

Institutions for Performance Oriented Tax Administration

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Abstract

This paper attempts to identify important hypotheses that underlie Milka Casanegra's well known saying "in developing countries, tax policy is tax administration". Emphasising that there is insufficient rigorous empirical research on tax administration to confirm these hypotheses, examples from both developed and developing countries are given, to demonstrate that the hypotheses are, nevertheless, not groundless. The hypotheses are that (a) Improved tax administration or administration friendly tax reforms can significantly and speedily enhance revenue collection – often by more than "text book" tax reforms. (b) Inefficient administration imposes significant distortionary and compliance costs on society. Furthermore these costs are very unevenly distributed across different groups in society. (c) To permanently improve tax administration it is not sufficient to increase manpower and institute new controls, nor to merely introduce IT enabled procedures, nor yet to outsource some activities to the private sector. (d) Good institutions are the key to improving tax administration and the most important institution is the structure of incentives. An institutional blueprint to improve tax administration performance is then outlined, while cautioning readers that more research is needed to fill in the details.

Key Words : Tax administration, Tax reforms, Compliance costs, Structure of incentives

Motivation

Governments all over the world face problems raising revenue to finance expenditures. Insufficient tax revenue usually leads to deficit finance, which impedes economic growth and causes inflationary price increases. Hoping to improve tax performance and also reduce the adverse impact of taxes on economic growth, taxes have periodically been reformed. For example, in India, three recent Task Forces all chaired by Vijay Kelkar have recommended major reforms of Central taxes. In most Indian states, in a sweeping tax reform, planned for over a decade, the major source of tax revenue of states, the sales tax, was replaced by a value-added tax (or VAT) in 2005. It is argued here that like earlier reforms it is unlikely that recent reforms will greatly improve tax revenue performance or reduce their adverse development impact.

A hypothesis that most fiscal experts pay lip

service, but few pay attention to is the subject of this paper. The hypothesis is, as Milka Casanegra, a former chief of the Tax Administration Division of the IMF once famously wrote that "in developing countries, tax policy is tax administration".¹ A key implication of this hypothesis is that tinkering with taxes in a country, without ensuring that the reformed tax regime can be effectively administered there, given its level of development, can lead to reforms being ineffective. For example it is not unlikely that the VAT will prove to be harder to comply with and administer than the existing sales tax in all but the most advanced states in India, a possibility that has not received enough attention in recent Indian debate.²

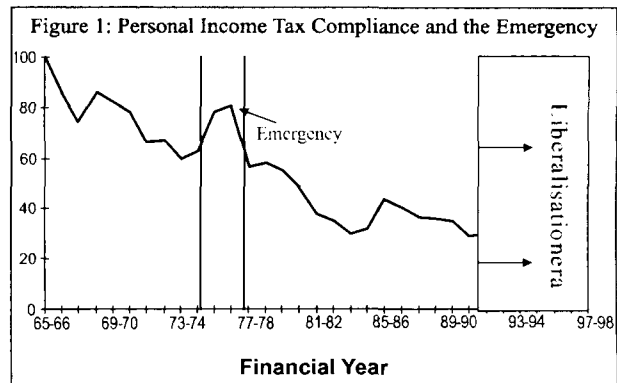
To motivate the hypothesis, begin with three macro and three micro examples.

In 1998 Mexico undertook sweeping tax administration reforms under the Salinas government. Reforms included reorganisation, allowing better monitoring and control of field offices, large scale automation, procedural reforms to increase transparency and accountability, and most importantly, introduction of positive and negative incentives for tax officials. For example, after the reforms, some tax officials earned up to 250 percent of their base salary from performance linked bonuses. At the same time, greater monitoring and accountability of officials, via both internal vigilance and citizen's groups (or *syndicos*), was instituted. As a result, more active pursuit of tax evaders led to over 200 tax evaders being jailed within two years, compared to three during the previous century! Better compliance and greatly reduced administrative corruption due to these reforms led to an appreciable revenue increase.³

A contrasting case is that of Bolivia which reformed its tax system in 1986, to make taxes due from most taxpayers transparent. In fact taxes due were fixed in advance. This administration friendly tax reform was accompanied by taxpayer friendly simplification of the procedure for remitting taxes to the government. As a result, tax collections rose 300 percent by 1987 and 800 percent by 1990!⁴

Though police states and curtailed civil liberties are rightly reviled, Indira Gandhi's 1975 emergency in India illustrates the value of measures to increase administration efficiency in tandem with the speeding up of normally glacial judicial proceedings. The emergency impacted tax administration in three important ways. Reduced civil liberties meant fewer impediments to prosecuting tax evaders. Second, tax investigations were stepped up. Third, reduced official corruption and greater diligence of tax officials, due to

fear of disciplinary action, led to improved administration and less revenue leakage. In conjunction with some compliance improving tax reforms the result was a dramatic increase in tax compliance and revenue, which has only recently been re-attained, after a decade of economic growth following the liberalisation of the Indian economy in 1991 (Figure 1).⁵



Of the three micro examples, one has an international base and two are from India.

The first example illustrates the potential but also possible pitfalls of outsourcing to the private sector. Pre-shipment inspection (PSI) services are provided contractually to customs administrations by private firms in countries from which the contracting country's imports originate. PSI firms, of whom the best known is the Société Général de Surveillance (SGS), a Swiss firm, verify the nature and value of shipments at the point of origin of the shipment. Indonesia, one of the first of over 30 countries to use PSI, and one with a highly corrupt customs administration, was able to use PSI information to achieve a major increase in customs revenues during the 1980s. However, the PSI firm's employees soon began to outdo their Indonesian counterparts in bribe-taking, causing Indonesia to abandon PSI after only a few years. By 1998, the Swiss government initiated legal action against "a leading PSI company" which allegedly paid several million dollars

to a politician in a developing country to ensure its contract was renewed. Yet a recent study found that PSI helps improve the annual growth rate of customs revenue in countries which have intelligently drawn up their contracts with PSI firms, by six to eight percentage points, primarily by reducing customs corruption.⁶

