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MOLDOVA

ALIGNING TO BEST TAX ADMINISTRATION PRACTISES

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PREFACE

In response to a request from the Minister of Finance of Moldova for technical assistance in tax administration, a mission comprising Messrs. Allan Jensen (head), Graham Holland, and Richard Fulford (both members of FAD's roster of experts) visited Chisinau during July 12-25, 2006.

In accordance with the minister's request, the mission reviewed the authorities' strategic plan for the reform of the tax administration. The mission also reviewed the tax administrations capability to take over those tax debt collection responsibilities that are currently handled by the Council of Creditors.

The mission held discussions with Ms. Zinaida Grecianii, First Deputy Prime Minister, Mr. Mihai Pop, Finance Minister, Mr. Valeriu Lazar, Minister of Economy and Trade, Mr. Sergiu Puscuta, Director of the State Tax Inspectorate (STI), and many of his management and technical staff at both headquarters and a territorial office in the Chisinau municipality. The mission also met with Mr. Anatolie Barbarosie, Vice Director General of Customs, and Mr. Valentin Mejinschi, Director of the Center for Combating Economic Crimes and Corruption. Finally, the mission took the opportunity to meet with Ms. Ludmila Moraru, Director of the Commodity Exchange, Mr. Dimi Armasu, Executive Director of the Foreign Investor Association, Mr. Bruno Pouezat, Resident Representative of the UNDP, and Mr. Nikos Economou, Team Leader of the EU's Tacis Program.

A wrap up meeting was held with the Deputy Prime Minister and the Finance Minister on July 25, attended also by the tax director, at which the mission presented it findings and recommendations. This was a useful opportunity for discussion on the current status of the STI, the shortcomings that the mission identified, and the opportunities now available for the authorities for reflecting on the recommendations of the mission in the process of finalizing the reform strategy for the STI.

The mission would like to express its gratitude for the assistance provided by the MOF and STI, especially Ms. Svjetlana Ciumac, who participated in almost all meetings and also ensured that the logistics for the mission ran smoothly. The mission was grateful for the very close liaison with the overlapping EUR mission, led by Mr. Thomas Richardson, and for the assistance from the IMF's resident representative, Mr. Johan Mathisen, and his staff before and during the mission. Finally, the mission appreciated the invaluable help provided by Ms. Tamara Burca and Ms. Elena Bivol, the mission interpreters.

EXECUTIVE SUMMARY

Using the occasion of the Spring Meetings—on April 22, 2006—Moldovan Finance Minister Michai Pop requested FAD's assistance to review the authorities draft strategic plan for a comprehensive modernization of the State Tax Inspectorate (STI). The mission has been informed that the government intends to finalize and adopt the modernization plan by the end of September 2006.

FAD has provided technical assistance to Moldova on tax administration reform for more than a decade, contributing to the authorities' successes to implementing aspects of modern tax administration. However, in May 2004 an FAD mission in revenue administration found that reform efforts had lost momentum and that the recommendations of the 2000 FAD mission[1] had been only marginally implemented. The 2004 FAD mission[2] made specific and detailed recommendations for restarting the reforms in a number of key areas. Many of these recommendations have since been implemented fully or partially (see appendix I) The STI, however, has chosen to not implement some of the key recommendations, in particular those related to organization issues, in part due to political constraints – and most recently due to the ongoing work on establishing a comprehensive modernization strategy.

It is evident that Moldova's European aspirations have further enhanced the impetus for reforms. The European Union-Moldova Action Plan[3], signed in February 2005, provides a platform—consistent with the authorities' Economic Growth and Poverty Reduction Strategy Paper—for advancing a broad agenda of measures (including in tax administration) designed to improve Moldova's long-run growth prospects.

The preparation and adoption of an acceptable tax administration reform strategy is a requirement under the European Union-Moldova action plan that may be the basis for large-scale European Union (EU) aid to Moldova in the coming years, and is a structural performance criterion (SPC) under a new Fund program that was approved by the Board in May 2006.

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[1] Olivier Benon , et al., Moldova: *Priorities for Improving the Large Taxpayer Unit and Strengthening Tax* Administration, August 2000.

[2] Graham Holland, el al., Moldova: *Further Modernization of the LTU and the VAT*, October 2004.

[3] The EU Moldova Action Plan is a political document laying out the strategic objectives of the cooperation between Moldova and the EU. Its implementation will support Moldova's objective of further integration into European economic and social structures by advancing the approximation of Moldovan legislation, norms and standards to those of the European Union

The aim of the tax administration reform is to reduce the administrative burden of the tax system and strengthen revenue collection. The Fund Program specifically requires a reform outcome that includes a risk-based approach to audit and enforcement, improvement to the VAT refund process, and the use of indirect audit methods of assessing tax liability as a means of combating under-invoicing in external trade. The authorities have since nearly completed the drafting of a tax administration reform strategy - which has been a subject for review by this mission. In line with an agreement between the mission, the deputy prime minister, and the finance minister in a meeting on July 12, 2006 that was also attended by the IMF's European Department, the mission has:

- ✓ verified whether sound strategic management methods have been used to develop the strategic plan for the modernization of the STI;
- ✓ assessed the STI's current development in key tax administration areas against internationally recognized practices to identify possible major deficiencies that require improvements;
- ✓ attempted to verify whether these needs for improvement are properly reflected in the objectives of the draft strategic plan; and
- ✓ assessed whether the strategic plan is a proper basis on which the STI can commence its reform activities or if adjustments are required.

The mission recognizes that the authorities have made considerable efforts to develop a comprehensive modernization strategy that contains many good elements. Nonetheless, the strategy paper leaves much open for interpretation. The objectives are very broad and, thus, are not measurable. In addition, it appears that the planned reform measures may not sufficiently match the objectives they are intended to deliver.

Obviously, the strategy has not been developed in the way large institutions would normally go about developing strategies that have major and long-term impact. Some key building blocks in the strategy building process have been left out (see chapter III). However, strategic planning is an ongoing exercise performed each year and the STI is encouraged to incorporate all phases of the planning process in a top-down manner when preparing the 2007 version of the plan. Meanwhile the current 2006 – 2010 strategic plan represents a good start and the mission believes that with some further work it may serve as a true guide for tax administration reform in Moldova.

In the course of the mission's review activities, it identified a number of deficiencies in the organization and operations of the STI, which are discussed in chapters I-VII of this report. STI management is aware of many of these shortcomings and may have intended the broad objectives of the strategic plan to include these issues. In finalizing the current strategic plan, the broad objectives it contains need to be replaced by clear, measurable objectives describing these and other issues the STI wish to address through the reform. Key recommendations of this report are:

⇒ Finalize the current strategic planning using a top-down process to identify, through this report and other analysis available to the STI, the major gaps in achieving a modern tax administration, formulate five or six long-term strategic goals to bridge these gaps, describe measurable objectives to achieve the goals, and, to the extent possible in the time available, identify specific actions and timeframes. Develop an estimate of project costs for 2007, and seek funding for these costs as part of the upcoming budget process.

⇒ Establish a modernization task force (MTF), headed by a talented seasoned project manager, with expertise from all key disciplines, and dedicated exclusively to the development and implementation of the reforms. The MTF is likely to evolve into the much needed developmental unit in STI headquarters, therefore, action now to beef up the resources at headquarters (particularly in IT and audit) would be advisable, to fill in the operational jobs of those assigned to the MTF.

⇒ Establish a steering committee headed by the STI director and including senior members of the STI and Ministry of Finance (MOF), to monitor progress in the reforms, effect decisions as required and resolve major obstacles encountered by the MTF. An advisory committee representing major stakeholders such as the accounting community, trade and business associations, and the Ministry of Economy and Trade, that meets three or four times a year may provide good public relations and a test-bed for new forms and information pieces.

⇒ Secure funding of the reform and outside expertise to help with the implementation by identifying costs, and describing how these initiatives will contribute to broader government goals (growth in businesses, foreign investment, revenues). The existence of clearly described objectives and goals will facilitate consideration by the donor community and assist in coordinating assistance in the areas required.

⇒ Strengthen the STI by implementing a headquarters organized according to functions with distinct units devoted to program development, operations and key support activities.

⇒ Recognize that large taxpayers are distinctly different from, not just larger than, smaller businesses and ensure that information programs, service delivery, risk criteria, audit procedures and staff training in the Large Trader Unit (LTU) are designed to suit the needs and characteristics of large taxpayers.

⇒ Expand the information sources for risk analysis systems and use these systems to establish priorities in debt collection, and to select high-risk cases for audit and refund verification.

⇒ Introduce throughout the STI a system to cover caseload control in enforced collections, audit and refund units to allocate cases, track progress, record action or phases performed and record results in a standard format suitable for feedback into risk analysis systems (self-evaluation of risk criteria) and management information needs.

⇒ Establish a performance measurement system covering all operational areas with standards designed to encourage the quality, service and effectiveness levels targeted by management. Performance standards in audit and refund verification, for example, should be designed to encourage auditors to focus on material issues and to move on when these are resolved rather than continuing to crosscheck documents in relatively non-productive cases.

⇒ Ensure that business processes are redesigned in a manner that will utilize common systems to support multiple tax lines wherever feasible, not inhibit management in changing where activities are carried out, permit access to data on all taxes through a single system and capture all data to manage workload and report results as part of the process and IT system that supports it.

Once the strategic plan has been adjusted, it should guide the STI's modernization efforts. Continuing political and management support and adequate funding will be critical. An early priority would be to establish a proper project management structure that should be staffed with some of the most talented people in the STI.

The reform program should draw from experience of other countries that have gone through similar reforms, and specialist assistance will be required to train STI staff in modern project development and management techniques. There would also be a need to seek outside expertise on other components of the modernization such as the development of information technology, management information systems, and audit.

I. TAX ADMINISTRATION REFORM

This chapter discusses the broad context for modernizing the tax administration in Moldova and summarizes the current status and future modernization priorities for the STI. Later chapters outline more detailed tax administration issues and recommend actions that should be taken to address them.

