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The Road to Improved Compliance

A McKinsey benchmarking study of tax administrations – 2008-2009

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Contents

page

Executive summary 3

What drives performance in tax administrations: an overview 5

1. Submissions processing 13

2. Examinations 17

3. Collections 23

4. Taxpayer service 29

Appendices

Detailed methodology 33

Detailed benchmarking data 35

List of participating countries 54

Acknowledgments 55

About McKinsey & Company 57

Executive summary

Virtually every adult citizen interacts with his or her nation's tax administration. The perception that a tax administration is effective, efficient, and fair is therefore a fundamental component of public confidence in government. Today, with governments having to grapple with increasing social obligations and projections of declines in the relative size of labor workforces, tax administrations are under even more pressure to collect every dollar of tax payable, and to ensure that every dollar they spend yields the maximum benefit for citizens. The global financial crisis has only intensified this pressure.

In this quest to drive greater compliance and improve effectiveness and efficiency, tax administrations ought to be able to learn a great deal from each other. After all, they are more similar than different. The core competencies for tax administration are the same in every country: to inform and educate taxpayers of their obligations, process submissions and ensure they are accurate, collect taxes, and provide assistance to taxpayers. Understanding its own performance can help an administration create an environment where citizens have a strong will to "do the right thing," where it is easy for them to do so, and where the tax administration is seen as legitimate and fair. Yet to date no fact base has been systematically developed to allow tax administrations to benchmark their performance. Leaders of tax administrations have little more than a vague sense of how they stack up against their counterparts in other countries, and how they might improve their operations and management practices.

McKinsey's benchmarking study seeks to fill that gap. Between June 2008 and July 2009, we conducted in-depth research on direct taxes at federal tax administrations in a diverse set of 13 countries: Australia, Belgium, Brazil, Canada, Chile, Denmark, France, Ireland, Norway, South Africa, Spain, Sweden, and the United States. Our research uncovered wide variability not only in the performance of tax authorities across countries, but also in the performance of each country in the four main functions of tax administration—submissions processing, examinations, collections, and taxpayer service. Some tax administrations that excel in submissions processing, for instance, do very poorly in collections. (An explanation of our research methodology and the detailed benchmarking data are in the appendix of this report.)

We estimate that, in aggregate, the tax administrations in our study can collect an additional $86 billion in direct tax revenues. Furthermore, the countries can save nearly $6 billion by improving their efficiency across all four functions—savings that can then be reinvested in initiatives to boost effectiveness. These numbers are significant and, in our view, highly achievable. They represent the value that all 13 countries could capture if they improved their performance in each function to the average level of the top one-third of performers in that function. Most of the gains lie in improving the effectiveness of the examinations and collections functions. If the entire group of countries could raise their absolute level of performance, as we believe they can, the opportunity would be even greater. In addition, our research encompassed only direct taxes, but we believe that applying the observed best practices across tax types (including indirect taxes) would yield significant benefits as well.

The clear message of these findings is that there is vast opportunity for every country to improve. Although our sample is not fully representative, general conclusions can be drawn from our research about how to run a world-class national tax administration and how to improve performance across the four core functional areas of tax administrations. There are no obvious patterns in performance; neither size of the taxpayer population nor the complexity of the tax code appears to be relevant factors. And because none of the participating countries is a top performer across all functions, we believe that this report's conclusions will be useful to any tax administration.

As we studied patterns of best practices across the core functions, we identified the following major drivers of performance: proactive demand management, sophisticated taxpayer segmentation, streamlined operations, and rigorous performance tracking. These four practices stood out among nearly 100 investigated. We delve into each performance driver in greater detail in the first chapter of this report; the subsequent chapters then discuss the specific performance drivers relating to each of the four core functions of tax administration.

Here, we summarize some of the highlights from our study. Some are confirmations of widely held beliefs, while others were surprising both to us and to the participating countries.

- Getting taxpayers to file their taxes online ("e-filing") is indeed beneficial. However, unless a country can achieve almost 100 percent e-filing rates, the resources, facilities, and legacy systems for paper processing will need to remain in place—drastically reducing the savings from e-filing. Countries with close to 100 percent e-filing rates are substantially more efficient than even countries with as high as 90 percent e-filing rates. Tax administrations should therefore push for 100 percent e-filing, but also introduce other data-capture technologies to reduce the costs of paper processing.

- Pre-population and pre-filing certification strongly correlate with high performance. Most top performers pre-populate all the fields for individuals' tax forms and have extensive pre-certification initiatives for businesses, thereby helping taxpayers improve the accuracy of their submissions by ensuring that the forms are correct from the beginning.

- In examinations and collections, speed matters some but segmentation matters a lot. The countries that do the fastest audits, for example, are not necessarily the most effective. Segmentation, on the other hand, is a huge driver of performance. While most tax administrations use taxpayer segmentation—that is, they divide the taxpayer base into distinct groups and tailor their approaches based on the characteristics of each group—the level of sophistication and detail of the segmentation vary widely. Top performers conduct extensive research on the nature and prevalence of noncompliance, and regularly refine their segmentation based on these insights.

- The most effective tax administrations provide clear, centralized guidance to examiners and collectors through detailed business cases, templates, step-by-step checklists, and well-defined guidelines. Individual judgment inevitably comes into play, but centralized guidance eliminates some of the variability in performance and results in a more uniform and systematic approach to conducting audits and settling debts.

- Top performers track more metrics more frequently and at a greater level of detail than their peers. They are therefore better able to find gaps in knowledge or failures to follow proper procedures, helping them continually discover ways to improve effectiveness and efficiency. For example, high-performing tax administrations assess the quality of examinations by reviewing both cases in process as well as cases that are already closed.

A tax administration keen to improve performance can emulate its leading-edge peers and implement their best practices. Some of those practices are admittedly more difficult than others and would require more drastic changes in the way things are done, but none are out of reach. Given the size of the prize, tax administrations everywhere ought not to shy away from a clear-eyed assessment of their performance and a serious look at what lessons they can take from their colleagues and counterparts around the world.

* * *

This benchmarking study is an ongoing effort and can only benefit from the participation of more countries. While we intend to update the data regularly for current participants, we also welcome the participation of other countries. An increase in the number of countries contributing their data and expertise will result in even richer insights, making this exercise more beneficial for all the countries involved. For further information or to discuss potential participation in this effort, please contact Thomas Dohrmann, a principal in McKinsey's Washington, D.C., office and a leader of McKinsey's Public Sector practice. He can be reached at Thomas_Dohrmann@mckinsey.com or +1 (202) 662-0963.

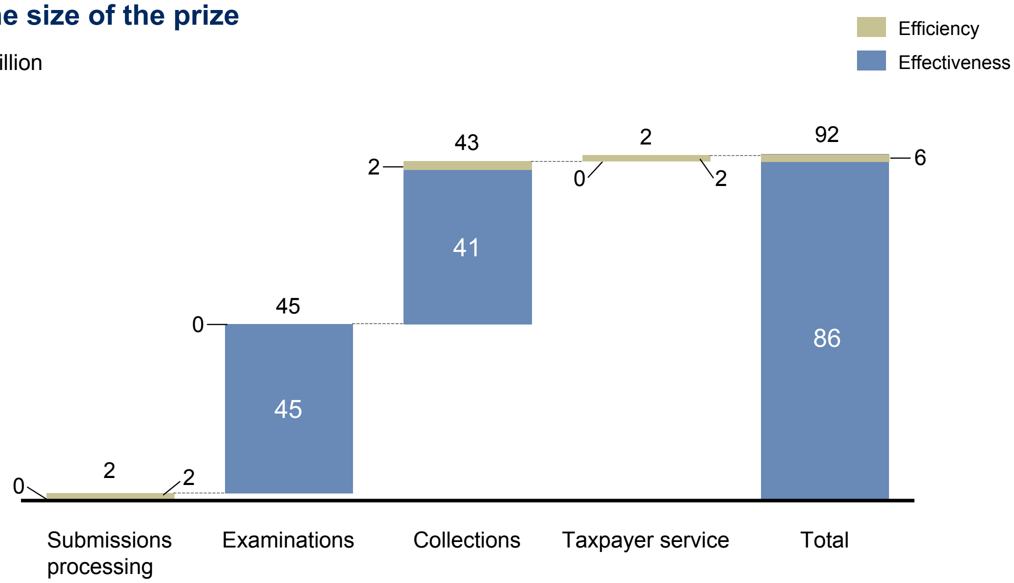
What drives performance in tax administrations: an overview

By our calculations, the 13 tax administrations in our study can collect an additional $86 billion in revenues through improvements in effectiveness and save nearly $6 billion in costs through greater efficiency *(Exhibit 1).* Although these numbers sound ambitious, we firmly believe they are achievable. They represent the total value all 13 countries could capture if they improved their performance in each of the four core tax administration functions to the average level of the top one-third of performers in that function. And if all 13 countries could raise their absolute level of performance, which we believe is a realistic goal, the gains would be even greater.

Exhibit 1

The size of the prize

$ billion



SOURCE: McKinsey analysis

In our research, we set out to determine how well countries perform—and how they can boost their performance—in the four core competencies of tax administration: submissions processing, examinations, collections, and taxpayer service *(Exhibit 2).* The chapters that follow are devoted to describing best practices in each of the following four functions.

Exhibit 2

The 4 core functions in tax administration operations

General management

Processes and behaviors that set the administration's vision and purpose and drive overall operational excellence; also includes performance management, target setting, and talent management

1 Submissions processing

- All activities involving the receiving of returns/ withholding of income; includes all cumulative (e.g., PAYE) and noncumulative withholding activities
- Does not include attempts to determine if the taxpayer paid the proper amount (beyond simple validation) or collect from delinquent or non-filing taxpayers

2 Examinations

- All activities that seek to validate and verify the balance due of a taxpayer (e.g., data checking, auditing, calculating balance due for non-filers)
- May or may not include a comprehensive audit of the taxpayer's own books

3 Collections

- The processing of collecting balance due from delinquent taxpayers; typically will include correspondence, phone, and field activities

4 Taxpayer service

Providing assistance to taxpayers with questions on filing, collections, audits, etc., through comprehensive outreach and education programs, call centers, Web sites, and tax administration offices; this is often measured through taxpayer satisfaction or wait-time lengths

SOURCE: Organization for Economic Co-operation and Development (OECD); McKinsey analysis

In assessing the performance of a tax administration, we considered both effectiveness and efficiency. Although the tax gap—the difference between the tax that would have been determined if all taxpayers had reported all of their activities and transactions correctly, and the tax determined in practice—is the key measure of tax system effectiveness, some countries do not measure it (see box, *Measuring the tax gap*). As a substitute metric for effectiveness, we used the proportion of taxes payable that are ultimately collected—a metric for which all the countries have available data. To measure efficiency, we calculated the cost of each dollar of revenue collected.

Measuring the tax gap

The tax gap is the difference between the tax that would have been determined if all taxpayers had reported all of their activities and transactions correctly, and the tax determined in practice. It is one of the most important measures of effectiveness of the policy and administration of a tax system. Five tax administrations in our sample conduct formal research to measure and analyze the tax gap in their country. While all five recognize that their findings are imperfect due to the limitations of information and methodology, they, and we, strongly believe that the research provides important and useful information.

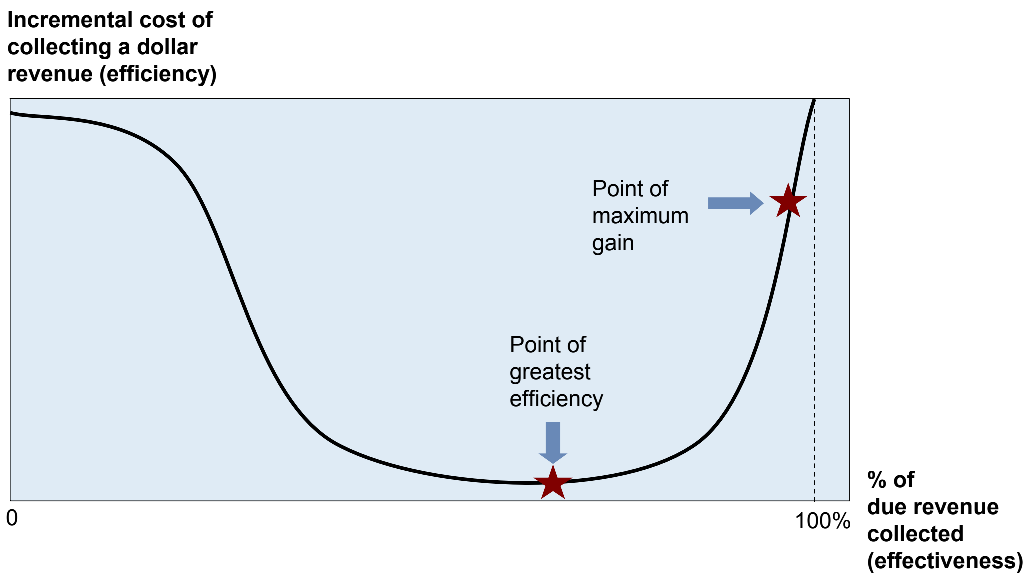
The tax administrations vary in their methodology for calculating the tax gap. One tax administration conducts only a macro-level analysis, while another calculates the size and composition of the tax gap by examining compliance of a random statistical sample across all types of returns. Other tax administrations fall between these two extremes: one complements macro-level analysis with microanalysis of a random sample of audited returns; another conducts a multi-year random sample program every three years to estimate the noncompliance rate of specific high-risk segments of individuals and small/medium-sized businesses.

Measuring changes in the size and nature of the tax gap over time is the most appropriate measure of tax administration effectiveness. A deep understanding of the tax gap can also be used to improve the effectiveness of core functions. In examinations, for instance, research on the composition of the tax gap can be used to improve the accuracy of risk profiling and exam selection.

There is naturally a point of diminishing returns, where increasing effectiveness actually decreases efficiency. As a tax administration approaches 100 percent collection, it becomes more expensive to collect each additional dollar *(Exhibit 3).* No tax administration, however, appears close to reaching that inflection point. All countries in our sample seem to have ample opportunities to improve both effectiveness and efficiency without sacrificing either.

Exhibit 3

Trade-offs in efficiency and effectiveness



SOURCE: McKinsey analysis

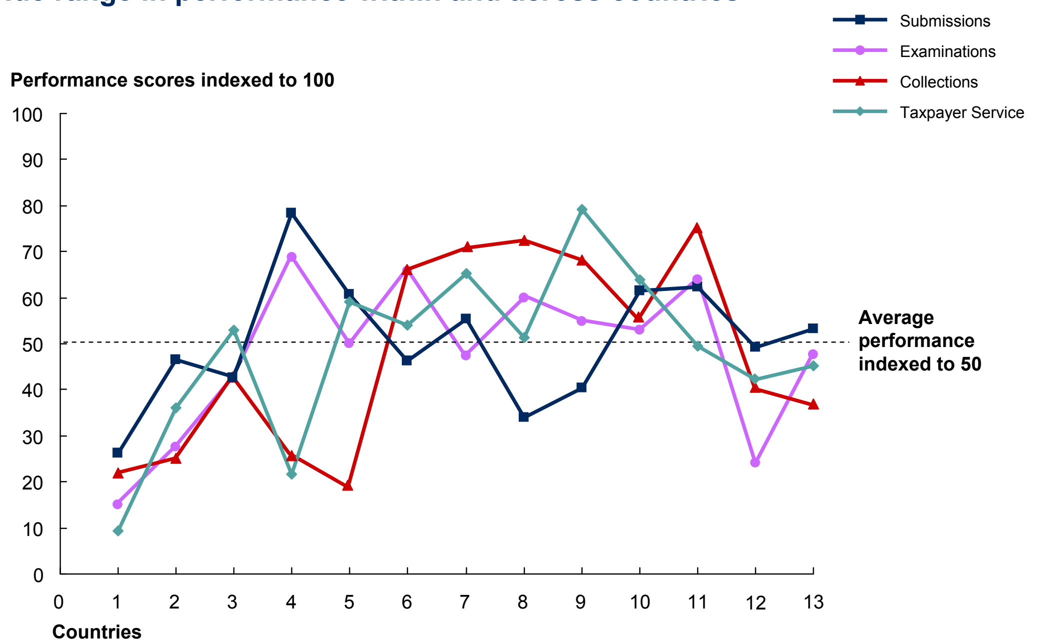
The potential gains in efficiency and effectiveness vary across functions. Most improvement opportunities in submissions processing, for example, are in efficiency, while in examinations most opportunities are in effectiveness. While the four functions are interrelated—inefficient submissions processing, for example, can adversely affect examination and collections—savings captured through higher efficiency can be reinvested in efforts to increase effectiveness. Efficiency and effectiveness are therefore additive, not zero-sum, until the inflection point is reached.

There is also an argument for tax administrations to continue investing even past the inflection point—they could invest until the incremental cost of gaining additional revenue equals the revenue gained. Because this would mean pursuing the last 10 percent or less of balance due, much of the gains would likely come from increased enforcement and greatly simplified tax structures. In many countries this could pose political, social, and cultural challenges and potentially undermine voluntary compliance. Governments and tax administrations should therefore weigh this decision carefully.

As Exhibit 4 shows, nearly every country performs above average in some functions and below average in others. Only one country performs above average in all functions, while only two are below average in all functions. Moreover, nearly every country shows a wide range of performance across functions. Clearly, neither excellent nor poor performance necessarily carries over from one function to others.

Exhibit 4

A wide range in performance within and across countries



Some of the variability is due to intentional trade-offs, an inevitable reality in light of limited resources and competing priorities. While we acknowledge the necessity of these trade-offs, both the absolute level and great variability of performance suggest substantial unrealized opportunity for every tax administration in this study.

Contrary to the expectations of both the research team and the participating countries, neither the scale (the number of taxpayers) nor the complexity of the tax code (the number of statutes as well as the political nuances involved) had much effect on a tax administration's efficiency. Regarding scale, the only possible exception in our sample was Norway, where certain challenges could arguably be attributed to lack of scale. In general we believe a tax administration can achieve most of the benefits of scale at around three million taxpayers. Because size and complexity of the tax code do not affect performance, tax administrations have a great deal of control over their success and should not rely on legislative changes to materially advance their efficiency.

Although the success factors in each core function are somewhat different, our research brought to light four major drivers of tax administration performance, each of which applies across two or more functions: proactive demand management, sophisticated taxpayer segmentation, streamlined operations, and rigorous performance tracking. These drivers should not be thought of as discrete choices, but as mutually reinforcing elements of an integrated system.

PROACTIVE DEMAND MANAGEMENT

Demand management strategies and techniques differ across functions, but in general they seek to limit the amount of work coming in to only what is truly necessary. This allows downstream processes to be at their most efficient. Most strategies focus on getting tasks right the first time, completing tasks only when necessary, and maximizing the value of each task.

