Tax administration changes to raise additional revenue over time

Background paper for Session 3
of the
Victoria University of Wellington Tax Working Group

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Executive Summary

This report is in response to a recent question from the Tax Working Group, "If Inland Revenue received additional funding what would it invest in (excluding policy changes) to increase revenue?"

Inland Revenue detects far more taxpayer non-compliance than it has the capacity to address, and must therefore prioritise which areas to focus its resources on (**priority compliance areas**).

Out of a number of significant priority compliance areas, we consider that investing additional resources in the following areas would provide the highest return (in terms of revenue and integrity of the tax system): the hidden (cash) economy; targeting inappropriate structures that result in artificial losses and claims for Working for Families tax credits; tax debt by investing a better tax debt management system; and property speculation.

Internationally, additional resources are being applied to address compliance issues similar to those highlighted above. For example the Australian Government will invest in excess of $600m over the next four years in the Australian Tax Office (ATO). This will be used to address key compliance areas such as the cash economy, abuse of tax havens, managing compliance risks to Australia's economic recovery and other public awareness campaigns.

Additional investment would also be made in Inland Revenue's **intelligence tools and processes**, such as increased automated data-matching. This would increase revenue by ensuring that Inland Revenue can identify cases of non-compliance more quickly and accurately. This would allow us to intervene more quickly and appropriately. Inland Revenue would also invest additional funding in **proactive compliance**, which will increase revenue over time by encouraging taxpayer compliance through education, awareness and influencing social norms.

It is estimated that for every $100m invested in the areas highlighted above, approximately $500m of revenue will be produced although there may be diminishing returns as investment levels rise. These key sectors and examples of areas for investment are set out in Figure 1. For the greatest impact, focus on all three sectors is needed to achieve the most efficient and effective results.
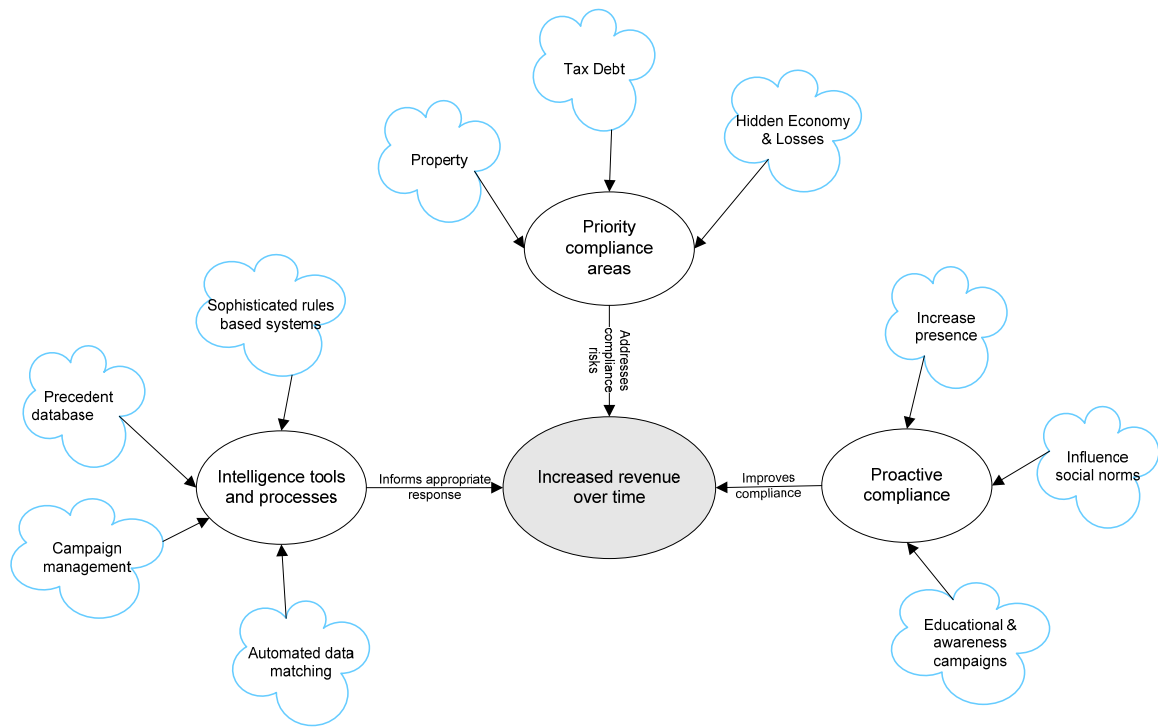
Figure 1 Key areas of compliance investment

Purpose

1.1　This report responds to the question from the Tax Working Group "If Inland Revenue received additional funding what would it invest in (excluding policy changes) to increase revenue?"　The responses set out in this report follow accepted international approaches and are designed increase revenue over time by influencing compliance behaviour.