The second and third examples are from the administration of state taxes in India. Most states in India have sales tax and state excise check posts at their borders with other states. As can be expected, check posts are reputed to be highly corrupt and inefficient. Even so, these posts are effective sources of information to curb tax evasion. For example, Punjab, which had no check posts, introduced "Sahayta Kendras" in 2000. These border check posts merely collected documents from truckers without actually inspecting trucks. Nevertheless, sales tax revenues increased by a dramatic 30 percent the year after they were introduced. Giving in to pressure from traders, Sahayta Kendras were, however, dismantled in 2002.⁷

More dramatic is the story of the state of Gujarat, which automated its major border check posts in 1999, allowing IT assisted examination of trucks, quicker document processing and on-line sharing of information with other sales tax offices in Gujarat. Revenues jumped by Rs 970 million in 1999, Rs 1670 million by 2000 and Rs 2370 million by 2001! However, due to "faulty maintenance", 42 out of 58 check posts had non-functioning equipment by 2002.⁸

These examples illustrate three important points about tax administration reform:

Improved tax administration or administration friendly tax reforms can significantly and speedily enhance revenue collection – possibly more than most "text book" tax reforms can.

Second, nevertheless, to permanently improve tax administration, it is not sufficient to increase manpower and institute new controls, nor to merely introduce IT enabled procedures, nor yet to outsource some activities to the private sector: Something usually happens to frustrate piecemeal reforms that focus only on these aspects. Further examination of this vital issue appears later in the paper.

Most importantly, tax "experts" – including, with the reader's permission, this one – do not yet know how to reform tax systems. They can (hopefully) learn by research into the reasons for earlier failures. From the perspective of a scientist, even if only a social scientist, the conclusions and suggestions in this paper must be seen as preliminary hypotheses based on as yet insufficient evidence. Even so, in the last part of this paper an existing blueprint to improve tax administration, one that appears to be working in some cases, is presented.

The discussion in the rest of the paper proceeds in five parts. First, an attempt is made to define what exactly a tax system is, at least for this paper, and what part of this is called "tax administration". Having done this, evidence on the high social cost of tax administration in a developing country, India, is then examined. This is done to argue that tax administration is worth studying, not only because it can increase tax revenue but also because making it more efficient can possibly appreciably decrease the 'net cost' of government to society. The discussion then moves to looking at how tax administration can possibly be improved. In successive sections it is argued that good institutions are important and that automation without institutional reform is inadequate. The final section describes what precisely good institutions are thought to be in the context of

tax administration. An actual reform blueprint, prepared by a committee for the state of Andhra Pradesh in India, is in the Appendix.

The scope of the Tax System⁹

The examples above represent only a small part of the sphere of tax administration, mainly because not much analysis is available of other areas.

To see what tax administration is, imagine that in an economy alternative, economically costless, government revenue became available to replace tax revenue and that, in consequence, taxes were abolished. Comparing the two situations, all activities, organizations and institutions in the economy that would disappear along with taxes constitute what may be termed the economy's *tax system*.

A modern economy's tax system can conceptually be divided into four parts:

First, the *tax design* or *tax structure* includes

normal and penal tax rates, tax bases, tax concessions, taxable entities, non-compliance penalties and the timing of tax payments, formalized as laws of the land.

Second there are institutions to translate tax design into law, or what may be termed *tax policy institutions*. This includes channels of public debate, executive branch tax proposals, legislative debate and processes related to legislating tax laws.

Third is *education and research* related to tax systems, both in general and specific to a particular tax system. Academic research and teaching or expert advice to governments are included here. In the intersection between this and tax policy institutions lie tax commissions, though commissions often also deal with tax administration.

All other activities within an economy's tax system can be taken to be within the scope of *tax administration*. A partial list of important components of tax administration is in Table 1.

Table 1: Important Components of Tax Administration

Institutions and organizations	Role and function
The "Tax Ministry"	Monitor, forecast and set targets for tax collection. Formulate administrative law to facilitate implementation of tax law
The Tax Department(s) (TDs) or "tax administration in the narrow sense"	Facilitating and enforcing compliance by taxable entities with legislated tax laws. <i>Taxpayer related</i> activities: Identification of taxpayers, valuation, physical checks and searches, investigation, tax liability determination, collecting taxes, facilitating compliance via taxpayer education, taxpayer services and grievance redressal, enforcing compliance, imposing administrative penalties in case of non-compliance. <i>Internal management</i> and related activities
Independent audit, anti-corruption and (usually legislative) oversight bodies.	Ensure that the TD discharges its functions in accordance with the law and at the lowest possible cost to society .
Agents and third parties to whom tax activities are outsourced (e.g. banks, tax withholders, tax farmers, tax form printers)	Performing outsourced activities.

Civil courts, arbitrators, tribunals to the extent that they deal with tax matters	Resolving disputes between TDs and taxpayers or third parties.
Police and the criminal justice system to the extent that they deal with tax matters	Providing protection to TD staff. Legal proceedings and judicial sanctions in non-compliance cases.
Tax practitioners (preparers, accountants, tax lawyers), their associations and their organizations.	Assisting taxpayers in complying with legal tax obligations and minimizing tax dues Representation in case of disputes.
Legally taxable entities (including individuals) and their associations	Associations: Coordinating with TDs, tax practitioners and tax policy institutions.

This description of tax systems merits three immediate comments: First, there is much cross-country and historical diversity in each component of tax administration. Second, several components of tax systems, particularly of tax administration, as defined here, have not been properly analysed and studied. As a result, tax administration reform principles outlined below are inevitably incomplete. In fact most of the discussion is of reform of the tax department or “tax administration in the narrow sense” (see Table 1). Third, since the full range of tax administration activities outlined above has not been researched, adequate estimates of the social cost of raising tax revenue do not exist. Nevertheless, even the partial estimates presented below are surprisingly large.

