

# TAX POLICY, TAX ADMINISTRATION —MAKING THE LINKS



Michael Keen

International Monetary Fund

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Views are mine alone

# Outline

- Fallacies, platitudes and misperceptions
- Integrating policy and administration
  - Thresholds and segmentation
  - Gap Analysis
- Striking the right balance
- Concluding

# FALLACIES, PLATITUDES AND MISPERCEPTIONS

# “BBLR—Broad base and a low rate”

- Many bad taxes are of exactly this kind
  - Financial Transactions Tax
  - Turnover tax (not VAT)
- And several possibly good reforms are not
  - Allowance for Corporate Equity
- Less dangerous way of capturing key idea?

# “Tax administration is tax policy”

- Opposite equally true—and depends what you mean by “is”

- Implies ‘administration dominance’, when...

“Vetoing tax measures because of the difficulty of administering them is in most cases less compelling than doing so on the ground of their failure to conform to acceptable principles. Administration is usually amenable to improvement where violation of first principles is not.”

Groves (1974)

# Do we attach too much weight to administration costs?

...relative to deadweight loss, compliance costs, and equity?

- On efficiency grounds, they are more damaging than compliance costs
  - because must be financed from distorting taxes
- ...but more fundamentally: Does their visibility lead us to over-weight them?

# One example: The administrative case against a reduced VAT rate for equity

- Two goods: ‘poor’ buy only one, ‘rich’ buy both—  
and only way to help latter is by a subsidy
  - Take as given tax on the good only the rich buy
- Even quite large administration costs can have quite a small effect on the subsidy
  - Because cutting the subsidy raises a lot from the rich’s consumption of the subsidized good

# Another: A tax that raises less than it costs to collect may not be dumb

There are non-revenue consequences of taxation—which can be a large part of their point

- Most obviously, environmental taxes
- But need to reflect other, more subtle distortions too
  - Exempting small firms can distort competition and protect inefficient firms—a small tax on them may improve efficiency even if it costs more to collect than it raises



# INTEGRATING POLICY AND ADMINISTRATION

# Thresholds and segmentation

# Policy and administration meet

- Efficiency case for threshold rests on implementation costs
  - But choice can profoundly affect nature of the tax, and so is a key policy decision
- Raises wider issue of taxpayer segmentation
  - A key aspect of most modern tax administrations, which can similarly affect impact, and appropriate design, of policy

# Choosing the VAT threshold

If all taxpayers compliant(!), increasing the threshold:

- Government loses revenue (only) from those at the threshold (each dollar valued at, say, \$1.2) but saves administration costs (of say \$400)
- Taxpayer has money in the pocket and saves compliance costs (of say \$1,000)

Balancing these effects (assuming 20% tax rate and value added 20% of sales), **optimal threshold is \$98,000**

# What if they are not necessarily compliant, but can...

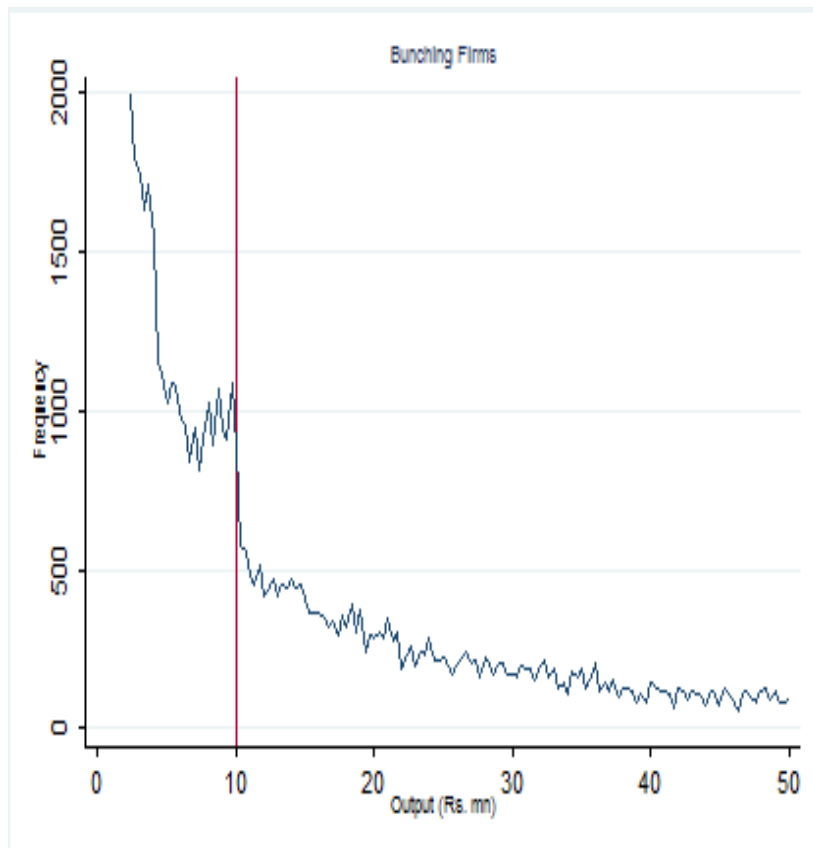
- Declare truthfully
- Adjust, legally, to below  $Z$
- Become ghosts/falsely declare under  $Z$
- Conceal a fraction of their income

