Chapter 1

Introduction

This chapter explains the purpose, context and scope of this report along with the key definitions and terms used throughout this report. It also sets out the business case and benefits of strengthening outcome measures.

Purpose of this report

The rationale for measuring outcomes is simple: outcomes are what revenue bodies' ultimately care about (such as improved compliance and sustained revenues). Therefore, successful performance is measured as improving outcomes. Measuring outputs (revenue bodies' deliverables) is a conventional way of assessing whether revenue bodies are on track to improve outcomes. However, output measures alone do not allow revenue bodies to tell whether their compliance strategies are effective at achieving their desired outcomes.

Revenue bodies have been working to strengthen their outcome measures for some time but have encountered practical difficulties in designing measures that provide timely indications of how successful they have been in terms of outcomes rather than outputs. Therefore this report sets out practical guidance to help revenue bodies measure the effect of their compliance strategies on outcomes, starting with guiding principles for outcome measures and then moving on to examples of current and emerging best practice in outcome measurement approaches. While the focus of this report is on outcome measures, performance measurement frameworks need to be balanced, including both outputs and outcomes, to show that the revenue body has used resources efficiently as well as effectively. As revenue bodies generally have well established output measures, achieving this balance requires enriching the performance measurement framework with more outcome measures to achieve a comprehensive overall framework of both efficiency and effectiveness.

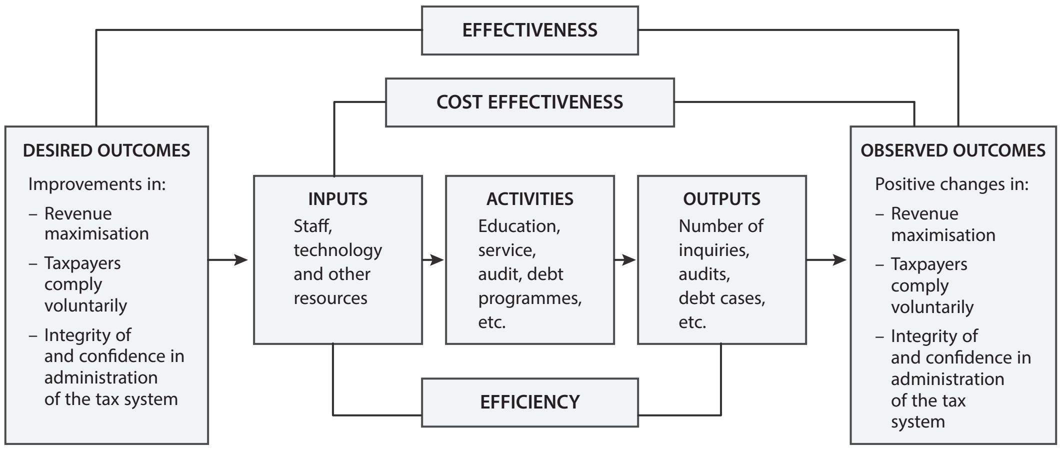
The purpose of this report is to help revenue bodies enrich and enhance their performance measures to measure the success of current and emerging compliance strategies in terms of improved compliance outcomes (defined and discussed in the next section). The context for this work is the evolutionary change in compliance approaches (discussed later in the introduction). Many of the developments in performance measures follow a similar evolution building on previous measurement approaches. Revenue bodies have common goals, such as collecting the right tax at the right time in the most efficient way, and therefore common interests in developing outcome measures. While there are common outcomes the best way of measuring these outcomes will depend on the data available to the revenue body. Additionally, differences in approaches and priorities mean that there is no single "right" set of measures and revenue bodies will need to decide what measures they need to manage their organisation.