To illustrate why careful examination of components other than tax departments is needed, consider the “Tax Ministry”. In India taxes at the Centre are overseen either by the Central Board of Direct Taxes or the Central Board of Excise and Customs. The chairpersons of these boards, traditionally the most senior Indian Revenue Service (or IRS) officers, have the rank of special secretary to the Government of India. They report to the Secretary of the Department of Revenue in the Ministry of Finance, who is typically from the Indian Administrative Service (IAS). This causes at least two problems. First, there is insufficient coordination and some duplication of work between tax departments

which are not under the same board. Second, IRS officers resent the in-built glass ceiling, whereby the most important revenue job, that of Revenue Secretary, is traditionally reserved for a generalist IAS officer rather than a tax professional from the IRS. It has also been held that the existence of a layer of bureaucracy between the board chairmen and ministers in the Finance Ministry is dysfunctional and reduces efficiency. While there is some research on different alternatives for tax ministry reorganization, existing prescriptions for performance improving organizations are still based on sketchy evidence.¹⁰

The social cost of Tax Administration

Even if we accept that *effective* tax administration reform can improve tax revenue, are *inefficient* tax administrations a cause for concern? To see that they are, one only needs to examine the partial information available about the high cost to society of tax administration as also the cost of the tax system as a whole.¹¹

One reason for high costs is that besides the direct cost associated with different components of the tax system, there are also opportunity or economic costs of different activities: Tax officials, company employees who deal with tax matters, taxpayers filling out tax returns at tax time, and the army of chartered accountants and lawyers who specialise in tax matters surely have socially

more productive time allocation alternatives. Alternative uses of the cars, capital and buildings employed by these persons also add to indirect costs.

Information reviewed here is on costs which are borne by taxpayers, conventionally called *compliance costs* of taxpayers, and second, on *administrative costs* of tax departments, for income and corporation taxes, focusing on two countries: India and the United States.¹² Compliance costs include such things as fees for chartered accountants and other tax professionals, money spent on record keeping and accounts, and the value of taxpayer time spent dealing with tax matters. These activities are undertaken largely to meet the demands of the tax administration.

One estimate for 2001 of the compliance cost of small and mid-sized business in the United States places it at around 27 to 28 percent of the taxes paid by these firms. Costs are around 10 times higher than the compliance cost of large firms.¹³ These compliance costs should be added to the direct cost of collecting taxes by the US Internal Revenue Service of about 2 percent of the taxes they collect. For India, recent estimates put the compliance cost of the corporation tax at between 5.6 percent and 14.5 percent of corporation tax collections. These should be added to Income Tax Department administration costs for the corporation tax of just under 1 percent.¹⁴

For the individual income tax, the latest US compliance cost estimate available is, unfortunately, for the early 1980s.¹⁵ These range between five to seven percent of individual taxes.¹⁶ On the other hand, the estimate for 2001 for Indian income tax compliance costs of taxpayers and third parties is a massive 57 percent of taxes collected, in addition to direct administration costs of 2.5 percent.¹⁷ On seeing this estimate, Richard Bird wrote, "...the [Personal Income

Tax] in India is a complete waste of time and money. The country (and the government) would, it seems, be significantly better off if the thing were simply abolished." Likewise in their report, the Kelkar Task Force on Direct Taxes constituted by the Indian Ministry of Finance in 2001 wrote "Such high costs raise serious doubts about income tax as an efficient source of revenue." (sic)¹⁸

The estimates here exclude at least three important cost components.

First, taxes distort prices reducing efficiency: Tax distortions reduce the reliability of price signals, leading to resources not being allocated to their best uses in market economies. The cost of such resource allocation distortions is hard to measure accurately but they probably add a few percent to the cost of raising taxes.¹⁹ The more disturbing distribution of these costs is discussed below.

Second, the administration cost estimates pertain largely to tax departments. They capture only a part of the cost of other government organs such as the "tax ministry", the judiciary, the legislature, and so on, to the extent that these entities deal with tax matters.

Third, the time and money spent by tax evaders to ensure that their activities remain hidden is only imperfectly reflected in the Indian figures and was not within the scope of the US studies.

On causes of high costs, the Indian studies found that a substantial part of compliance cost, particularly for corporations, is associated with instability and ambiguity in tax provisions and rules.²⁰ Stable and predictable taxes appear to be one attribute of tax administration friendly tax design.

An important feature of compliance costs is that they are usually regressive for individuals

and firms: Costs as a percentage of taxes paid are much higher for small taxpayers. This has been documented by most studies of compliance costs including the United States and India studies cited. Costs are also much higher for the self-employed. In India compliance costs of some self-employed individuals even exceed taxes paid by them.

Compliance costs are also unevenly distributed between bribe-takers and bribe-payers. The cost of bribes is not reflected in estimates reported above. Bribes are merely transfers from the pockets of bribe payers to bribe takers. However reprehensible, they do not have any net impact on total social costs. Clearly, bribe inclusive costs of bribe payers will be higher than otherwise, while bribe takers are probably net beneficiaries of the tax system. During the course of the Indian study, cases of some businessmen whose bribe payments exceeded their tax payments came to light!

While lower compliance costs may reduce the overall cost of the tax system, it should be pointed out that this may not significantly improve their *distribution* across different groups. Recent estimates by Arnold Harberger suggest that, for the corporation tax, economic costs borne by labour in the United States are 250 percent of US corporation tax revenue.²¹ This dwarfs compliance and administration cost estimates of this tax.

It is worth repeating that cost estimates presented do not have a high degree of scientific reliability: More research is needed to obtain reliable estimates.

The Importance of Good Institutions

How to improve tax administration so as to raise more revenue at a reasonable cost to society? In the rest of the paper, four points are made:

- a. Good institutions are the key to improving matters and the most basic institution is the structure of incentives.
- b. Quick fixes such as automation or private sector involvement are unlikely to work in the absence of improvements in basic institutions.
- c. There does exist an institutional blueprint to improve performance, at least for tax departments.
- d. Much more research is needed before enough is known about how to improve all components of tax administration.