In examinations, for instance, one particularly effective demand-management technique is pre-filing certification for businesses. Ensuring tax forms are accurate prior to filing frees examiners to work on other cases. In taxpayer service, high-performing tax administrations focus on making answers available to taxpayers through self-service options. One country in our sample has even discontinued walk-in service at its in-person centers, requiring taxpayers to make appointments for advice. This policy ensures that taxpayers first have a telephone conversation with agents, which often leads to the use of less expensive self-service options. Since implementing the change, the tax administration has substantially reduced service costs, wait times, and time to resolve issues at its in-person service centers.

Successful demand management in one function can lead to improvements in others. Efficient taxpayer service helps achieve a lower error rate and greater compliance, reducing demand in the other three functions. Similarly, pre-population and early validation in submissions processing reduces demand in examinations, collections, and taxpayer service. Given these relationships, tax administrations should invest in initiatives that enable taxpayers to file their taxes as easily and accurately as possible.

SOPHISTICATED TAXPAYER SEGMENTATION

Another major driver of performance is a tax administration's capabilities in taxpayer segmentation. Put simply, segmentation is the identification and classification of distinct customer groups; tax administrations can then develop customized approaches to meet the needs of each group. Taxpayer segmentation and treatment can be based on taxpayer characteristics (e.g., individual vs. business), debt characteristics (e.g., value or age of debt), and level of risk or complexity in collecting the debt. Best-practice segmentation in the collections function, for instance, includes an assessment of taxpayer willingness and ability to pay, as well as value at risk.

Different tax administrations are at different stages in their use of segmentation. One country in our sample has developed a comprehensive segmentation portfolio and continually mines taxpayer data to refine its operating model. One of the many positive outcomes has been a 15 percent improvement in customer satisfaction within a year. Other countries have only recently begun to focus on segmentation. One country, for instance, has calculated the revenue contribution of various industry sectors and has decided to prioritize one large business-taxpayer segment.

In developing their segment portfolios, leading tax administrations first define their objectives and guiding principles. This aligns the organization around key parameters such as the universe of taxpayers included (e.g., current taxpayers only, future taxpayers including students), the number of segments, and the scope of the operating model (e.g., specific functions vs. end-to-end). Top performers also look to other industries, such as consumer goods or financial services, for innovations such as behavior-based segmentation. In addition, they use both internal and external information—including taxpayer data, surveys and focus groups, government reports, and data from credit bureaus—to help them develop a granular understanding of taxpayer characteristics, behaviors, and pain points. They then pressure-test their segmentation with stakeholders and continually refine it.

Developing the segmentation portfolio of taxpayers is only one step. A tax administration must then implement differentiated operating models for each of the segments—varying, for example, the key messages, tone, and method of its communications according to the characteristics of each segment.

STREAMLINED OPERATIONS

Over the past decade, the top-performing tax administrations in our sample have streamlined their operations in two specific ways: investing strategically in IT and applying "lean" techniques.

We found that strong performance is highly correlated with effective use of IT in several functions, but not with the absolute level of IT investment. The strongest correlations between IT and increased efficiency occur where IT substantially reduces or eliminates manual work (e.g., data capture technology in submissions processing, sophisticated Web site features in taxpayer service). Although these are not always the highest-profile investments, they free up the most resources, which can then be reinvested in initiatives to improve effectiveness.

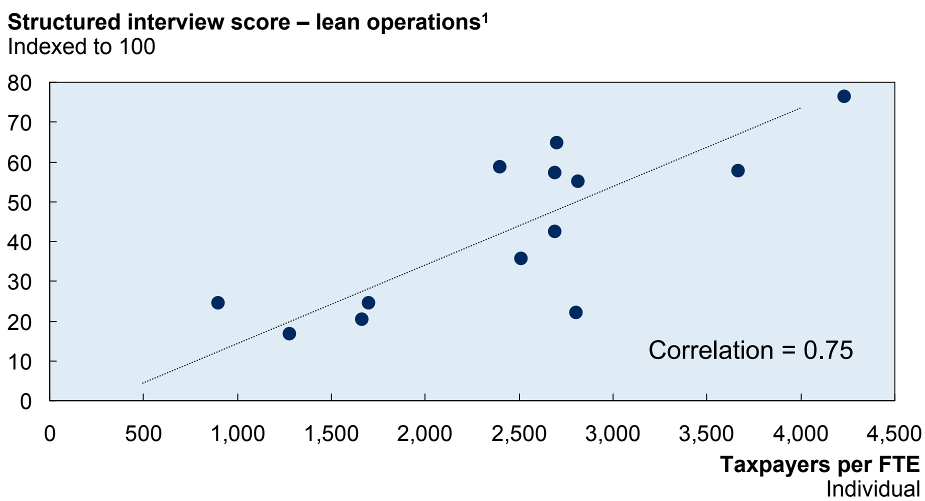
The economics involved in online filing of taxes ("e-filing") illustrates how IT investment can be deceptively difficult to target, and should be allocated strategically. Over the past few years, nearly every country in our sample has made a major commitment to increasing the rate of e-filing. Yet we found that e-filing only weakly correlates with overall efficiency in submissions processing. Countries with virtually 100 percent e-filing, however, do show some of the lowest overall costs. This could mean that countries unable to reach nearly 100 percent take-up will find the return on e-filing investment limited, because processing the remaining paper returns will remain costly.

In its 2008 report, the Organization for Economic Cooperation and Development found many tax administrations spend at least 15 percent of their total budgets on IT.[1] However, countries that spend the most on IT are not necessarily getting the most out of their investments. IT investment is more productive, in both the long and short term, when tied explicitly to strategic priorities. One country in the study provides a particularly compelling example. Prompted by a 1998 mandate to maximize revenue collected and improve efficiency, the country's tax administration began IT-enabling every aspect of its operations. By 2007, it had achieved a 97 percent e-filing rate, incorporated advanced screening techniques and risk engines into examinations, developed a taxpayer-education Web site, and collected substantial backlogs of debt. After making significant investments up front, the tax administration now spends less on IT as a portion of its total spending (about 5 percent) than any other country in our study, and has one of the most efficient FTE-to-taxpayer ratios.

Another way leading tax administrations have streamlined their operations is by applying lean techniques for eliminating waste, variability, and inflexibility *(Exhibit 5).* The idea of lean, which has its origins in manufacturing processes, is continually to strive for greater efficiency by reducing or eliminating time spent on processes and activities that do not add value, such as waiting, reworking, or handing off tasks from one person to another. Successful lean efforts launched by high-performing tax administrations include automating repetitive, labor-intensive tasks, or establishing small working units in which a manager acts as a productivity coach.

Exhibit 5

Lean operations are strongly correlated with overall efficiency



[1] Scores are based on qualitative information provided by tax administration officials during structured interviews. Lean operations was scored only in the submissions processing and general management sections; score represents the average of scores in each of these categories.

SOURCE: McKinsey analysis

One tax administration in our study undertook a substantial lean transformation in its service centers, with dramatic results. The administration's employees frequently switched between call-center duties and paper-

1 OECD Centre for Tax Policy and Administration, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2008)*, January 2009

processing activities, creating substantial waste and increasing response times for both service channels. By creating a dynamic workforce-management model and automating the simplest and most common transactions, the tax administration was able to improve taxpayer satisfaction by approximately 20 percent, while increasing productivity by 10 to 15 percent. Moreover, it reduced the time to process a paper return by half.

RIGOROUS PERFORMANCE TRACKING

The impact of IT enablement and lean efforts cannot be sustained without rigorous performance tracking, and feeding back insights gleaned from tracking into strategic and operational planning processes. Above-average performance trackers in examinations, for example, had a four-fold efficiency advantage in terms of revenue assessed per dollar spent.

High-performing tax administrations demonstrate a number of best practices when it comes to tracking. First, they track outcome metrics in addition to output metrics. Outcome metrics measure the ultimate result of an activity rather than the process; for example, customer satisfaction rather than the number of calls answered per hour. High performers also track a wide range of key performance indicators (KPIs), which help reveal how various aspects of performance are related and the trade-offs involved. The most effective tax administrations also have real-time, easily accessible data on absolute performance (for instance, revenue collected per FTE) as well as on performance trends (for instance, how this month's collections figures compare to those of last month).

Successful tax administrations also track quality, giving them a more complete view of their performance. Quality audits help ensure that processes are not only running well, but are also producing the desired results. These audits provide valuable feedback into both strategy and operations design, and can be used to identify systemic or systematic errors, provide coaching to employees, and refine processes. Quality audits are particularly relevant in examinations and taxpayer service (where individual judgment is a significant factor), but can be beneficial in every function.

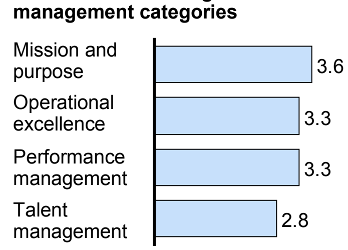
A best practice we observed in our research is the closed-file review. One tax administration reviews closed audits for procedural, technical, and computational accuracy against 22 attributes to gauge the performance of an examiner. It also produces monthly national and regional quality reports.

One interesting observation: in our benchmarking study, all 13 countries scored low in talent management (see box, *Talent management*). Tax administrations can certainly achieve greater effectiveness and efficiency through more rigorous performance tracking, but we believe with better talent management the gains can be exponential.

Talent management

The four areas identified and described in the prior pages were those that, among the nearly 100 areas we investigated, repeatedly correlated with tax administration success. Talent management also stood out. Scores on elements of talent management showed some of the lowest averages of any element measured. Given that these low scores were near universal, there was little correlation shown between talent management elements and high performance.

Talent management scores were the lowest of all the general management categories



We believe, however, that these low scores represent a substantial, unrealized opportunity to drive performance through improvements to talent management practices. In the public sector, structured coaching and mentoring, stretch opportunities and career flexibility, and non-monetary rewards for performance have proven to be major drivers of performance improvement. Applying these principles has the potential to result in substantial improvements in tax administration performance.

* * *

The potential rewards for adopting best practices in the four core functions are too large to ignore. Collectively the countries in our study stand to gain $86 billion in increased revenue and nearly $6 billion in reduced costs, if every nation in our study performed as well as the top one-third of participants. We urge all tax administrations to take action, learn from their peers around the world, and embark on a journey toward greater compliance through improved efficiency and effectiveness.

1. Submissions processing

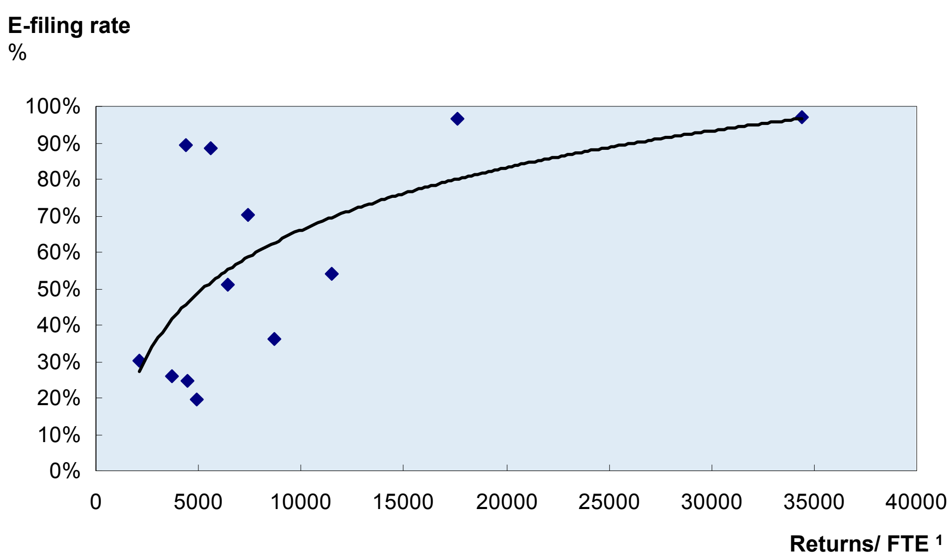
Submissions processing includes all routine activities related to the collection of taxes and provision of refunds as necessary, including the normal receiving of returns and withholding of income. In our definition of submissions processing, we include all cumulative (e.g., pay-as-you-earn) and non-cumulative withholding activities, but exclude attempts to determine whether the taxpayer paid the proper amount (beyond simple validation) or to collect from delinquent or non-filing taxpayers.

INCREASING ELECTRONIC FILING RATES

Over the last few years, tax administrations in many countries have aggressively pursued electronic filing to reduce costs and processing times. The benefits of higher e-filing rates are generally well-known and widely accepted. Our findings reaffirmed that high e-filing rates correlate with FTE efficiency *(Exhibit 6).*

Exhibit 6

The benefits of achieving ~100% e-filing rates are significant



[1] Data unavailable for 1 country.

SOURCE: Tax administration data, team analysis

Although our study confirms the benefits of e-filing, the most interesting finding is that a tax administration accrues the full benefit of e-filing only when it reaches close to 100 percent e-filing rates. The case of e-filing provides a particularly good example of how IT investment can be difficult to target. Our data show the method of filing is not the primary driver of cost; processing the remaining paper returns is far more costly. The two countries with e-filing rates above 98 percent are substantially more efficient than countries with rates as high as 90 percent. As e-filing levels approach 100 percent, the labor-intensive resources, facilities, and legacy systems dedicated to processing paper returns become unnecessary. If tax administrations were to achieve nearly 100 percent e-filing rates, they could, on average, reduce submissions processing costs by 45 percent: from $16 to $9.50 per return. Such a reduction would translate into about $2 billion in total savings for all the countries in our sample.

It is worth noting that a number of the countries in our sample do not require certain taxpayer segments to submit returns, as they operate extensive cumulative withholding mechanisms. Where taxpayers are not required to submit a tax return they are excluded from the e-filing rate calculations.

All the tax agencies in our study provide a range of incentives and services to encourage e-filing. Some countries allow taxpayers to submit their returns online for free (while charging a fee for paper forms); provide free tax-preparation software to taxpayers and tax preparers; or give e-filers an extended filing period. In addition, some countries pre-populate tax returns only if filed online. In some countries, e-filers receive their refunds much earlier than paper filers—as early as 48 hours after submission for electronic returns, compared to 60 days for paper returns. Some countries including Chile require that paper filers physically submit their tax forms at a tax administration branch, making e-filing a much more convenient option (see box, *Reaching high penetration: How Chile achieved over 97 percent e-filing*).

Reaching high penetration: How Chile achieved over 97 percent e-filing

Countries have faced several obstacles in their quest to reach 100 percent e-filing rates. Only two countries in our sample, Chile and Brazil, have managed to come close to 100 percent. Australia has also achieved a high rate (88 percent) through a disciplined process of educating and providing high levels of service and Internet access to its taxpayers.

In its efforts to boost e-filing rates starting in the late 1990s, Chile faced several barriers, including sparse Internet connectivity and the high cost of Internet usage. The low skill level of the general population meant a continued reliance on accountants and tax preparers, who, in turn, were reluctant to embrace e-filing both because they were unfamiliar with the new technology and perceived it as a threat to their profession. An unreliable postal service, combined with high levels of fraud, made mailing pre-populated forms difficult and risky. Furthermore, even as the tax administration started to promote e-filing, internal IT systems were not prepared for the massive congestion that resulted, especially in the few days immediately before the deadline.

To overcome these barriers, Chile decided to invest in—and continuously upgrade—user-friendly systems that enable taxpayers to conduct the entire tax-payment process online. Pre-population of forms reduced process time and complexity for e-filers. In addition, innovative initiatives were implemented to overcome the connectivity issue. A national public-private network of more than 880 centers, providing up to 3,000 connectivity points, was put in place. By 2007, the nationwide public and private network of Internet access points accounted for nearly half of new e-filings. Other initiatives included agreements with Internet cafés to allow taxpayers to make online submissions at no cost; training operators at access points, including shopping centers; and aggressive marketing and awareness campaigns to increase the use of access points. The government also designated specific weeks for mobile units with computers and tax agents to travel to different parts of the country to help people file their taxes online.

Besides making e-filing easier, the government offered incentives to taxpayers to file returns online. While e-filers were offered early refunds, paper filers were required to submit their tax forms at tax-administration branches or kiosks. The government also put in place selective mandates that required businesses and large taxpayers to submit returns online.

Figure 1: Trends in e-filing rates, 1999-2007
Percent

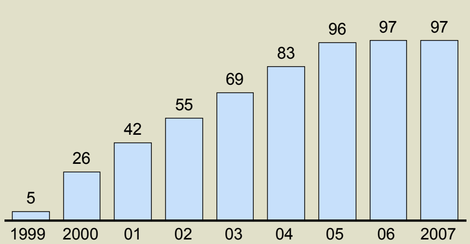
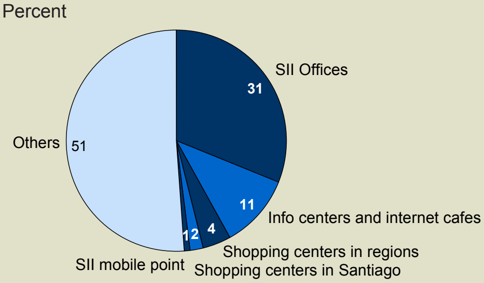


Figure 2: Breakdown of e-filed return source, 2007
Percent



Source: Servicio de Impuestos Internos (Chile), tax administration data, interviews

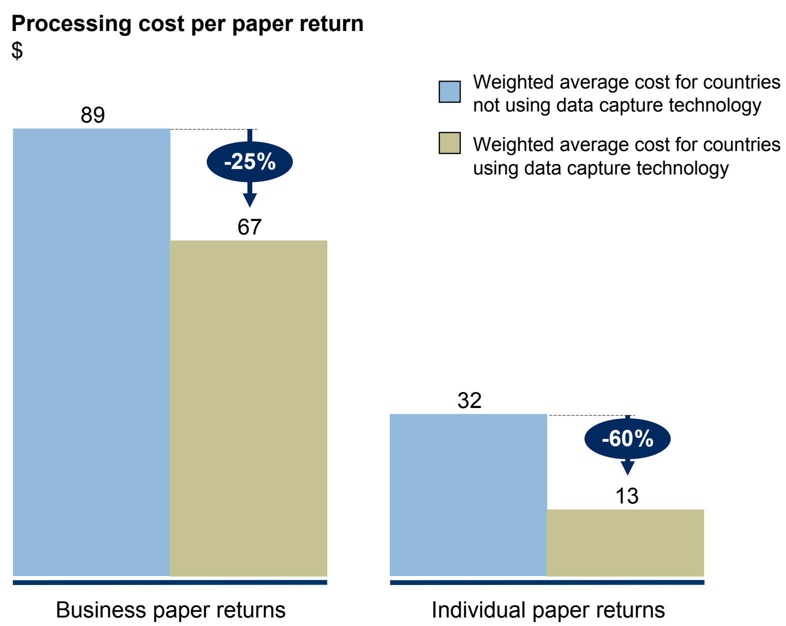
ENHANCING PAPER PROCESSING EFFICIENCY

The likelihood of achieving an e-filing rate near 100 percent is understandably lower in certain countries due to various constraints, including low Internet penetration, aversion to technology, and regulatory policy. In such cases, data capture technology must supplement attempts to push e-filing rates higher. We found that countries with low e-filing rates (below 35 percent) that use data capture technology are, on average, 20 percent more efficient than countries with e-filing rates between 70 and 85 percent but which do not use data capture technology. Data capture technology could reduce processing costs by 25 percent, bringing down the average processing cost for our sample of countries from $16 to $11.50 per return (assuming e-filing rates remain constant). This would translate into about $550 million in aggregate savings for the countries in our sample.