A. Economic Context of Reform

Moldova's economic growth has been robust in recent years, ranging from 5 to 7 percent annually. Real GDP growth in 2005 was over 7 percent, and 6 percent in the first quarter of 2007. Inflation, which trended down since 2003 toward 10 percent by end-2005, has accelerated since, partly driven by rising import prices for oil and natural gas, reaching 11.7 percent at end May 2006. Russia's recent ban on imports of wine from Moldova and the doubling of import natural gas prices thus far in 2006 (and expectations for further increases in late 2006) pose considerable risks to Moldova's economic outlook.

Fiscal policy has remained tight. The general government posted a cash surplus of about 1.7 percent of GDP in 2005, about twice the level of 2004, and considerably better than the deficit predicted in the revised 2005 budget (1/2 percent of GDP). Moldova started 2006 running a surplus of 0.4 percent of (annual) GDP at end-March, compared with a projected deficit of 0.6 percent of GDP. The over performance stems mainly from higher-than-projected revenue—particular VAT (mainly on imports, themselves fed by continued strong remittance inflows), direct taxes, and special funds and special revenues (see table 1).

Table 1. Level and Composition of Tax Revenues, 2001-2006

(In percent of GDP)

	2002	2003	2004	2005 Est	2006 Pro.
Tax revenues	25.8	27.5	29.8	32.3	34.0
Profit tax	1.9	2.1	2.4	1.9	2.3
Personal income tax	2.1	2.3	2.5	2.6	2.5
VAT	9.0	10.1	10.7	12.6	14.0
Excises	2.9	3.2	2.8	3.2	2.6
Foreign trade taxes	1.5	1.7	1.5	1.9	1.8
Other taxes	1.2	0.9	1.0	0.9	0.8
Social fund contributions	7.3	7.2	7.8	8.1	8.7
Health fund contributions			1.0	1.2	1.3

Sources: Data provided by the authorities; and Fund staff estimates and projections.

Aiming at increasing the role of the private sector in the economy, the government has gradually been lowering the direct tax rates. The rationale is that this will encourage businesses and individuals to leave the shadow economy, while shifting overall tax incidence toward consumption. The corporate income tax rate has been reduced from 18 percent to 15 percent, and the individual income tax rates from 9, 14, and 20 percent to 8, 13, and 18 percent, respectively. At the same time, the VAT tax base has been broadened through removal of some of the exemptions, and specific excise rates have been indexed to inflation.

Income tax represents a relatively small but stable portion of Moldova's general government tax revenues, ranging from the low of 6.6 percent in 2000 to 8.3 percent in 2004. In terms of GDP, income tax revenue reached a high of 2.6 percent in 2005. One explanation for the relatively low productivity of the income tax is the large share of informal economy (estimated at 20-40 percent of GDP), in part linked to the important role played by the agrarian economy (agriculture contributes 20 percent to overall GDP). The desire to expand the income tax base by bringing in more taxpayers and the previously unreported income motivated the government's decision to lower income tax rates. This was done gradually over several years.

One of the interesting developments accompanying the income tax rate reductions has been the growth in personal income tax collections. The authorities attributes the increase in income tax collections, expressed in percent of GDP, mainly to the transition toward the official economy encouraged by lower tax rates and stepped-up tax compliance enforcement.

B. Current Status of Tax Administration in Moldova

The State Tax Inspectorate was established in 1990 and administers primarily income tax, VAT, excises and social contributions. The authority has a staff of 2,162 spread across a headquarters, and 41 offices across the country. The overall tax collection in Moldova is relatively high when compared with other CIS countries (see table 2).

Table 2. CIS: Tax revenue—2000–04[4]

(In percent of GDP)

	2000	2001	2002	2003	2004
Armenia	17.7	16.9	17.2	16.5	17.2
Azerbaijan	14.5	14.6	15.1	15.7	16.9
Belarus	37.7	37.1	35.4	36.9	35.2
Georgia	14.2	14.3	14.4	14.5	18.2
Kazakhstan	20.0	22.3	22.5	24.1	24.4
Kyrgyz Republic	15.1	15.7	17.5	17.7	18.4
Moldova	25.0	24.4	25.8	27.5	29.8
Russia	35.1	35.1	35.1	33.9	33.9
Tajikistan	12.9	14.1	15.0	14.9	15.2
Ukraine	33.4	33.5	36.5	30.8	30.9
Uzbekistan	33.2	30.4	29.5	29.6	29.7

Source: country authorities and IMF staff estimates.

The STI has succeeded in implementing a number of aspects of modern tax administration. This included the reorganization of the State Tax Inspectorate (STI) largely along functional lines and the establishment of the initial structures of a large taxpayer unit (LTU). Some strengthening of taxpayer audit and enforcement activities was also achieved, and a

[4] Includes social contributions

centralized national document-processing center was established. It has achieved a situation of near full taxpayer compliance with VAT returns filing requirements and has no encoding backlogs. The top management in the STI is committed to modernization (preparation for reform is underway – a draft reform plan has been developed for 2006-10.

While some progress has been made in recent times in audit, VAT refunds and in the cooperation with other Moldovan law enforcement agencies, the STI is still characterized by a number of weaknesses which, unless addressed, will limit the tax department's ability to improve tax payer compliance and thereby revenue collection performance.

Many of the legitimate concerns of the private sector of the business environment stem from the authorities' lack of efforts to effectively address shortcomings in tax administration. There is a distinct need to improve the effectiveness and efficiency of tax collections and lower the administrative burden of the tax system.

Most of the weaknesses and some of the solutions needed to correct them, are known to senior officials in the STI, and with the limited resources available to them, they have made efforts to improve their operations. However, the STI is limited in its capacity to translate modern concepts of administration into reality. The weaknesses they face in the system include:

- There is a generally weak community culture towards paying tax, with evasion and fraud in many areas.
- Taxpayers are unclear about their tax liabilities due to frequently changing, complex tax laws and poor information programs.
- Because reporting requirements change frequently, taxpayers manually complete numerous tax reports, supplements and lists, often involving the same data requested for different reports.
- There is relatively little taxpayer education, information dissemination, and taxpayer assistance.
- There is a lack of strategic management, business planning and organizational performance management systems.
- The lack of management information systems is limiting management's ability to monitor performance and make informed decisions about where to deploy limited resources
- Headquarters do not perform the developmental activities needed to maximize the current effectiveness or ensure the continuing health of field operations.

- Audit staff operates with outdated procedures, little equipment, poor systems support, and are unable to deal directly with computerized accounts.
- Operational process which need to be updated to increase their efficiency and effectiveness.
- Government salaries are relatively low making it difficult to attract people with education levels suitable for audit or to staff headquarters positions with qualified people.
- Insufficient skilled and trained staff.
- Lack of a human resource management system to adequately measure and reward good performance or to identify and deliver staff developments needs.
- Worn-out physical infrastructure and equipment. The office environments are not conducive to modern tax administration. Much of the IT systems are outdated.

The challenge now facing the STI and the government is to conclude on a reform strategy that can capitalize on the recent years positive developments and can attract donor interest in providing technical assistance to the modernization of the STI. Section C of this chapter provides a vision of the type of tax administration that the authorities should be aiming to create in the coming years.

C. Key Features of Modern Tax Administration

Recent years have seen major reforms in tax administration all over the world as governments strive to improve efficiency and effectiveness of their operations. Central to these reforms has been the establishment of sound corporate governance practices, including the application of modern self-assessment and risk management approaches aimed at achieving the best overall tax compliance outcome for the resources employed.

Tax administration is about optimizing collections under the tax laws in ways that sustain community confidence in the tax authority and in ways that demonstrate that tax systems are operating correctly. Many factors impact on the efficiency and effectiveness of tax systems and thus on compliance outcome - for example, the political, socio-economic and organizational context in which the system operates, tax policy and legislation, organizational set up of the tax authority, turnover of institutional knowledge, resource allocations, IT-systems, tax payer services and education, compliance cultures, deterrent instruments, educational skills and powers of tax personnel as well as staff moral and corruption levels .

In recent years, however, other factors have substantially increased tax compliance risk. These include the growth in international trade, supported by e-commerce developments, changes in employment patterns and growth in the numbers of contractors, innovations in business structures and financial products.

Therefore, tax administrations are witnessing increased demands on their resources that necessitate they constantly keep up-to-date with trends in modern tax administration. Current experience shows that the most efficient and effective tax systems are those with the following features:

- ✓ **Legislation.** Laws and regulations, which are relatively simple, easy to understand, implement, and to comply with. Legislation that (1) takes full account of taxpayers' rights, accountability and responsibility; (2) provides the basis for a modern and efficient tax administration; (3) ensures an adequate administration and enforcement of the tax legislation; (4) includes feedback systems, which identify failures in the implementation of the legislation.

- ✓ **Autonomy**. Modern tax administrations have political autonomy to manage their day-to-day decision making and operational activities – they are independent of political changes. They enhance taxpayer confidence in the administration through the display of fairness, impartiality, honesty, integrity and professionalism and through the development of transparent systems and procedures.

- ✓ **Integration.** All tax administration and social contributions collection matters are integrated and administered by a single tax administration. This includes law enforcement matters such as intelligence gathering and fraud investigations.

- ✓ **Public opinion.** Public opinion represents an important consideration for revenue authorities. The regard with which an authority is held within the community has a direct impact not only upon the community attitude towards compliance but also upon the ability of the revenue authority to successfully administer the taxation system – and upon the morale of revenue agency staff.

- ✓ **Voluntary compliance.** The promotion of voluntary compliance is a major strategic objective of modern tax administrations. A taxpayer compliance policy is designed and implemented throughout the country. Services dealing with taxpayers' assistance and education are accessible and provide timely dependable information through different means (e.g. by telephone, in writing, personal contact, electronic network, etc.) The Tax administration contributes to the development of a compliance-friendly framework for bookkeeping, invoicing (including electronic invoicing and self-billing) and filing.