The term “institutions” stands for laws and “rules of the game”. Rules range from tax laws, to requirements for awarding university degrees, and even the Duckworth-Lewis rule for calculating cricket scores in rain-shortened games. Scholars working on governance reform identify as important institutions that promote: Transparency; individual and group accountability; effective citizen’s voice; inter-departmental competition and coordination; and above all, performance orientation through operational flexibility and incentives.

Incentives refer to carrots or rewards for good performance or conduct, and sticks or punishment for bad performance or inappropriate conduct. Incentives work best when codified as clear rules for persons, groups and other entities. Examples and evidence on incentive are now presented to support the claim that incentives are crucial. Other important institutions for tax administration are identified below as part of a blueprint for performance improvement.

The first illustration is an old story from the private sector, about *The Hudson Bay Company versus The North West Company*.²²

The Hudson Bay Company, founded in 1670, is one of the world's oldest commercial entities. It started as a royal monopoly over trade in lands near the Hudson Bay (chiefly furs). In its early days, the company was managed from London. Communication between the management in London and trading posts near the Hudson Bay in Canada, was by sailing ships across the Atlantic! The Hudson Bay Company's organisation was rigidly hierarchical. Negative incentives (including floggings!) were freely used to ensure that employees adhered to company rules and discipline. Reminiscent of most government bureaucracies today, this led to employees being rigidly rule bound and afraid to take entrepreneurial risks.

The North West Company (NWC) operated out of Montreal – approximately 1500 miles away from the source of furs – a huge cost disadvantage.

In contrast to the Hudson Bay Company, the NWC's style emphasised operational autonomy and positive incentives. The company operated as a partnership, with partners sharing all company profits. Partners on trading trips were left free to make operational decisions in the field. Furthermore, outstanding employees could eventually become partners.

From 1779 to 1809 the NWC dominated the fur market, eventually capturing an 80 percent market share, despite their huge cost disadvantage. Their dominance only ended in 1810 when the Hudson Bay Company reorganized along the lines of the NWC.

As a second example, consider the careful 2002 study of *tax department reform in Brazil* by Kahn, Silva and Ziliak. The Brazilian reform introduced monetary bonuses for tax officials based on their individual and group performance in identifying and collecting taxes from tax evaders. Bonuses were funded

from fines imposed on tax evaders. As in Mexico, incentive bonuses frequently exceeded salaries of tax officials. The incentive programme led to a sharp increase in collections from fines despite a decrease in the number of tax officials doing tax audits.

Of course, incentives to tax officials have their darker side, if they are not designed with appropriate safeguards. *Midnight raids by overzealous US Internal Revenue Service officers*, reported in the *New York Times* in 1998 are a dramatic example of this. Like other areas, in designing incentives, "the devil is in the details".²³

Macro evidence on the importance of institutions and incentives can be found in the writings of the late Mancur Olson. In a 1996 paper titled "Big bills on the sidewalk: Why some nations are rich and others are poor", he summarised evidence about the world's development experience over the past century or so, concluding that:

Evidence strongly favours the hypothesis 'countries with the best public policy and institutions achieve most of their potential while other countries achieve only a tiny fraction of their potential income' over the hypothesis 'poor countries are poor primarily because they are short of resources'.

"The familiar assumption that the quality of a nation's economic institutions and policies is given by smallness/largeness of its public sector or by the size of its transfers to low income people does not fit the facts very well... The hypothesis that economic performance is determined mostly by the *structure of incentives* ... has far more evidence in its favor".

Institutions, particularly incentives, are of wider importance rather than being merely a means to improve tax administration performance.

The inadequacy of automation without institutional reform

What of technology? Earlier in the paper the sad story of Gujarat's automated check posts was reported. Further examples of the inadequacy of technology without institutional reform are now presented.

Begin, once again, with the private sector. Clegg et. al. (1997) report interviews with 45 leading researchers and consultants in the UK on their assessment of the performance of information system (IS) reforms. These experts, in turn, drew on their knowledge of over 14,000 organisations and businesses, small and large. The key conclusions of the study were that around 40 percent of IS investments were complete failures; and that only between 10 percent to 20 percent could be counted as largely successful.

Craig Neal of the World Bank has held that the reason for such an alarmingly high rate of failure is because IS projects are extremely "fragile": IS projects seek to automate activities which are traditionally people-based. In Neal's words, "people make lots of mistakes, but are great at handling error, computers make 'no mistakes', but are terrible at handling error. Managers and staff typically don't understand this and expect computers to behave like people". To successfully automate, "business process re-engineering" is critical. The key lesson is "don't automate the paper: re-locate, re-balance and eliminate redundant procedures". Above all, incentives should be put in place to ensure that people continue to see themselves as coming first, instead of being reduced to hand-maidens of machines.

Consider three examples of unsuccessful IS projects in tax departments.²⁴

The CARD Project in Andhra Pradesh

Stamp duties and registration fees are among the three most important taxes in Indian

states. The project for Computer-aided Administration of the Registration Department (or CARD), to automate and improve the speed and quality of registration services in Andhra Pradesh has received much national and international attention. Under CARD, several sub-registries in Andhra Pradesh were equipped with document scanners and on-line document storage using writeable CDs. Software was introduced to record and control registrations and also make the registration process transparent and time-bound. But nothing was done to change the basic culture of the sub-registries nor to do away with the ubiquitous touts who are to be found outside these offices.

Jonathan Caseley (2004) surveyed over 300 citizens in rural Andhra Pradesh who had registered property sale deeds. He concluded that "...it still takes days to register a document and CARD has simply made corruption at the [Department of Stamps and Registration] easier". The study presents evidence to show that the incidence and quantum of bribes were similar in both CARD and non-CARD sub-registries. Though the time taken for registration had come down in CARD offices, there was no impact on "information transparency, staff behaviour and the payment of bribes". In fact 87 percent of interviewed citizens had not been given official receipts for duties and fees paid by them.

