated through qualified intermediary (QI) regulations. QI required banks and financial institutions abroad to institute mechanisms to identify and inform on benefiting investors and account holders who should be subject to withholding. Extensive

raids have also been carried out on promoters of tax evasion schemes using offshore banks and trusts.

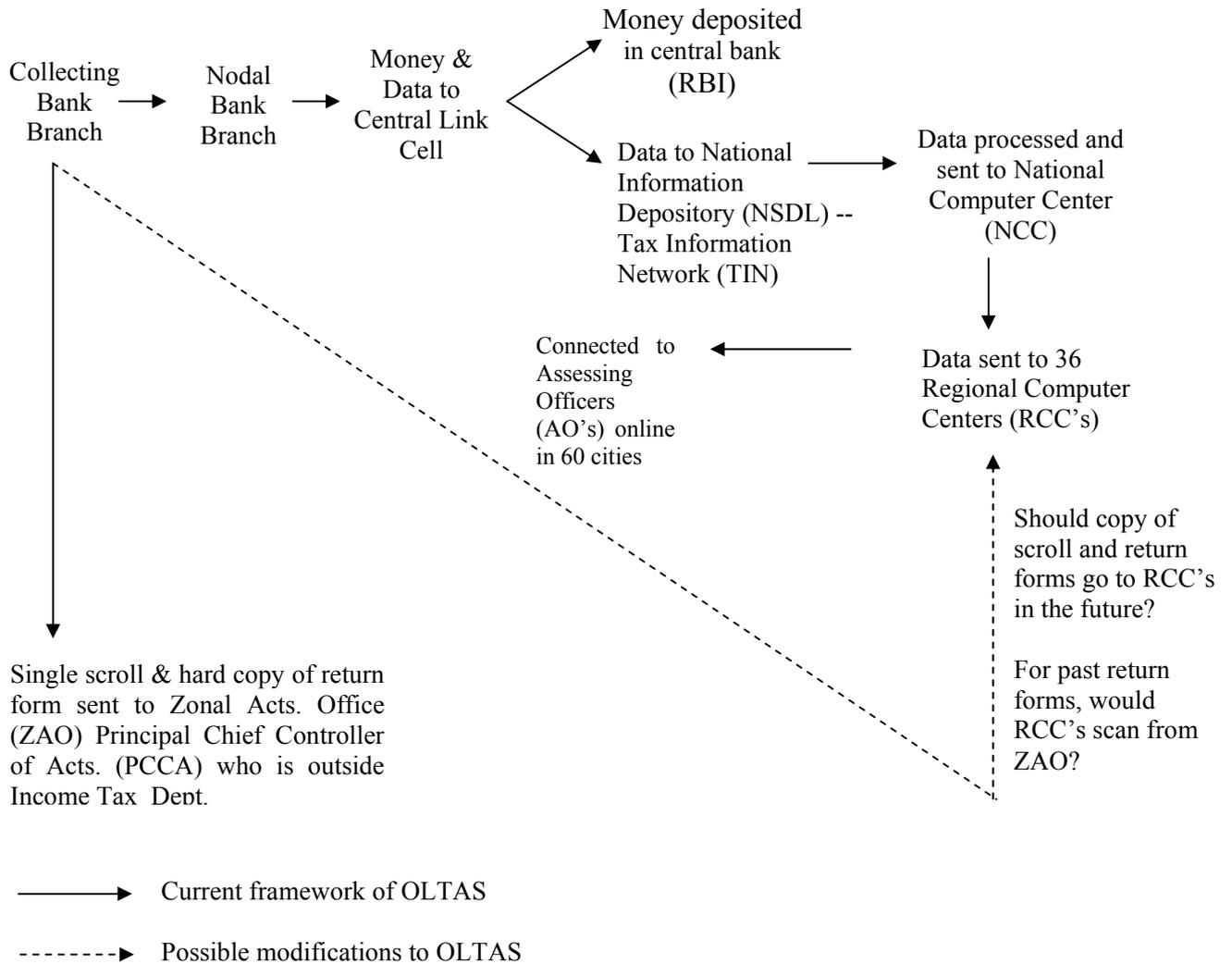
In sum, recent experience in Asia and the developed economies demonstrates an increasing awareness of tax effects of trans-national economic activity and follow-up action through joint audits of subsidiaries within national boundaries, fine-tooth comb examination to ensure arms length application of transfer pricing in both domestic companies and MNC's and, if warranted, use of investigation, raids, and pecuniary and non-pecuniary punishment.