- ✓ **Risk Management.** The operational priorities of tax administrations are driven through the process of risk assessment. Strategies to identify risks, including internal risks, are developed. In the framework of its national and international environment, the tax administration analyzes the business and legislative trends and anticipates the risk of tax avoidance and other foreseeable changes. The selection of taxpayers to be audited and selected for other types of control is based on the assessment of risk and the development of risk-based selection techniques.

- ✓ **Business planning and follow up.** A long-term strategy plan is implemented through a medium-term business plan, defining the priorities and the needs of the tax administration. Specific measurable, realistic and achievable objectives are assigned to the different levels of the tax administration in the framework of annual operational planning. A set of significant performance indicators in all areas of activity is developed, which takes into account quantitative and qualitative aspects of the tax administration and is regularly reviewed and improved where necessary.

- ✓ **Organizational structures.** The modern tax administration is organized to meet the most significant commercial risks and priorities, and the setting up of large cases/taxpayers units has high priority. Special units requiring specific skills and offering economies of scale are carefully considered (e.g. returns processing centers, tax intelligence, tax enforcement, audit units specialized by industry, etc.) The administration principally determines the structure, functional organization and allocation of resources throughout the organization by operational demand.

- ✓ **Resources.** In a general context of budgetary constraints, sufficient resources and financial means are given to the tax administration to efficiently implement and maintain the tax system. The tax administration maintains a human resource management system that supports the achievement of the administration's objectives and at the same time explicitly recognizes that human resources are the most valuable resources of the organization.

- ✓ **Collection systems and procedures.** Simple forms and straightforward self-assessment, filing, and payment arrangements facilitating administration and compliance are in place. The administration takes care not to impose procedures that unnecessarily impede the business operations of honest taxpayers.

- ✓ **Information technology.** All tax administration work functions and processes are facilitated through modern information technology - to include communication and data interchange with other national and international bodies as well as taxpayers, etc. Generally, IT systems should adopt designs that centralize and aggregate data to facilitate control by headquarters, and should be integrated in nature, as opposed to having a separate IT system for each tax type. If any IT activity is outsourced, the tax administration should retain full control over the decision-making relative to the content and operation of IT systems.

- ✓ **Internal audit**. An internal systems audit function is established, adequately empowered and operational.

D. Priorities for Reform of Tax Administration in Moldova

While the Moldovan tax administration certainly has made modernization efforts in the past, there is a need for further improvements to align the administration to modern tax administration features. The mission has identified a range of areas where it is critical that the tax administration develops and it thus offers a number of recommendations that, when prioritized, sets the global framework for the reform. The following are the mission's proposals for reform priorities for the STI (the background for the proposals can be found in the report's chapter II –VII and in the annexes):

Reform Implementation

⇒ Finalize the strategic plan for the modernization of the STI giving priority to a well-sequenced implementation over the next 3-4 years.

⇒ Establish a project team, with expertise across key disciplines, and headed by a seasoned project manager.

⇒ Establish a steering committee headed by the STI director to oversee the reforms.

⇒ Secure funding for that part of the reform program to be carried out in 2007, as part of the upcoming budget cycle, and look for donor funding for the coming years.

Establishing a Strategic Modernization Plan

⇒ Revise the current draft strategic plan to incorporate a set of strategic goals and measurable strategic objectives.

⇒ Develop key foundation statements to guide the STI strategic direction. These may include statements of mission, vision and values.

⇒ Conduct a comprehensive environmental scanning activity

⇒ Expand the information sources for risk analysis systems and use these systems to establish priorities in debt collection, and to select high-risk cases for audit and refund verification.

Organization and Management

⇒ Review the organization structure of the STI once the strategic plan has been finalized.

⇒ Create a full time strategic planning unit.

⇒ Develop and implement a comprehensive performance measurement system.

⇒ Develop a comprehensive human resource management strategy.

Large Taxpayer Unit

⇒ Establish a quality review function in the LTU, through the creation of a small team reporting directly to the head of the unit.

⇒ Establish an intelligence, risk analysis and audit planning unit reporting directly to the head of the LTU

⇒ Create a specialist unit to provide legal interpretation and advice.

⇒ Introduce industrial specialization within the two Chisinau based control units

⇒ Review the approach to audit case selection, frequency of audit and techniques applied - following the creation of the intelligence and risk analysis unit.

Audit

⇒ Develop audit procedures and performance standards that encourage the performance of audits based on analysis, judgment and materiality.

⇒ Expand the annual audit plan to include all significant audit activities, including VAT refunds, and the strategic allocation of audit resources to each audit activity.

⇒ Expand the data used by the risk-based audit selection system to include third party information such as government contracts, withholdings, interest earned; and introduce weighting of risk criteria.

⇒ Develop and introduce into all territorial offices computerized workload control systems that will receive assigned caseload, allocate cases to auditors, track their progress, record results to be fed back into risk-based selection system, analyze time utilization, and prepare management reports.

⇒ Establish a mid-term objective to establish unit(s) in the STI to undertake investigation of cases where tax fraud is suspected.

⇒ Amend the Criminal Code to ensure that unintentional errors in tax liability determination are not regarded as criminal offences, regardless of the amount of tax involved.

⇒ Develop detailed procedures for the indirect methods of proof to be used by the STI and establish small units of auditors to be trained in the application of these measures.

Selected Tax Administration Issues

Collection Enforcement

⇒ Amend the article of the Tax Code authorizing payment demands to be made on persons (third parties) indebted to tax debtors to provide that if the third party pays money to the tax debtor after receiving a payment demand from the STI the third party will be liable to pay that amount to the state budget as if it were taxes.

⇒ Develop procedures for issuing third party demands and encourage greater use of this enforced collections power.

⇒ Enhance the tax accounting system to permit distinction of categories of non-actionable debts (assessments in dispute, debts subject to installment agreements, debts suspended pending outcome of bankruptcy proceedings, and uncollectible debts that are dormant pending write-off) and the aging of accounts receivable.

⇒ Provide a mechanism and authority for uncollectible tax debts to be removed from the accounts of the STI.

⇒ Amend Article 180 of Part 5 of the Tax Code to permit agreements to be extended up to two years.

⇒ Amend Article 261 of Part 5 of the Tax Code to suspend the application of penalty to tax arrears covered by an agreement under Article 180.

Vat Refunds

⇒ Customs cease processing refund claims for VAT paid on imported goods and refer all such claims to the STI for approval.

⇒ Permit all taxpayers with excess VAT credits to claim a refund.

⇒ Refund claims for category 2 trusted taxpayers be subjected to desk review with 100 percent payment of the approved amount within 15 days.

⇒ The practice of auditing 100 percent of refund claims, other than trusted taxpayers, be replaced with a risk-based selection of refunds to be audited to the extent permitted by resources allocated in the audit plan.

Other Tax Administration Issues

⇒ Permit voluntary registration for newly formed businesses with sufficient investment and intent to achieve sales in excess of the VAT registration threshold.

⇒ Develop and apply systems to automatically compare monthly VAT input credits for imports claimed by taxpayers with the aggregate of VAT paid to Customs for imports by that taxpayer in the same period as recorded in the Customs database.

⇒ Establish distinct developmental units within the headquarters functions for Audit, enforced collections and returns processing, to identify, develop and introduce the training, procedures, systems and tools needed to ensure effective performance of field operations.

⇒ Ensure the IT unit in headquarters has sufficient design and programming staff to carry out systems reform.

II. Reform Implementation

A. Introduction

Many countries have undertaken comprehensive tax administration reforms .Those, which have been most successful have carefully, developed their plans recognizing the complex inter-dependencies that exist between the main components, provided adequate resources for their implementation, and tightly managed them.

Strong management of a reform project is essential in ensuring implementation success. There are numerous examples of projects that have failed because the importance of proper project management has been underestimated. To be effective, any reform and modernization program needs to be managed as a project, using modern project management techniques and governance.

The immediate task ahead is to complete the project plan for the modernization of the STI, establish a suitably equipped project team, and get appropriate management arrangements in place. This section discusses these factors and provides guidelines for how the STI's strategic plan might be implemented. It is assumed that the STI will succeed in obtaining funding for a full-scale modernization over the next 4-5 years.

B. Mobilizing resources

Given the requirement for the reform plan to be adopted by the government by the end of September 2006, immediate attention should be given to appointing a full time project manager and the initial members of a project team (4-5 persons). The project team should proceed quickly to work on immediate reform priorities (e.g., finalizing the strategic plan and ensuring that proper budget and funding proposals are worked out). This team would ultimately provide the core of a full time planning and development unit.

The project manager would have a number of responsibilities, including: (1) preparing comprehensive plans for the approval of the steering committee; (2) managing the planning or execution of the reform project; (3) working closely with stakeholders; and (4) reporting regularly to the steering committee.

Experience suggests that the bulk of the project team members should be selected from the most qualified tax administration employees who possess the required attributes and qualifications (including the ability to work effectively as a team, under pressure, and who are open to new ideas). The project team should be supplemented with people possessing specific technical skills and experience contracted from outside the current tax administration.

As the project expands, from 2007 onwards, a considerably larger (15-30 persons) modernization task force (MTF) will be required with expertise across: (1) legislation; (2) organization design; (3) business process design; (4) information technology; (5) human resources and training; (6) taxpayer communication and education; (7) buildings and facilities; and (8) project management. Box 1. outlines the responsibilities of the specialist groups within the project team.

Box 1. Responsibilities of the project team groups

Legislation. Responsible for the preparation of all proposals related to the modification of the law and regulations; and participation in the writing of guides and brochures for taxpayers.

Statistics. Responsible for the collection of data from internal and external sources to provide the project team members with analysis and statistical reports on taxpayers, tax collection, assessment, etc.

Business processes. Responsible for: (1) the design of the tax administration structure at all levels, writing of job descriptions and participation in the preparation of internal procedure manuals; (2) the design of all business processes (definition of business rules, design of forms and reports. definition of codes, etc.); (3) collaboration with the IT group in testing software applications; (4) training of staff; and (5) participation in implementation.