How not to automate Tax Administration? The United States Internal Revenue Service saga

It is not only developing countries that encounter problems when trying to implement large technology investments. The Internal Revenue Service (IRS) in the US has had continuing problems implementing its Tax Systems Modernization Programme (or TSM). TSM is the centerpiece of the IRS's

vision of virtually paperless tax processing to improve operations and serve taxpayers better. During 1986 to 1997 the IRS spent over \$3.1 billion on the TSM. In December 1998 a technology contract was given to the Computer Science Corporation, worth an additional \$5 billion over its 15-year life. However, by 1997, the National Commission on Restructuring the IRS reported that

“The IRS has experienced great difficulty in managing technology.

“The technology deficiencies are an outgrowth of *management and governance problems* and the agency’s inability to pursue a long-term strategic vision in its business operations. *Absent a strategic vision, no quantity or quality of technological modernization can be truly effective.*”

Other examples of ineffective computerisation in India and elsewhere are not hard to come by: Thailand’s 1992 tax computerisation project, funded by the World Bank, was till then the most ambitious computerisation project ever funded by it. It was supposed to put in place Thailand’s largest automated system. By 1996, when the project ended, it had totally failed and not a single component was operational.²⁵

Or take automation of land records, an area related to stamps and registration, in the city of Pune in Maharashtra state in India. To quote Wadhwa (2002), “So, today, instead of incorrect presumptive land records, we have computerised incorrect presumptive land records in the city”.²⁶ It should be noted that sub-registries in Maharashtra introduced automation with private sector participation via “Build-Operate-Transfer” contracts.

With these examples in mind, tax administration reform programmes with wide-spread automation and partial privatisation cannot inspire much confidence.²⁷

How Tax Administration might be Improved

A two pronged approach to tax and administration reform which some tax economists have been advocating for some time is now presented.

First, taxes should be made as easy to comply with and administer as possible. The example of Bolivia presented earlier illustrated how major revenue gains were made with simple taxes which required next to no computation, and were known to taxpayers and officials in advance. The key to simplicity is *information*: The easiest tax for a taxpayer to comply with is one that requires the least information to calculate taxes, and that has the lowest record keeping and reporting burden. Likewise, leaving aside the actual collection of taxes, the tax that is easiest to administer is the one that imposes the least information gathering and processing burden on the tax administration. This is now standard advice. As Wallschutzky (1989) puts it:

“Keep the tax laws as simple as possible; – aim for a global tax with few exemptions, credits, rebates, or deductions; – Do not try to use the tax system to achieve too many social and economic goals “.

Of course, taxes must also be moderate and fair, else, large scale tax evasion and even taxpayer revolts can result.²⁸ Further problems arise if complications creep into tax laws because of pressure from special interest groups.

The second suggestion is to introduce performance oriented institutions as outlined in Table 2. If institutional reform succeeds in making tax administrators interested in good performance, then they are likely to themselves adopt automation where warranted, and privatise tax administration activities where warranted, to improve performance. Further elaboration of the table is in the Appendix.

Table 2: Institutions for Performance Orientation ²⁹	
Objective	Operational implementation
Clarity of goals	(a) Mission and Vision statements (b) Citizen's Charter (c) Medium range modernization plan
Measuring goal achievement or performance	Systems of Performance Indicators reflecting effectiveness, efficiency and citizen's service quality, that permit achievement of the administration's mission and modernization plan to be quantitatively assessed
Enabling performance	(a) Operational autonomy for tax departments. (b) Functional organization
Communicating performance	(a) Annual Reports to government on administration effectiveness and efficiency in delivering performance. (b) Performance Reports for individuals, functional units and field offices based on performance indicators
Rewarding and motivating performance	(a) Administration budgets linked to performance (b) Positive and negative individual and unit performance incentives

It may be worthwhile, however, to examine the appropriate goals for a tax department. With informed and honest taxpayers the only role of tax administrators would be to make it easy for citizens to pay tax – a tax department would not really be needed. That taxpayers are neither fully informed nor all honest provides its rationale. So a tax department's goals should be to (a) educate taxpayers about taxes and their tax obligations, (b) help honest taxpayers comply and (c) enforce compliance of the non-compliant. And it should discharge these duties in a way that imposes the least possible cost to society. Institutions to bring about goal or performance orientation are in Table 2, and a blueprint for tax administration in Andhra Pradesh is in the Appendix.

It is worth noting that, in India, the kernel of the suggestions made here formed part of precepts of good state-craft at least 2300 years ago (Box)!

**Box: "Confound these ancestors...
They've stolen our best ideas!"³⁰**

"No work shall be started without authorization, except in cases of emergencies.

"An officer negligent or remiss in his work shall be fined double his wages and the expenses incurred.

"An officer who accomplishes a task as ordered or better shall be honoured with promotion and rewards.

"Every official who is authorized to execute a task ... shall communicate [to the King] the true facts about the nature of the work, the income and the expenditure, both in detail and the total"

Kautilya, *The Arthashastra*, (c. 320 B.C.)

(Book 2, Chapter 9, Translation by L.N. Rangarajan, New Delhi: Penguin, 1992)

Conclusion: A research agenda

To critically modify and augment the blueprint proposed in this paper, four areas possibly require the most urgent research attention:

1. How does tax administration limit the scope of practical tax design?³¹
2. What are the true costs of tax administration in relation to tax revenue, taking account of all its components and not just tax department and taxpayer compliance costs?
3. How and where should the private sector be involved in tax administration?
4. Most importantly, in practice what features do successful (and unsuccessful) incentive systems for public officials have?

APPENDIX:

Reforming Tax Administration to Improve Performance: A Medium Term Strategy³²

To improve tax administration performance, a suitable institutional reform strategy should be formulated and implemented over, say, the next 10 years. Key ingredients of this strategy (as in Table 2) are now discussed.