The two most commonly used data capture technologies are optical character recognition (OCR) and bar-coding. Concerns regarding the efficacy of OCR technology have declined considerably in recent years. Several countries report that the latest OCR technology enables accurate scanning of more than 95 percent of paper-filed returns—similar to or better than manual entry. Furthermore, top performers have adapted their tax returns to ensure accurate and easy OCR readability through simple changes such as removing free-text boxes from the forms, providing an adequate number of lines per entry, and using extensive pre-population. By adopting OCR technology, countries can, on average, reduce paper-processing costs for business paper returns by 25 percent and for individual paper returns by 60 percent *(Exhibit 7).*

Exhibit 7

Data capture technology reduces processing costs for paper returns



SOURCE: Tax administration data, team analysis

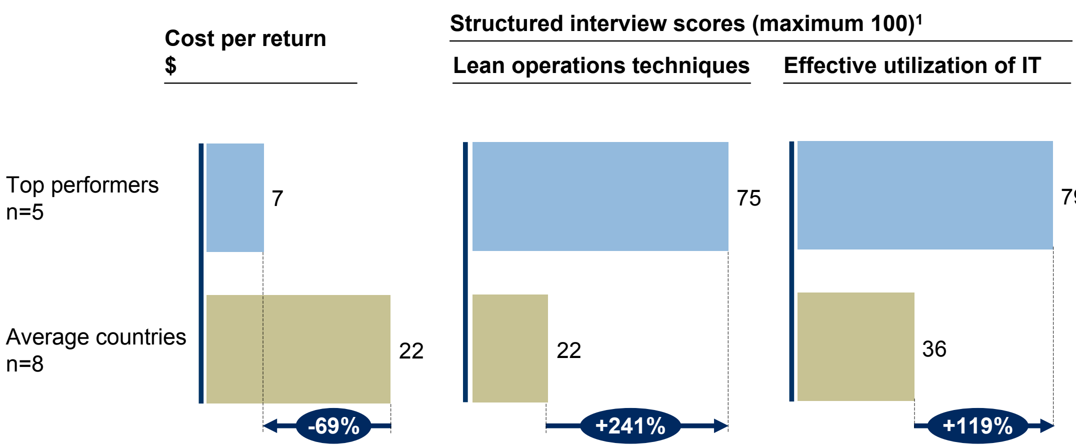
An alternative to OCR is machine-readable 2-D bar codes placed on the computer-prepared paper form. The bar codes are updated automatically as the taxpayer types in the data. The taxpayer prints the form and submits it, usually via postal mail. The tax administration then scans the form to extract all the data automatically. Countries making extensive use of bar-coded paper forms also achieve significant efficiencies.

On occasion, countries have adopted sophisticated technologies but have not tailored them in such a way that they can be used widely or easily by taxpayers and tax administration employees. A key aspect of using either of the two technologies is ensuring the technology is effective and user-friendly.

Our findings suggest countries continuing to process a significant number of paper returns would benefit not only from effective use of IT, but also an increased focus on lean operations *(Exhibit 8).* Almost all top performers use variable hiring, for example—they either assign employees from other divisions of the tax administration to help handle processing demands during peak seasons, hire temporary staff, or outsource processing to external vendors.

Exhibit 8

Key operational drivers of submissions processing efficiency



[1] Scores are based on qualitative information provided by tax administration officials during structured interviews.

SOURCE: Tax administration data, team analysis

There are several further opportunities for all the countries in our sample to improve efficiency by adopting lean techniques. For example, one country currently requires taxpayers to submit tax returns to regional offices, which then send the paper returns to a central location for processing. The country could reduce transportation costs and wasted time by allowing taxpayers to mail their forms to the central location directly. In addition, early and automated validation of returns could prevent data errors from entering the system, reducing the need to manually re-enter data. Other, more ambitious options for efficiency improvement may require legislative action—for example, adopting different submission deadlines for different taxpayer segments, to even out workflow throughout the year.

* * *

The 13 countries in our sample stand to save a total of about $2 billion in processing costs by approaching e-filing rates of 100 percent. For this reason tax administrations should continue to push e-filing as the preferred mode of submission. If, however, they confront insurmountable obstacles to achieving close to 100 percent e-filing rates, countries should adopt data capture technology, which can also provide considerable efficiency benefits and result in about $550 million in aggregate savings for the 13 countries in our sample. Lean operations techniques should underpin each country’s submissions-processing strategy. Making it easy for taxpayers to submit tax returns will not only boost compliance, but also streamline examinations processes and provide a foundation for improved taxpayer service.

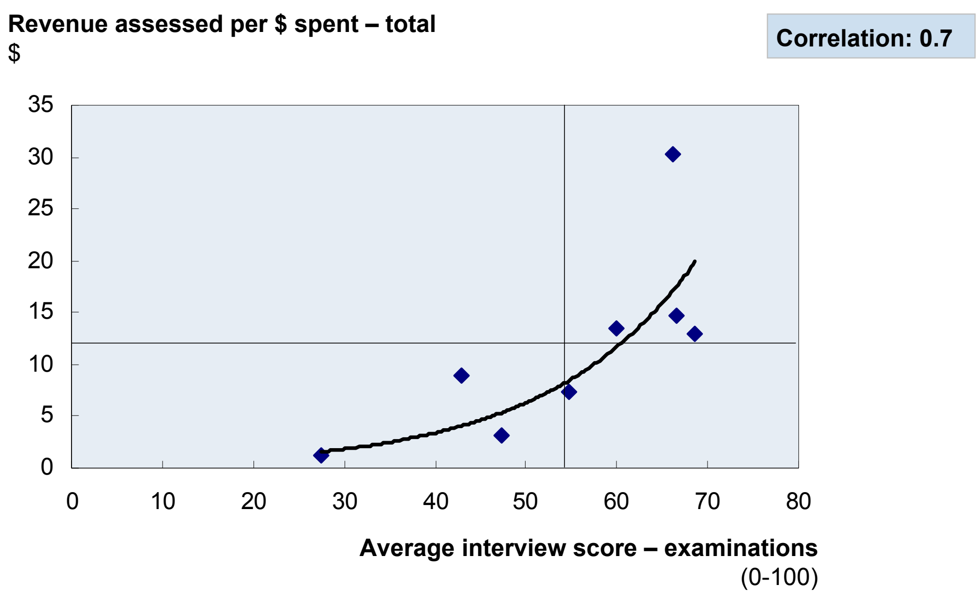
2. *Examinations*

Our definition of the examinations function encompasses issue-specific and comprehensive auditing; calculation of balance due for non-filers; and all proactive efforts undertaken to increase compliance, such as outreach programs and deterrence initiatives. The variation in examinations performance within our sample suggests most tax administrations have sizeable opportunities to improve their operational practices in this particular function and thereby reduce the tax gap. We measure the effectiveness of examinations based on revenue assessed per dollar spent.

Top-performing tax administrations in examinations are significantly more effective than others in our global sample *(Exhibit 9).* The best performer is 2.3 times as productive as the next two highest performers, which in turn are 2.6 times as productive as the remaining administrations. We estimate tax administrations could, on average, increase revenue assessed per dollar spent by 270 percent (when the difference in revenue assessed across countries is weighted). This represents up to $42 billion in additional revenue assessed for our global sample, with the same level of resource investment. (Our estimate of the size of the opportunity excludes adjustments made due to errors in the submissions phase.)

Exhibit 9

A clear group of top performers emerges in examinations



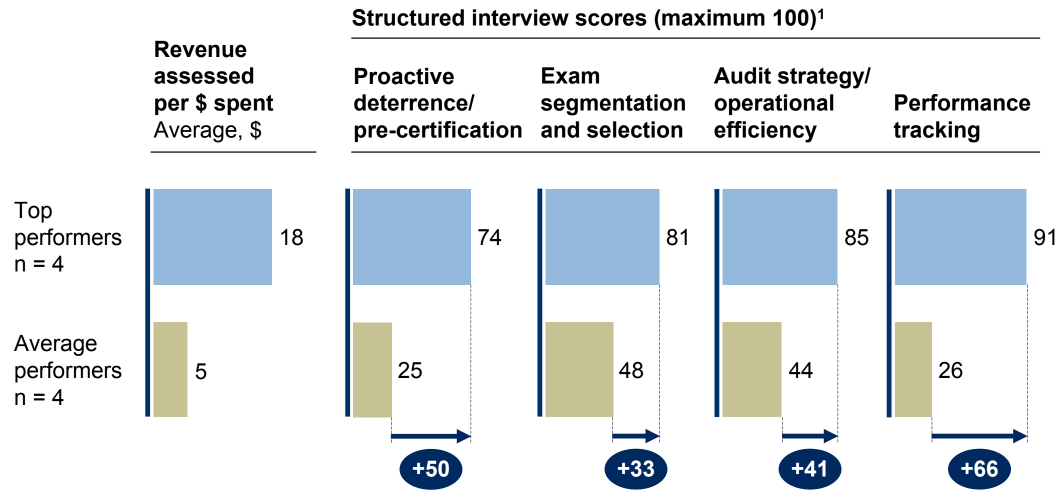
Note: Data unavailable for 5 countries.

SOURCE: Tax administration data

Contrary to our expectations, faster does not necessarily mean better in the examinations process. Faster start cycles and shorter audit durations are not correlated with high performance. What our research did reveal is a substantial correlation between effectiveness in examinations and distinctive practices in the following areas: proactive deterrence, sophisticated exam segmentation, centralized guidance on audit strategy, and rigorous performance tracking *(Exhibit 10).*

Exhibit 10

Drivers of effectiveness in examinations



[1] Data unavailable for 5 countries. Scores are based on qualitative information provided by tax administration officials during structured interviews.

SOURCE: Tax administration data; team analysis

PROACTIVE DETERRENCE

A tax administration's proactive efforts at deterrence, including awareness campaigns and pre-filing activities, can have tremendous impact on the performance of the examinations function. If successful, proactive deterrence can improve the accuracy of tax forms filed, boost compliance, and substantially reduce examiner workloads. This applies to both under-declaration as well as over-declaration (and hence overpayment).

Outreach and awareness campaigns

Top performers mount integrated awareness campaigns targeted at the taxpayer segments that pose the highest risk for noncompliance. For example, they send issue-specific letters to targeted taxpayer groups (e.g., reminding restaurant owners to report gratuities as income), or they partner with industry associations and labor groups to provide guidelines on how to be compliant. One top performer developed an outreach program at trade schools targeted at construction workers, a high-risk segment for noncompliance. Another top performer launched a bold media campaign aimed at young taxpayers, with a strong message against illicit labor. An evaluation of the campaign, conducted by an objective third party, indicated that it had indeed succeeded in changing the attitudes of its target audience.

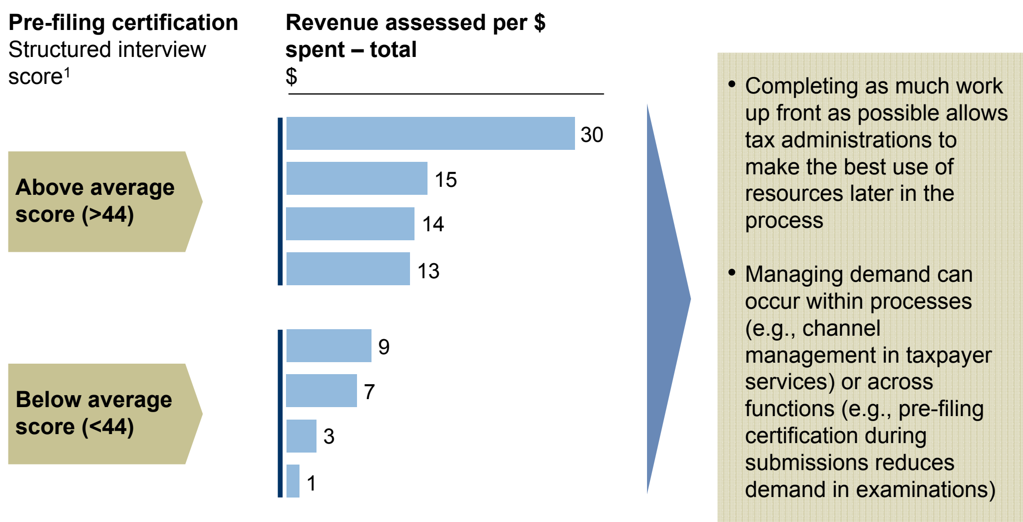
These targeted deterrence efforts are usually supported by a strong focus on high-risk segments in the examinations process itself. High-risk taxpayers are audited more often; in some cases all members of a high-risk taxpayer group are selected for detailed inspection.

Pre-filing certification

Through pre-filing certification programs and initiatives, high-performing tax administrations help both individual and business taxpayers file their returns correctly, thereby reducing demand in the examinations function and improving efficiency *(Exhibit 11).*

Exhibit 11

Pre-filing certification strongly correlates with efficiency



[1] Data unavailable for 5 countries. Scores are based on qualitative information provided by tax administration officials during structured interviews.

SOURCE: Tax administrations; interviews; McKinsey analysis

1. Pre-population for individuals. Top performers utilize pre-population to improve the accuracy of individual returns. All but one of the top performers pre-populate certain fields in individual returns; most top performers pre-populate the entire form. As mentioned earlier, some countries pre-populate only tax returns filed online in order to encourage e-filing.

For a tax administration to accrue the maximum benefits from pre-population, the accuracy of the pre-populated fields becomes crucial. To this end, high-performing countries mandate that third parties—including employers, banks, insurance companies, health-benefit providers, and money managers—provide information about taxpayers on a regular basis. They also maintain historical records of taxpayer returns. Countries must make extensive use of third-party and internal data to validate pre-populated returns before they are sent to the taxpayer for review, particularly in those countries where taxpayers can simply accept their pre-populated returns as correct. In addition, tax administrations should strive to validate information submitted by taxpayers against data received from third parties.

2. Pre-filing certification and assistance for businesses. Top performers have extensive pre-certification initiatives for businesses. These initiatives include what some administrations term "pre-filing agreements" or "co-operative compliance agreements." Most top performers focus on large businesses, but at least one tax administration also has pre-filing certification activities for small and medium-sized businesses. They work collaboratively with businesses and their tax advisors throughout the year to improve the accuracy of returns through guidance, compliance review, and issue resolution. They publish issue-specific guidelines in historically confusing areas of the tax code and spell out positions that, if adhered to in the filing process, will not be challenged by the tax administration. The guidance papers are incorporated in education and assistance programs targeted at businesses.

SOPHISTICATED EXAM SEGMENTATION

Top performers employ comprehensive segmentation methodologies based on extensive research into the nature and prevalence of noncompliance. They generally segment taxpayers first by taxpayer type (e.g., individuals vs. businesses), income, and industry sector. They then use automated filters and risk-scoring models to further segment taxpayers based on level of risk and potential yield. In addition, one top performer segments taxpayers based on their attitude towards compliance (e.g., “are willing to comply” vs. “have no intention of complying”).

High-performing tax administrations conduct extensive research and analysis on the tax gap in order to understand taxpayer characteristics and the nature and sources of noncompliance: which groups of taxpayers are at highest risk of noncompliance? How much of the tax gap is due to specific groups of taxpayers underreporting income? How much is due to them overstating their expenses? The resulting taxpayer segmentation then serves as the basis for tailoring enforcement strategies.

Top performers use automated risk-scoring models to prioritize cases for audit, supplementing these automated processes with manual reviews to identify cases for detailed inspection. An independent, specialized group within the examinations function generally conducts exam selection. Top performers seek to optimize revenue assessed (hit rate multiplied by yield) and therefore focus on higher-risk segments, but they also ensure appropriate coverage across segment types through random audits.

High-performing tax administrations update their examination selection processes regularly to enhance their effectiveness. They use findings from detailed tax gap research and other forms of noncompliance research to update risk-scoring formulas. They also research trends proactively, account for anomalies observed by examination staff, and analyze new tax schemes to improve their ability to detect noncompliance.

CENTRALIZED GUIDANCE ON AUDIT STRATEGY

For top performers, most audits are focused on a specific issue within a certain taxpayer segment (e.g., ensuring self-employed individuals are reporting work-related expenses honestly and accurately), but can be expanded progressively based on findings during the audit. One tax administration starts and ends more than 90 percent of individual examinations as issue-specific examinations. Another top performer’s biannual audits of all large taxpayers start with clear hypotheses and expand to additional areas if required.

To ensure a uniform and systematic approach to conducting audits, top performers provide centrally developed audit guidance to all examiners. One high-performing tax administration develops a detailed business case, step-by-step audit guides, and checklists for issue-specific examinations. These are tailored to major taxpayer segments defined by size, sector, and participation in activities liable to fraud. Each checklist details the mandatory and discretionary steps involved in the examinations, the amount of time that should be devoted to each case, and the skill level of examiners required to handle such cases. Channels (e.g., correspondence, field examinations)—and, in many cases, even resources—are assigned centrally.

1. Targeted correspondence. Top performers address a large majority of cases—often more than 75 percent—through correspondence. One top performer treats 88 percent of cases through correspondence and less than 2 percent through field examination. The vast majority of cases handled through correspondence are also resolved in this channel, with between 80 and 88 percent of cases resulting in a change in what the taxpayer owes. Although top performers generally do not assign a single point of contact for individual correspondence exam cases, they often do so for business correspondence exam cases. To encourage compliance, most top performers allow taxpayers to submit documentation and pay balances electronically. They also have ongoing processes in place to refine the tone, language, and key messages of notices based on the input of taxpayer focus groups.

2. Field examinations. Top performers tend to specialize their field examinations staff by industry, facilitating the development of deep industry-specific knowledge. This knowledge is complemented with broader issue-based experience due to mandated staff rotation—an examiner must rotate off a specific issue after a certain period. Other top performers specialize their examination staff for large business examinations. In one country, the largest 3,000 businesses are audited by a special examinations unit in which many of the examiners have industry-specific expertise.

RIGOROUS PERFORMANCE TRACKING

Top performers have the most rigorous and comprehensive performance-tracking practices of the tax administrations in our sample. They track more metrics, more frequently, and at a greater level of detail. One tax administration tracks 16 metrics and analyzes the data at multiple levels of disaggregation. It generates most of its performance reports monthly, with some quarterly, bi-weekly, or even weekly.

Another high performer maintains a database that monitors all office-based and field exam actions and documents. Using the database, the tax administration can keep track of key metrics (e.g., revenue assessed, audit duration) for each case in near real time. The system is useful for revealing gaps in knowledge or failures to follow proper procedures, helping the tax administration constantly find ways to improve both the effectiveness and efficiency of examinations.