Information technology. Responsible for: (1) development or procurement of the IT system (and its adaptation to local needs); (2) participation in the training staff; and (3) capacity building and knowledge transfer to the IT department to facilitate ongoing support for the IT system.

Human resources and training. Responsible for: (1) identification of human resource requirements and definition of their profile; (2) identification and selection of human resources; (3) preparation of the training strategy and plan; (4) identification and definition of the training topics and courses; (5) identification of the trainers; (6) organization of the training sessions; and (7) execution of the training program.

Taxpayer communication and education. Responsible for: (1) preparation of the communication and education strategy and plan; (2) identification of targeted groups; (3) identification of communication and education tools; (4) preparation of communication and education material; and (5) execution of the communication and education program.

Buildings and facilities. Responsible for: (1) securing office space that is adequate for the functions of tax administration; and (2) managing office design and fit out.

Finance and administration. Provides administrative support to the reform team, including finance and administration, and services.

It is a feature of most tax administration modernization projects that many of the reform team members build considerable skills and knowledge important to the future tax administration. Accordingly, the project team presents an opportunity to identify and prepare future tax administration managers. The MTF will have a fixed life-span, and once the project is implemented, new headquarters functional divisions will take responsibility for the management of operations.

Funding the reforms

As with other government agencies, the STI has a budget appropriation approved on an annual basis. The government budget cycle begins in July-August and final budgets are established in November-December. An early priority will be to develop a preliminary estimate of project costs for 2007, and to seek this as part of the upcoming budget process. Progress with modernization in 2007 will be limited unless adequate funding is provided for implementation. In estimating project expenditure needs, consideration should be given to the deliverables that the STI's project plan proposes for 2007.

The development budget should cover the estimated costs of the necessary elements to prepare all the reform components such as: salaries of local and contractual employees, operating expenses of the development team, fees of consultants, training costs, and communication. A possible structural implementation budget should cover all the implementation costs related to the modernization program, including building repair costs related to reorganization, etc., procurement of information technology, and redesign of business processes.

Securing External expertise

Moldova has no experience in implementing large revenue administration reforms of this scale. The project would benefit from external expertise from the early stages. Specialist skills should be secured to assist with aspects of the implementation.

This certainly is the case for the project management task – particularly in the earlier stages of the implementation until the STI project management team has obtained sufficient project experience. Such a person (preferably with a background in modern tax administration) could support and advise the general manager, project steering committee and project manager, on key implementation issues.

Outside expert assistance would also be required for the IT program and could be useful in other areas where the tax department has little experience, such as developing management information system and audit programs. Individuals or organizations with experience in the key fields can be contracted for specific tasks. An alternative would be to seek technical assistance from appropriate organizations on a peripatetic basis.

The project should also draw from the experience of other tax administrations that have undergone similar reforms. Many countries worldwide and in the region have completed tax administration modernization projects. It would be beneficial to learn from their experience. Senior managers and project staff should consider visiting other tax administrations that have made significant progress with reforms.

C. Formalizing the reform plan

The STI should finalize its work on establishing a strategic plan for the modernization of the tax administration to comply with the government's decision to adopt the plan by the end of September 2006. This mission's recommendations should be taken into account to the extent possible. The plan should list the objectives for the modernization, the related deliverables, actions, time lines, and cost estimates.

Sequencing the reforms

The countries that have most successfully implemented a program of this size and scope, including introducing self-assessment and moving from a type-of-tax organizational structure to one based on functions and segments, have adopted a phased approach. This approach has often focused initially on strengthening headquarters and introducing or strengthening the LTU to control the obligations of the largest taxpayers. The sequencing of the reforms must be carefully determined, and the timetable for implementation must be realistic given the capacity constraints of the STI, the ability of staff and public to adjust to the reforms, and the need to ensure the effective management of current operations.

While aspects of the reform will necessarily take time to implement (for example, the redevelopment of processes and implementation of information technology), it is possible for some significant structural and organizational changes to be made during each year of the reform project. Successful implementation of major improvements in the first 12 months is likely to set the scene for the implementation of later stages of the reform program, be visible evidence to stakeholders that the reforms are progressing, and may impact on revenue mobilization.

Within the above broad sequencing, the project manager and his team will need to develop detailed plans. An important element will be a well-designed human resource plan that supports the implementation at critical stages. This will need to encompass all support activities, including: (1) management, technical, and functional training plans; (2) job analysis and design; (3) development of job descriptions; (4) workforce planning; and (5) management of the recruitment of staff into new functions.

There are usually a number of activities in a reform program that are likely to have a large bearing on the overall implementation timetable. Slippage in any of these critical elements is likely to have a serious impact on implementation of the overall plan, for example:

- Legislative timeframes will influence the ability of the tax department to implement modernized systems and processes.

- IT procurement will take some time, and the development of software applications will have a significant timing impact. Developing a high-level view of the requirements for the information technology system, identifying and contracting with a supplier, and customizing one of the many software application packages, will take at least two years.[5]

- Resolving possible accommodation issues related to a reorganization of the STI will take time. New building acquisition and fit out will require planning and careful management.

Careful attention will need to be given to such components of the modernization program implementation both during the design of the plan and all the way through implementation.

D. Project governance

The governance structure of the project is perhaps the most critical factor in ensuring success of large-scale modernization programs. There a many examples of project that have suffered serious cost a time overruns, or have failed, simply because of the absence of effective oversight.

Establishing a project steering committee

To provide appropriate oversight of the modernization program, it is proposed that a project steering committee be established as soon as possible. The director STI should chair this committee, and its membership could include deputy directors and possibly senior officials from the ministry of finance. The project manager would report to the steering committee, and would attend meetings, often with key project staff when particular issues are discussed. A possible governance structure for the STI's reform efforts is shown in Figure 1.

An early task for the project steering committee should be to bring to completion the strategy plan for implementing the reforms over the next years, including the timing of key

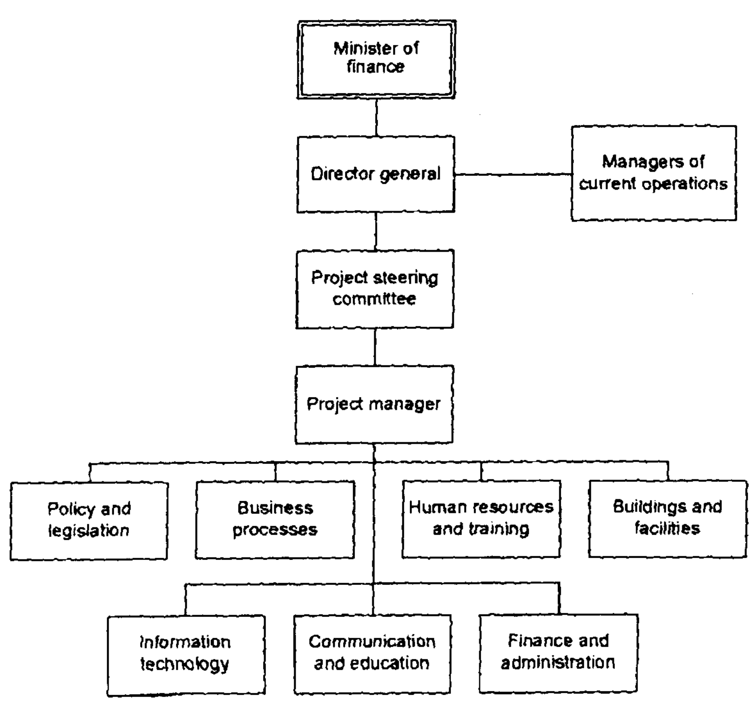
[5] Modules may be able to be implemented progressively.

deliverables. Assisting the steering committee with the development of this overall plan would be an early key task for the project manager and the existing project team leaders.

The steering committee would: (1) ensure project objectives, outcomes and benefits are clearly defined and achieved; (2) provide strategic direction and guidance to the project team; (3) approve the overall project plan; (4) ensure adequate resources are provided to achieve project objectives; (5) approve key proposals associated with various elements of the project; (6) resolve conflicts and monitor progress; and (7) recommend changes as appropriate to the minister.

Establishing an advisory committee to the steering committee representing major stakeholders such as the accounting community, trade and business associations, and the Ministry of Economy and Trade should be considered. This committee, which would meet three or four times a year, may provide good public relations and a test-bed for new tax administration initiatives.

Figure 1. Governance Structure for the Tax Administration Reform Project



E. Conditions for successful reform

Managing change associated with reform is a difficult task. During the transitional period, operations must continue, revenues must be protected, services to taxpayers must not decline, and enforcement obligations must be met. Success will be contingent on many factors, including political commitment and strong leadership.

Box 2 describes some of the conditions for successful reform in tax administration, based on worldwide experience. Not all of these conditions are yet present in Moldova. Nevertheless, the demonstrated commitment of the government, new strong leadership in the STI, and an early recognition of the importance of good project planning and management provide a good basis for the modernization.

Sustaining focus on these vital conditions for success throughout the reform period by the government, the director of the STI, and the project steering committee will be a major contributor to successful implementation and management of project risk.

All projects carry some degree of risk. Large administrative reform projects are particularly susceptible to different risks, which can affect the sustainability of the reform process. It is recommended that a formal risk management plan including mitigation strategies be prepared by the project manager and regularly updated.

Box 2. Conditions for successful tax administration reform

- ✓ Sustained political commitment and support.
- ✓ Competent, committed, and dynamic leadership.
- ✓ A clear vision for the organization's future state, with well-articulated strategies and comprehensive plans to realize the vision.
- ✓ Change initiatives set out in manageable "chunks," rather than a "big bang" approach.
- ✓ Legislation that supports the reform proposals or is modified to do so.
- ✓ Initiatives to develop executive, middle management, and other institutional capacity.
- ✓ Adequate resources, funding, and cash flow arrangements.
- ✓ A high level of accountability, founded on sound corporate governance and management structures and processes.
- ✓ Good project management and budgeting processes, with appropriate external oversight and supervision.
- ✓ Staff and external stakeholder involvement, and strong communications.
- ✓ Cohesion within the administration, between those developing and implementing reform and those performing current operations.
- ✓ Appropriate use of technical assistance.
- ✓ Steps to ensure ownership of the reform process throughout the organization.