Defining and Measuring Performance

In interactions with officers from revenue collecting department in Andhra Pradesh (AP), the lack of uniformity and shared purpose within these departments stood out. "It is fair to conclude that no two officers in any of the departments have the same view of what the role of the department is." Lack of a common purpose leads to diffused effort and confusion, with adverse consequences. To correct this, it is important to build a framework which leads to a clear and shared sense of purpose in each department. The framework proposed here involves five document based measures.

Mission Statements

To articulate a common purpose, all major

revenue collecting departments need to draw up Mission Statements, in English and the local language, by the end of the calendar year. Training to understand the department's mission should then be made a compulsory part of basic training. Mission statements should lay out the four objectives of each department in no more than 500 words. There are three shared objectives: To collect revenue for the government effectively, efficiently and through equitable procedures. These objectives must be elaborated by each department given the levies it has to administer. The fourth set of objectives, which are most important for transport, registration (but not stamp duty) and mines is the provision of identified non-revenue services or enforcing other laws. Examples of such services are exploitation of mineral wealth, environmental protection, preservation of documents and control of spurious liquor.

Vision Statements

Management experts point to Vision Statements being key motivating devices in guiding actions and reforms of organisations. A Vision Statement should lay out the goal of what the department aims to be and how it hopes to deliver services in the future. A critical question which it answers is "What skills and capabilities do we want to bring to our mission in the future?" The ideal Vision Statement is a short, inspirational, single sentence statement *which all department staff are able to recite and feel proud of.*

The word "we" is highlighted above as it is important that the Vision of a department be shared by all staff and indeed, by other stakeholders including taxpayers, tax professionals and the government. Therefore, the design of Vision Statements is best done through a consultative process with staff and other stakeholders.

Citizen's Charter

Citizen's Charters already exist in some state level revenue collecting departments but they are capable of improvement. Charters should list services provided to different citizens with whom the concerned department deals. An adequate citizen's charter should contain:

1. The mission of the department and citizens groups that are served by the department
2. Standards of behaviour that citizens are entitled to from department staff
3. Physical comforts and conveniences that citizens are entitled to in department offices, including a list of minimum facilities (toilets, drinking water, waiting rooms, etc)
4. Service delivery time and quality norms and concerned officials
5. Office locations, timings and staff
6. Whom to contact for guidance, with full contact information
7. Whom to contact in case of complaints and grievances, both within and outside the department, with full contact information
8. The Charter may, as a matter of convenience, also list duties of citizens

Even if Citizen's Charters exist, arrangements to monitor compliance with the Charters are weak or absent in most tax departments. It is important to institute regular monitoring of time and quality norms in Charters. Furthermore, provision should be made for citizens to anonymously send feedback in prescribed and pre-addressed forms on quality, timeliness and encounter with corrupt practices, in every instance where they approach the department for a service or were contacted by the department to discharge an

obligation. Feedback should be sent not to the department, but to an independent agency appointed for the purpose.

In evaluating compliance, absolute levels of compliance are not as important as *improvements* in compliance compared to previous years, and *relative* compliance of different offices that have public dealings.

Performance Indicators

Performance indicators are required to enable services listed in Mission Statements to be quantitatively and qualitatively measured. They should be designed for each function and be used for (a) individuals, (b) offices in different locations, (c) different functions and (d) for the department as a whole. Furthermore, indicators should strive to reflect revenue effectiveness, effectiveness in the discharge of any non-revenue functions, cost efficiency, citizen's convenience (via compliance with Citizen's Charters) and procedural equity. Performance indicators should be developed and introduced in all major revenue departments.

In evaluating performance, absolute levels are not as important as *improvements* in performance compared to previous years, and the *relative* performance of different offices with public dealings.

Medium Range Plans

All departments should have medium range rolling plans, to be updated, say, every two years. These plans could cover 5 years at a time, and contain descriptions of specific reforms that are to be introduced *together with the expected commencement date and completion date of these reforms*. Furthermore, performance standards should be laid down and cost-benefit calculations reported for each reform. Performance benchmarks are not yet systematically laid down, even for the large expenditures incurred in connection with

automation. Nor is any attempt made to do cost-benefit calculations. Progress in achieving medium range plans should be monitored by the head of the responsible department.

In the context of medium range plans, possible staff increases and cadre strengthening, particularly in the context of hiring freezes in government and overall fiscal austerity, need some explanation. In revenue earning departments, additional staff and resources can lead to enhanced government revenue and a lower fiscal deficit. It is recommended that revenue-cost ratios from additional staff should be around 50:1 for most tax departments. Non-achievement of these ratios in a pilot phase should cause the reform measure to be dropped. An exception to this arises in the area of citizen's services where no tangible revenue benefits can be expected.

Oversight and Coordination

Too many revenue collecting departments cause coordination problems, lack of uniformity in administration and fragmented taxpayer records. So the number of departments engaged in collecting tax revenue should be minimized. In the absence of non-revenue functions one tax collection department in a state would be ideal. Except in the case of commercial levies including the sales tax or VAT, departments collecting major taxes in States in fact do perform important non-revenue functions. So, multiple tax collecting departments are inevitable. There is also one non-tax department, Mines and Minerals, whose revenue importance is increasing.

A viable structure is four main revenue collecting departments, for Transport, Land Revenue (including registration and land records), Other Taxes (say the Tax Department) and Mines, *with a permanent, principal secretary level Revenue Coordination*

Committee. The responsibility of the coordination committee could include, besides general oversight, resolution of coordination problems, monitoring exchange of information between departments and joint operations.

The Revenue Corporation, Targets and Budgetary Reform

For performance oriented reform to be taken to its logical conclusion, department management should have the flexibility to deploy and utilize their human and non-human, including budgetary, resources as they see fit. Under current government expenditure accounting and control institutions, operational flexibility is very limited and constitutes an impediment to effective functioning. Many countries, both developing and developed have achieved operational autonomy for revenue administrations by setting up Independent Revenue Authorities.³³ A review of legal, governance, financing, personnel, and accountability design features of some Independent Revenue Authorities in Africa and Latin America is given by World Bank (2004). Advanced states in India should consider beginning the process of converting the Tax Department into an independent Revenue Authority in the medium term.