# Then taxpayers partition such that

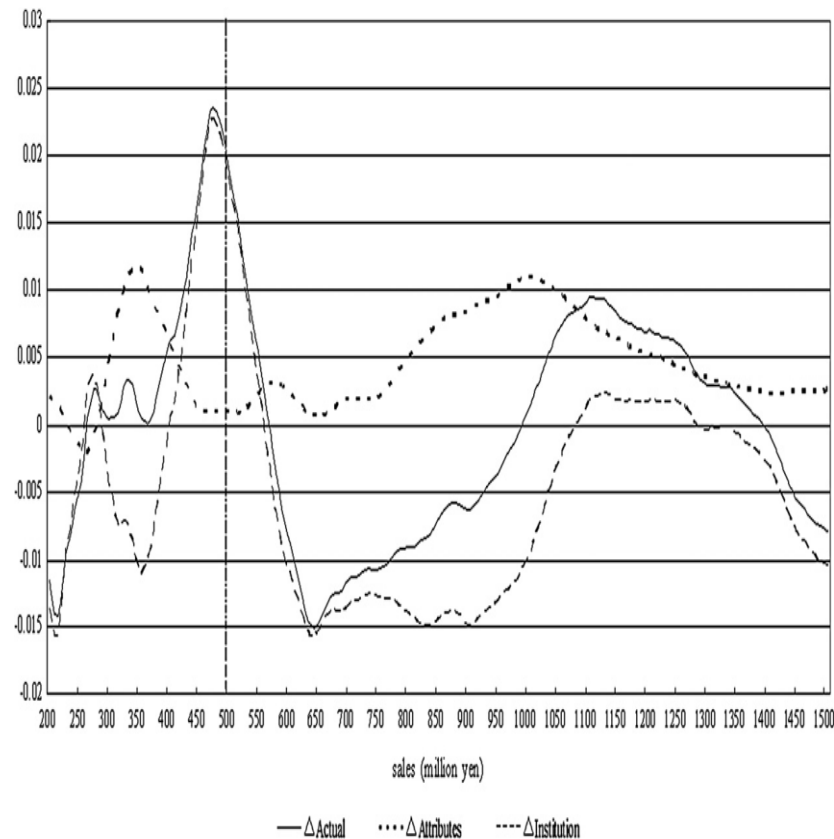
Starting at the lowest level of true income

- Lowest are (honestly) out of the system
- Next lowest adjust out
- Then there are the bounders
- Then the cads
- And the largest are fully honest

# Adjusters (and bounders?) in practice



Source: Chatterjee and Wingender (2012)



Source: Onji (2009)

Ghosts? Non-filers 7% all potential US taxpayers

# Towards optimal segmentation...

But what is the optimal threshold?

- Set high enough to eliminate ‘bounders’, because....

Increasing threshold gives:

- No output or revenue loss from B’s who become A’s
  - Increased output of A’s
- More generally, likely higher than with full compliance



# ...with compliance patterns suggesting:

Administrative challenges are related to size:

- For top: compliance likely to be good; control avoidance and ensure timely payment
- Middle segment: Concealment
- Bottom segment: Concealment and ghosts

This looks much like LTO, MTOs and STOs....

# But problem much more complex

- Many other instruments—including non-tax
- What treatment within partitions?