Definitions of key terms

The tax compliance programme logic model is frequently used to relate how revenue bodies' actions deliver outputs which in turn improve outcomes (Figure 1.1). This model includes measures of outputs and efficiency as well as measures of outcomes and effectiveness. These terms are defined briefly below:

- **Outputs** are the deliverables (products or services) of the revenue body's completed internal activities.
- **Outcomes** are the ultimate desired objectives, what the revenue body's strategy sets out to achieve; these are often external to the revenue body.
- **Efficiency** is the ratio of the revenue body's outputs to inputs; increased efficiency means delivering more for less.
- **Effectiveness** is the extent to which the revenue body's activities and outputs achieve desired outcomes.

Figure 1.1. **Tax compliance programme logic**



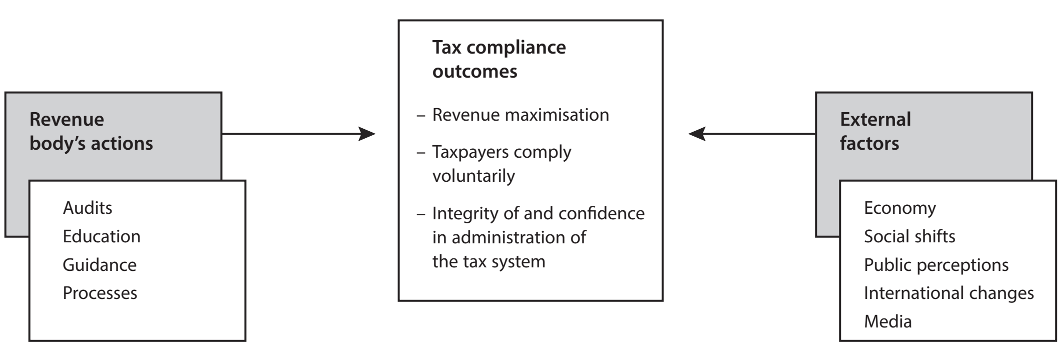
Source: Based on *"Evaluating the Effectiveness of Compliance Risk Treatment Strategies"* (OECD, 2010a).

There are three main interconnected categories of tax compliance outcomes:

- **Revenue outcomes**: These relate to collecting the right tax at the right time. The focus is less on taxpayers' behaviour and more on getting the right tax result. This is often expressed as maximising tax revenues or closing the tax gap.
- **Voluntary compliance outcomes**: These relate to taxpayers' behaviour in complying voluntarily with tax obligations: registration, filing, reporting, payment and any additional obligations. In essence, it is about taxpayers being "in control" of their tax obligations, which covers both what tax results and how the taxpayer got to that result.
- **Integrity outcomes**: These cover both that the revenue body administers the tax system fairly and that the community has confidence in the revenue body's administration of the tax system.

Given this report's focus on outcomes and effectiveness it is important to note the distinction between outcomes and effectiveness (which are sometimes used interchangeably). Tax compliance outcomes are defined as the levels of voluntary compliance, the levels of uncollected tax and the levels of confidence in the tax administration. Effectiveness is defined as the extent to which the revenue body's actions achieve these outcomes. Outcomes are affected by both the effectiveness of the revenue body's actions and external factors outside the revenue body's control.