Bottom up Targeting

Even before revenue corporations are constituted, target setting and incentives to achieve targets can still be institutionalised. Current target setting practices for tax departments are largely "top down". Targets are often unrealistic, impeding the accuracy of budgetary planning and cannot be used to hold individual departments accountable for performance. In Table A1, actual collections are seen to be below targets in every single year. Furthermore, except possibly in 2000-01, the shortfall was unacceptably large.

Table A1: Tax Collection Targets and Achievement by the Commercial Tax Department

(Rs. 10⁶)

	1995-96	2000-01	2001-02	2002-03	2003-04
(a) Budget Estimate/Target	3344	7202	7860	8803	9741
(b) Actual Collection	2955	7117	7623	8338	9197
(b) as a % of (a)	88.35	98.82	96.98	94.71	94.41

Source: GOAP, Commercial Taxes Department

Instead of this, a system of **bottom-up targeting** could be instituted. In this system each division should be required to provide its own revenue target for the next financial year, based on macro-guidelines provided by department heads, in consultation with the government and based on forecasts of macro variables (like GSDP, new investment, etc). These targets should be divided across major heads and computed using prescribed methodology. Divisions should be made aware that their budget demands are to be linked to their targets. How target setting and target achievement should both be incorporated in performance incentives is discussed below. *However, individual division and budget heads should, thereafter, be free to determine their own targets and should be held accountable for their achievement in their performance reports.*

Tax Department Budgets

Budgets should be fixed at an appropriate percentage of targeted collections. However, the actual budget release should be based on performance achieved during the previous six months.

Besides collections, improvement or deterioration in citizens services and performance in implementing long range plans should be incorporated via a formula into budget release rules: Improvements in service should be reflected in an increased percentage, while deterioration or failure to implement planned reforms should be

reflected in decreased percentage. Furthermore, capital expenditures for the acquisition of assets, should be treated as a notional ten year loan from the government to the concerned department, to be recovered with interest from their budget allocations. Any unspent balance from the budget allocation of the department should be used for further loan recovery. The basic percentage of collections may be fixed at around 2 percent of collections for departments collecting the sales tax or VAT before performance based adjustments. Appropriate percentages may also be fixed for other departments. For clarity in targeted performance agreements, department heads should sign a Memorandum of Understanding with the government, as recommended for Central taxes by the Kelkar Task Forces, and should be held accountable for their achievement.

Top Management

Several problems exist under current practice with the top management of major revenue earning departments. The following reforms to improve top management can be suggested.

1. Heads of tax collecting departments should have a fixed five year term, with a three month overlap between outgoing and incoming heads. This should be reduced only in the case of non-performance for two years or in the case of misconduct.
2. Selection of heads should be by open interview by a committee constituted

for this purpose. All Indian nationals, not just government servants belonging to particular state cadres, meeting laid down criteria, should be eligible to apply for the post.

3. Criteria should, importantly, include familiarity with the tax or sectors in question, basic government procedures, and knowledge of Telugu.
4. In order to ensure continued eligibility of IAS officers, a system of two or three year deputations of IAS officers to these departments, possibly as Officers on Special Duty, may be instituted.

Anti-corruption and External Performance Reviews

Current external “watchdog” bodies for revenue earning departments include the CAG, the Vigilance Commission and CBI, and legislative oversight through Public Accounts Committees. These bodies, as a rule, concentrate on identifying shortfalls in adherence to procedures or adverse proceedings in the case of alleged corruption. This leads to three problems.

First, in case of CAG audit objections (and PAC findings), there is no institutionalised mechanism to ascertain the underlying management or procedural infirmity giving rise to these objections in order to carry out appropriate reforms. In consequence, the nature of audit objections, though not necessarily the specific content, remains the same year after year.

A second problem arises in that the threat of adverse notice and punishment leads officers to avoid taking individual initiatives and adopting innovations which could potentially improve the department’s effectiveness.

Turning to corrupt practices by some staff, as recognised by the *Arthashastra*, ascertaining if a revenue official has taken a bribe is more difficult than ascertaining if a fish has drunk water. It is not surprising that despite allegations of large-scale corruption, for example, only 24 departmental and other inquiries for corruption were initiated against Commercial Tax Department staff in Andhra Pradesh in 2003-04, while no inquiry closed during the year had an adverse finding!

While the Committee endorses the need for continued oversight and operations by watch-dog bodies, it should be recognised that these “sticks” alone cannot bring do away with corruption and non-performance. On the contrary fear of punishment reduces effectiveness. So watch-dog institutions have to be balanced by other positive institutions.

First, it should be recognised that the only sure cure for corrupt practices is attitudinal change. Besides training, measures that can foster *espirit-de-corps* and pride in one’s department may also prove effective. This reinforces the attractiveness of an Independent Revenue Authority and underscores the need for a Vision Statement and a shared sense of purpose. An additional step the Committee recommends is the adoption of logos, badges and insignia to be displayed prominently outside all offices of concerned departments and compulsorily worn by all department officials and staff while on duty.

Second, there should be positive incentives for good performance. These incentives, if they have a monetary component also act as a counterweight to ill-gotten bribes and gratuities.

Third, the CAG should be requested to review administrative reforms that have been instituted in response to major types of audit objections made during the past five years.

This will ensure continuity across years and provide an incentive for long term reform.

Performance Oriented Pay and Career Structures

Incentives for good performance by individuals and divisions in a department should be built into the system of monetary compensation. The introduction of performance indicators along with safeguards against unintended mistakes allows this to be done on an objective basis. Furthermore comparison between units can be used to foster competition between them to deliver good performance.

To make this possible we recommend that performance indicators be devised so that individual and unit performance indicators can be compared across units or individuals carrying out identical functions. For units that perform unique functions, such as payroll accounting, comparison with past performance may be used. Comparison should be done having regard to the potential for increased performance and not by comparing absolute scores.