Background and Overview

1.2　New Zealand's tax and social policy systems are built on the basis that the majority of New Zealanders voluntarily comply.　Inland Revenue's compliance approach reflects this and uses the compliance model (below).
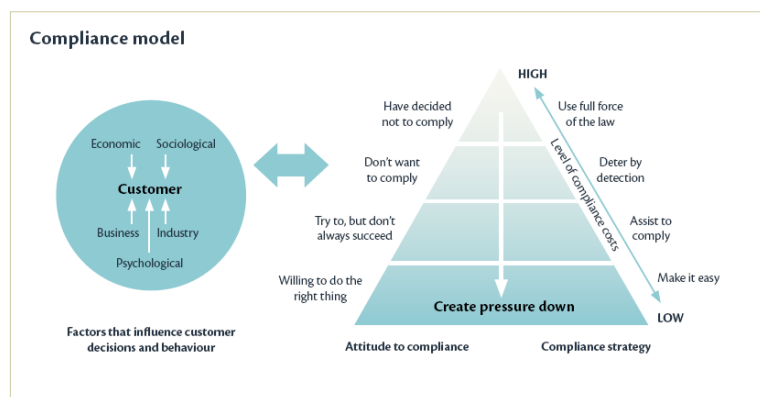

Figure 2 Compliance Model

1.3   The compliance model identifies a number of factors and drivers associated with compliance behaviour. There are five key influences on compliance behaviour:

- Deterrence – eg audits, perceived risk of detection and severity of sanctions;
- Norms – both personal and social norms;
- The opportunity both to be compliant (eg low compliance costs, easy rules) and to be non-compliant (eg opportunities for evasion);
- Fairness and trust both in the government or tax authority and in other taxpayers; and
- Economic factors, containing general economic and other factors related to business/industry and amount of tax due.[1]

1.4   These influences on compliance behaviour are currently taken into account when Inland Revenue designs its compliance responses. The compliance responses are focused on maintaining and improving compliance. They also focus on addressing threats and risks to both the revenue base and the integrity of the tax and social policy systems. Various approaches are used to improve compliance, ranging from the provision of information, tools and advice through to investigation and prosecution.

Dynamic environment

1.5   Inland Revenue is operating in a dynamic environment. To maintain compliance and protect revenue, compliance responses are changing. Inland Revenue has moved beyond a singular emphasis on traditional investigative activity.[2] This changed approach is based on a better understanding of:

- Compliance behaviour and the influencing factors;
- Compliance treatments and measures;
- Likely impacts from the economic situation; and
- Compliance risks (eg e-commerce risks).

1.6   Inland Revenue is investing in a range of innovative compliance responses to increase its influence on social norms. This is being balanced with maintaining an emphasis on enforcement through more traditional investigations. If Inland Revenue was to make further investment, the key areas that would most effectively influence compliance and increase revenue would be investment in priority compliance areas, intelligence tools and processes, and proactive compliance.

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[1] There is work being undertaken in this area by the Forum on Tax Administration Compliance Subgroup of the OECD, which is expected to be published at http://www.oecd.org.
[2] Examples of this movement on an international front can be found at http://www.ato.gov.au and http://www.oecd.org.

1.7   For every \$100m invested, Inland Revenue expects that in the vicinity of five times the amount of revenue would be produced in areas such as property, hidden economy and losses, although there may be diminishing returns as investment levels rise. To obtain this result, Inland Revenue would target its investment in intelligence solutions and the use of proactive responses.

1.8   Internationally, additional resources are being applied to address compliance issues similar to those highlighted above. For example the Australian Government will invest in excess of \$600m over the next four years in the Australian Tax Office (ATO). This will be used to address key compliance areas such as the cash economy, abuse of tax havens, managing compliance risks to Australia's economic recovery and other public awareness campaigns.[3]

Increased focus on priority compliance areas

1.9   Tax authorities around the world have moved to compliance responses based on a risk assessment of taxpayers. This not only improves the effectiveness of the compliance responses, but also minimises the impact on compliant taxpayers. This approach is widely recognised across regulatory and enforcement agencies and is used by other agencies in New Zealand, including the New Zealand Customs, the New Zealand Police and the Ministry of Fisheries.