Taxpayer size	Estimated number of taxpayers	Estimated turnover range (SP)	VAT regime	Income tax regime	Tax office
Large	1,000-1,500	≥ 70 million	Monthly	Real (self assessment)	LTO
Medium 1 (larger)	10,000- 12,000	15 -70 million	Quarterly	Real (self- assessment)	Eight, integrated offices
Medium 2 (smaller)	30,000- 40,000	5-15 million	Exempt	Real (administrative. Assessment0	Current offices
Small and micro	370-450,000	<5 million	Exempt	Lump sum	Current offices

# Gap analysis

# Strong interest in measuring 'gaps'

- Particularly 'compliance' gaps
  - To give some sense of administrations' effectiveness
  - Next step from looking at ratios of implementation costs to revenues
- But opportunity also to link with 'policy gaps'
  - Similar to tax expenditures
  - ...especially for VAT

# Decomposing VAT revenue: C-efficiency'..

Can write VAT revenue as

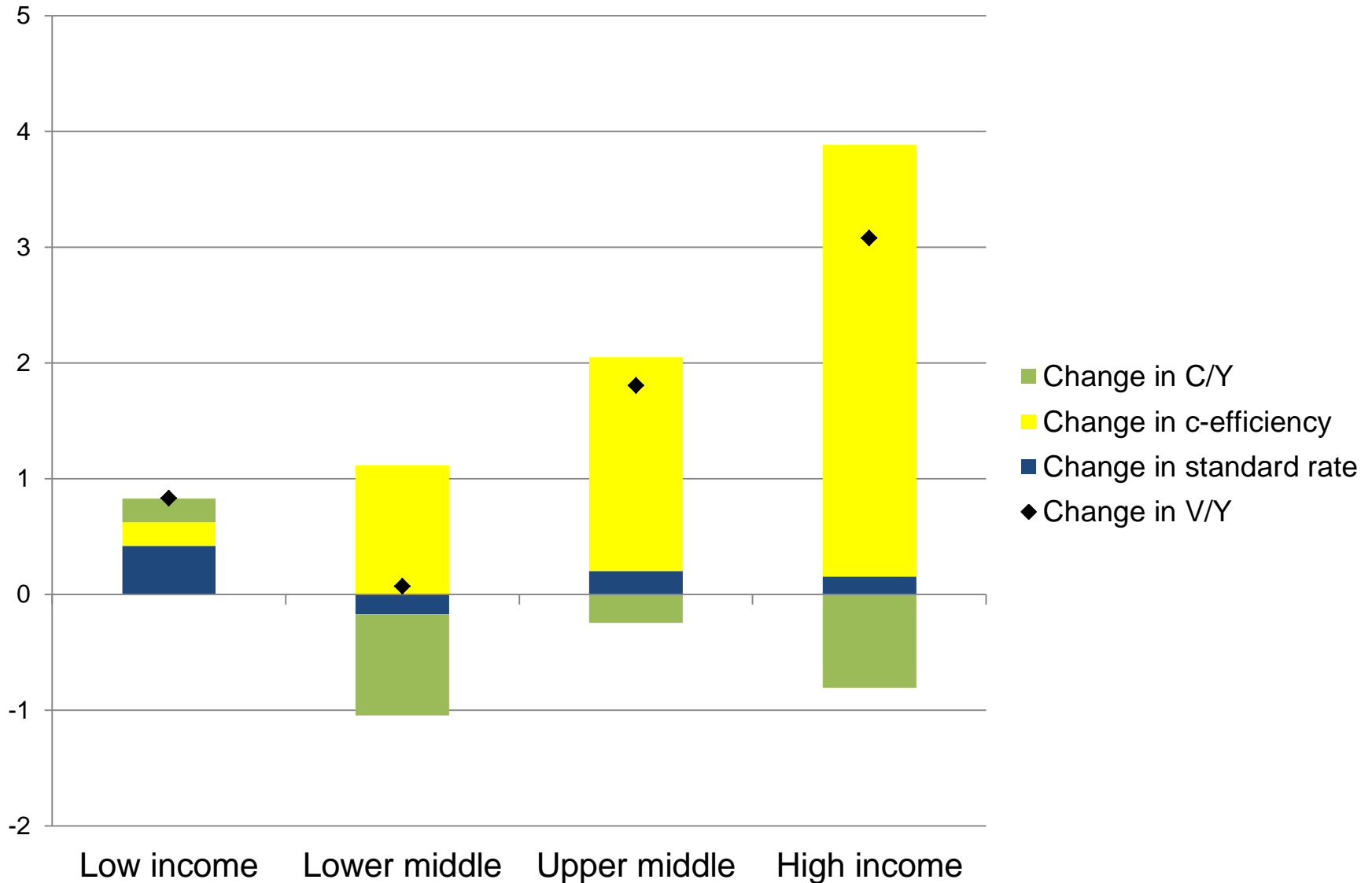
$$\frac{V}{Y} = \tau_s E^c \left( \frac{C}{Y} \right)$$