The steering committee should regularly assess the status of risk and respond flexibly to dealing with these. In controlling risks, the tax department management will need to be responsive to the following:

- ***The need to be flexible while adhering to the critical milestones.*** In the face of the inevitable obstacles and new information and opportunities, management will need to adapt the specifics of the plans to the evolving situation, without jeopardizing the delivery of the key milestones.

- ***The need to maintain a steady and phased approach to modernization that minimizes the risk of disruption to the government's revenues.*** The sequencing of the modernization into manageable phases will contribute to a sustainable outcome. It is also important that multi-year projects of this kind deliver some early successes in order to build confidence and momentum in the reform program.

- ***The need to continuously involve key stakeholders in the modernization process.*** Government, taxpayers in their various interactions, staff, and the general public all have a legitimate interest in the successful modernization of the tax administration. All will have different concerns and needs. A careful analysis of the needs of the various stakeholders, and a plan to meet those needs, including effective consultation and participation in the reform process is essential to achieving successful outcomes.

- ***Giving emphasis to preparing taxpayers for the changes.*** This is particularly important with the proposed move to on-line filing

F. Recommendations

⇒ Finalize the strategic plan for the modernization of the STI giving priority to a well-sequenced implementation over the next 3-4 years.

⇒ Establish a project team, with expertise across key disciplines, and headed by a seasoned project manager.

⇒ Establish a steering committee headed by the STI director to oversee the reforms.

⇒ Secure funding for that part of the reform program to be carried out in 2007, as part of the upcoming budget cycle, and look for donor funding for the coming years.

III. ESTABLISHING A STRATEGIC MODERNIZATION PLAN

A. Strategic planning

The fundamental task of any tax administration always will be to maximize revenue compliance in terms of the current law. The range and complexity of the different taxes collected, national attitudes towards tax compliance, resource constraints and managerial and operational capacity combine to make this a highly complex task.

Management approaches to the task differ quite widely between countries, but the experience of the most effective revenue administrations is that the greatest compliance gains are achieved by adopting an integrated approach to performance improvement, which provides clear organizational direction and leadership through:

- developing a good understanding of the environment in which the organization operates;
- selecting and communicating initiatives and clear organizational statements directed at performance improvement;
- aligning all organization decisions to the stated aims (including those related to staffing, funding, technology, process and organizational design); and
- objectively and regularly monitoring organizational achievement of the aims.

A key mechanism for enabling the chief executive to lead the organization through this process is the adoption of a structured strategic management system. While strategic management differs between organizations, certain themes are common to most approaches. Figure 2 sets out the key steps, which generally comprise a complete strategic management system and shows, broadly, the linkages between them and a traditional development sequence. In summary the steps are:

1. Develop mission, vision and values statements
2. Conduct environmental analysis
3. State broad strategies
4. Establish strategic objectives
5. Develop action plans and allocate projects
6. Implement the plan, ensuring ongoing alignment

7. Monitor performance against plan

8. Feedback findings

The following section provides a brief explanation of each of the above steps.

Foundation statements

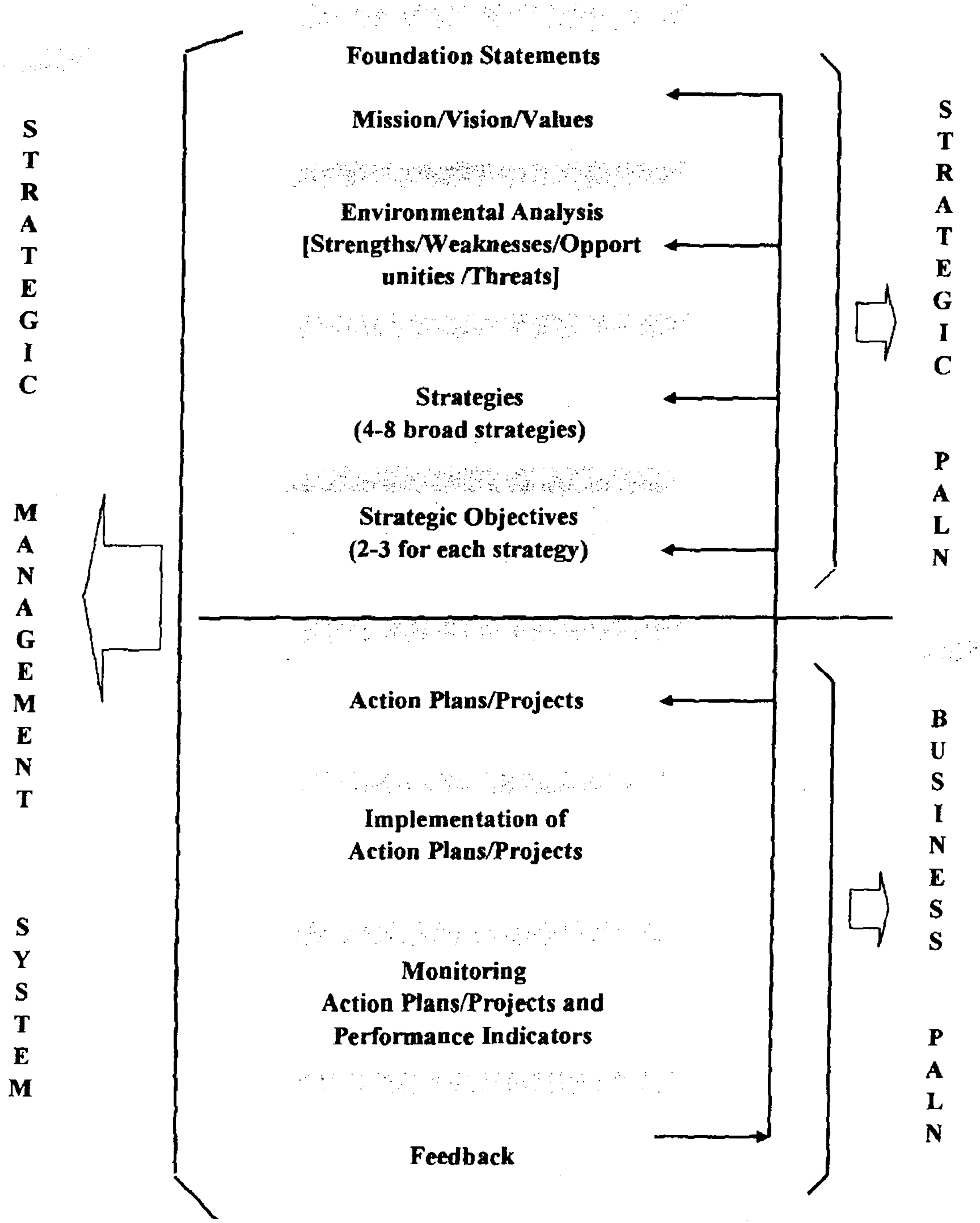
Mission. The purpose of a mission statement is to state the organization's fundamental reason for existing. Tax administration mission statements generally focus on collection, quality service and enforcement. It is quite common for there to also be a reference to the fact that tax collections contribute to the economy and the maintenance of the social system.

Vision. The purpose of a vision statement is to state the senior management's view of the future shape of the organization. It is a means of motivating staff and clearly indicating direction to external stakeholders. Most vision statements will emphasize the excellence of the organization, the achievement of targets and the establishment of an effective and efficient administration.

Values. A values statement specifies the behaviors and attitudes that the staff are expected to display on the job. It also indicates how the tax administration wishes to be seen externally. There are close similarities between most tax administrations, with the most common values being integrity or fairness, honesty, professionalism, respect, efficiency, responsiveness and cooperation.

Examples of these foundation statements used by selected tax administrations are attached in Appendix II.

Figure 2. Generic Strategic Management System



Environmental scan

The second step is key to ensuring that the strategic plan is forward looking and that it will enable the organization to react appropriately and in a timely way to the internal and external pressures on it. It involves a structured environmental scanning activity during which the organization will use all available internal and external information sources to understand the environment in which the STI operates and to identify the risks and opportunities expected to impact on the organization over the next 4 to 5 years. During this activity, the organization would review a wide range of available data including, for example:

- Statements by the Government of their priorities for revenue administration, general state sector performance and intentions for other state activities which could be impacted by the STI
- An analysis of the organization's performance data so that areas requiring improvement can be objectively identified
- Views of department specialists of emerging issues and developments relative to their area,
- Views expressed by stakeholders, obtained through consultation and if available, customer survey data
- Staff attitudes and ideas
- International developments particularly in advanced revenue administrations, but also in neighboring countries
- Market research of taxpayer attitudes to the organizations performance
- Formal reviews of the organization or other similar entities
- Internal expert's views including reports on reviews by organizations such as the IMF, OECD, and the EU.

During this part of the process, the STI ought also to be considering and documenting their own strengths and weaknesses as this will assist in developing the specific strategies needed to address the emerging trends being identified[6].

[6] Sometimes referred to as a SWOT analysis (Strengths, Weaknesses, Opportunities and Threats)

Box 3 provides an example of some of the environmental issues identified by the New Zealand Inland Revenue Department during a recent update of their environmental scan.

Box 3. Summary of Environmental Pressures- New Zealand Strategic Document 2006

1. Government priorities
The Government's priorities over the next decade are New Zealand's economic transformation, families—young and old—and national identity.

2. New Zealand in the international community
New Zealand's economy is significantly influenced by the global economy, which can influence our customers' decisions, for example, where businesses operate and where they make their investments. These decisions often have flow-on tax implications. Three examples of where we will need to focus are:

- **The increasing effect of globalization on New Zealand**—businesses are operating on an increasingly global basis. New Zealand is vulnerable to international developments owing to factors like our small economy and geographic isolation. Our tax base is particularly at risk because of our significant reliance on company tax as a revenue source and the relatively high foreign ownership of companies.