Second, to integrate this with bottom-up targeting, performance indicator systems should be revised to give weight to ambitious targets relative to other units (but non-achievement of ambitious targets should lead subsequently to poor performance scores).

Third, a system of bonuses to different units can be introduced, to be funded from the department's budget, once the budget is linked to collections. These bonuses should be linked to performance indicators with appropriate weight being given to self-set targets and their achievement. *It should be mandatory for at least one unit or individual in each comparable group to receive no bonus in a year.* For units performing unique functions, a minimum performance level to make the unit eligible for a bonus should be laid down

at the beginning of the year.

Transfers of staff to postings in high demand should also be made transparent, and based on performance of eligible staff having the necessary experience in the previous year.

However, performance indicators can be used to evaluate performance in the current position and not potential for broader responsibilities and a supervisory role. We recommend that while poor performance should act as an impediment to promotion, good performance should not lead to out-of-turn promotion.

Performance Reporting

The final strategy plank to bring about performance orientation is transparent and improved performance reporting by departments to the government and to the public. To this end we echo the recommendations of the Kelkar Task Forces for Annual Performance Reports by tax raising departments. Reports should be published on the government's website and given publicity through a press release.

Annual Performance Reports of departments should:

- Reflect the department's achievements – but only relative to targets.
- Incorporate independent evaluations of watch-dog bodies
- Summarise performance as reflected in institutionalised feedback from citizens.
- Permit disinterested individuals and scholars to assess performance claims made in the reports.

Models for transparent annual reporting of performance in terms of effectiveness,

efficiency and citizen's convenience are, for example, those of New Zealand Inland Revenue, The Inland Revenue Authority of Singapore and UK Inland Revenue.

Endnotes

- 1 Casanegra (1990), p 179.
- 2 But see Mukhopadhyay (2004).
- 3 This description is based on Das-Gupta and Mookherjee (1998).
- 4 This description is based on Das-Gupta and Mookherjee (1998).
- 5 For a description of the compliance index as well as econometric analysis of compliance during this period, see Das-Gupta and Mookherjee (1998). Briefly, the compliance index (base: 1965-66) is the ratio of tax collected to a proxy for potential tax collection. The proxy is (Average Effective Income Tax Rate). (Non-Agricultural Gross Domestic Product). Analysis of income tax compliance in recent years is in Das-Gupta (2005).
- 6 This discussion is largely based on Low (1995) and Johnson (2001). The recent study is that of Yang (2005).
- 7 This example is based on a presentation by M. Govinda Rao in January, 2005.
- 8 This example is based on Pandey (2002).
- 9 This section is based on Das-Gupta (2006).
- 10 For example, see Jenkins (1994), Talierco (2003) and World Bank (2004).
- 11 For a much more detailed and recent review of "tax operating costs" see Evans (2003).
- 12 As mentioned, Evans (2003) has detailed information on these costs.
- 13 See Slemrod and Blumenthal (1996) for large businesses and Slemrod and Venkatesh (2002) for small and medium firms.
- 14 See Chattopadhyay and Das-Gupta (2002).
- 15 See Slemrod and Sorum (1984).
- 16 Information to express more recent compliance cost estimates for the US in Blumenthal and Slemrod (1992) as a percentage of tax paid was not available.
- 17 See Chattopadhyay and Das-Gupta (2002a).
- 18 See Ministry of Finance and Company Affairs (2002), page 183.
- 19 The classic paper on the excess burden of taxes is Harberger (1962), which examines the incidence of the corporation tax in the United States.
- 20 The Indian studies found costs of tax instability and tax ambiguity to be respectively 3 percent and 10 percent of tax revenue for corporations. Corresponding figures for individuals were 4 percent of tax revenue for each of these.
- 21 See Harberger (2006).
- 22 The example is taken from Milgrom and Roberts (1992).
- 23 See, for example the article "I.R.S. Hearings Resume" in the *New York Times* and another by Johnston (1998) there. See also the transcript of the Public Broadcasting Corporation TV show *Washington Week in Review*, April 16, 1999.
- 24 The first example is from Caseley (2004). The US and Thailand case studies are from Barbone, et. al. (1999).
- 25 See Barbone, et. al. (1999). The project aimed to overhaul the existing computer system and establish a modern, decentralized tax administration department. As mentioned, this was the largest stand alone computer project supported by the World Bank till then, and also the largest integrated computer system in Thailand. However, when the project closed in December 1996, it had failed completely. No comprehensive data base management and processing system had been established and most of the applications software had not even been delivered. The World Bank found the main reasons for failure to be: (a) Lack of strategic analysis: Technical requirements in tender document did not provide descriptions of the Revenue Department's business processes that were to be automated. (b) Weak project implementation and supervision: The project implementation plan listed only major project milestones, but gave no indication

of how they were to be achieved. This made supervision difficult. In fact, even in January 1996, 11 months before it came to an end, the project was rated satisfactory, though it had run into problems at an early stage of implementation.

- 26 For similar conclusions see also an editorial in *Economic and Political Weekly* (2005), p341.
- 27 Unfortunately, current efforts to streamline Central tax administrations in India consist of precisely these elements. See Ministry of Finance and Company Affairs (2002) and (2002a).
- 28 An interesting aspect of this is the need for careful taxpayer education before a major tax reform. See, for example Chapman (2002).
- 29 This is a modified version of a table in Pradeep Apte and Das-Gupta (2002). For the economic theory underlying this framework see, for example, Mookherjee (1997), Das-Gupta and Mookherjee (1998), Dewatripont, Jewitt and Tirole (1999 and 1999a) and Silva (2003).
- 30 This quotation is attributed to Ben Jonson.
- 31 For discussion see Das-Gupta (2006).
- 32 This Appendix summarises parts of Chapter 10 of the Report of the Andhra Pradesh Revenue Reforms Committee (EAS Sarma Committee), 2004. The author, a member of this committee, prepared the first draft of this chapter.
- 33 See, Glen P. Jenkins (1994), Simon Delay, et. al. (1998), Roberto Taliercio (2003) and Richard Bird (forthcoming).

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