4. Computerization and automation

It is needless to emphasize at this point, after describing the complexities that a modern tax administration encounters, how important the role of appropriate computerization is in its overall management and in the control of tax avoidance and evasion. Successful administration is essentially based on the assimilation of a comprehensive information pool, combined with intelligent, result-oriented data mining. Physical controls including raids for search and seizure can be used but they are mainly reserved for extreme circumstances. In this section, the issue of computerization is addressed.

It is not the objective to provide a checklist for computerization needs as tends to appear in many an advisory report of tax and computer experts. Rather, what is attempted is to provide an essence of the type of problems faced in developing a computerized system, for example, for cross checking information on tax collection and crediting of taxpayer accounts for the income tax or the VAT. Let us take income tax. India has recently computerized various processes in the income tax that provide a good illustration of lessons that could be learnt in computerizing a tax department. This case study is described below.

Figure 3 Income Tax: Online Tax Accounting System (OLTAS)



One aspect of computerization of income tax processing is the On-Line Tax Accounting System (OLTAS) that was initiated in 2004 on the basis of a single hard-copy system. Income tax payment can be made through one return form in banks. The form appears to be quite simple and well-designed. It has two “major heads” (individual income tax and corporate income tax) and four “minor heads”(self assessment, TDS, advance tax, and regular tax). It also has a block for “assessment year.”

Let us take the case of TDS and track its processing. This is illustrated in Figure 2.3. An employer who has withheld tax at source from his employees goes to any collecting bank branch and deposits the money. The bank keeps the form and gives him a receipt which is the portion below a perforated separation on the form. At the end of the day, a bank entry operator enters the details into the bank's self-developed software that processes the form. A supervisor tallies the entrance and approves it. The bank passes the money through a nodal branch (clearing house) that is designated to receive all inflows in one day (T+1). Within three days (T+3), the receipts are transferred to a central link cell. Here the monies are, in effect, separated from the information flows. The receipts are sent for deposit in the central bank (RBI) that simply credits the government's accounts.

The data with the details on the return form, as entered by the banks, are sent electronically to a data depository and processing entity (NSDL) which is the pivot of the Tax Information Network (TIN). NSDL processes and transmits the data to a National Computer Center (NCC). From the NCC, the data are fed into 36 Regional Computer Centers (RCC's). The RCC's are connected to Assessing Officers (AO's) in 60 cities so far (to be extended to 510 cities when the project is completed). Ideally an AO will have ready online access to the information when he makes an assessment or undertakes an audit.

The only hard copy of the return form is sent by the nodal bank branch to the Zonal Accounts Office (ZAO) where it rests with the Principal Chief Controller of Accounts. In sum, the monies are sent to the RBI; the electronic data are accessible by the AO at the RCC's after some routing; and the single hard copy of the return form rests with the ZAO. This results in three final destinations for the money, electronic data, and hard copy. The structure may be expected to function well except where human error in the previous stages of entering the data frustrates information matching.

Initial experience has unveiled such practical *lacunae*. First, in India, the term "income tax" covers both individual and corporate income tax in the Income Tax Act. Initially, therefore, the form was often filled wrongly so that collection showed a disproportionate individual income tax collection over corporate tax collection. The form was accordingly modified by separately identifying the corporate income tax. Second, the fact that data entry is left to bank entry operators who may not be familiar with the Income Tax Act led

to errors of non-matching. For example, TDS in 2005-6 must necessarily relate to assessment year 2006-7. But TDS entries have been found to be entered with 2005-6 as the assessment year (mistakenly interpreted to be the current financial year). Even employers who turn in the return form sometimes commit this error. Third, no hard copy of the return form remains with the TDS deductor/depositor (who only has a receipt). This tends to leave little trace of the bank-attested details of his deposit payments with him that he could usefully produce if summoned by an AO. Fourth, the AO cannot easily access a hard copy on his own (for making corrections with respect to a return) since the only hard copy lies at the ZAO where the keepers of government accounts could rightfully be expected to be cautious about parting with the sole hard copy information.

Thus the system's initial creases would need to be ironed out. Would the requirement of a second hard copy, that would go from the nodal bank branch to the RCC's be a retrograde step for modern computerization techniques, or should that be perceived as an evil necessity for cross-checking electronic information that arrive at RCC's from the NCC? Further, should bank entry operators be trained to familiarize them with the basic relationships underlying the return form, or would it be more efficient and user-friendly for the income tax administration to make available (or insist upon) its own software to all banks that would cut out built-in inconsistencies?

Alternately, should the prevailing system itself be tightened up rather than trying to modify it? For example, by insisting that bank data entry be done at the front end (rather than end-of-the-day entry) under the assumption that those who physically come to the banks to deposit the checks are more familiar with the return form so that their presence would minimize errors in data entry? But this may not be possible since data entry is carried out only after a bank's clearing house has cleared a check. On the other side, if forms are not correctly completed by depositors, should banks be instructed to refuse them? These are carious considerations that would need to be weighed appropriately before arriving at a comprehensive solution to the teething problems.