- **The future of the trans-Tasman tax relationship**—this is important because of our very close relationship with Australia.

- **Our population is becoming more internationally mobile**—in some cases, people living overseas may still have obligations in New Zealand, such as repaying student loans, and outstanding tax or child support.

3. New Zealand's diverse population
New Zealand's population is changing across a range of demographic variables, including age profile, ethnic diversity and dynamic family profiles. This affects the population we service.

4. Changing age profile
New Zealand's population, like other OECD countries, is ageing. In the long-term, the ageing population will have implications for revenue flows and the decisions that government will make about resource allocation. The ageing population will also affect the way we deliver our services and plan our future workforce.

5. Ethnically diverse population
New Zealand's population is becoming more ethnically diverse, as an increasing proportion of the population identify as Maori, Asian and Pacific peoples. One implication of increasing diversity is that different ethnic groups may have different service requirements.

6. Changing family profiles
Family structures in New Zealand are changing. The changing proportion of one- and two-parent families, will have an impact on the delivery of our child support, family assistance and paid parental leave services.

Strategies

Virtually all strategic plans contain a set of four to eight broad strategies identified by senior management as being the major issues on which the organization must focus if it is to properly address the factors emerging from the environmental scan and achieve the stated vision. These strategies need to be big, bold and challenging if they are to assist in achieving significant and worthwhile organizational change. They should not be purely incremental.

Strategic objectives

In this stage of the process, it is normal to take each of the strategies and to select two or three objectives which will translate the broad aim into operational or delivery terms. This is a significant part of the process as it is largely the level of achievement of these objectives, which will dictate whether the whole plan is achieved.

In this context, objectives are highly specific statements of deliverables which are expressed in measurable terms and which are time bound. Objectives not developed in this way are open to abuse and can compromise the achievement of the whole plan.

Develop Action Plans

This stage of the process involves translating the high-level strategic objectives into action plans or actual deliverables. Effectively, in this model, it is the point where the strategic management system shifts from broad strategic planning to narrower business planning which is concerned with shorter-term deliverables. The action plans should clearly identify:

- the tasks to be performed,
- the strategic objective to which they relate,
- the person or unit responsible for their delivery,
- measurable standards by which performance can be assessed, including, ideally, measures of the quantity, quality and timeliness of delivery
- the costs of implementing the action plan

Implementation

This simply refers to the delivery or implementation phase

Monitoring.

It is important that the performance of all key organization tasks be monitored. Generally, this requires that performance standards be set for each major task and that achievement against those standards is regularly monitored, evaluated and responded to. The importance of doing this is that it:

- ensures that those required to implement the strategic or operational task are held accountable for their "stewardship"
- provides a mechanism enabling senior management to assess the performance of units and individuals, and to make informed judgments about the performance of the organization and to objectively assess the need for operational intervention where targets are not being met
- provides a mechanism for shifting the performance focus away from simple revenue measures to all of the major operational issues which impact of compliance levels and which can be most directly influenced by management
- supplies objective information, which can be used to review and if necessary modify the strategic plan.

Feedback

This simply refers to the need to be regularly updating the strategic plan through constant reviews of performance and environmental scanning to ensure that the right issues are being addressed in the right way. The information required to enable these reviews to be conducted is gathered from evaluations of performance standard achievements and a constant updating of the initial environmental scan.

B. Current situation

The STI has been working for 2 years on the development of its first strategic plan in an attempt to develop a document, which fully integrates all of the necessary major operational improvement initiatives. A draft plan has been prepared and approved in principal by the minister of finance, although, during the mission the plan was still being worked and modified quite extensively. The intention is for the plan to be presented to Government for final approval by the end of September 2006.

The plan covers the period 2006-2010, but most of the deliverables are scheduled for 2006 and 2007. It has been calculated that additional funding of about 18 million Lei will be needed to implement the plan (about 50 percent of which is for computer development) but this estimate does not include any allowance for additional staff or increased remuneration.

The mission is impressed with the STI efforts to produce this first plan but considers that it is not sufficiently forward looking and strategic to meet the longer term needs of the STI.

C. Issues

There are no foundation statements. Not all strategic documents initially include such statements, so their absence is not fatal to the development of this first strategic plan. However, the mission senses that, as with many organizations developing their first plan, the STI is finding it difficult to lift their focus beyond the day-to-day pressures of managing the tax system and onto the longer-term issues. Developing a set of strategic statements alongside the development of a comprehensive environmental scan could materially assist in establishing a broader and longer-term view of issues.

The strategic plan does not appear to be based on the results of extensive environmental scanning. While it is clear that there has been significant internal consultation during the development of the draft plan[7], the mission does not see clear evidence of an understanding of the major emerging issues, which it needs to be preparing to address now. The documentation does not include any broad statement of the environment in which the STI is operating, nor is there a statement of the emerging trends, risks and opportunities, which the leadership sees, relevant to developing the plan.

The mission's view is that the plan has been developed from "the bottom up" rather than from "the top down". In other words, the strategy appears to have been constructed by looking at the issues, which the STI units currently want to pursue, and fitting them into an integrated statement rather than starting from the perspective of what needs to be done by the organization, and then developing the actions, which therefore ought to be done.
The mission therefore considers that the draft strategic plan needs to be refined, as a matter of urgency, to include the development of appropriate strategic objectives.

However, the mission emphasizes that this does not mean that work on the approval and implementation of the plan, as currently being drafted should cease. The current plan is a very useful operational guidance document, which integrates and identifies many important activities, which should continue to be implemented. Therefore, rather than proposing that work should be stopped on the current plan, the mission believes that implementation should

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[7] For example, working groups were formed in most areas to assist in identifying activities.

continue, but that work should start almost immediately on the preparation of the revised edition which will be a more strategic document.

The strategies are not sufficiently strategic. Because of the fundamentally "bottom up" approach adopted in the plan, the strategies do not meet the normal tests of being big, challenging and directional. Essentially, the objectives relate to continuing development of existing practices rather than to establishing major new directions or advances. For example, objective 1 (*improve* organizational functional management); objective 3 (*improve* administration of taxes ...); objective 5 (*improve* fiscal control); and objective 7 (*improve* awareness of fiscal legislation) are clearly incremental rather than strategic.

It is important that the strategies are developed by the director of the STI in close consultation with his key staff as this will ensure that they are relevant and achievable and also that there is true "ownership" of them within the STI. The mission has therefore, not attempted to construct strategic objectives from the existing planning document. However, to assist management we have considered some of the broad themes, which are reflected in the plan and set out in table 3, some indicative strategies which could address these themes.

Table 3. Indicative strategies

Basic theme	Indicative broad strategies
Human Resources	We will increase the capability of our staff so that they are recognized by government and taxpayers as being a professional, effective and efficient work force.
Taxpayers	We will increase our understanding of taxpayer needs and will tailor our interactions with them so that their specific needs are met
Procedures	We will redesign and streamline our core processes to ensure they are effective efficient, reinforce our compliance aims, and are easily complied with by taxpayers and their agents.
Compliance	Taxpayer compliance levels will be significantly increased through the use of modern control techniques such as risk based auditing

Below the level of broad strategies, the STI should develop a set of strategic objectives, which will contribute to achieving the stated broad strategic goal. Generally, there would be 2-4 measurable objectives for each of the strategies. This level of planning is similar to the goals (and some of the priority actions) included in the STI draft strategic plan, but each would be more specific. Using the above indicative compliance strategy as an example, strategic objectives could be:

1. Develop and implement, by September 2007, a comprehensive risk based audit case selection system for the LTU.

2. By March 2008, develop and implement an IT based audit support system to assist auditors to (1) plan audits and conduct risk analysis assessments; (2) conduct on site verification of computer based accounting systems; and (3) manage reports and working papers.

3. Implement, by July 2007, computerized audit workload control systems in all territorial offices.

D. Possible immediate steps to meet the September 2006 deadline

There is insufficient time to include all of the above features in the plan prior to its scheduled approval date of September 30, 2006. However, in the mission's view it will be possible to inject an appropriate level of broader strategic direction by undertaking the following actions:

State the strategies for reform. Arrange for the Director, his deputies and the staff assisting the planning process to meet to consider, and state, the four or five key broad strategic aims that define the direction that the management team wishes the STI to take over the next four years. In doing this, the members of the team should base their selection on:

a) their knowledge of the current environment;

b) existing awareness of the STI's strengths and weaknesses.

c) This mission's recommendations

A full environmental scan and STI analysis should be conducted for the 2007 plan.

Select the appropriate strategic objectives. Review the current draft of the plan, this report and any other relevant analyses, and for each of the selected strategic aims, select three to five of the strategic objectives, which the management team believes, are realistically achievable and which will make the greatest impact on achievement of the stated aim.

Express the strategic objectives in measurable terms. Draft the objectives in a way which:

- Ensures that the objective specifically addresses the strategy to which it relates,
- Enables achievement of the objective to be measured

- States the date by which the objective will be achieved.

Resource requirements. To the extent that time permits, identify the human and financial resource needs for each of the strategic objectives and identify the person responsible for delivery.

Specify the action plans. To the extent that detailed information is already included in the current draft plan, align the specific actions already identified with the relevant strategic objective.

Work on developing the full set of strategic statements (for example, mission and vision and the full environmental scan) can be done in the context of the 2007 plan.

E. Other strategic considerations

Strategies for supporting tax administration functions. The functional units in headquarters should be identifying changes in the future business environment such as the growth in number and size of businesses, increasing use of computerized accounting systems, electronic trade; and other factors such as government budgetary constraints and how STI may contribute to broader government strategies such as encouraging business growth and foreign investment.

Then strategies to ensure that STI operations are effective in that environment and consistent with broader government goals should be identified. These broad strategies might include modernizing the audit techniques, tools and systems available to the audit staff; developing expertise in issues related to multi national firms such as transfer pricing; developing information programs tailored to large and small businesses; developing performance standards to measure and improve efficiency and effectiveness of operations, and linking all offices in a network to access systems online.

