TAX ADMINISTRATION RISKS

Mihalcovici Doina
Direcţia Generală a Finanţelor Publice a judeţului Arad Arad, str.Milova bl.253 ap.14 email – doinamarsieu"yahoo.com tel. – 0723636930

Risk administration/management is a formal process, where environmental risk factors are identified, analysed, evaluated, classified, and systematically treated. Risk assessment means to appreciate the degree of tax compliance for different categories of taxpayers, in other words making sure that tax owed by legal taxpayers are collected respecting legal deadlines.
An efficient tax administration develops risk management strategies through increasing professional training, efficient support for taxpayers, correct audits, fighting tax evasion, and cooperation with other tax administrations in order to avoid double taxation. Tax administration performances can be appreciated according to the measures used in solving tax administration challenges.

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Identification, evaluation, administration and risk management

1. Risk identification

Risk administration/management is a formal process, where environmental risk factors are identified, analysed, evaluated, classified, and systematically treated.
Risk can be addressed in several ways:
- taxpayers are treated as a undifferentiated group (non-group), in which case tax administration is organized according to functional criteria, and tax categories;
- taxpayers are treated differently, as separate entities, with their own motivation. This situation requires better support services for taxpayers, encouraging voluntary tax compliance and discouraging tax evasion.

Quantitative and qualitative assessment of current and potential risks leads to one of the following alternatives for risk management:
- avoiding risk, altering the structure of the system so that the risk doesn't occur;
- reducing risk by limiting the event and the consequences;
- risk transfer, through insuring measures;
- taking risks when the costs of managing risk is too high compared to expected results.

Risk assessment means determining the degree of tax compliance of different categories of taxpayers, in other words making sure that tax owed by legal taxpayers are collected respecting legal deadlines.
An efficient tax administration develops risk management strategies through increasing professional training, efficient support for taxpayers, correct audits, fighting tax evasion, and cooperation with other tax administrations in order to avoid double taxation. Tax administration performances can be appreciated according to the measures used in treating tax administration problems. The quality of the results depends in good measure by structural factors, the quality of the services offered, the manner in which the taxpayers are treated and by the risk management procedures.
A large part of the risk of the risk that tax administration faces is caused by the informal economy.
This includes illegal activities and unreported income. Furthermore, politicization of the enforcement system, tax incentives and tax evasion leads to substantial gaps between legal tax rates and effective/ actual tax rates in tax collection.
Risk assessment is aimed to emphasize the risks to be studied in detail by tax administration, minimizing the possibility of omissions and facilitating a future detailed analysis. "The source"

and “the impact” of these risks represent two distinct dimensions of the risk identification phase. In order to understand risk causes, one must, first, discover its source.

Risks can be identified through top-to-bottom techniques, such as macro economical analysis, or through bottom-to-top such as case basis risk evaluation system. Accurate segmentation is essential for correct risk identification.

Multi-level approach of the risk identification and assessment process in needed for a comprehensive understanding of the risk. Risk identification processes that offer insight about understanding tax compliance behaviour are the most informative.

Analysis of current taxation laws is often the best way of starting a strategic risk assessment. Marginal revenue experts can easily identify the parts of tax law at the higher potential risk. Strategic risks identified at this level – often classified as” marginal” concepts about the environment – can be analysed using other strategies like market segmentation or organizational capabilities.

Most tax laws in the world are generally prescriptive in its nature. The law, itself tries to cover all the consequences of its application or lack of application. Unfortunately the nature of prescriptive legislation creates some problems given the inability of legislative bodies to address all situations that arise as a result of applying the current laws in force. Therefore, it is almost impossible to create a set of clear and concise set of laws. This ambiguity of the legal system favours taxpayers’ non-compliance which exploits the grey areas of the law. There always were and there will always be taxpayers determined to identified and exploit for their own purpose, the cracks in the legislative shield. Moreover, prescriptive legislation, usually, lacks flexibility to adapt to the dynamic business world.

When addressing the strategic risks, a common language framework is very helpful in assuring that the whole spectrum of risk is taken into consideration and all participants in risk identification conversation can knowingly take part. At a basic level, this language framework is represented by the matrix of non-compliance risks correlated to major obligation of compliance of the major segments of taxpayers, namely non-filling the tax return, non-reporting and non-paying the tax debts.

Identifying risks will often allow detection of problems which, if ignored, can become a risk to long-term sustainability of revenue collection. Community confidence in administration ability to properly and honestly manage the tax system, may affect future tax collections. Similarly if tax administration costs are onerous, this system will erode public confidence.