where  $V$  is VAT revenue,  $Y$  is GDP,  $\tau_s$  is the standard VAT rate,  $C$  is consumption, and

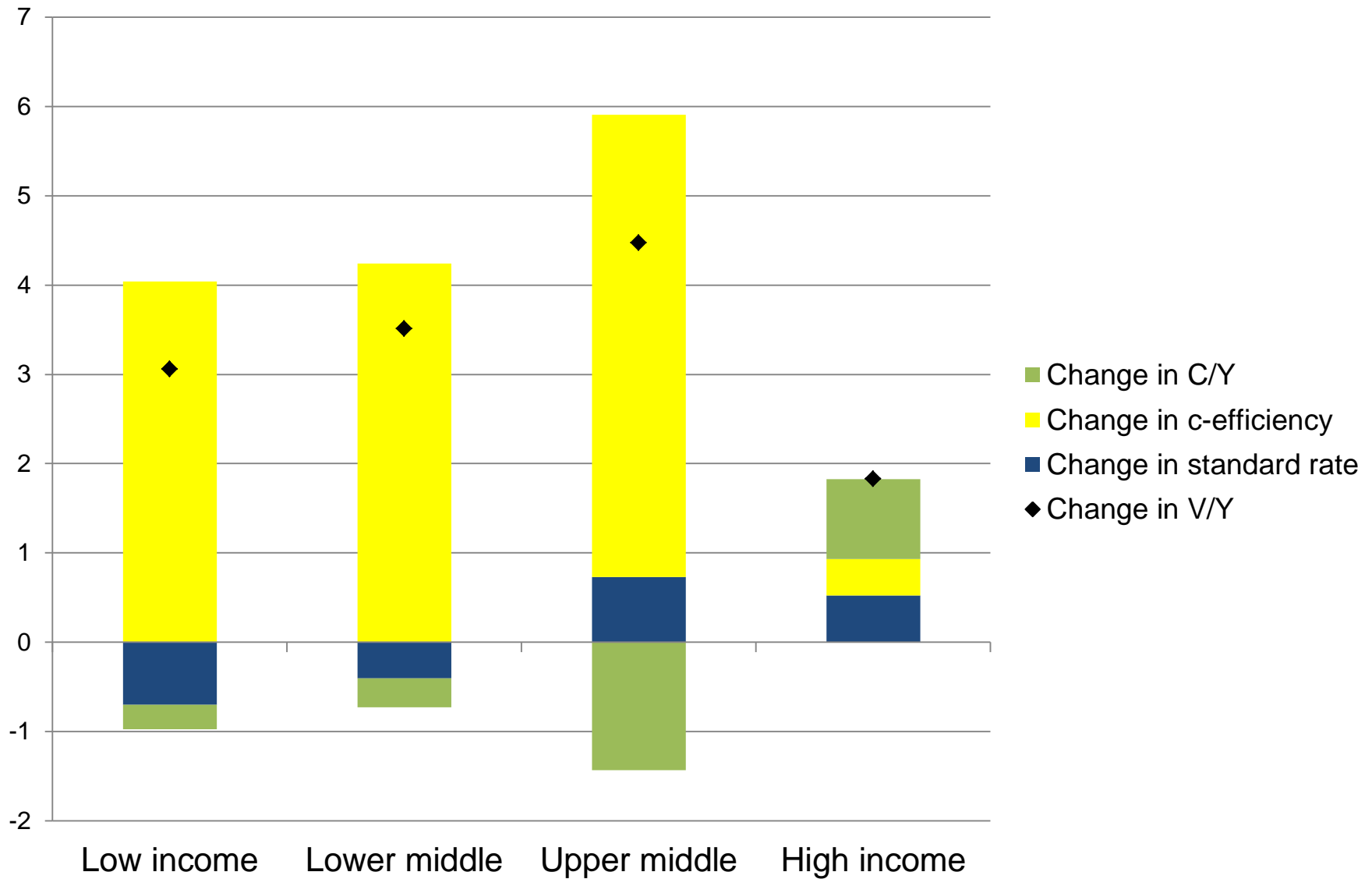
$$E^c \equiv \frac{V}{\tau_s C}$$

is 'C-efficiency'

# C-efficiency drove changes in VAT Revenue, 1993-2002



# ...and for 2003-2010



# So what drives C-efficiency?

C-efficiency = (1 - Policy Gap)X (1 - Compliance Gap)