At high-performing tax administrations, the quality of examinations is assessed through a review process. Most conduct reviews of cases that are in-process as well as cases that have been closed, and some provide quarterly performance assessments of each industry group.

* * *

Contrary to what some might believe, the speed at which audits are completed is not an important driver of examinations performance. Much more critical are proactive deterrence, sophisticated taxpayer segmentation, a clear audit strategy, and rigorous tracking and quality management. At stake for the 13 countries in the sample are gains in effectiveness of up to 270 percent. This translates into $42 billion in additional revenue assessed—a prize well worth the effort.

3. Collections

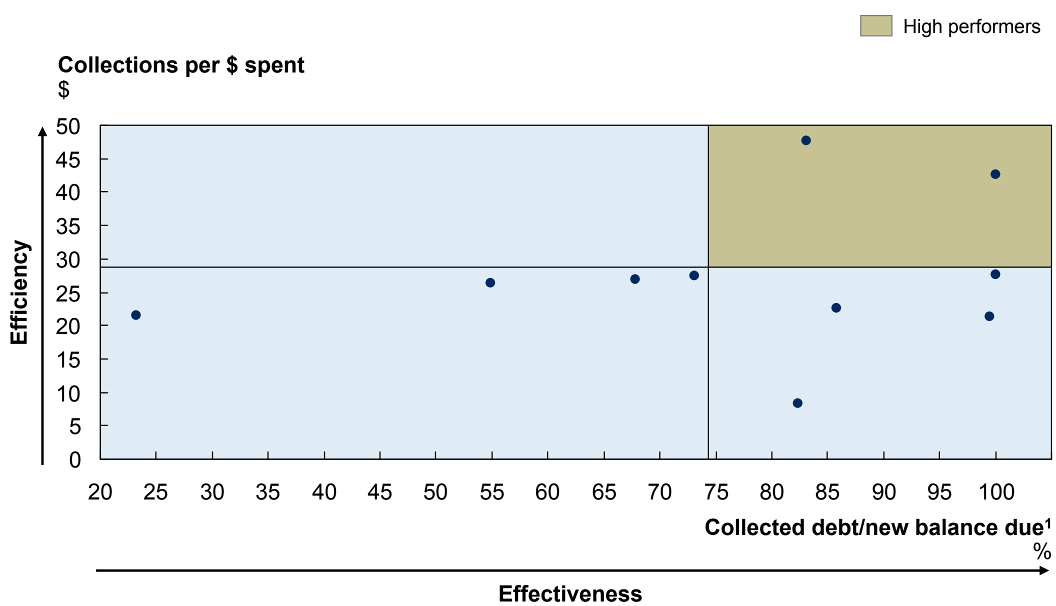
In the current macroeconomic environment, the collections function—responsible for collecting balances due from delinquent taxpayers through correspondence, telephone, and field activities—has taken on even greater importance. Improved performance in collections could provide much-needed additional revenue at a time when tax revenues are declining considerably.

The value at stake, both in effectiveness and efficiency, is substantial. If those countries that are least effective in collections were to achieve the effectiveness of middle-tier countries in our sample, and if middle-tier countries were to achieve top-tier effectiveness, we estimate that they all would boost their effectiveness by an average of 25 percent. For our sample that represents an additional $40 billion in revenue collected, and the collection of slightly more than 90 percent of their new debt. In terms of efficiency, we estimate that if countries can match the efficiency levels of the upper half of performers in our sample, they could reduce costs by 35 percent. And if they can become as efficient as the top three countries in our sample, they could reduce costs by as much as 45 percent.

As Exhibit 12 shows, only two countries in our sample emerged as both efficient (based on revenue collected per dollar spent) and effective (based on share of new debt collected) in collections. Only one of those countries excels in managing the share of debt entering the collections stage. A handful of other countries are either highly efficient or effective, but not both.[2]

Exhibit 12

The efficiency-effectiveness matrix in collections



1 Data unavailable for 1 country. For two other countries, the new balance due forms a significantly higher share of their total tax agency revenue.

SOURCE: Tax administration data, team analysis

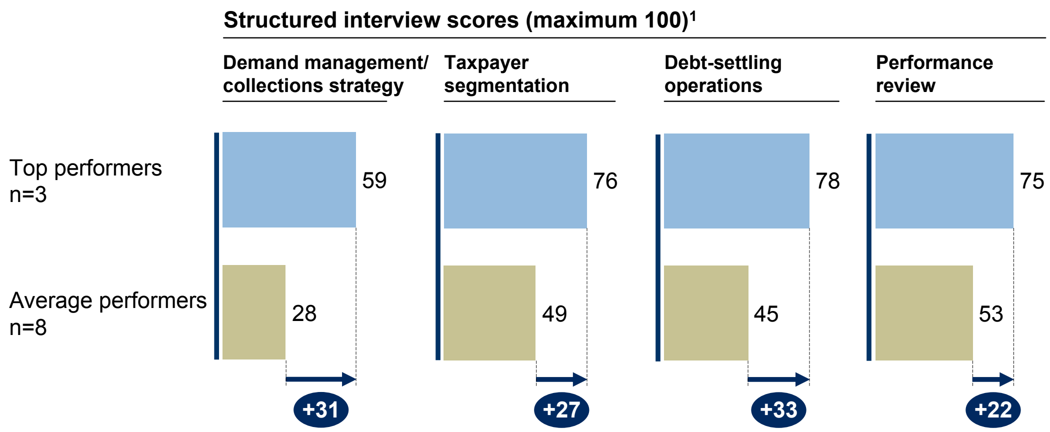
2 We considered several measures of effectiveness; we used this metric (the share of new debt collected) in order to avoid the discrepancies caused by large stocks of outstanding debt or different write-off policies in the various countries.

In 2007, most countries in our sample collected 65 to 85 percent of their new balance due. Two countries collected revenues in excess of their new balance due—that is, they collected most of their new debt as well as some of the backlog.

We found, counterintuitively, that tough unilateral action—for example, freezing a delinquent taxpayer's assets—correlates weakly with high performance, and that timeliness in collections (i.e., quick turnaround of different stages of the collections process) does not have as high an impact on performance as expected. The more important drivers of collections performance are demand management, taxpayer segmentation, streamlined debt-settling operations, and performance tracking *(Exhibit 13).*

Exhibit 13

Key operational drivers of performance in collections



[1] Data unavailable for 2 countries. Scores are based on qualitative information provided by tax administration officials during structured interviews.

SOURCE: Tax administration data; team analysis

DEMAND MANAGEMENT

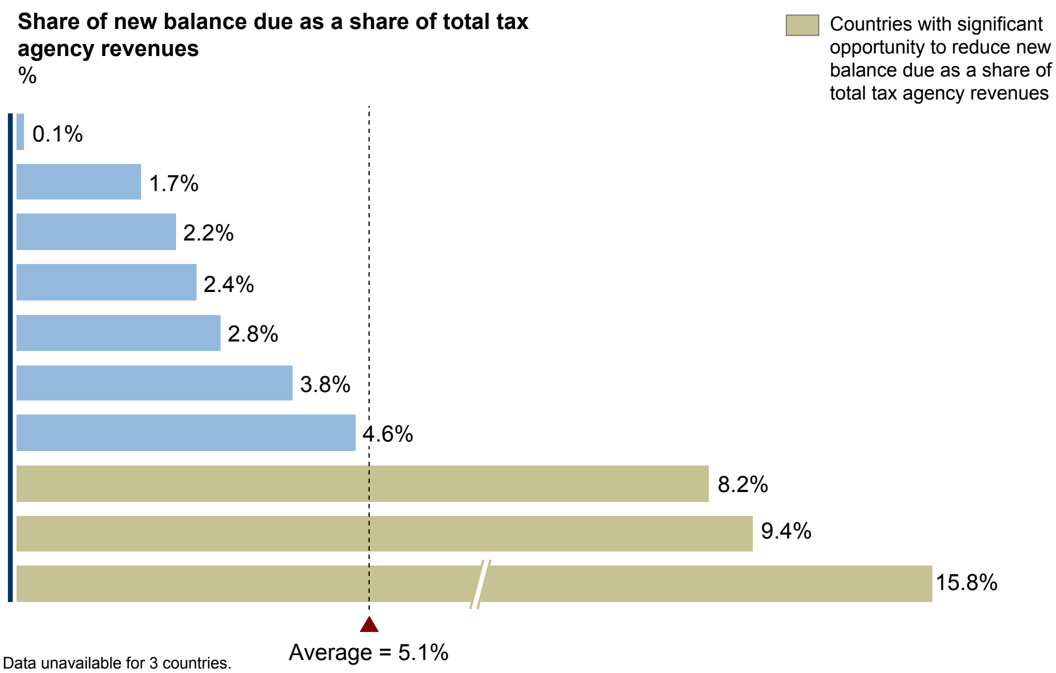
Demand management in collections is about minimizing new balance due as a share of total tax-administration revenue—in other words, reducing the share of debt entering the collections stage. New balance due as a share of total tax administration revenues was less than 5 percent for most countries in our sample *(Exhibit 14).* But even those countries with small shares of collections-stage debt have opportunities to improve their efficiency and effectiveness.

Countries can reduce the balance due entering the collections phase in a number of ways. One, which would require legislative action and substantial operational change, would be to establish a dynamic pay-as-you-earn system like Ireland's. Such a system not only withholds taxes but also adjusts, at regular pay intervals, the amount of tax withheld from individuals. Another option might be to require payment of the entire debt at the submissions stage. While this requirement would theoretically decrease the amount of balance due entering the collections stage, its impact on compliance needs further study.

Countries can also conduct a risk-based analysis for initiating collections action. Many countries in our sample wait too long—sometimes more than 100 days—before initiating action. Our experience in private-sector collections suggests that as debt ages, the likelihood of it being collected declines. Some countries take the opposite approach, classifying balance due as debt immediately, and initiate collection activities even in cases that might have eventually resolved themselves. Tax administrations should understand the patterns and timing of how taxpayers pay their taxes (e.g., the number of days after which past-due taxes are unlikely to be paid) and conduct a cost-benefit analysis to identify the optimal points for initiating collection activities.

Exhibit 14

New balance due is less than 5% of revenues for most tax agencies



Note: Data unavailable for 3 countries.
SOURCE: Tax administration data

TAXPAYER SEGMENTATION

While most tax agencies use taxpayer segmentation, the sophistication and detail of the segmentation vary widely. The criteria for segmentation usually fall into three categories: taxpayer characteristics, debt characteristics, and risk or complexity of debt collection. The criteria should vary depending on the country context, and should be refined regularly to ensure segmentation can translate into differentiated processes that lead to greater effectiveness. A country might segment taxpayers by geography for a few years, for instance, before deciding it is an unhelpful segmentation because the same processes work well across geographic regions. Exhibit 15 shows the criteria used by one of the countries in our sample. This list is the result of several iterations and prioritization based on the country's previous experience.

Once they have segmented the cases, high-performing tax administrations determine the probability of default based on the taxpayer's ability and willingness to pay. Ability to pay is determined by analyzing the taxpayer's financial situation and by contacting the taxpayer, while willingness to pay is assessed largely through contact with the taxpayer and analysis of previous payment behavior. The tax administration then considers taxpayers' probability of default and their debt value to calculate the value at risk (VaR). The cases with the highest VaR are given top priority and allocated first to collectors.

Effective segmentation, combined with early validation of debt, ensures resources are allocated to cases that will yield the highest returns; dynamic risk scoring enables tax administrations regularly to re-prioritize and reallocate resources to cases with higher-risk profiles. One country in our sample updates risk profiles weekly.

Effective tax administrations tailor their collections strategies to each segment, and regularly adjust these strategies based on new insights. Top performers in collections take into account both VaR and cost to serve when determining collection channels. For high-value and/or high-risk cases, top performers initiate contact both by mail and in person, whereas lower-risk or lower-value cases receive only a form letter. Top performers customize the message and tone of letters to delinquent taxpayers based on the taxpayer's characteristics and risk profiles. Customized letters are significantly more effective than standard form letters, as shown by the experience both of top-performing countries and of private-sector companies.

Exhibit 15

Criteria that can be used to segment debt and debtors

Taxpayer characteristics

- Entity type
- Tax type
- Geography
- Estate vs. live
- Taxpayer's trading status
- Compliance history

Debt characteristics

- Value of debt
- Source of debt
- Previous outcome approved for case
- Age of debt
- Multiple tax types
- Capital vs. penalties, interest, and additional tax

Risk/complexity to collect

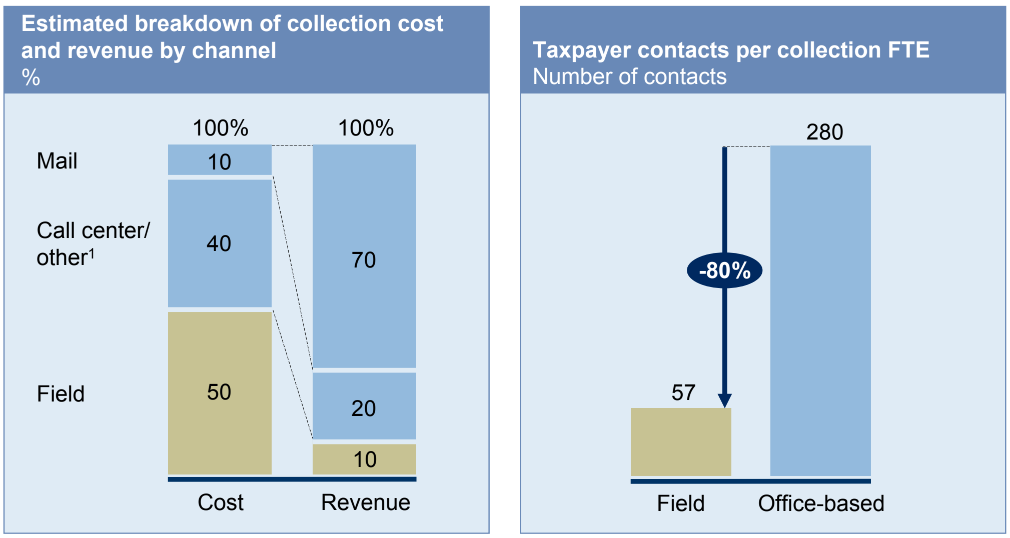
- Fraudulent intent
- Taxpayer agreement on debt amount
- Correctness of taxpayer contact details
- Financial situation of taxpayer
- Taxpayer trustworthiness and willingness to pay

SOURCE: Tax administration interviews; McKinsey analysis

Tax administrations also use segmentation to determine contact strategy. High-value, complex cases—those that require field-based surveys, for instance—are assigned to the field force, and most other cases are assigned to call-center agents and other office-based staff. Our findings suggest the use of office-based staff allows the administration to initiate several times as many contacts with taxpayers as field-force personnel—almost five times more in one country in our sample. Field forces are also usually more expensive *(Exhibit 16).* Accordingly, high-performing countries shift away from the traditional placement of higher-skilled personnel in field operations and toward call-center collections operations and other office-based communication instead. Tax administrations are also using techniques such as sophisticated forecasting, flexible scheduling, and workforce management (e.g., performance and consequence management) to optimize call-center productivity.

Exhibit 16

Field forces are more costly and less efficient than office-based options



1 Includes estimate of all collection revenue/cost not captured in field or mail.

SOURCE: Tax administration interviews; McKinsey analysis

DEBT-SETTLING STRATEGIES

Top performers have dedicated personnel focused on understanding the particular characteristics of each case (often described as a "case work" approach to debt and compliance management). To facilitate debt settling, top performers offer taxpayers flexible installment agreements based on an assessment of their financial situation, occasionally negotiating interest payments and penalties. Some installment agreements let taxpayers pay over a 3- to 5-year period for small to medium-sized debts, and up to 10 years for large debts. Only two countries in our sample reduce the amount of the debt, and even those countries do so very infrequently.

Top-performing administrations give tax agents clear guidance—for example, in the form of simple templates and scripts posted at agents' workstations—about the nature of flexible arrangements that can be offered. The guidelines include timelines for finalization of agreements (e.g., within 15 days of contacting the taxpayer), down-payment requirements (e.g., at least 25 percent, and up to 40 percent in very high-risk cases), minimum repayment periods, and projected interest. Direct debit installments or payroll deductions are often used to ensure compliance with the agreement, and agents are instructed to make clear that if an arrangement breaks down, enforcement will be undertaken as soon as possible.

The recruitment process for debt-settlement representatives ensures new hires have the requisite experience and capabilities to handle collection negotiations. They are given significant training and constant on-the-job coaching. Regular reviews at the team level and formal quality assessments of random cases also ensure the technical accuracy of case handling and provide the foundation for improved performance.

PERFORMANCE TRACKING

Top performers in collections rigorously track the performance of the entire collections unit as well as individuals, against the most critical measures. They communicate these results to staff, and adjust and improve their operations accordingly. The performance-tracking measures allow tax administrations to assign cases based on individual capabilities, alter channel strategy as needed, and develop appropriate coaching plans.

The best-performing collections functions track several unit and individual KPIs on daily, weekly, and monthly bases. In addition to typical KPIs, such as debt collected and number of cases finalized vs. number outstanding, other KPIs are also measured, such as the percentage of first-time debtors contacted within 7 days or the share of payments made by due date. Some also measure debt collected as a share of gross revenue, a metric of the significance of the collections function for the administration. Targets are set for the division and then cascaded to individual employee targets. The results are communicated to all staff members and coaching plans are designed based on the performance reviews.

Top administrations also use quality audits to improve effectiveness. Team leaders in one tax administration listen in on selected phone calls along with the representatives and provide immediate feedback; they also monitor the number of arrangements made over the phone and how those arrangements fare over time.

* * *

Even in countries where the new balance due accounts for a very small percentage of total tax administration revenues, there is ample opportunity for boosting effectiveness and efficiency in collections. If the least effective countries in collections were to achieve even middle-tier effectiveness, and if middle-tier countries were to achieve top-tier effectiveness, the result would be an additional $40 billion in revenue collected. With increasing pressure on the collections function to pursue every dollar payable, tax administrations should take note of the performance drivers in collections—demand management, taxpayer segmentation, streamlined debt-settling operations, and performance tracking—and implement best practices in these areas.