Another *lacuna* is with respect to the deductee in this system. The deductor deducts from his employee (the deductee) and deposits TDS in a bank as explained. Today the deductee receives, from the deductor, a certificate of deduction specifying the amount

deducted. It is proposed to do away with this requirement (*de-materialization* of TDS certificates) under a fully-functioning OLTAS. However, until the remaining *lacunae* are fully plugged, the deductee has been temporarily protected with continued issuance of TDS certificates to him. In sum, the *minutae* of computerization can be challenging and are certainly interesting; there is no option but to address issues as they emerge since its ultimate purpose to facilitate the process from both tax administration and taxpayer points of view. They are unlikely to be resolved in the short term. A medium term framework is its essence.

The medium term nature of the solutions, in turn, poses a related problem. The advancements in information technology are so overwhelming, and hardware and software changes are so rapid, that project proposals are likely to become dated faster than due process of government examination, both at departmental and political (cabinet) levels, contract tendering and actual implementation. This remains a constant challenge in environments where large projects are particularly subject to various checks and balances through expenditure control and management mechanisms, stoutly in place and actively operational.

Just as in the case of the income tax, VAT computerization has been a topic of constant attention. While the focus is usually on software to facilitate cross-checking by the tax administration, the newest proposals are being made in the direction of *unilinear* checking. Thus, only when a taxpayer A in the VAT chain credits the account of another taxpayer B (from whom A has collected VAT) and this is reported in the bank (where credit scrolls would be maintained for different taxpayers), would B's account be credited. In this simplified method, the onus of cross-checking is effectively passed on from the government to the universe of taxpayers. As indicated above, therefore, computerization models of tax administration are in continuous development and represent one of the most dynamic areas in the taxation field.

A final point on the computerization theme that should be mentioned is the information relationship between the center and states (or provinces) in a federal fiscal system. Co-operation was already mentioned in the context of successful joint audits in China. In addition, it is imperative to develop information exchange systems to minimize tax evasion.

In particular, information should be easily exchangeable if the states too are assigned important taxes that they themselves legislate, collect and appropriate, rather than being subject only, or mainly, to revenue sharing with the center. The majority of Indian states introduced a VAT on 1 April 2005, at the sub-national level. The center also has a VAT (called the CENVAT) up to the manufacturing stage. A computerized information exchange system (TINXSYS) is being developed on a cost-sharing basis between the center and states that will link various states in a common information exchange network. Eventually, such information exchange should also be carried out between the center, on the one hand, and the states, on the other. A successful TINXSYS should be able to identify and check tax evasion more efficiently in the future.

5. Design of tax policy to support tax administration

Last, but not least, we touch upon some tax policy instruments that are being used as new innovations in tax administration control. While they do not yet feature in a large number of countries, there seems to be a spreading *demonstration effect* encouraging more countries to adopt such policies. Usually tax policy experts have considered them to be distortionary (Shome and Stotsky 1995); but it appears that tax administrators are using them successfully without their commonly believed distortive effects coming into view. The two most common ones are taxes on financial transactions and on fringe benefits of employees. These are examined next.

Financial transactions taxes have been introduced by Brazil at 0.038 percent on an array of financial transactions, followed by Argentina (0.75 percent), Colombia (0.4 percent), Peru and a few other Latin American countries. All countries are reporting an increase in revenue collection. But its main benefit seems to be in the form of enhanced flow of information for the tax administration. Brazil has experienced a 40 percent rise in tax assessments issued against taxpayers during the first nine months of 2004 as a result of the tax administration's new strategy of cross checking taxpayers' records of the financial transactions tax (CPMF) with information provided by credit card companies and real

estate brokers (Soares da Silva 2004). In the first three quarters of 2004, assessments resulting from CPMF cross-checking totaled 28 billion BRL, a record since the CPMF was begun to be used as a tax audit instrument. An increase in assessments is projected for 2005, mainly reflecting a new 0.005 percent capital gains withholding tax on stock sales in stock exchanges. This tax was created to cross-check stock sales with taxpayers' tax returns (stock sales are exempt from CPMF).

With exactly the same objective, in her annual 2005-6 central fiscal budget, India has just introduced a withholding tax of 0.1 percent on cash withdrawals from bank checking accounts above a specified threshold. To quote Chidambaram (2005), the Finance Minister: 'The National Common Minimum Program (NCMP) requires the government to introduce special schemes to unearth black money and assets. I am obliged to carry out the mandate, but without giving undeserved relief or amnesty. I am concerned about large cash transactions, especially withdrawals of cash, when there is no ostensible purpose to withdraw such large amounts of cash. These cash withdrawals leave no trail, and presumably become part of the black economy. Therefore, ...I propose to levy a tax on withdrawal of cash...from banks at the rate of 0.1 percent' (Chidambaram (2005): 31).