1.10   Inland Revenue detects far more non-compliance than it has the capacity or means to address. To help prioritise resources, the compliance management cycle, which follows the OECD model, is used to prioritise areas of risk and identify the best suite of treatments. Compliance risks are set out in the Compliance Management Programme "Helping you get it right: Inland Revenue's compliance focus 2009-10".[4] Figure 3 provides a snapshot of the Compliance Focus (below).
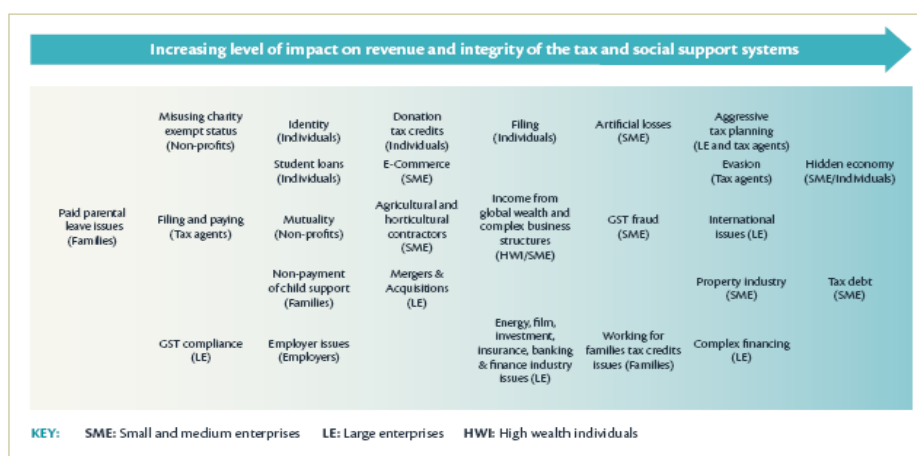

Figure 3 2009-10 Compliance snapshot

[3] This report can be found on http://www.budget.gov.au.
[4] The Compliance Focus is available at http://www.ird.govt.nz.

1.11   Particular areas for the application of additional funding would be an increase in focus on the hidden economy, losses, tax debt and property industry compliance.

a.   *Hidden economy* – In times of economic difficulty, fraudulent activities increase in the hidden economy. These fraudulent activities deeply affect a compliant business's ability to compete for work in a tight marketplace.

The Australian Taxation Office (ATO) is placing significant emphasis on this area (about 50% of case selections), using sophisticated automated data-matching processes. Inland Revenue has also initiated industry partnership work to influence social norms and compliance in this area.

With added investment, a dedicated team could be set up to focus on:

- *Facilitating a cash economy workshop (or on-line forum) with key business and industry partners* – The ATO used a similar workshop as a platform to address the cash economy.

- *Expanding industry partnership work and pilot benchmarking for industry* – The ATO has benchmarked all industry types at a very granular level. Benchmarking in New Zealand would take Inland Revenue between 2 and 3 years to implement.

- *Leveraging educational material into schools and trade schools* – this would be done through the existing curriculum set by the Ministry of Education.

- *Increasing presence* – the emphasis in this area would be on social marketing campaigns.

b.   *Losses* – The effects of the economic downturn are now being seen clearly in the tax take. Provisional tax payments have fallen substantially and in the Budget Economic & Fiscal Update 2009 ("the BEFU") the Treasury forecast that the company tax take for the year to 30 June 2009 would fall $2 billion, and the individual tax take $1 billion from the 2008 actual figures.[5] It is clear from these figures that there has been a substantial increase in the number of taxpayers with losses and the level of losses in the 2009 income year. Losses incurred in the 2009 income year will reduce the tax take in future years (until fully utilised).

A project focussed on losses would target inappropriate structures that result in artificial losses. By treating artificial losses, loopholes associated with Working for Family entitlements would also be addressed. This would be in line with the activities of revenue authorities around the world and the OECD that are focussing on loss monitoring.