Figure 1.2. **Influences on tax compliance outcomes**



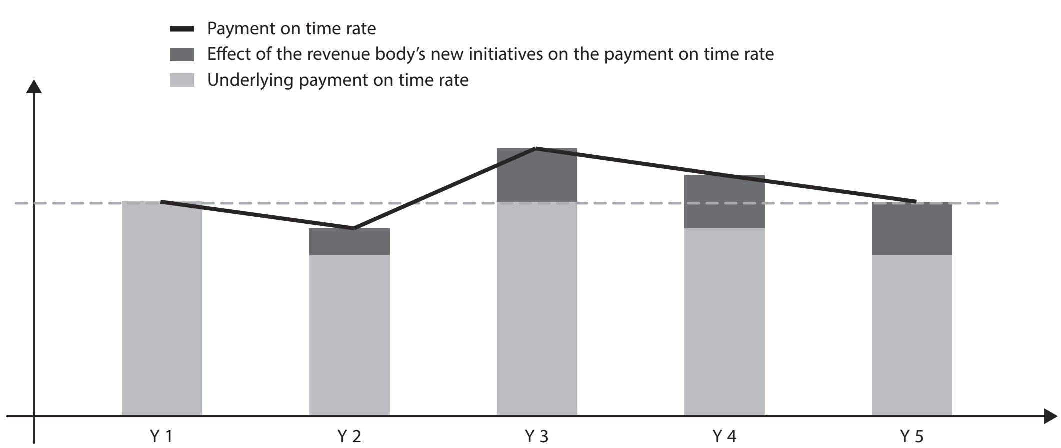
At the strategic level (organisational level or across the wider tax administration system), outcomes are revenue bodies' ultimate goals so it is important to measure outcomes even if changes may be due to external factors and the effect of specific interventions cannot be disentangled. These outcome measures need to be interpreted in context, such as considering changes to external factors and the trend in the outcomes.

However at the operational level (programme, project or team view), measures are required that allow the revenue body to identify what approaches are working (whether the intervention is effective). Revenue body use numerous interventions simultaneously and if only the outcomes are measured it will not be able to tell which interventions are successful and should be increased, and which interventions are unsuccessful (or even damaging) and should be ceased.

Therefore what makes an outcome measure fit for purpose depends on the purpose that the measure will be used for. For use at strategic level measuring outcomes and interpreting in context may be enough, but for use at operational level revenue bodies need measures that help identify which interventions are effective.

Figure 1.3 illustrates the difference between outcomes and effectiveness. In this example, a revenue body's desired outcomes are high rates of payment on time. It therefore introduces new initiatives to influence taxpayers to pay on time. At the operational level, it measures the effect of these interventions (shown by the blue bar). These interventions are effective and increase the payment on time rate higher than it would otherwise have been (the grey bar shows what the payment on time rate would have been without the new interventions). At the strategic level, the overall outcome (shown by the black line) fluctuates due to the revenue body's actions and changes in external factors, such as economic conditions.

Figure 1.3. **Differences between outcomes and effectiveness**



Strategic measures of the overall outcome and operational measures of effectiveness are complementary. Together they allow the revenue body to present a nuanced performance narrative: the overall outcome has remained stable as the effectiveness of the new interventions has been balanced out by more challenging external factors.

Context

Revenue bodies' approaches to achieving tax compliance outcomes have evolved significantly in recent decades, in part due to a changing operating context and an improved understanding of why taxpayers comply. Each new step has built on experience and knowledge from the previous steps. However performance measures have not kept pace with this evolution of approaches.

Revenue bodies' traditional basic instrument for ensuring tax compliance is auditing submitted tax returns. This remains one of the most important compliance treatments for all revenue bodies. Traditional deterrence approaches focused predominately on audit coverage, motivated by a view that taxpayers' compliance behaviour is decided primarily by an economic cost-benefit risk calculation. This assumes taxpayers comply because the likelihood and costs of being caught evading outweigh the likelihood and benefits of getting away with evading. From this viewpoint, revenue bodies' sole administrative tool to increase tax compliance is to increase the frequency of audits, with audit coverage (the ratio of taxpayers to audits) an obvious performance measure.

However, auditors are one of revenue bodies' most precious and expensive resources. Therefore revenue bodies sought to utilise audit resources more efficiently by selecting the highest risk cases for their auditors. The OECD Forum on Tax Administration (FTA) report *"Compliance Risk Management: Managing and Improving Tax Compliance"* from 2004 articulated this risk based approach. The focus on risk selection of audit cases has been enabled by data and technology as explained by the supporting report *"Compliance Risk Management: Audit Case Selection Systems"*. This risk based approach is designed to be more cost efficient, delivering more tax revenues for lower operating costs. The success of this approach is measured primarily by the additional tax revenues from audit activities (audit yield).