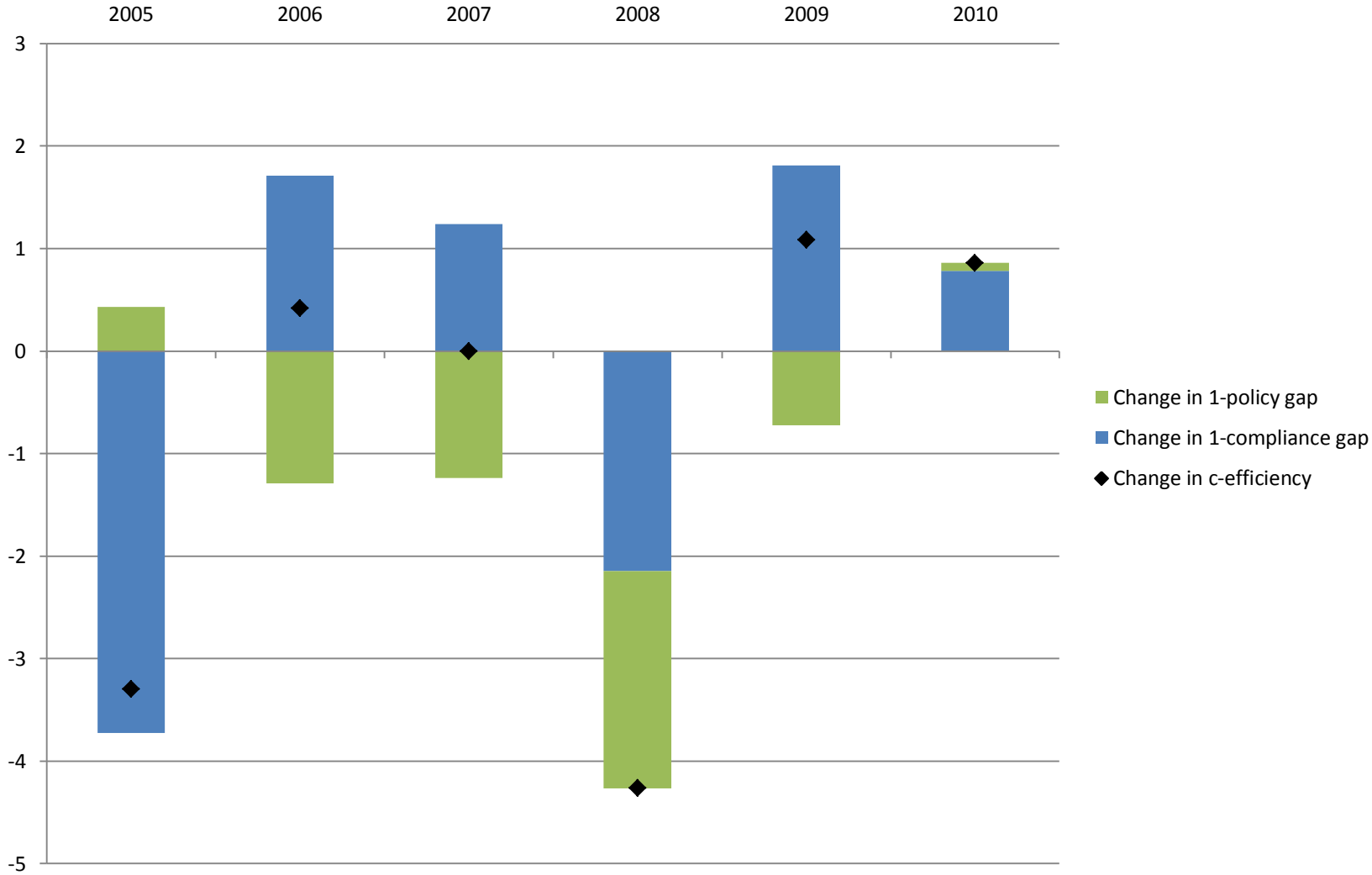
# Compliance gap

- Excess of tax (e.g. VAT) theoretically due over that actually collected, as percent of former
- An increasing focus in many countries
  - UK has produced ‘VAT gaps’ for several years
  - Australia has started
  - Reckon (2009) and CASE (2013) for EU
  - RA-GAP project at IMF
- With policy gap as residual from C-efficiency and compliance gap:

# Decomposing C-efficiency in the EU

Country	C-efficiency ( $E^C$ )	Compliance gap ( $\Gamma$ )	Policy gap ( $P$ )
Austria	59	14	31
Belgium	52	11	42
Denmark	64	4	33
Finland	61	5	36
France	51	7	45
Germany	57	10	37
Greece	47	30	33
Ireland	66	2	33
Italy	43	22	45
Luxembourg	87	1	12
Netherlands	60	3	38
Portugal	53	4	45
Spain	57	2	29
Sweden	56	3	42
United Kingdom	48	17	42

# Decomposing Changes in C-efficiency (UK)



# Uses of gap analysis

Can identify:

- **Priorities for policy makers**
  - E.g. If UK were to halve its compliance gap, VAT revenue would increase by 10%
  - If it were to halve its policy gap, the increase would be 36%
- **Areas in which to improve compliance**
  - Depending on how calculated

# But

Gemmell-Hasseldine critique:

- Compliance gap may not be recoverable
  - Because raising effective rate through enforcement may reduce the base

And....

Striking the right balance

Optimal compliance?

# Is the compliance gap too big or too small?

- Many considerations: Horizontal equity, cycle....
- Pure efficiency: Extending a standard model, optimal compliance gap depends on
  - Responsiveness of the tax base to ‘enforcement,’  $E_A$ :  
‘The enforcement elasticity of taxable income’
  - Adjusted ratio of implementation costs to revenue,  $C$

E.g. if  $E_A=0.2$ ,  $C=5\%$ , optimal gap is 20%

NB: This assumes no G-H effect—but generalizes