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[5] This report is available at http://www.treasury.govt.New Zealand/budget/forecasts/befu2009.

c.	*Property Compliance Programme* - Inland Revenue has received 3 years of additional funding to address risks associated with property, particularly property speculation. Using sophisticated data mining techniques, 2,000 people have been identified who have bought and sold 6 or more properties over a period of 4 years. Of this group, 312 people appear to have bought and sold 20 or more properties. Overall, it is estimated that there is up to $214m potential additional tax associated with transactions for the 2,000-strong group. Addressing the 2,000-strong and other groups (eg 5,112 people have bought and sold 3 to 5 properties during the same period) will take longer than the 3 year funding base which concludes in June 2010.

d.	*Protecting the debt book in the current environment* - Funding for Inland Revenue's management of debt and returns output class has remained relatively static over the last 5 years. Over the same time, the revenue base has grown alongside the level of debt (some of which is outside the control of Inland Revenue, such as a result of the economic climate). Inland Revenue needs to have better information to understand the drivers behind debt in order to realise higher returns on the government's debt book asset.

The recent Auditor-General's review into the management of tax debt[6] made five recommendations that rely on improved information collection, use and reporting. There are some constraints in acting on two of these recommendations due to limitations in our existing debt management system. The constraints are associated with the lack of ability to report on methods used to resolve debt cases and to distinguish types of contacts with taxpayers. Investment in an integrated debt management system would remove these constraints and create a position where the department could more fully address the increase in debt and thereby raise revenue.

Intelligence Tools and Processes

1.12	The compliance responses highlighted above need to be supported by sophisticated and, where appropriate, automated processes to ensure that they are effective and efficient. A greater emphasis on intelligence tools and processes in areas such as automated data-matching[7] campaign management[8] and sophisticated business rules[9] are key to:

- Capturing a greater level of information on what drives compliant and non-compliant behaviour;

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[6] The report is available at http://www.oag.govt.New Zealand/2009/managing-tax-debt/.
[7] Automated data-matching allows for the comparison of separate data sets. It is typically used to compare personal information from two or more records (including data from 3rd parties). Results could be used for example to gauge accuracy of information or aggregate personal information on an individual.
[8] Campaign management consists of both direct and indirect contact with taxpayers. Campaign responses in this report focus on direct channels that include letter, phone, email or text as a department broadcast to a targeted specific group. Unlike audit, it is "one to many" contact.
[9] Business rules are statements that define or constrain some aspect of the business. They are used to define what actions should be taken (for example, send letter A to taxpayer X, while letter B should be sent to taxpayer Y). Business rules provide the tactical detail about how strategy translates into actions.

- Evaluating the effectiveness of compliance responses;

- Establishing social norms and identifying outliers;

- Reducing resource intensive manual processes and interventions;

- Speeding up the identification of optimal interventions; and

- Extending current intelligence to include end-to-end compliance processes (eg considering debt alongside assessment and intervention).

1.13 A precedent database would allow for quicker decision-making for tax binding rulings and, if made public, would allow taxpayers (particularly large enterprises) to better self-manage compliance.

1.14 Many of Inland Revenue's responses are currently manual. Examples of this include outbound calling campaigns, preventative letters, and income and data-matching. Manual processes require greater resources than automated systems.

1.15 Both the ATO and the Canadian Revenue Authority (CRA) have invested in automated data-matching and rules based systems. As a result, they use sophisticated and routine compliance responses as part of their core business activity. Examples include:

- Ratio-based benchmarking together with peer and prior year comparisons to highlight outliers for possible investigation. The CRA complete this exercise twice a year.

- Data-matching exercises to compare business income with either "life-style" (CRA) or "conspicuous consumption" (ATO).

- Behaviour based analysis applied to on-line filing/registering – the CRA employs psychologists to perform analysis of on-line filing.

Proactive Compliance Responses

1.16 Inland Revenue has signalled a change in approach to compliance through the external release of its compliance programme "Helping you get it right: Inland Revenue's compliance areas of focus". This is a positive step towards building Inland Revenue's visibility and presence in the community as well as building a moral commitment to tax and social policy obligations. Key to this change is the movement towards proactive compliance responses.