"Compliance Risk Management" also set out a more sophisticated view of taxpayer behaviour which saw deterrence as just one factor amongst many in determining whether taxpayers comply voluntarily. This was in recognition that non-compliance covers a continuum from unintentional error to deliberate evasion, which cannot be explained by a purely economic model of deterrence. In response revenue bodies began to segment taxpayers according to the "compliance pyramid" (OECD, 2004a). While enforcement responses will always be required for the deliberately non-compliant, a supporting, educating or enabling approach is likely to be more efficient and effective for taxpayers that want to comply.

The OECD FTA report from 2010 *"Understanding and Influencing Taxpayers' Compliance Behaviour"* built on this with a model of five drivers of taxpayer behaviour: economy, norms, deterrence, opportunity and fairness. Through a better understanding of taxpayer behaviour, revenue bodies can make more effective use of their resources to develop strategies which will have a sustainable impact on taxpayer compliance (OECD, 2010a). While a risk based audit approach remains at the core of compliance approaches it has ceased to be the sole treatment available and revenue bodies have developed risk differentiated frameworks that apply different treatments to different types of taxpayer.

These approaches increasingly look to prevent errors from occurring at the early stages of processes ("upstream"), often before the tax return has been submitted, rather than responding and correcting them after the event ("downstream"). Upstream and downstream approaches are applicable to all taxpayer segments as revenue bodies want all taxpayers to pay the right tax at the right time, and take actions against those who don't. However the implementation of these approaches needs to be adapted to the taxpayer segment because segments' environments and compliance risks are not identical.

The OECD FTA report from 2012 *"Right from the Start: Influencing the Compliance Environment for Small and Medium Enterprises"* set out that some risks are most effectively addressed through upstream approaches and some by downstream approaches. Therefore "prevention and cure are, in this way, complementary aspects of any balanced regulatory strategy" (OECD, 2012). However the OECD FTA report *"Together for Better Outcomes"* from 2013 noted that work is needed on performance measures for these approaches:

> Narrow output measures are relatively easy to work with, but may channel attention and resources away from innovative approaches. Documenting outcomes and attributing them to revenue body activities (and their individual components) on the other hand represents a number of challenges. Therefore more pragmatic approaches are often required (OECD, 2013).

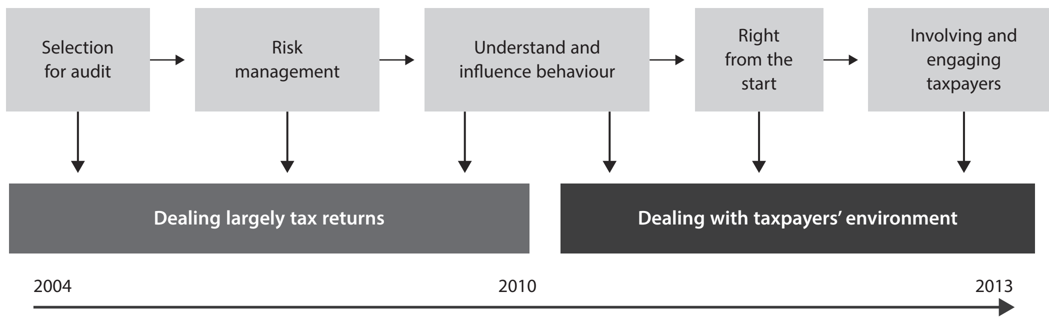
The OECD FTA report from 2013 *"Co-operative Compliance: A Framework"* sets out seven pillars for a co-operative approach to achieving large businesses' tax compliance outcomes. This approach aims for the right tax to be paid at the right time so that the revenue body has justified trust in the tax return rather than needing to audit by default. As with the approaches outlined in *"Right from the Start"*, the tax return ceases to be the starting point in the compliance process and should often be the end of the compliance process, as contentious issues are identified and resolved prior to filing. This approach is not suitable for all businesses as it is dependent on taxpayers providing disclosure and transparency upfront. However it brings benefits of early certainty for these business and reduced costs from tax disputes. The report identified limitations of current measures for demonstrating the success of co-operative compliance and made three relevant recommendations on developing performance measures:

- Measures of the effectiveness of co-operative compliance strategies need to be refined and integrated into the assessment of the overall compliance strategy. Measures which rely on audit interventions alone will not suffice. Revenue bodies need to place greater emphasis on a basket of measures with an outcome rather than an output focus. At the tactical/operational/activity level measures are needed that help guide activities towards actions that are most effective in terms of outcomes.
- Measures of co-operative compliance will need to focus on the portion of the tax base that is assured as accurate as a result of there being a co-operative relationship. There is also scope for revenue bodies to make much better use of data about disputes to inform strategic thinking and policy making.
- Revenue bodies should use improved measures to validate the business case for co-operative compliance and to make the contribution it makes to overall compliance outcomes more transparent to their key stakeholders (OECD, 2013).

The most recent work of the OECD FTA from 2014 *Tax Compliance by design: Achieving improved SME tax compliance by adopting a system perspective* focuses on designing compliance into systems. This encompasses not just the revenue body's processes, but recognising that revenue bodies can influence the compliance environment, and the processes of taxpayers and stakeholders. Insights from behavioural economics and psychology show that "small changes in the taxpayer's environment can have a big impact on behaviour" (OECD, 2013). Revenue bodies utilising these approaches have found that small changes in processes or the taxpayers' environment can have significant effects on compliance.

Figure 1.4 summarises the evolution of tax compliance approaches: each new approach has built on those preceding it. However, performance measures have not kept up with innovations in the range of revenue bodies' compliance interventions (defined as any action initiated by the revenue body to correct taxpayer non-compliance or encourage taxpayer compliance) hence the need for this report.

Figure 1.4. **The evolution of tax compliance strategies**



Source: OECD (2014), *Tax Compliance by design: Achieving improved SME tax compliance by adopting a system perspective.*

The introduction of innovative approaches has been highly influenced by changes in the operating context, as new technologies have both facilitated new approaches and created new risks that need to be addressed. For some revenue bodies the need to reduce costs has also led to changes in compliance approaches. Throughout the evolution of revenue bodies' compliance strategies, each new approach has built on previous approaches, and audits remain a key source of insight into compliance behaviour. These approaches have not replaced each other but as set out in *"Right from the Start: Influencing the Compliance Environment for SMEs"* are complementary as each approach works best in different circumstances. Therefore the best compliance strategies choose the most appropriate intervention for the risk or opportunity, rather than utilising one approach for all. This will be a balance of upstream and downstream approaches.

These new approaches have not diminished the importance of core audit activities. In fact, they have increased the effectiveness of downstream audits (and investigations) as these are increasingly targeted at the minority of taxpayers who are the worst and most prolific deliberately non-compliant. This complements upstream approaches for taxpayers willing to engage and co-operate with the revenue body. It sends a strong deterrent message and reassures taxpayers who voluntarily comply, that deliberate non-compliance is being tackled and penalised. Many revenue bodies embarking on upstream compliance approaches have at the same time focused resources on the most serious forms of non-compliance, such as prosecutions for tax evasion.

The business case for an improved set of performance measures

As the previous section shows most revenue bodies have well established performance measures for their traditional activities. Measures such as audit yield generally work well and their limitations are known and can be mitigated. Similarly some output measures, such as measuring the quality of the revenue body's work, will be required for upstream and co-operative compliance approaches. Output measures will remain an important component in the basket of compliance measures for most revenue bodies as output and outcome measures together deliver a balanced performance narrative. However, these performance measures do not do justice to many of the newer approaches. Performance measures therefore need to be refreshed as revenue bodies' compliance strategy and approaches evolve.