# What we know about the enforcement elasticit(ies) of taxable income

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- Experimental evidence
  - For audit,  $E_A$  0.1-0.2
- Empirically, some IRS work (Plumley)
  - Mainly concerned with choice between administrative instruments

Suggests  $E_A$  for audit starts of 0.03 (?)
- Also need to break into G-H and non-compliance effects

# Balancing policy and administration

# If \$1 more is needed, should it come from higher rate or stronger implementation?

Answer is more likely to be implementation:

- Higher is the elasticity of taxable income with respect to the tax rate,  $E_T$ 
  - Because that means high inefficiency
- Higher is the tax rate
- Higher is enforcement elasticity
- Lower are administration and compliance costs
  - With former especially damaging to case for implementation

# Implications?

- **Most literal:**
  - E.g. if  $E_T = 0.4$ , and ratios of administration and compliance costs are both 0.05, implementation preferred if  $E_A$  is at least 0.95
  - But not very sensitive to  $E_T$ : if this is 0.8, critical  $E_A$  is 0.90
- **Broad trends and comparisons**
  - If globalization means more mobile tax bases, more resources should go into implementation
  - Where administration weak, especially important to focus on less responsive bases

**CONCLUDING**

# It is possible to move beyond platitudes...

...at least, it should be

- Theory points to what we need to quantify
- Many are behavioral
  - Impact of enforcement efforts key
- But also need for more on
  - Structure and extent of compliance costs
  - Comparative data for benchmarking: RA-FIT

# Two views

“...it is time to put to rest the claim that [evasion, avoidance, and administration] is an understudied area”

Slemrod and Yitzhaki, 2002

“...there is still only a relatively small scholarly literature [on] tax administration”

Hasseldine, 2011