Examples of some specific goals that might be proposed by audit headquarters should include the recommendations described above as well as such broader goals as development of, or progress towards, laptop computers for auditors containing programs to assist in the performance of audits and standardizing working papers and reports, linking the risk-based audit selection system and refunds selection system to computerized workload control and results reporting systems in each office; software packages and training to permit audits of computerized accounts; and improved performance measurement systems. In enforced collection, these goals might include some of the recommendations described above for improved information and caseload control.

Strategies for supporting IT System. A tax administration needs to think about its IT systems strategically, attempting to foresee the things that need to be automated, and looking forward to future operational and information needs.

The STI estimates that more than 50 percent of the costs of implementing the plans for reform are in respect of IT hardware and development costs. Success in modernizing the STI will depend on making wise choices for information technology investments. Based on the experience of other revenue administrations, certain IT trends observed elsewhere may be useful in Moldova as well. Two of these, the trend towards centralized data and systems to achieve geographic independence; and the opportunity of building common systems to support multiple tax lines, are worth a closer look.

Managers in the IT area have already moved to centralizing some important data bases in recognition that modern computers and networks can easily serve decentralized needs but great effort is required to make decentralized systems serve centralized needs. However, pursuit of this centralization runs counter to a management culture and operating philosophy that is highly decentralized. Because of the allocation of certain tax types to the budgets of local governments, the traditional view that all work in support of these must be done at the territorial level might lead to an IT implementation that is regionalized.

In designing future systems, the STI should think strategically about where work might be performed and ensure, through centralization of data, that there are no inhibitors to the flexibility that management is likely to require. For example, at some future point management may wish to provide that taxpayers be able to make payments, file returns and make enquiries at any tax office, regardless of the office responsible for their account.

As few systems as possible should be specific to a particular tax. Traditionally, revenue administrations built complete IT systems for each tax type. These involved a full range of modules from taxpayer registration through to audit. Increasingly, revenue administrations systems are being built along the lines of activities, and not tax types.

As a result, common systems supporting all or most tax types are possible for registration, returns and payment processing, accounting, collections, statement and notice production, management of client correspondence, workload control, support of taxpayer services and support of internet based services (such as electronic filing, account management, taxpayer information, electronic forms and guides). Other functions such as those for assessing returns and audit selection are usually tailored to the features of the various tax types.

Examples of some forward-looking factors management might consider in the redesign of processes include:

- Workflows that currently involve paper should not be automated in such a way that assumes continued existence of paper or the physical movement of work
- Processes should be designed and automated so that there is no requirement for any particular step to be limited as to where it occurs
- Good process design should look for opportunities to apply the same processes to multiple tax lines, thereby enabling common IT systems to be built to serve multiple tax lines, significantly reducing costs
- Modern processes should capture all the information required to manage workload and report results as part of the process and IT system that supports it, rather than gathered and reported separately.

F. Recommendations

⇒ Revise the current draft strategic plan to incorporate a set of strategic aims and measurable strategic objectives.

⇒ Develop key foundation statements to guide the STI strategic direction. These may include statements of mission, vision and values.

⇒ Conduct a comprehensive environmental scanning activity

⇒ Develop a small number of bold and challenging strategies

⇒ Expand the information sources for risk analysis systems and use these systems to establish priorities in debt collection, and to select high-risk cases for audit and refund verification.

IV. Organization and Management

A. Organization

Introduction

The mission has not studied the structure at all levels of the administration, but instead has focused on headquarters. In doing this, the mission has observed that the structure at this level is unchanged from that which was in place at the time of the previous mission, and therefore that, with a few modifications, the earlier proposals stand.

However, it is important to note that the fact that the STI is currently engaged in developing its first comprehensive strategic plan has two important implications for this evaluation of the organizational structure.

First, it would not have been appropriate to make significant changes to the structure while at the same time developing a strategic plan. This is because the design of the organization structure is one of the more important change management tools available to the director. Therefore, as the organization is about to enter a period of change and realignment, the direction needs to be firmly settled and agreed before changes can be made to the organizational structure. Therefore, the mission considers that the STI acted properly in delaying making any such changes.

Second, and closely linked to the first point, this mission is proposing that further and more comprehensive strategic reviews be conducted, and it is therefore not possible to be specific about the precise organizational structure changes required until that work is complete. Therefore, the comments on structure in this section are an indication of best practice concepts and an indicative structure rather than a formal proposal for implementation.

Design criteria

The overall design of an organizational structure is an important aspect of developing an effective and efficient organization. A good structure will contribute to:

- speedier decision making;
- better quality of analysis and improved delivery design;
- improved coordination between activities;
- more accurate and generally higher quality information flows between staff and managers; and
- increased consistency of delivery and performance monitoring.

Best international tax administration practice suggests that the organizational structure is most likely to contribute to achieving these aims if:

- communications lines are shortened by eliminating units or layers which do not add value to the process
- there is a clear separation between the design and delivery of systems. This essentially means that headquarters should not become involved in operational delivery issues.

- staff are grouped according to the functions they perform or a mix of functions and the customer segments serviced;

- the structure reflects all main operations of the organization; and

- functions or customer segments are grouped in a rational manner according to their primary responsibility areas so that departments required to contribute to common outputs are combined.

Current situation

The structure of the STI is a hybrid based principally on a functional allocation of staff but with elements of tax type specialization and an element of segmentation (LTU). Appendix III shows the current structure in simplified form.

Issues

Some rationalization of the structure would be possible. The mission's view is that the structure meets a number of the above design criteria, although, once the eventual direction of the organization is clearer, some improvements could be made to it. For example:

The functional grouping of units could be improved. Communication and coordination can be improved by grouping the functional departments or divisions according to their primary, responsibilities which, in a revenue administration's headquarters, are:

- ***Policy and legislative development.*** Conducting research and proposing legislative amendments to government, analyzing the impact of new legislation and assisting with the preparation of instructions and training material on new laws.

- ***Operational design.*** Developing improvements to procedures and operational policies, translating new laws into operational instructions, forms design, assessment of staffing needs, developing standards, and monitoring systems.

- ***Operational delivery.*** Oversight of field office activity, regular review of field outputs, making short term adjustments to resource allocation to ensure outputs are achieved.

- ***Service and support functions.*** Functions that support the operational units such as personnel, training, finance, planning support, publicity and systems development.

- ***Management and control***. Top-level oversight, internal control and security of personnel and departmental assets, strategic management and planning.

Although each of these broad areas is reflected in the current structure, an alternative grouping could improve coordination and communication. The following table 4, which is derived from a similar analysis presented in the 2004 mission report, indicates how each of the current functions could be grouped more logically.

Table 4. Allocation of Current departments Amongst responsibility Areas

Policy and Legislation	Operational Design	Operational Delivery	Service and Support	Management and Control
Direct Taxes Dep.	Methodology And Claims	LTU	Information Technology	Area Administration
Indirect Taxes Dept	Payment Collections	Information Processing	Public Relations	Internal Security
Foreign Tax		Field Offices	Taxpayer and Revenue Records Finance	
			Personnel and Training	

Source: STI

Reporting lines between the field and headquarters could be improved. As noted by the 2004 mission, the current structure under which all of the 40 offices report through to headquarters (spread between the four deputies) is cumbersome, unnecessarily involves a number of headquarters design specialists in field delivery activities and can lead to a lack of consistency in delivery. Many revenue administrations have addressed similar problems in one of the following ways:

- By inserting a regional office level between the field offices and headquarters (similar, in concept, to the approach used for the Chisinau offices) and requiring only the regional office heads to report to a single senior manager in headquarters. The regional offices should be small efficient guidance and oversight units only.

Structuring this way reduces the headquarters reporting to a manageable level and increases consistency by enabling all field operations to overseen by one person.

- A similar result can be achieved through a conceptually different approach, if the number of offices can be rationalized and reduced to a much smaller number. For example, if there were no more than 10 offices, it would probably be possible to have each head reporting to a single deputy, and thus achieve the same benefits as those gained through a regional approach. The mission has not attempted a review of the field structure, but notes that in its experience, a network of 41 offices appears to be excessive for the number of taxpayers in a country the size of Moldova.

- A combination of the above.

The mission cannot provide more specific advice on this issue, but recommends that it should be considered as part of the development of the next strategic plan as it is clearly an issue of some strategic importance to the STI operation.

Not all functions are clearly identifiable in the structure. While there is clear responsibility for functions such as the design of the debt collection activity, policy development, most support services, appeals and legal issues, responsibilities for dealing with return management, taxpayer services and audit design are not clearly identifiable.

As noted above, it is not appropriate to propose specific changes to the structure at this time. However, Figure 3 presents, in simplified form, an indicative structure, which would bring together the issues identified above.