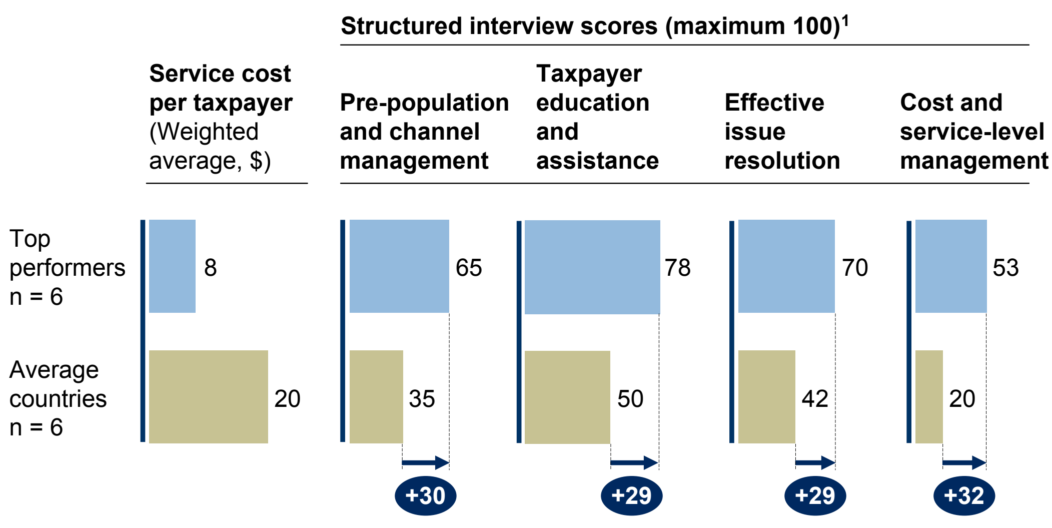
4. Taxpayer service

We define taxpayer service as any activity that involves providing assistance and answers to taxpayers who have questions about filing, collections, audits and other issues. Service is provided through multiple channels including call centers, Web sites, mail, and tax administration offices. By adopting efficient and effective operating practices in taxpayer service, tax administrations can not only reduce costs but also boost taxpayer satisfaction. Moreover, improvements in taxpayer service help increase the likelihood of voluntary compliance, in part by making it easier for taxpayers to comply.

Top-performing tax administrations report relatively high levels of taxpayer satisfaction as measured against their own indices, and high levels of efficiency based on service cost per taxpayer. The weighted average service cost per taxpayer for top performers is 2.1 times less than the weighted average for other tax administrations. If the highest-cost tax administrations were as efficient as the lowest-cost tax administrations, they could achieve a total cost reduction of up to 48 percent, representing approximately $1.7 billion in savings. Our study of top performers in taxpayer service indicates that demand management, taxpayer education and assistance, effective issue resolution, and a focus on costs and service levels are four key drivers of performance in taxpayer service *(Exhibit 17).*

Exhibit 17

Key drivers of performance in taxpayer service



1 Data unavailable for 1 country. Scores are based on qualitative information provided by tax administration officials during structured interviews.

SOURCE: Tax administration data; team analysis

PROACTIVE DEMAND MANAGEMENT

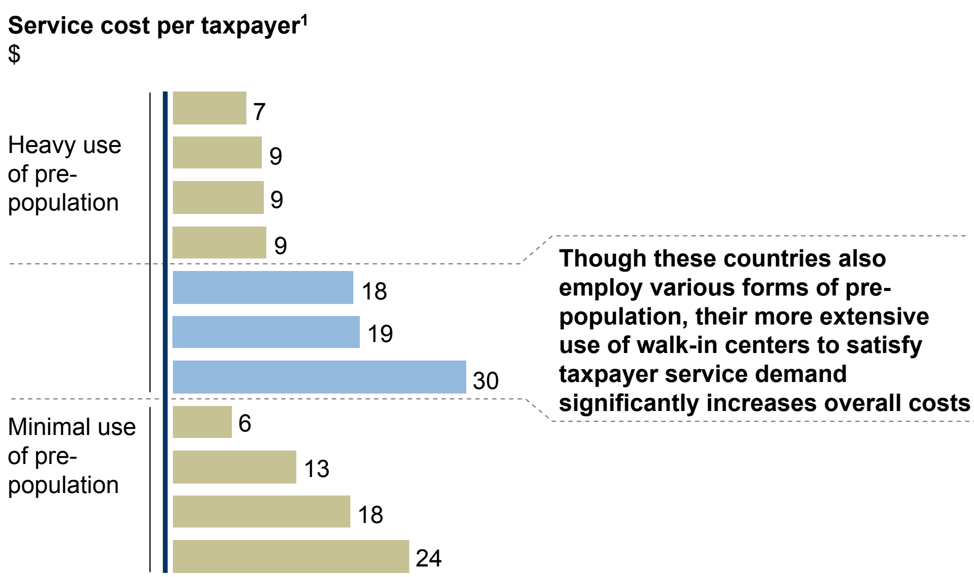
Top performers proactively manage demand for taxpayer service by pre-populating individual returns and adopting innovative practices in channel management.

Reduced service demand through pre-population

As discussed in the chapter on examinations, most top performers provide extensive pre-population of individual tax returns, an effective lever for increasing voluntary compliance by making it easier for taxpayers to comply. To capture the full benefit of pre-population in taxpayer service, tax administrations must combine extensive use of pre-population with effective channel management practices. Tax administrations with extensive pre-population and distinctive practices in channel management have 52 percent lower service costs than other tax administrations *(Exhibit 18).*

Exhibit 18

Pre-population, combined with effective channel management, reduces service costs



1 Data unavailable for 2 countries.

SOURCE: Tax administrations; interviews; McKinsey analysis

Increased use of self-service options

Top performers are aggressive about increasing the use of self-service options like Web sites and automated phone service (the least expensive service channels), and promoting the availability and benefits of these channels. For example, they analyze how users navigate the Web site, the search terms they use, and the most popular queries, to adapt the Web site to changing taxpayer needs throughout the year. They continually revise online issue-specific information based on post-call feedback surveys directed at taxpayers who consulted the Web site before calling the call center. One tax administration has also made significant investments to improve the usability of automated phone service and has achieved one of the highest self-service utilization rates in our sample: 41 percent of inquiries are now being resolved via phone self-service, never having to be routed to an agent.

Targeted use of in-person service channels

Given that in-person service is an expensive channel, high-performing tax administrations promote targeted use of in-person services. Some top performers provide in-person tax filing assistance only to certain taxpayer segments (e.g., low-income taxpayers, the elderly, new citizens). In an effort to reduce demand and taxpayer waiting time, one tax administration has implemented an appointment-only model that requires taxpayers to call a national toll-free number and schedule an appointment before visiting an in-person service center. This gives call-center agents a chance to resolve taxpayer issues before scheduling in-person appointments. Call-center agents are often able to guide taxpayers to resolve their issues through self-service options.

Other top performers concentrate service activity in a few central hubs, providing only very limited services in smaller, remote offices. One tax administration, which has more than 100 in-person service centers, is now combining 70 percent of these with another government agency, thus dramatically reducing the number of service centers solely dedicated to tax administration.

One high-performing tax administration has integrated its service channels for greater efficiency. For instance, taxpayers who attempt to resolve their issues online are given priority access to phone service through "click-to-speak" links in several strategic places on the Web site. The links allow taxpayers to request a call, and an agent responds within minutes.

TAXPAYER EDUCATION AND ASSISTANCE PROGRAMS

Well-defined and well-executed education campaigns help ensure taxpayers understand compliance requirements, such as when and how to submit their tax returns. Top performers offer targeted taxpayer education and assistance programs, particularly to taxpayer segments with the greatest need or the greatest risk of noncompliance. Some of these programs involve external organizations as partners. For example, one top performer has partnered with Internet cafés throughout the country. The cafés, aside from providing access to the tax administration's Web site, also give basic assistance to taxpayers. Two other high-performing tax administrations work with nonprofit and volunteer organizations to provide free in-person filing assistance to high-need taxpayer segments. These programs assisted nearly 2 percent of the total taxpayer population in their countries in 2007, showing these programs are large enough to make an impact.

EFFECTIVE ISSUE RESOLUTION

Top performers resolve between 89 percent and 93 percent of issues at the first point of contact in the phone service channel, and resolve most issues within one visit in the in-person service channel. This high rate of first-contact resolution reduces overall demand, since failure to resolve issues typically leads to additional inquiries. The remaining unresolved issues enter a clear process with specific guidelines to ensure timely issue resolution. Top performers focus on effectively triaging issues, making sure they are transferred to the right people for effective resolution or, for more complex issues, elevated to more specialized tiers. One tax administration has established a clear service standard for timeliness of complex issue resolution: specialists must address issues and follow up with taxpayers within 24 hours, having either resolved the issue or developed a clear action plan.

A FOCUS ON COST AND SERVICE-LEVEL MANAGEMENT

Top performers demonstrate a clear focus on continually identifying opportunities for improvement, particularly in cost and service-level management. Guided by taxpayer feedback, cost-benefit analysis, and lean operations principles, these tax administrations have successfully implemented initiatives within service channels to keep costs low while maintaining high service quality and taxpayer satisfaction.

Top performers capture improvement opportunities in both small ways and large. They make modest changes, such as shifting the ability to order paper forms exclusively to the Web site or automated phone, or significant moves, such as extensively using variable staff and lean operations principles to increase staff utilization. One top performer uses variable staffing by having only part-time phone-service staff in off-peak periods. This allows for increases in staffing during peak season without having to hire and train a new workforce. Another top performer hires large numbers of temporary staff to improve peak-season service levels—a step that has helped keep its staff size in taxpayer service at the same level for the past 15 years.

In another case, a top performer applied lean operations principles to increase staff utilization in both the phone and correspondence channels. The tax administration improved demand forecasting, allowing for better resource allocation, less wasted time, and higher service levels. It also revised correspondence practices to first address the queries with the greatest impact on taxpayer satisfaction. The result was a reduction in calls inquiring about the status of correspondence and a significant improvement in taxpayer satisfaction.

* * *

In its pursuit of greater efficiency and effectiveness in taxpayer service, a tax administration may at times face a trade-off: should it increase efficiency if doing so adversely affects taxpayer satisfaction or vice-versa? Such choices must be evaluated carefully. There are, however, win-win opportunities, as the top performers in our sample show. Through proactive demand management, taxpayer education and assistance, clear processes for complex issue resolution, and a focus on costs and service levels, the highest-cost tax administrations could become as efficient as the lowest-cost tax administrations—and capture approximately $1.7 billion in savings.

Appendix: Detailed methodology

From July 2008 to June 2009, McKinsey & Company carried out a systematic benchmarking effort among 13 tax administrations worldwide. Our goal was to pinpoint the management practices and operational processes that drive the greatest efficiency and effectiveness. We wanted to find out what drives world-class performance among tax administrations.

The scope of the study was limited to direct taxes only. This included taxes on income, capital gains, and wealth for individuals and corporations. The study focused on the four core functions of tax administration—submissions processing, examinations, collections, and taxpayer service—but also touched on general management and support functions.

Our methodology consisted of the following steps:

1. Gathering contextual data

We collected information on the context in which national tax administrations operate, including data specific to the country (e.g., socio-economic data, demographics, economic structure), the tax system (e.g., tax rates, withholding approach, complexity of the tax code), and the tax administration itself (e.g., organizational structure, size).

2. Collecting quantitative metrics

We worked closely with the tax administrations to collect quantitative metrics concerning individual and business taxpayers. We gathered information on tax administrations' overall performance as well as metrics in each of the core functions. Examples of the types of information we collected include:

- Overall administration performance: taxpayers per FTE; revenue to cost ratio
- Submissions processing: processing costs per paper return; processing costs per electronic return; average time to refund
- Examinations: revenue assessed per dollar spent; duration of audits
- Collections: revenue collected per dollar spent; share of outstanding debt collected
- Taxpayer service: taxpayer contacts per FTE; response time; time to resolution

3. Conducting structured interviews

For each of the core functions in tax administration—general management, submissions processing, examinations, collections, and taxpayer service—we developed detailed performance-evaluation scorecards. With valuable input and feedback from the OECD and a number of tax administration officials in the United States and Europe, we came up with specific criteria for assessing each function on a five-point scale. Our in-country research teams then conducted structured interviews (i.e., standardized interviews in which the researcher asks the same questions in the same order) with top officials at tax administrations, as well as with the heads of core divisions:

- **Top management officials.** We interviewed approximately 5 senior management officials at each tax administration. These interviews focused on overall administration performance in four key management areas: mission and purpose, operational excellence, talent management and performance management. We disaggregated each of these areas into several dimensions, and scored the administration on its performance in each dimension.

- **Heads of core divisions.** In each tax administration, we interviewed 2-3 heads in each of the core functions about the specific function they oversee. For example, we interviewed 2-3 examinations officials about the examinations function. Here again, we disaggregated the functions into several dimensions and assigned scores of 1 to 5 based on information and insights gathered during the interviews:

  — Submissions processing: 14 dimensions including degree of pre-population of returns, electronic filing context and targets, innovative methods of data capture, and variable hiring in peak and non-peak months.

  — Examinations: 18 dimensions including methodology for case selection and automation, enforcement strategy, audit strategy, and pre-filing certification activities.

  — Collections: 19 dimensions including level of customer segmentation, correspondence contact strategy, workout strategy, litigation, and revenue seizure.

  — Taxpayer service: 16 dimensions including portion of taxpayer queries resolved through automated services, treatment of taxpayer feedback, Web presence, and complex-issue resolution process.

4. Facilitating working sessions

Our in-country research teams held a number of working sessions with the heads of the core divisions at each tax administration. In these sessions, we focused on mapping detailed process flows for the core operating processes across all functions.

We then analyzed the scores and the qualitative data derived from the structured interviews to identify any correlations with the quantitative metrics. Through this analysis, we were able to isolate the biggest drivers of performance.

QUANTIFICATION METHODOLOGY

In assessing the opportunity for tax administrations to improve their performance we looked at both effectiveness and efficiency potential. The effectiveness opportunity applies to functions primarily focused on collecting additional taxes, namely examinations and collections. The efficiency opportunity, by contrast, looks at the functions where improving cost is a key focus—submissions processing and taxpayer service. We also sized the efficiency opportunity for collections given the strong focus on cost in this area. We followed two approaches in quantifying the potential:

(1) To quantify the effectiveness opportunity in examinations and collections and the efficiency opportunity in taxpayer service and collections, we calculated the difference in performance between the top one-third and bottom two-thirds of tax administrations. Our estimate of the opportunity is equal to the value that could be captured if the bottom two-thirds could become as effective or efficient as the top one-third.

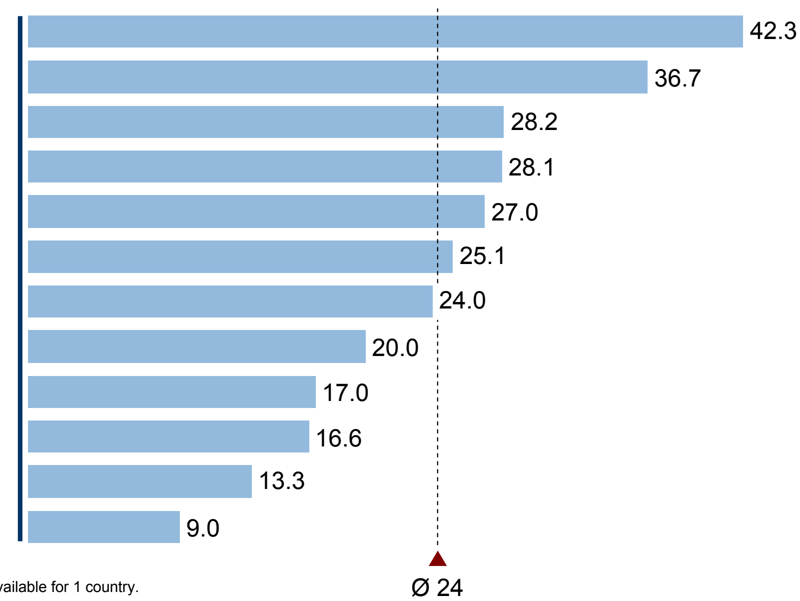
(2) Given the nature of submissions processing, we sized the efficiency opportunity in this function by comparing the countries' current costs to what they could achieve with an e-filing rate of 98 percent (the current rate for one of the countries in our sample).

Appendix: Detailed benchmarking data

Exhibit A-1

Taxpayers per FTE – Individual

Hundreds



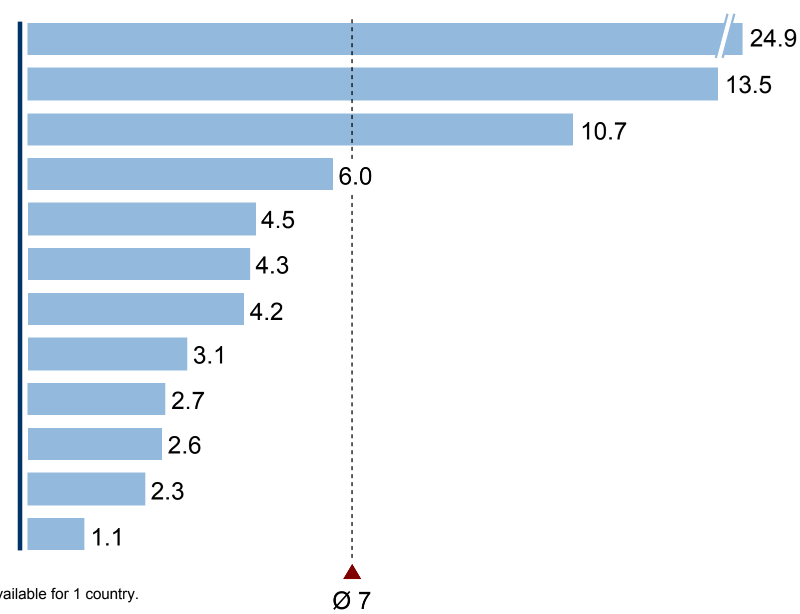
Note: Data unavailable for 1 country.

SOURCE: Tax administration data

Exhibit A-2

Taxpayers per FTE – Business

Hundreds



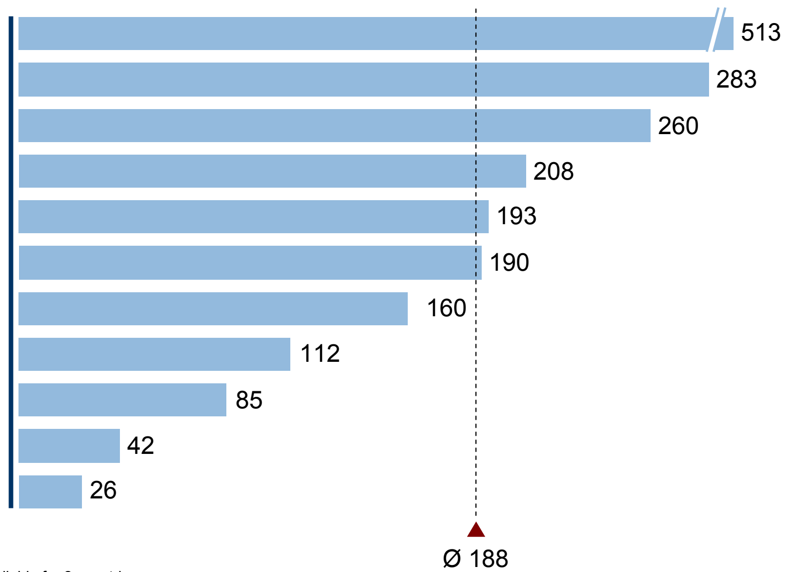
Note: Data unavailable for 1 country.