While initially it met with popular opposition, it has come to stay in a scaled-back form with respect to its base. Despite its clipped wings, if it could still be successfully used, the instrument could assist in tracking money laundering. A common form of money laundering appears to take place through false-account stock transactions and their subsequent channeling through multiple bank accounts, thereby legitimizing their existence without payment of tax.

Taxation of fringe benefits (FBT) accruing to employees - that comprise non-salary benefits that may be cash or non-cash - can be carried out in one, or a mix, of three ways. Most appropriately, it can be taxed at the hands of the employee through his individual income tax return, thereby requiring voluntary declaration by the taxpayer. Developed countries use this method and tend to have stringent provisions to make it work. The second method is through disallowance from expenses under the corporate tax. If a company is declaring losses anyway, the disallowance would not be binding, however, way and would not yield revenue. The third method is to have a *positive* list of fringe benefits

and tax them at the hands of the employer at pre-specified presumptive rates. While the employer would be allowed to deduct all such expenses from his income tax, the more he deducts, the larger would be his tax base for the FBT.

As in the case of the financial transactions tax, the FBT is also a relatively new tax and not yet *a la mode*. Nevertheless, some have extolled its virtues. To quote Brooks (2001): ‘A second obvious example of a technical rule that is unenforceable is one that allows business people to deduct the cost of business meals and entertainment. Allowing business people to deduct the cost of their business meals and entertainment makes absolutely no sense in terms of basic tax principles. Almost inevitably the personal value of a business meal, and in every case the personal value of a business entertainment expense, will equal its cost. The most basic tax principle is that taxpayers should not be allowed to deduct the cost of expenditures from which they derive personal value. But even if in some cases business people do not enjoy the business meal or entertainment that they inflicted on their clients, these expenses should still be nondeductible since they are impossible to verify. Who knows what business people talk about while enjoying a meal at a fancy restaurant. In Toronto, over 90 percent of Blue Jays’ (the cities National Baseball League team) season tickets are deducted as business expenses. It is impossible for the tax department to verify that these tickets were in fact used to take business clients to baseball games. Basically, for all so-called dual purpose expenses, from which people customarily derive some personal benefit, such as home-office expenses, education expenses, travel expenses, and automobile expenses, drafters should be ruthless in drafting enforceable bright-line tests for distinguishing between personal and business expenses and disallowing all of the rest’ (Brooks (2001): 23).

Australia and New Zealand are two developed countries that have introduced the FBT. India followed in the 2005-6 annual fiscal budget with initial sharp adverse reaction from the corporate and firm sectors that are subject to the tax. It has since been revised but is nevertheless in operation currently. The Indian version lists out fringe benefits that are primarily enjoyed jointly by employees. It also includes some benefits that are identifiable with individual employees but it has not been easy to collect tax on them (through a perquisites tax that falls on the employee). The new FBT assigns a presumed percentage of

such benefits - health club membership, entertainment expenses, travel, tour and lodging, telephone expenses, scholarships for children, optional pension schemes tailor-made for the upper end of the salary scale - as fringe benefits that do not represent business expenses. These vary between 100 percent for the pension scheme, 50 percent for entertainment and health club expenses, 10 percent for telephone, and 20 percent for most others. The corporate tax rate of 30 percent is applied on that fraction and is to be collected as an annex to the corporate income tax return. Certain business activities such as airlines and tour companies, information technology, pharmaceuticals and construction in which travel forms a significant component of business expenses, are given special treatment. The tax was essentially introduced as a device to reduce tax evasion and is expected to be revenue productive.

The Indian FBT has been introduced *pari passu* with a major simplification of and scaling up of individual income tax brackets that has reduced the income tax burden of the taxpayer across all income brackets and categories such as salary earners, non-salary earners, women and senior citizens. In combination, therefore, the FBT is expected to improve the equity of the individual income tax: even though it will be collected from the corporate sector, its incidence is expected to be shared, if not passed on, to the upper-income salary earner enjoying fringe benefits without being adequately taxed on them.

To conclude, a word of caution must be provided here. While theoretically fine tax structures may not be too helpful in successful tax administration, at the same time, tax administrators should be very cautious about introducing taxes that merely collect revenue but cause inefficiencies in resource allocation or are intrinsically inequitable. In the medium term, such taxes will arrest economic growth and, therefore, would have a dampening impact on tax revenue.

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