In some European countries there are two specific ways of aggregate case information needed for further risk identification:

- first way is collection and storage of standardized data from audit activities, in order to generate statistical information and relations frequency in standard conditions;
- second way refers to taxpayers behaviour in different successive events.

Non-compliance risks must be identified at a stage where they can be resolved. Even if informal economy is globally acknowledged as a problem for tax authorities, only when the concept is divided into act of specific conduct that can be attributed to sub-groups in the community, the appropriate counterbalance strategies can be found.

Non-compliance risks can be analysed from several perspectives. Most often, the individual taxpayer’s perspective is used when analysing risks. However, risks can be analysed from an industrial group perspective or from socio-economical or psychological perspective.

In order to obtain an accurate risk identification and assessment, there must be sufficient information for evaluation of non-compliance level. Gathering correct data for risk evaluation requires considerable effort.

To identify risks, the following types of information are fundamental:

- tax return (income statement) including information regarding taxpayer’s financial state;
- another information for tax purposes – industrial classification code, payroll data, VAT;

- details of bank interest , pension data, firm registration information;
- public information, especially Internet information (company publications, news);
- information needed in analytical and interpretative analysis – norms for net and gross profit for certain trade sectors, costs-to- profits ratio, the average profit per family depending on the neighbourhood;
- data from audit and other programs.

2. Risk assessment

Tax authorities need a mechanism for objective evaluation of the relative proportion of non-compliance risk in the context of organizational priorities. Not every type of risk can be resolved; we just need a balanced approach for treating this wide variety of risks.

A balanced approach to risk makes possible focusing on certain risks, risks that do not represent major budgetary threats.

Essential for risk evaluation and prioritizing is the existence of a sound environment in which repeated comparative assessment of every type of risk evaluation and prioritization is possible. Decisions regarding treatment and acceptability of non-compliance risk must be based on a set of quantitative and qualitative criteria agreed upon. The purpose of risk evaluation and prioritization is to distinguish between major and minor risks and to anticipate risk management stage. In order to do that, one needs to take in account the source of risk, possible consequences for corporate objective and the probability for their occurrence.

Measurements are qualitative or quantitative or both, but they must be relevant for the considered objective. Every consequences model purpose is to provide authorities with mechanisms that allow repeated comparative evaluation of separate risks.

Probability is measured taking into account the probability of risk to become real. Measurement can be qualitative or quantitative. Probability is measured in terms of the likelihood that risks to be materialized. Measurement may be quantitative or qualitative.

Decisions regarding risks to be monitored and solved can be influenced by several factors like:
- internal capabilities;
- existence of efficient solving measures;
- existing implementation capability of the solving measures;
- rating/ risk level;
- contamination / infection level of the risk or risk deterioration level;
- current result of the measures (per year);
- the result of measures through time (income recovered each year in the future);
- public perception of tax administration versus risks;
- costs / benefits of the proposed measures (next phase feed-back);
- broader context of risk as a group.

The efficiency of the solving strategies is evaluated taking in account these issues.

Definitive risk ratings, usually, offers information about who in the organization is responsible for managing those risks. For example, the higher risk on the probability and consequences (effects) scale will be managed by the higher organizational level, and the other way around.

Non-compliance risk evaluation and prioritization will be taken whenever necessary.

Efficient non-compliance risk management requires a considerable research, factual evidence, analysis and logical reasoning. So, tax authority needs time to organize analysis and prioritize risk.

3.Risk administration

Risk management activity takes place cyclical, and this phenomenon is present in developed and developing countries. In developed countries, this phenomenon has a reduced magnitude, given that their tax systems are more stable, tax arrears are less frequent and tax administering abilities

are superior compared with the developing countries, in transition As regards developing countries, it was noticed that those who are in an advanced stage of development presents fiscal processes similar to those of the European Union, and a direct relation between efficient tax administration and progress in transition.
In less advanced countries, efficient tax collection depends rather on state administrative control. Field researchers have faced, in their attempt to determine the differenciall between the two levels of the rate, lack of conclusive information that could assure accuracy of calculations, and that is why one has chosen an aggregated approach of the problem.
As a result, the effective (actual) tax rate is calculated according to the following formula:

$$C_r = \frac{I_c}{B_i} \quad (1)$$

Where:
C_r – effective tax rate/ actual tax rate
I_c – volume of collected tax income/ amount of taxes collected
B_i – tax base/ taxable income
The ratio between effective tax rate and legal tax rate is generated by the following formula:

$$\frac{C_r}{C_l} = \frac{I_c}{C_l B_i} \quad (2)$$

Where:
C_l –: legal tax rate, and the remaining symbols retain their meaning
In order to avoid necessary data collection difficulties, a relevant even for international comparisons indicator was calculated. This one was named „normalised tax" and can be determined with this formula:

$$RNI = \frac{I_c}{PIB}\frac{r}{C_l} \quad (3)$$

Where:
RNI - „normalised tax efficiency (productivity)
r – benchmark tax rate from a country considered to be representative (where legal tax rates are close to effective tax rate)
This kind of indicator allows determining the analysed country's tax efficiency when legal tax rate is the same for all countries.

4. Risk management

Risk management is a structured procedure for identifying, evaluating, ranking and systematic treatment of risk related to tax non-compliance (for example inadequate filling and reporting of taxable objective). Administration of tax non-compliance risk is a recurrent process consisting of a sequence of well-defined steps that facilitate mechanism for decision making. But there are questions that need to be raised: Which are the main risks? Which categories of taxpayers are targeted? How should these risks be treated to obtain the best result? Finding the answers to these questions is hampered by the complexity of taxpayers' behavioural types (and the factors that favour a certain kind of behaviour), by the plurality of sources of taxable income and by many other influences.
The benefits of adopting a risk management policy are well outlined:. - a structured basis for strategic planning;
- focus on factors (no symptoms) behind tax and promote diversity in the treatment of major risks related to tax non-compliance unlike general approach solution designed to fit in most cases;
- better results in terms of efficiency and effectiveness of the program (e.g. a high rate of tax compliance, tax laws that favour a better collection of taxes and high quality public service);

- an approach able to resist external scrupulous research;
- a solid foundation for the direct evaluation, based on evidence.

Tax non-compliance risk management can be both at the strategic level (top down) and at operational level (bottom up). Risks identified at the strategic level usually require extensive and carefully planned interventions, but those identified at the operational level can be treated as arising in the daily activities.

A fundamental aspect of the process of non-compliance risk management is that strategic risk identification should take place and be resolved before the identification of operational risk. If scanning the environment sets the context in which strategic risks can be effectively identified, in turn, to identify strategic risks is where operational risks are identified. But the process of identifying strategic risks is documented by continuous accumulation of data which are progressively transformed into information and knowledge. This accumulation of data often occurs in part as a result of measures related to operational risks in the past.

Conclusions

The main purpose of the tax authorities is to collect taxes payable under the law and make it so as to maintain confidence in the tax system and its leadership. Taxpayers' actions – due to ignorance, indifference, or deliberate avoidance - and the weaknesses of the tax authorities, lead to the conclusion that the examples of failure in law enforcement are inevitable. Therefore the tax administration should possess designed strategies and structures needed to minimize the deviations.

At operational level, the objective is to identify individual cases or persons representing specific examples of customers who collectively represent strategic level risk that the authorities intend to deal with. In operational systems (or cases based), the selected taxpayers characteristics and financial transactions are examined to generate an objective measure that reflects the level of risk a taxpayer is placed compared to another.

In terms of history, many tax authorities have faced the risks of non-compliance only in terms of enforcement. Traditional reactive intervention strategies such as comprehensive audit represent a costly but necessary approach to solve certain aspects of tax non-compliance. However, the factors underlying the conduct of persons subject to any area of risk are often very complex and, therefore, it is unlikely that a one-dimensional strategy to be successful - especially one based only on verification and enforcement. Starting from these considerations, the tax authorities should be encouraged to pay more attention to understanding the factors that shape taxpayer behaviour in order to implement a more efficient set of reactions - reactions that can address the factors underlying taxpayers' compliance behaviour and not focus only on symptoms.

An effective approach to managing risk and tax compliance should be developed as a structured process of risk management that includes:
- continuous monitoring of the operational context of the tax authority and the taxpayer activity;
- identifying, assessing and prioritizing risks to the budget (revenue), the tax system overall, and reputation in the community;
- understanding taxpayer behaviour underlying factors leading to non-compliance;
- measures in case of non-compliance behaviour;
- evaluating the success of any intervention.

No strategy should be implemented without a process of assessment and reporting of results. Measurement considerations should, therefore, be an integral part of building a tax compliance strategy.

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