1.17 These responses maximise the level of compliance and revenue over time by influencing social norms, increasing presence and using educational and awareness campaigns. Examples of proactive responses are set out in Figure 4 (below). The responses are designed to enable individuals to self-correct and then self-manage voluntary compliance.
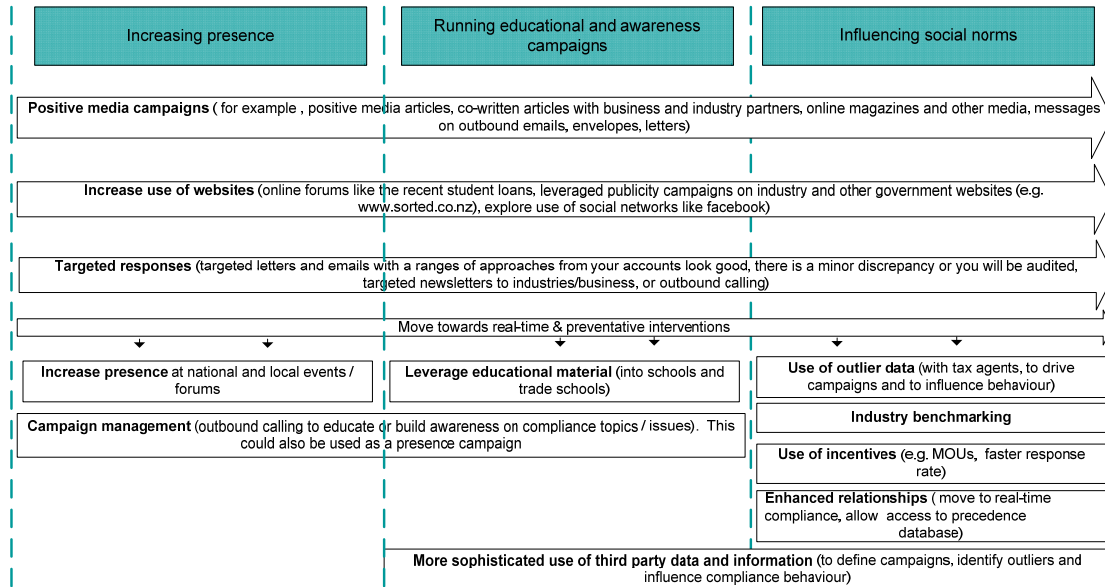

Figure 4 Examples of Proactive Compliance Responses

1.18 The responses highlighted above have a positive impact on both compliance and revenue levels. The Australian Taxation Office (ATO) recently used a similar approach that employs taxpayer communication via letters and an online magazine ("Targeting tax crime – a whole of government approach – July 09"), talking to tax agents about compliance trends, and benchmarking industries to set guides. The taxpayer letters and conversations with tax agents were particularly successful. Taxpayer letters were sent to 40,000 taxpayers within the micro and individual segment. The letters indicated that the ATO was focusing on the taxpayers. As a result of this campaign, $235m revenue was collected.

1.19 In the conversations with tax agents, compliance trends were presented and discussed. The material showed compliance for Australia at the national level, the state level and for tax agent clients. This resulted in a change in compliance behaviour the following year, where the tax agents met the previous year's state compliance level.

1.20 The Netherlands Tax and Customs Administration focussed on media publicity to publicise a voluntary disclosure scheme that allowed taxpayers to declare previously undeclared foreign bank balances without being fined. Of all the elements, normative messages in the media appear to have had the greatest positive influence.

1.21   This finding is supported by work carried out by the Swedish and UK Tax Authorities that showed that the way that a message is conveyed (either from a negative or positive reference point) influence a taxpayer's attitude towards compliance.   Messages that started with the acknowledgment that most taxpayers comply were more effective than messages that started with a negative reference point – for example, "this taxpayer was caught…."

Conclusion

1.22   Inland Revenue is responsible for maintaining the integrity of the tax and social policy systems.   Approximately $60 billion of tax payments are voluntary.   By influencing social norms, increasing presence and using enforcement (when required), it is possible to ensure and improve compliance over time and increase revenue.

1.23   Further investment in priority compliance areas, intelligence solutions, and proactive compliance responses would allow more innovative responses to be implemented faster.   This is in line with work in the Australian Taxation Office, Canadian Revenue Authority and the Swedish Tax Agency.

1.24   The compliance responses set out in this document would increase Inland Revenue's presence, allow the influencing of social norms and increase the focus applied to high priority risks.   In turn, this would result in increased revenue over time.   It is estimated that for every $100m invested, in the vicinity of five times the amount of revenue would be produced.