SOURCE: Tax administration data

Exhibit A-3

Revenue per $ spent – Individual

USD



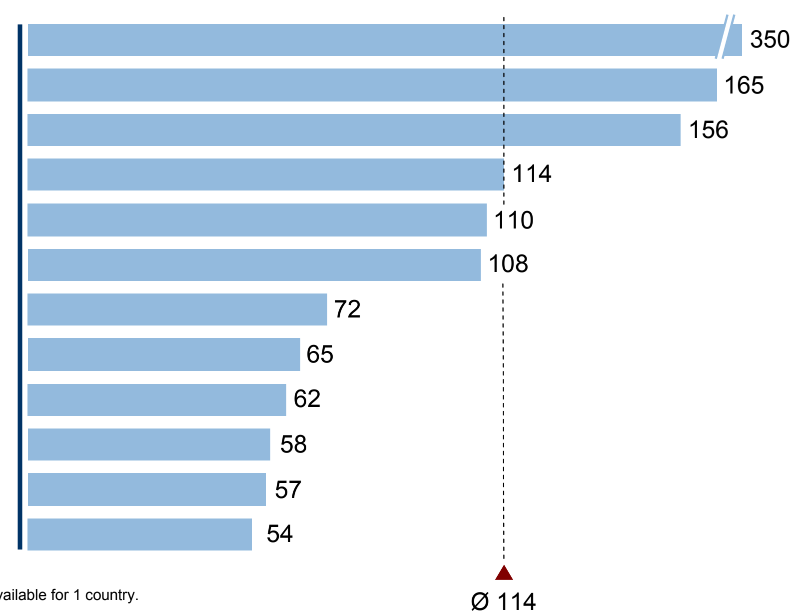
Note: Data unavailable for 2 countries.

SOURCE: Tax administration data

Exhibit A-4

Revenue per $ spent – Business

USD



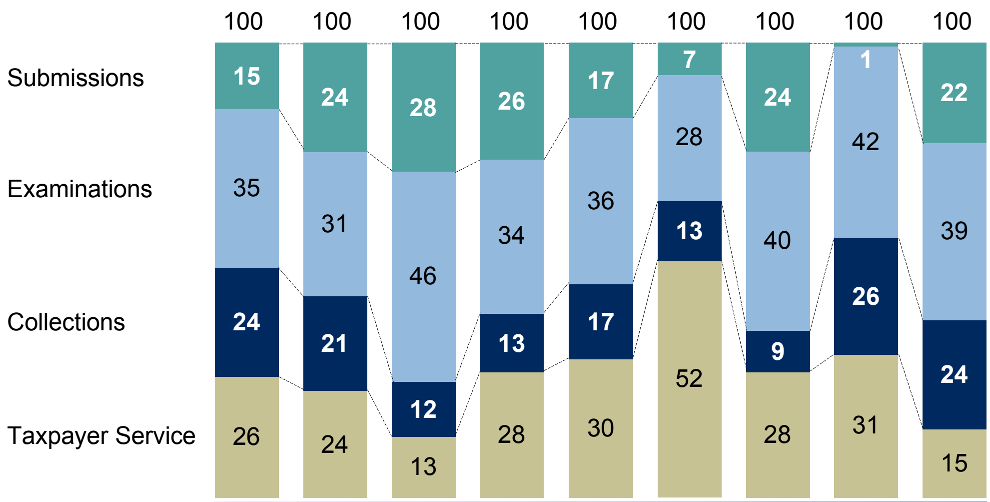
Note: Data unavailable for 1 country.

SOURCE: Tax administration data

Exhibit A-5

Cost by function as a share of total costs

Percent



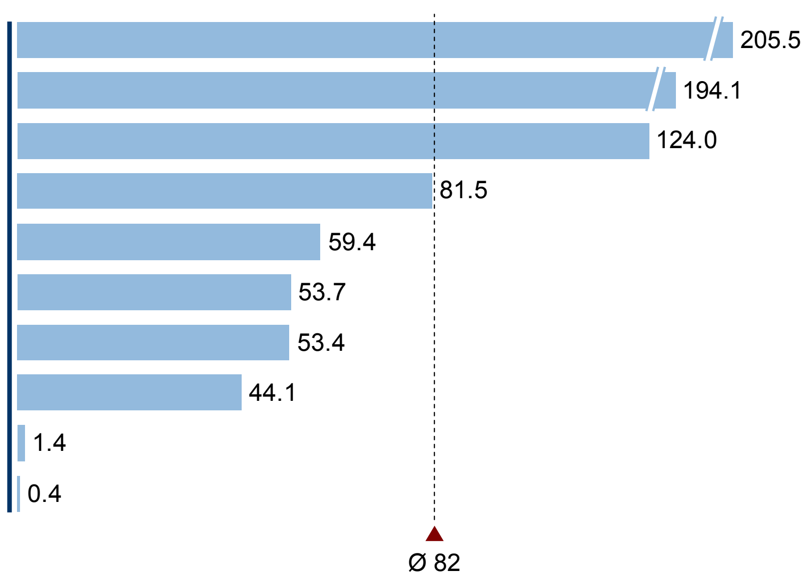
Note: Data unavailable for 4 countries.

SOURCE: Tax administration data

Exhibit A-6

Processing cost per return – Business Paper

USD



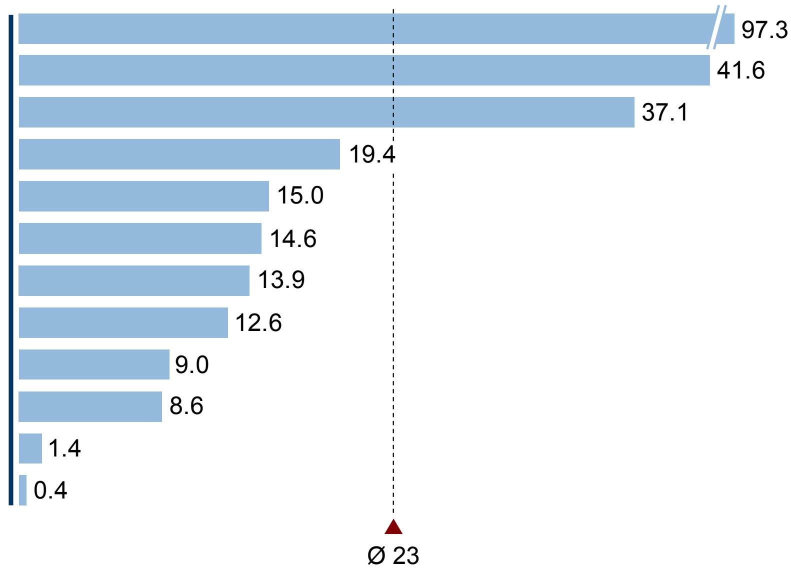
Note: Data unavailable for 3 countries.

SOURCE: Tax administration data

Exhibit A-7

Processing cost per return – Individual Paper

USD



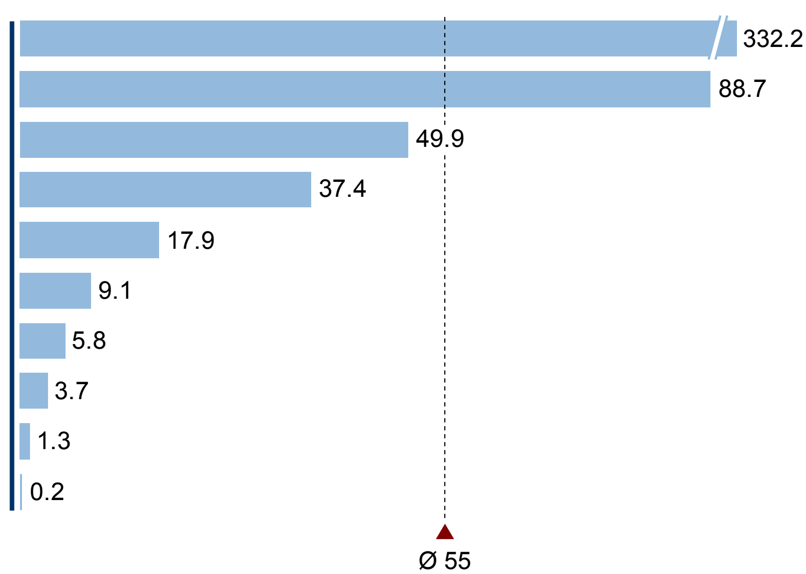
Note: Data unavailable for 1 country.

SOURCE: Tax administration data

Exhibit A-8

Processing cost per return – Business Electronic

USD



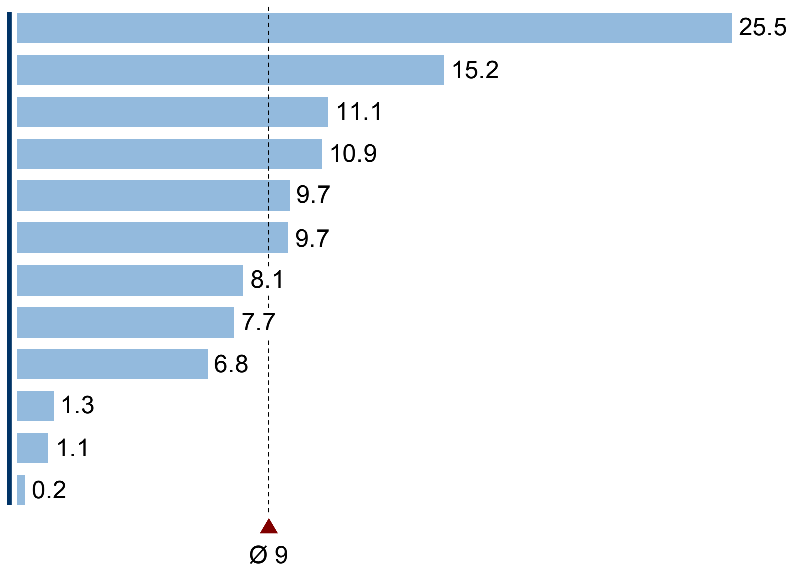
Note: Data unavailable for 3 countries.

SOURCE: Tax administration data

Exhibit A-9

Processing cost per return – Individual Electronic

USD



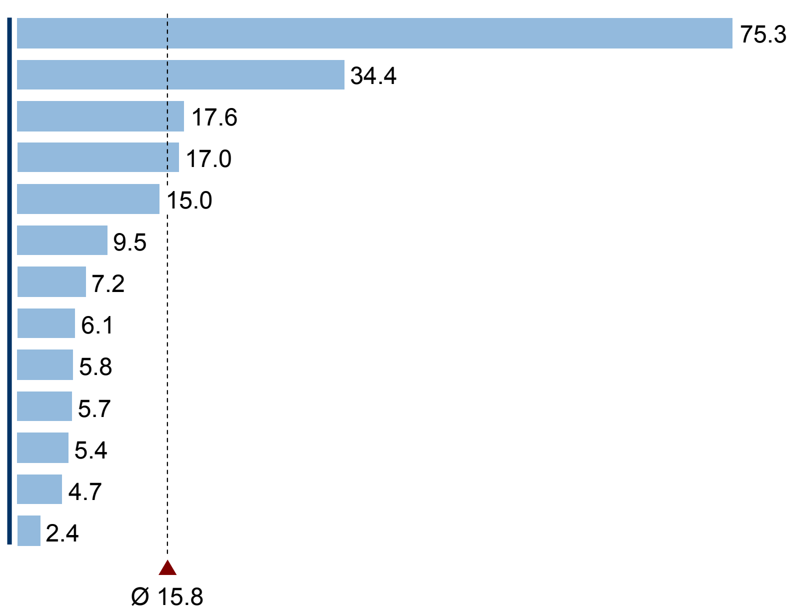
Note: Data unavailable for 1 country.

SOURCE: Tax administration data

Exhibit A-10

Returns per FTE – Individual

Thousands

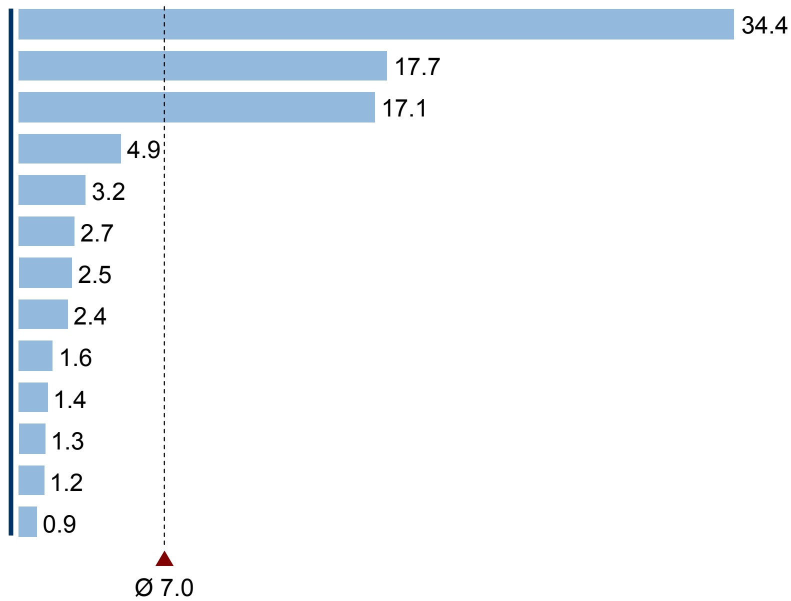


SOURCE: Tax administration data

Exhibit A-11

Returns per FTE – Business

Thousands

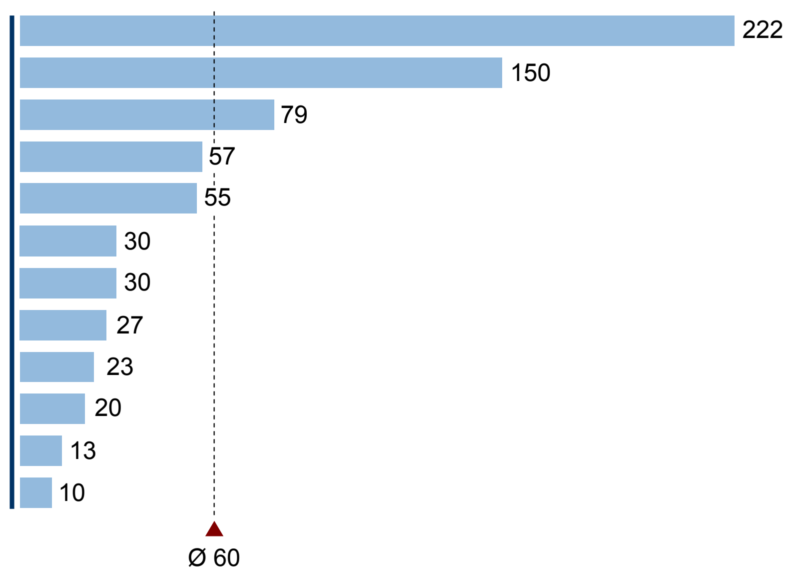


SOURCE: Tax administration data

Exhibit A-12

Average time to refund

Days



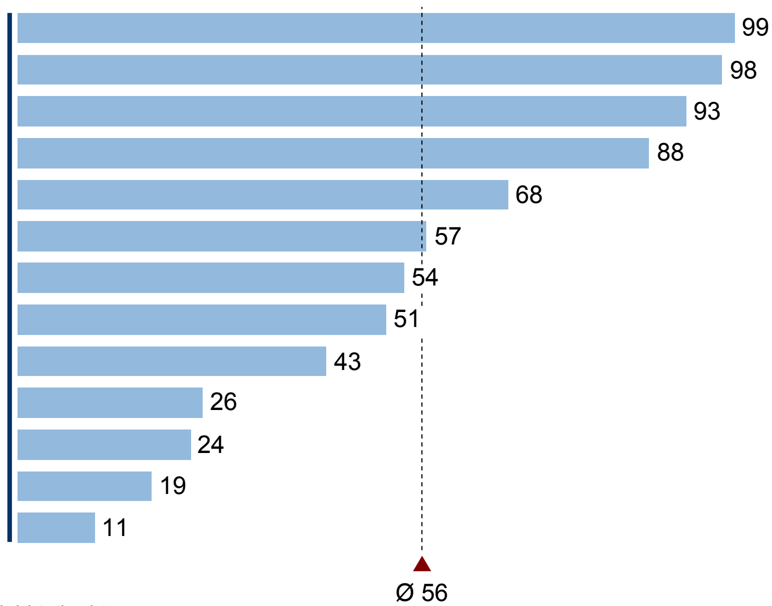
Note: Data unavailable for 1 country.

SOURCE: Tax administration data

Exhibit A-13

Electronic filing rate – Individual

Percent

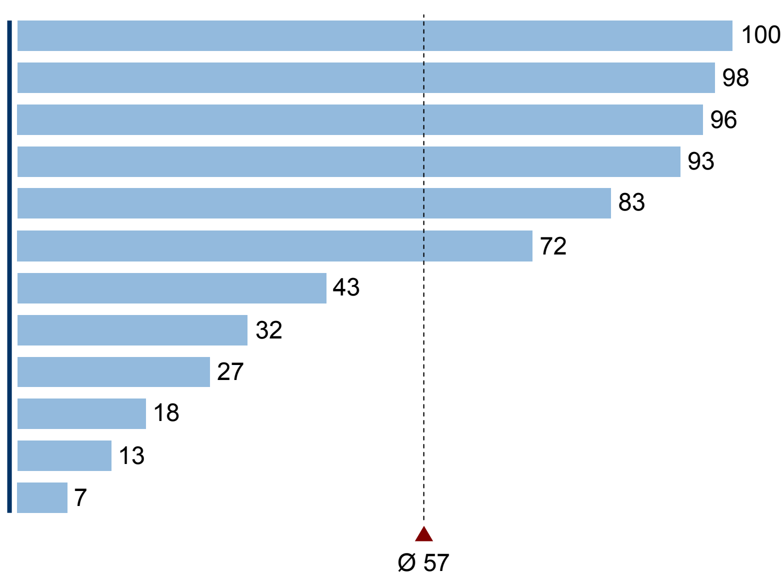


SOURCE: Tax administration data

Exhibit A-14

Electronic filing rate – Business

Percent



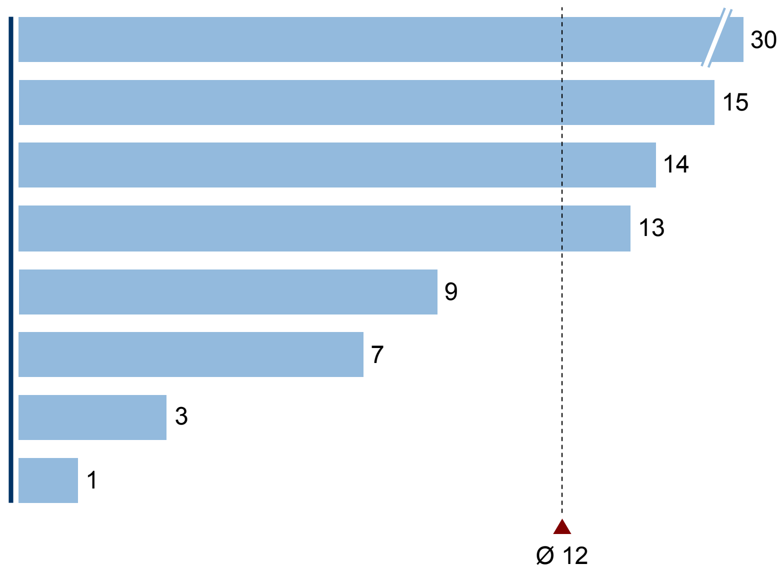
Note: Data unavailable for 1 country.