These limitations have been noted in two OECD FTA reports from 2013 *"Together for Better Outcomes: Engaging and Involving SME Taxpayers and Stakeholders"* and *"Co-operative Compliance: A Framework"*. Revenue bodies have become increasingly concerned that their existing performance measures can suggest failure when the true story is one of success. For example, adopting a right from the start or co-operative compliance approach might see audit yield from compliance activities decrease which appears as failure on current measures, when in fact voluntary compliance has improved and additional revenues have come in voluntarily.

A survey of the FTA membership for this report identified three main concerns with current performance measures, which tend to be focused on the revenue body's outputs rather than the impact on the desired outcomes:

- **Strategic decision making**: Current performance measures are often output focused. As the deliverables vary by activity these metrics can only measure the outputs of a limited range of compliance activities. These deliverables are not comparable across activities (particularly upstream and downstream) and this lack of common currency makes it difficult to compare the value of potential investments on a like-for-like basis, which limits the usefulness of the measures for strategic resource allocation decisions.
- **Execution of the strategy**: Current performance measures are not fully aligned with revenue bodies' desired strategic objectives and the strategic approaches used. This limits their operational usefulness as it is difficult to see the line of sight from the activities set out in the strategic compliance approach and demonstrate how they contribute to the desired outcomes.
- **Explaining the performance narrative**: Current performance measures do not enable revenue bodies to fully explain their performance narrative to external stakeholders. Revenue bodies want to be able to demonstrate how their actions influence outcomes, and explain why the approach taken was the most effective approach available.

While revenue bodies might address some of these issues through evaluation or tax gap estimation, these methods are inevitably backward looking and of limited usefulness for operational management. Therefore this report does not consider how to estimate tax gaps, which some revenue bodies use as a strategic tool, health indicator or performance indicator; or evaluation techniques, which remain important for understanding and improving interventions. Instead, this report suggests guiding principles and approaches for practical outcome-orientated performance measures to help revenue bodies run their organisations and to help address the above issues.

Scope of this report

These outcome measures are relevant for all taxpayer segments but the application and measurement approach needs to be adapted to the segment as the available data and relative compliance risks vary for each segment. Therefore this report includes standalone sections considering how each approach can be applied to SME taxpayers (which are relevant to other high-volume segments) and large business taxpayers (which are relevant to other high-value segments). While there is less coverage of private taxpayers much of the application to SMEs is relevant, and similarly many of the insights for large business can be applied to measuring the outcomes of compliance initiatives for high net worth individuals. This report does not specifically consider outcome measures for tackling organised fiscal crime; while many of the principles and approach have some application to this context there are additional challenges that need to be addressed. Some of the relevant differences between SME and large business for outcome measurement are summarised below:

Relevant differences between taxpayer segments for outcome measures

SME	Large Business
• SMEs are numerous and diverse, with a range of compliance risks, attitudes and behaviours • One-to-one engagement and audits are not possible on an ongoing basis due to the numbers of SMEs. • Wide range of compliance approaches used • Revenue bodies are taking advantage of better relevant data for compliance At the strategic level, overall compliance outcomes and trends can be estimated by sampling some SMEs in depth. At the operational level, the impact of projects can be attributed by using statistics to create counterfactuals of similar cases. Increasingly data insights will provide understanding across the whole SME population.	• Large businesses are large, complex and unique making generalisations difficult • Tax issues often take years to resolve due to complexity and litigation (often on points of law) • One-to-one engagement and audits provide the revenue with a firm understanding of taxpayers Outcomes may be visible on an individual basis, but isolating a counterfactual is challenging. For example, under co-operative compliance programmes the revenue body may be able to see that the right outcome has been achieved but it is more challenging to prove that this was due to the revenue body's actions.

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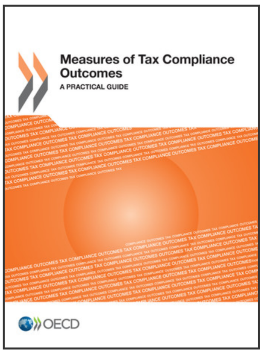

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