SOURCE: Tax administration data

Exhibit A-15

Revenue assessed per $ spent – Total

USD



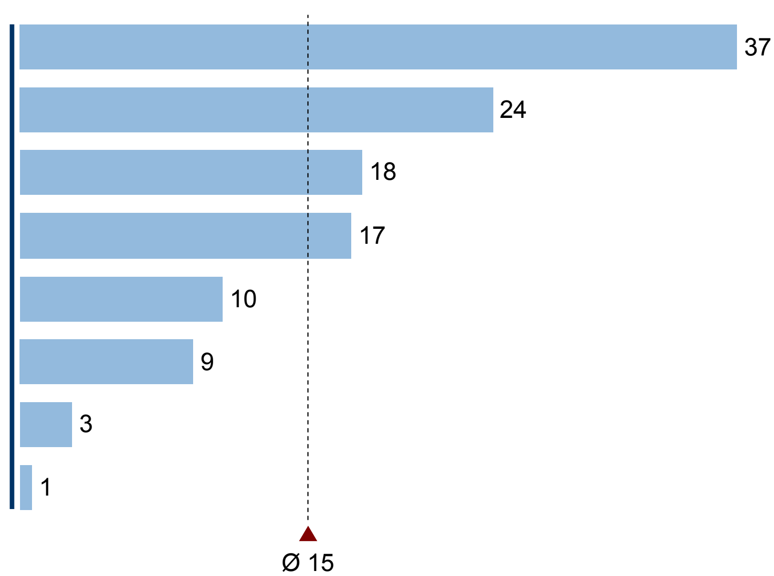
Note: Data unavailable for 5 countries.

SOURCE: Tax administration data

Exhibit A-16

Revenue assessed per $ spent – Business

USD



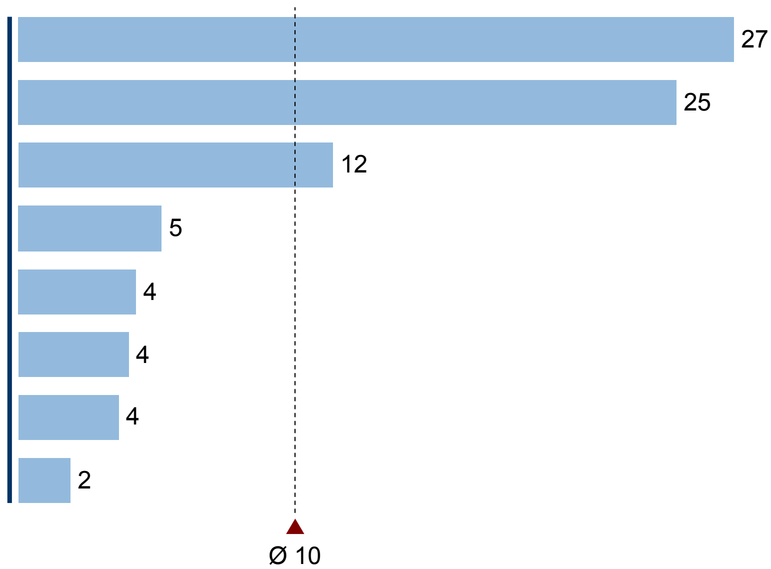
Note: Data unavailable for 5 countries.

SOURCE: Tax administration data

Exhibit A-17

Revenue assessed per $ spent – Individual

USD



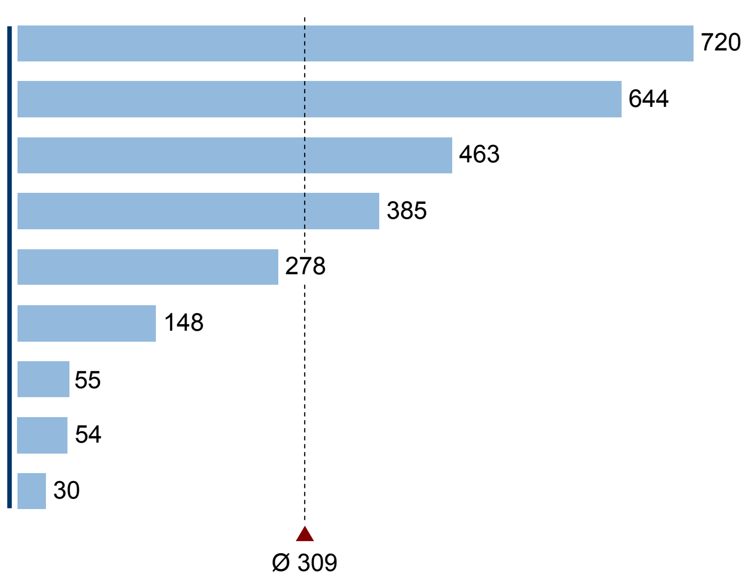
Note: Data unavailable for 5 countries.

SOURCE: Tax administration data

Exhibit A-18

Time between filing and exam start – Business

Days



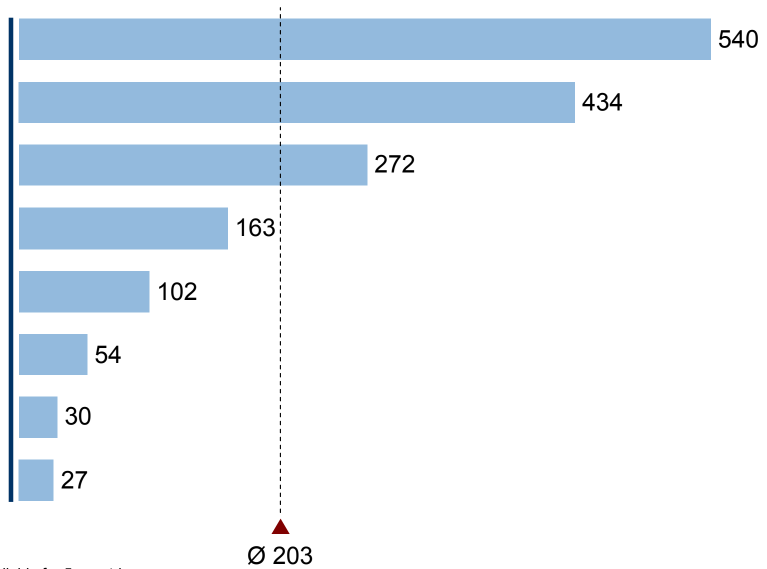
Note: Data unavailable for 4 countries.

SOURCE: Tax administrations; interviews; McKinsey analysis

Exhibit A-19

Time between filing and exam start – Individual

Days



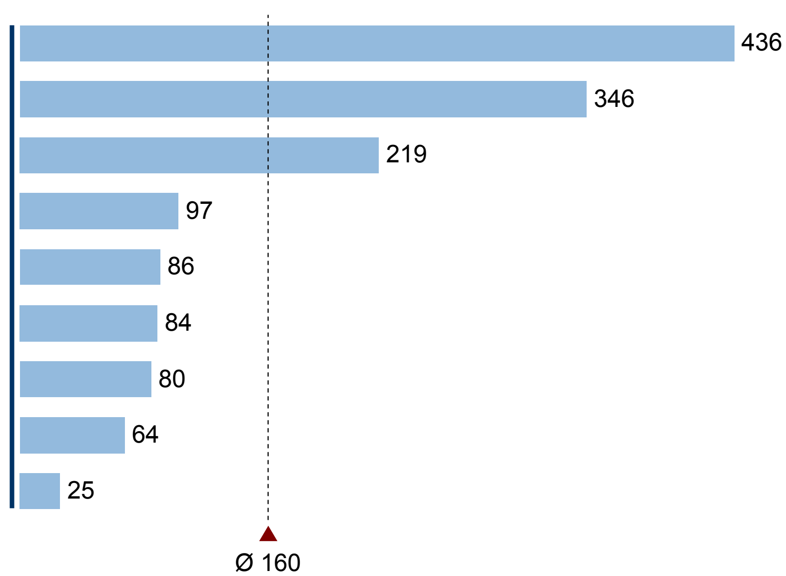
Note: Data unavailable for 5 countries.

SOURCE: Tax administrations; interviews; McKinsey analysis

Exhibit A-20

Duration of exams – Business

Days



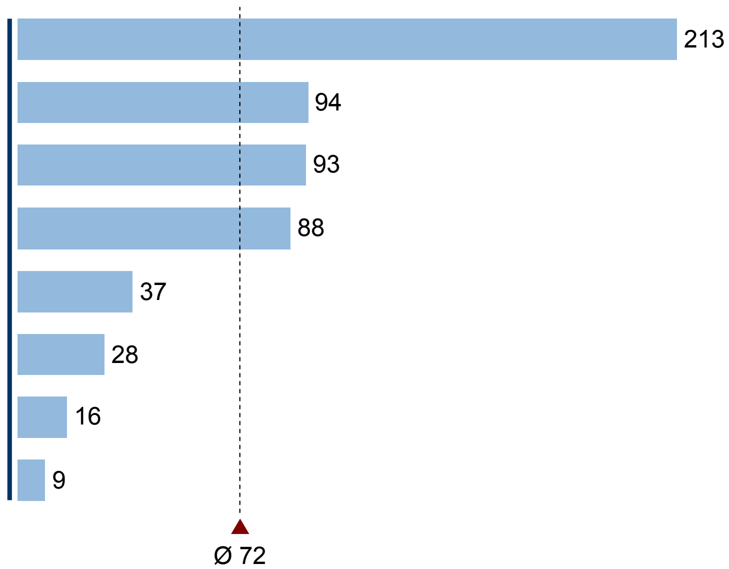
Note: Data unavailable for 4 countries.

SOURCE: Tax administrations; interviews; McKinsey analysis

Exhibit A-21

Duration of exams – Individual

Days



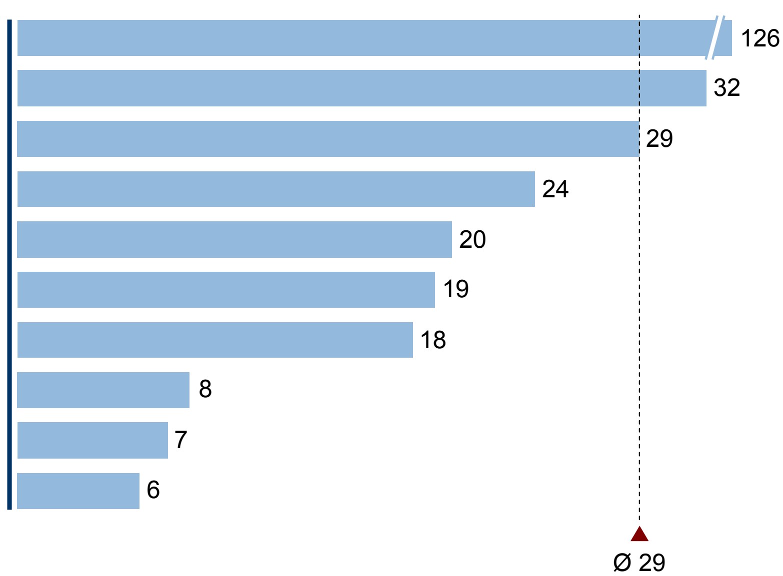
Note: Data unavailable for 5 countries.

SOURCE: Tax administrations; interviews; McKinsey analysis

Exhibit A-22

Collections per $ spent – Individual

USD



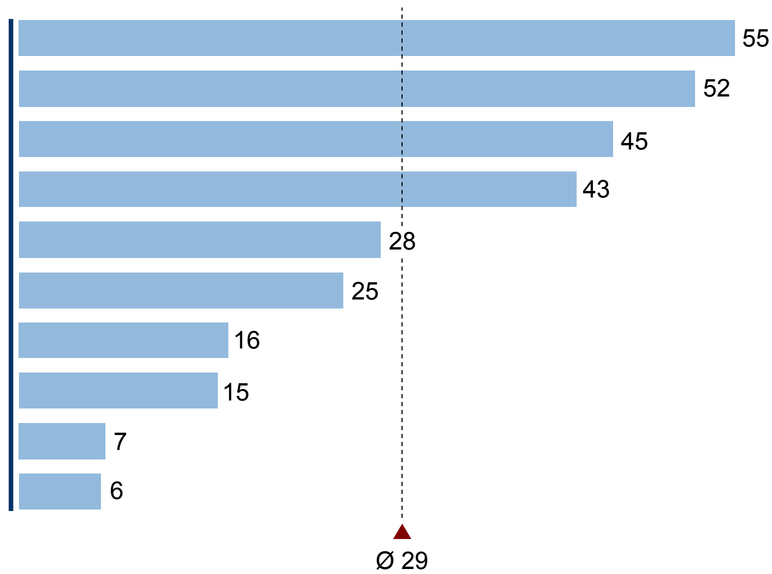
Note: Data unavailable for 3 countries.

SOURCE: Tax administration data

Exhibit A-23

Collections per $ spent – Business

USD



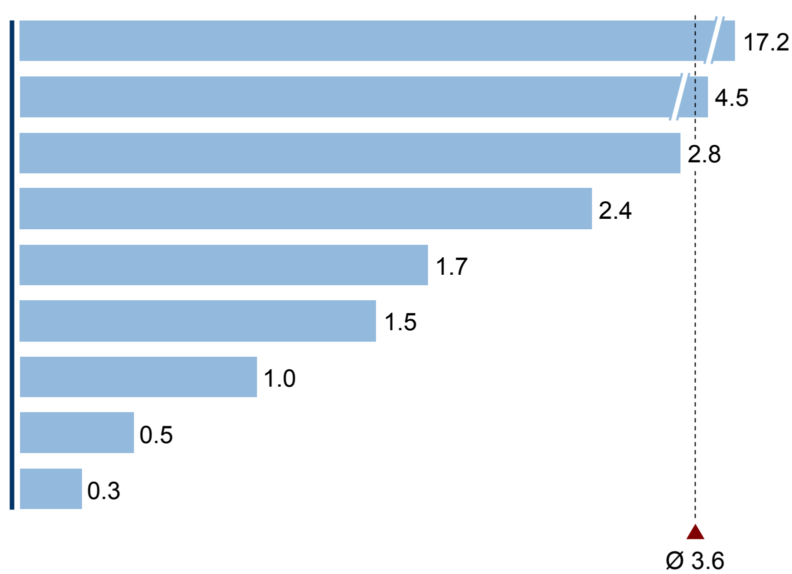
Note: Data unavailable for 3 countries.

SOURCE: Tax administration data

Exhibit A-24

Collections per FTE – Individual

Millions, USD



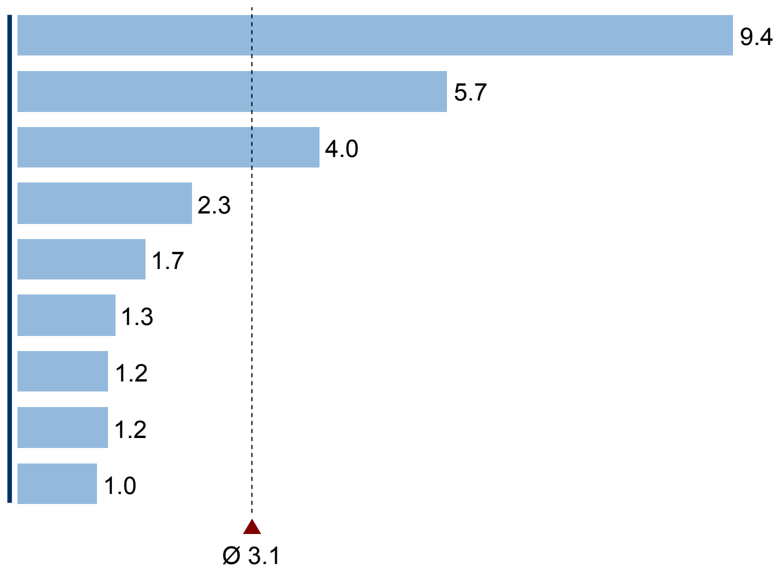
Note: Data unavailable for 4 countries.

SOURCE: Tax administration data

Exhibit A-25

Collections per FTE – Business

Millions, USD



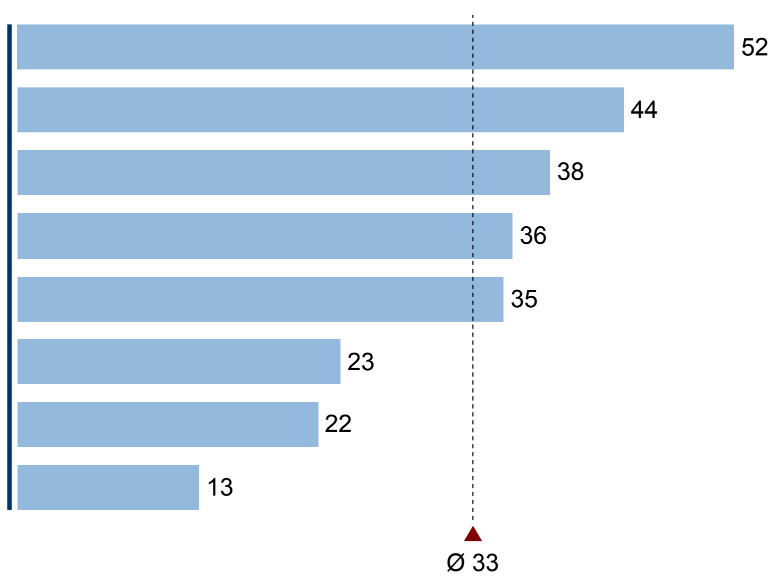
Note: Data unavailable for 4 countries.

SOURCE: Tax administration data

Exhibit A-26

Share of outstanding debt collected – Individual

Percent



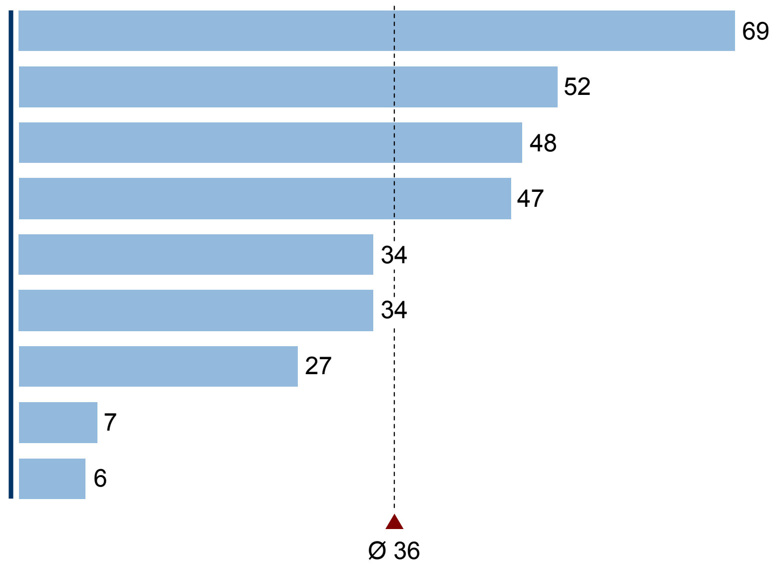
Note: Data unavailable for 5 countries.

SOURCE: Tax administration data

Exhibit A-27

Share of outstanding debt collected – Business

Percent



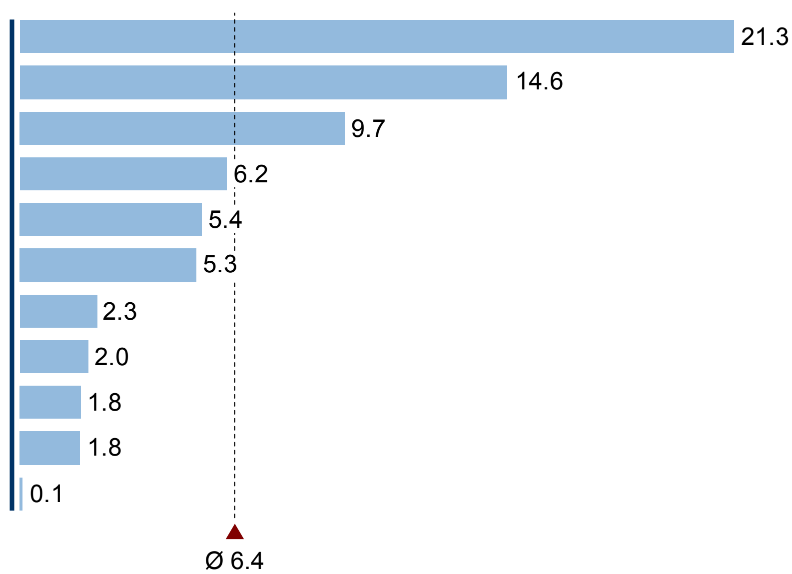
Note: Data unavailable for 4 countries.

SOURCE: Tax administration data

Exhibit A-28

Written-off debt/(existing + new balance due)

Percent



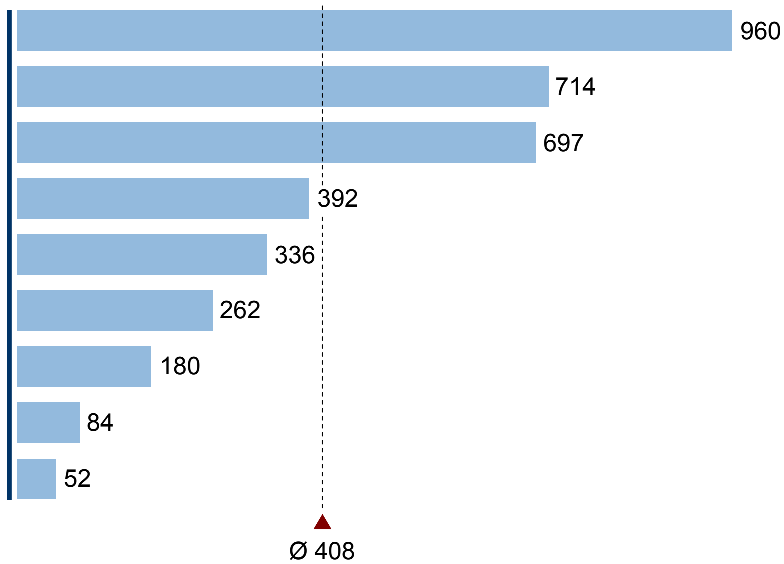
Note: Data unavailable for 2 countries.

SOURCE: Tax administration data

Exhibit A-29

Duration of collection cases – Individual

Days



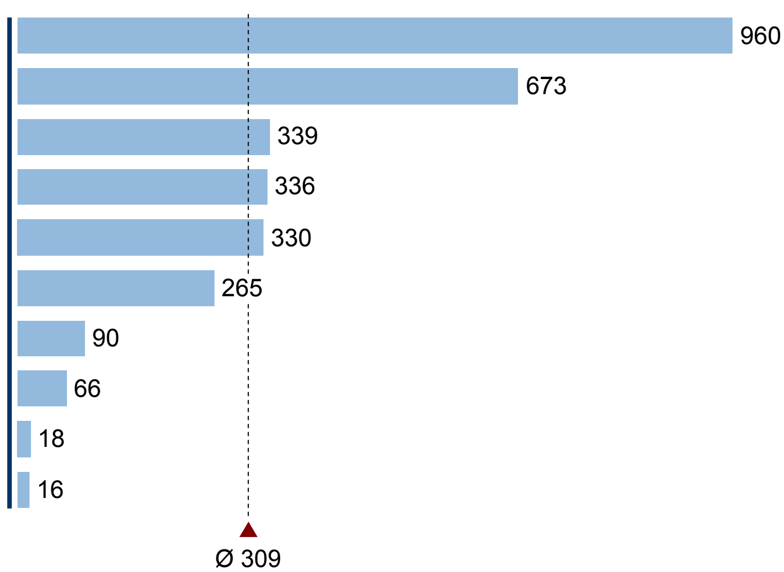
Note: Data unavailable for 4 countries.

SOURCE: Tax administration data

Exhibit A-30

Duration of collection cases – Business

Days



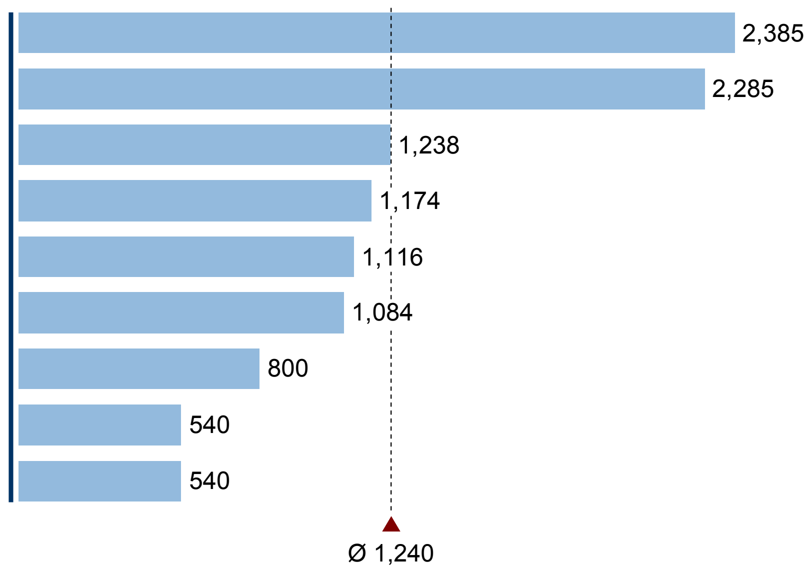
Note: Data unavailable for 3 countries.

SOURCE: Tax administration data

Exhibit A-31

Average age of debt

Days



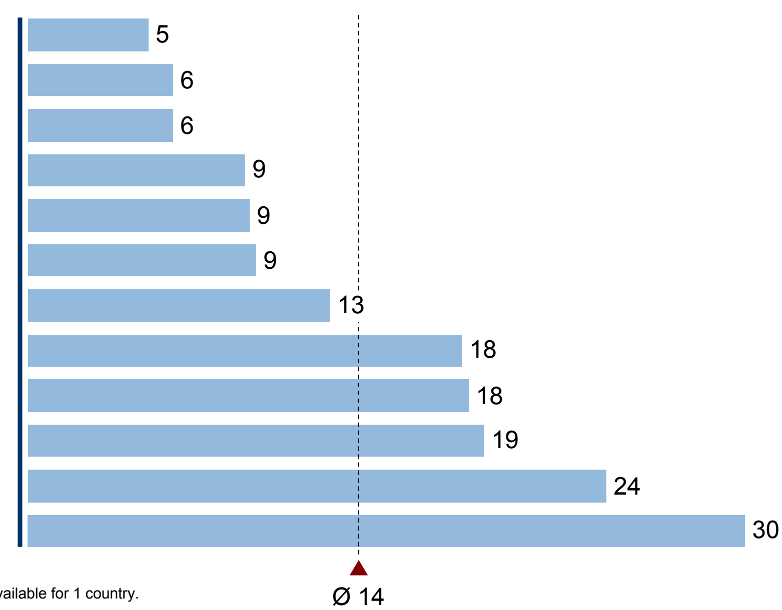
Note: Data unavailable for 4 countries.

SOURCE: Tax administration data

Exhibit A-32

Service cost per taxpayer

USD



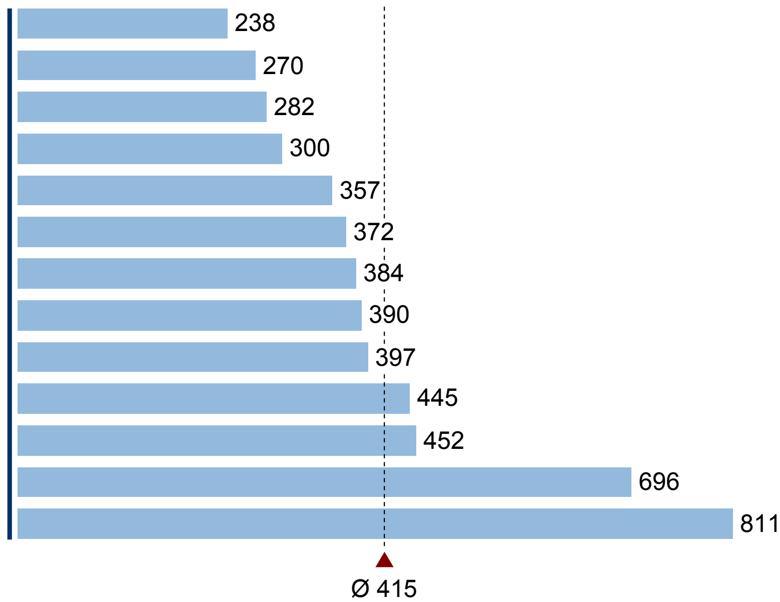
Note: Data unavailable for 1 country.

SOURCE: Tax administration data

Exhibit A-33

Average handle time – phone

Seconds

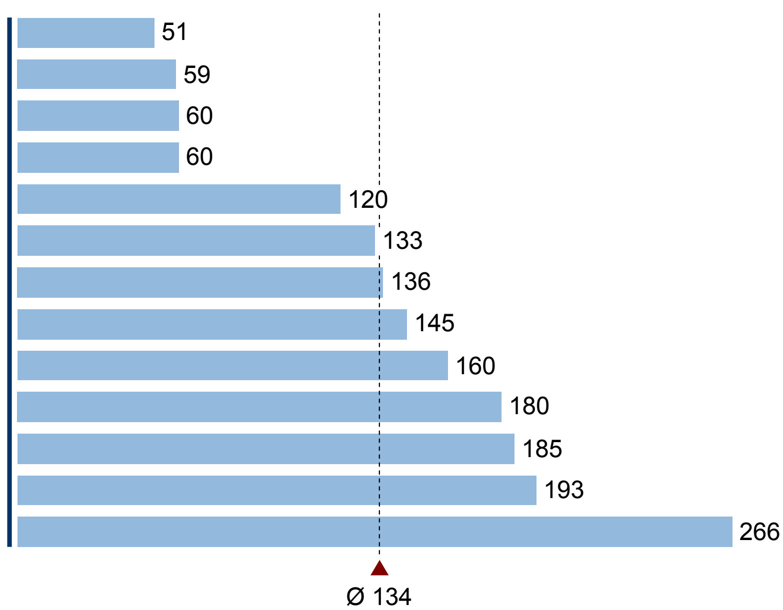


SOURCE: Tax administration data

Exhibit A-34

Call-center wait time

Seconds

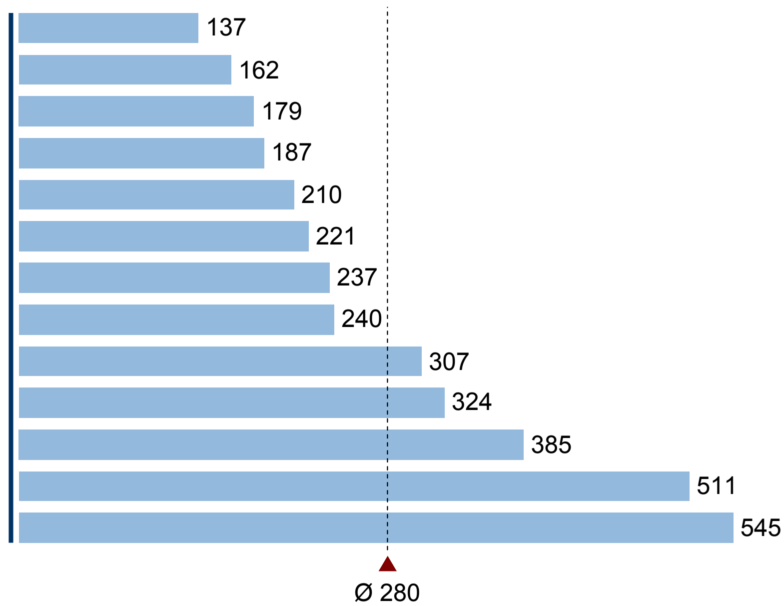


SOURCE: Tax administration data

Exhibit A-35

Time to live phone resolution

Seconds

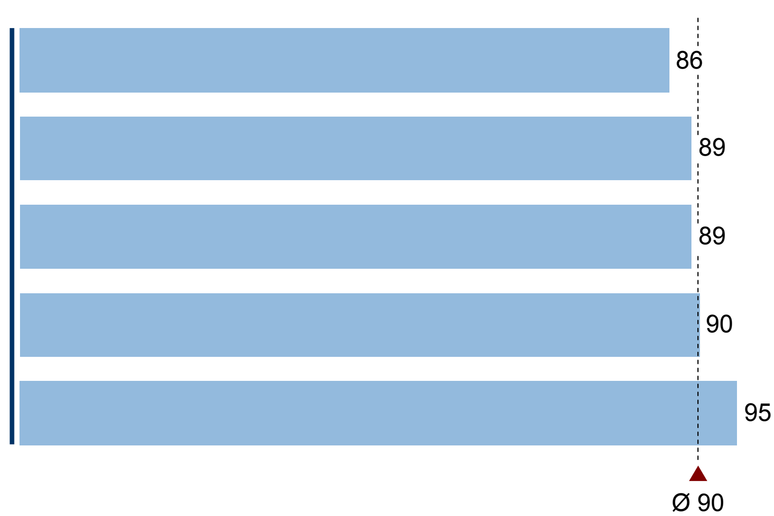


SOURCE: Tax administration data

Exhibit A-36

First-contact resolution by phone

Percent



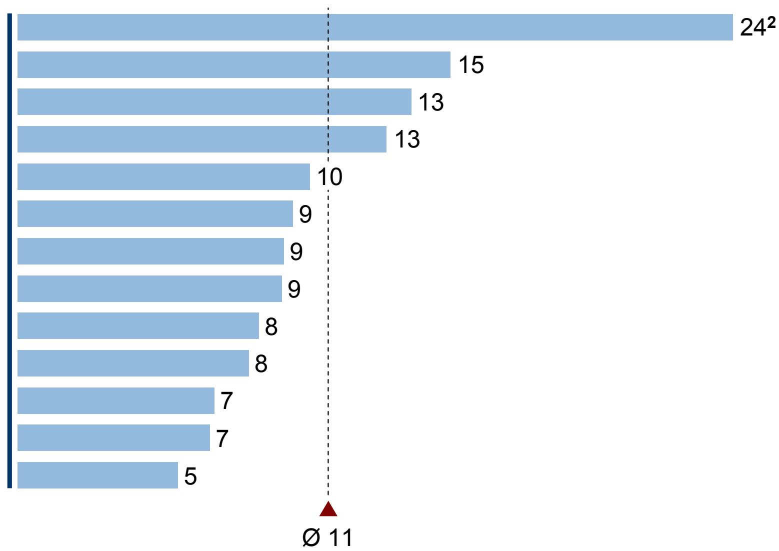
Note: Data unavailable for 8 countries.

SOURCE: Tax administration data

Exhibit A-37

Taxpayer contacts by phone per call-center FTE[1]

Thousands



1 Includes individual and business customers.
2 For this country, this metric includes IVR calls. This country has a high IVR utilization rate (87%). The IVR utilization rate for all countries is not available, so the IVR calls could not be isolated out of this metric.

SOURCE: Tax administration data

Appendix: list of participating countries

The following countries participated in the benchmarking study in 2008-09:

- Australia
- Belgium
- Brazil
- Canada
- Chile
- Denmark
- France
- Ireland
- Norway
- South Africa
- Spain
- Sweden
- United States

Acknowledgments

We would like to acknowledge the various tax administrations and individuals without whose support and input this report would not have been possible.

First, a sincere thanks to the following countries for participating in the study and sharing their data and insights: Australia, Belgium, Brazil, Canada, Chile, Denmark, France, Ireland, Norway, South Africa, Spain, Sweden, and the United States. The rich insights and detailed best practices presented in this report are a result of the generosity of senior tax administration officials, who graciously shared their in-depth knowledge and expertise.

This study has also benefited immensely from the support of the OECD's Forum on Tax Administration (FTA). The FTA, in particular through Lisa Wise and Richard Highfield of the OECD's Centre for Tax Policy and Administration, helped refine the methodology, recruit participants, and review our findings. We would also like to express our gratitude to Pravin Gordhan, current Minister of Finance and former Commissioner of the South African Revenue Service and chairperson of the OECD's Forum on Tax Administration; and David Butler and Sean Moriarty, former and current heads respectively of the OECD's Tax Administration and Consumption Taxes Division, who gave their support to the work.

Many current and former McKinsey colleagues around the world played critical roles in this research effort. We would especially like to acknowledge the contributions of Michael Betz, Hilary De Grandis, Jared Katseff, Christopher Laws, Kate McDonald, Ebele Mora, Aly Spencer, Anirudh Suri, and Jonah Wagner.

Last but not least, we thank the US Internal Revenue Service (IRS) for allowing us to pilot and refine the methodology with them. Special thanks to Linda Stiff, Deputy Commissioner, IRS; and Fredrik Aksnes of the Norwegian Tax Administration, for providing early input into the methodology. The input and feedback we received ensured the methodological foundations of the study were robust and sound.

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