A full time planning unit is required. It is common for revenue administrations with strategic planning systems to establish a small full time strategic planning unit at headquarters. Such units, which need initially comprise no more than 2 or 3 staff, would not be responsible for developing the strategic plans themselves, but for assisting top management with its responsibility to do so. Their principal functions would therefore be to:

- Gather information relevant to the environmental scanning activity, sort and analyze the information and prepare evaluations for senior management

- Facilitate the scanning activity by consulting with staff, taxpayer representatives and stakeholders and reporting findings to management

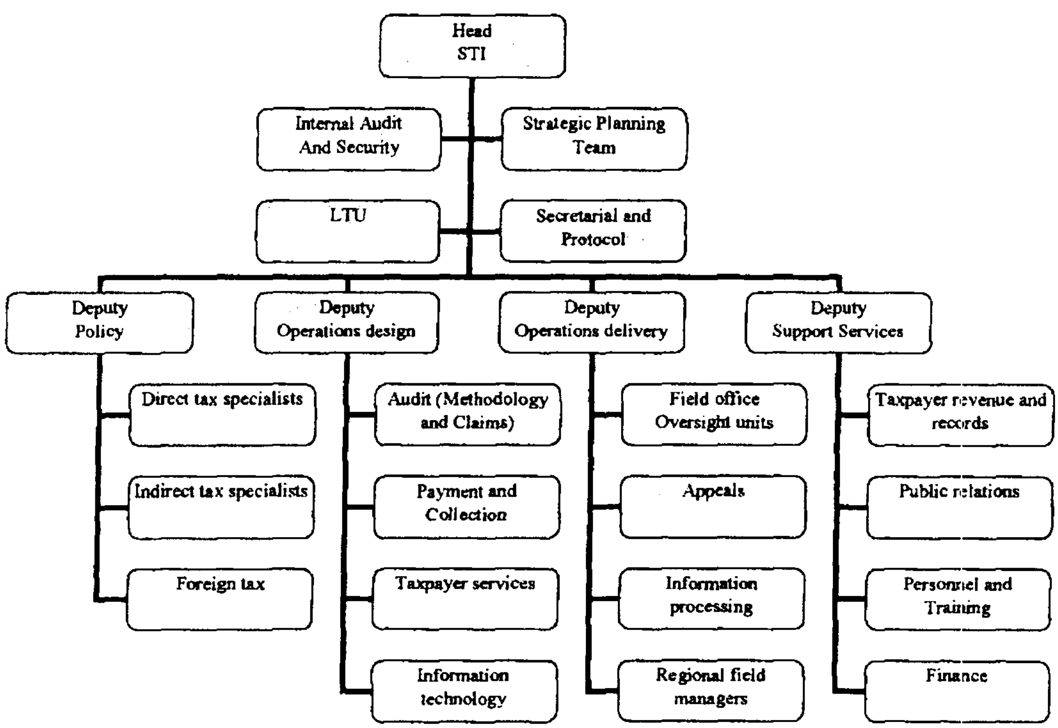
- Review periodic performance reporting data to identify the success in meeting strategies

- Assist the Director with communicating the strategic plan to staff and stakeholders

- Prepare an annual report of achievements against the strategic objectives and action plans
- Advise the director on the development of appropriate performance standards
- Coordinate the assessment of financial implications of strategic plans

A planning unit could report either to the director of the STI or to the deputy director responsible for administration or corporate servicing issues depending on the focus that the director wishes to give to the issue.

Figure 3. An indicative structure for the STI



Recommendation

⇒ Review the organization structure of the STI once the strategic plan has been finalized.

⇒ Create a full time strategic planning unit.

B. Performance Management

A well-designed and implemented performance management system is essential for the STI to be able to monitor its operations in order to: (1) create accountability for results; and (2) to learn from its performance levels so that information can be fed back into the strategic plan.

Measuring results

Measures of tax administration results are used to assess the organizational effectiveness for all key operational areas such as taxpayer services, audit and enforcement. Effective revenue administrations have all developed performance management systems which aid in assessing the organization's performance by reference to a range of deliverables rather than simply focusing on revenue yield. Such measures typically cover quantitative and qualitative factors.

Quantitative measures include the number of actions taken by the agency (e.g., the number of taxpayers served, phone calls answered, letters replied to or audits conducted). They also assess the efficiency of operation by measuring issues such as the number of calls answered per person or the amount of revenue assessed per hour of auditor time.

Qualitative measures assess the extent to which service and enforcement actions delivered meet the required quality standards. They are determined by comparing work performance against preset standards. Additional quality measures will assess accuracy and timeliness.

Current situation

The STI does not have a modern structured approach to measuring performance although key performance information is reported to headquarters and revenue achievement is closely tracked. What performance is tracked, relates primarily to quantitative issues.

While enforcing performance accountability always requires effective performance measurement, the introduction of structured strategic management provides both a further need and is also an ideal opportunity to introduce improved measurement. Without a proper measurement system, the STI will not know if strategic objectives are being achieved and it will have no objective way of providing essential feedback.

The section therefore proposes an approach to developing and introducing a performance management system.

Implementation of performance management

The development of a performance measurement system will involve the following basic steps:

1. Identify an initial set of measures for each function
2. Establish baseline levels so that future performance can be evaluated
3. Develop methods for measuring performance
4. Analyze and report results for each measure

Identify an initial set of measures for each function. From the existing workload data, procedure sheets, guidelines and practice, identify departmental expectations for how much of each task has to be completed, the time it ought to take and required accuracy of delivery. Table III.2 gives indications of sample measures for some core tax administration tasks.

Establish baseline performance levels. Until baseline performance levels are established it will not be possible to set future standards or to assess whether standards have been achieved and if so to what degree. If existing data is adequate, it will be possible to set baselines and standards at the inception. However, in many cases, the data will simply not have been kept for earlier periods and it will therefore be necessary to establish baselines (and then standards) from initial performance measurement.

For example, it can be assumed that simple quantity measures will already exist for many core activities (such as the number of audits to be conducted and the number of returns to be processed). However, it is unlikely that there will be sufficient data to enable standards and targets to be set, initially, for issues such as the standard time required to comple a complex audit.

Develop methods for measuring performance. Some measures (such as simple quantities and timeliness) can be easily measured as byproducts of processing. For example, the number of returns received and numbers of payments processed are already known from the IT system and data processing reporting. Timeliness data is probably not currently recorded, but can be easily measured if a proper time recording system is introduced.

Pure quality measured are not so easily measured as they require the work performed by staff to be independently verified. Quality can be assessed by conducting formal quality reviews of randomly selected samples of work.

Analyze and report results. Headquarters staff should prepare regular performance reports for all managers, analyzed by geographic area and functional unit. The reports should, for each target, provide information on the target, performance to date, past performance and comment on any major factors influencing the period achievement.

The development of a performance management system will be resource intensive – both during the inception phase, and to a lesser extent, during ongoing operation. The initial measurement systems development and the ongoing task of analyzing and reporting at the national level would be an appropriate task for a strategic planning unit. Table 5 shows examples on measurements.

Table 5. Tax Function Work Products

Function	Examples of Primary Work Product Outputs (Quantity)	Examples of Measures of Timeliness and Accuracy (Quality)
Taxpayer Service	Total Number of Taxpayers Assisted • Number of taxpayer calls answered • Number of walk-in taxpayers assisted • Number of correspondence answered • Number of e-mail requests answered • Number of accesses to tax agency internet site • Number of tax guidance requests completed	Average taxpayer wait time for service Average time to respond to taxpayer requests Accuracy of responses provided
Returns Processing	Number of Returns Processed Number of Refunds Issued Number of Notices Issued Percentage of Returns Filed Electronically Percentage of Returns Filed by Paper Number of Payments Processed Total Value of Payments Processed	Average processing time Average number of days to issue a refund Return processing accuracy/error rate Payment processing accuracy/error rate
Account Representatives	Number of Taxpayers Counseled/Monitored by Account Representatives Number of Risk Assessment Reports Completed	Quality of Risk Assessment Reports
Audit	Number of Audits Completed • Number of Simple Audits • Number of Comprehensive Audits	Time spent each audit Average length of audit Audit quality score Tax assessed
Collections	Total Value of Arrears Collected Total Number of Collection Cases Closed Total Number of Taxpayers Contacted	Average age of collection cases Percentage of cases resolved within X months Collection case quality score
Appeals	Total Number of Appeals Cases Closed	Average length of appeals case Appeals case quality score

Recommendations

⇒ Develop and implement a comprehensive performance measurement system.

C. Human Resource Management

Current situation

The STI currently employs 2162 staff who are distributed, geographically, as indicated in table 6.

Table 6. Geographical distribution of staff

Location	Number of staff
Headquarters	350
Chisinau (all offices)	519
Rayons	1174
Gagauzia	118

Source: STI

Both the total number and the allocation between the various levels are similar to the position when the last IMF revenue administration mission visited in 2004. This is a positive result as in the 4 years prior to that mission, staff numbers had reduced by about 900, and there were good grounds for concern that further reductions would seriously compromise the ability of the STI to perform its duties. The proportion of total staff allocated to headquarters is consistent with international standards.

The STI continues to have responsibility for its own recruitment, promotion, staff development and training, and staff turnover remains low[8]. There have been no substantive changes to remuneration levels and the performance appraisal and bonus payment systems remain ineffective[9].

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[8] In the last year, 128 staff left the STI, giving a turnover ratio of less than 5 percent, which would be low by international standards.

[9] Basically, all staff receives the performance bonus, which means that it has no incentive effect. Also, performance appraisals are conducted only every second year, and the results are not used for setting remuneration or for identifying staff development needs.

Since the last mission, a code of conduct has been developed and promulgated through the STI. The mission fully supports this initiative, as it is a positive step towards improving the private sector confidence in the integrity of STI staff. Guidelines for its use and operation have been prepared and awareness levels are said to be high (although the mission has not attempted to verify this).

There have been no developments towards the implementation of a comprehensive human resources strategy, but the draft strategic plan contains some of the elements of one. Box 4 shows elements of a human resource management strategy.

Box 4. Elements of a Human Resource Management Strategy

- The development of an organizational vision and statement of values that recognize the needs and contribution of staff.
- The provision of interesting and challenging work at all levels of the administration.
- The proper design, description, and documentation of jobs to provide the basis of recruiting, selecting and promoting people with the skills and attitudes required to do the job.
- The determination of qualification requirements, and classification grades commensurate with the responsibilities of the particular job.
- Workforce planning processes to project staffing requirements (i.e., numbers, grades, timing), having regard to workload and modernization developments.
- Flexible recruitment policies and practices to meet projected needs.
- A system of qualitative performance appraisal and feedback linked to organizational achievement.
- Selection processes based on merit, and the relative assessment of candidates against predetermined selection criteria.
- Adequate remuneration.
- The provision of training facilities throughout the administration, and the delivery of a national training program combining internally developed, and externally provided training and development.
- The adoption of codes of employee conduct (including one for taxpayer audits).
- The application, where required, of appropriate disciplinary measures, sanctions, etc.
- Balanced and legally sound retrenchment policies and practices.

Issues

***A structured approach to human resource management is required*.** The STI still does not have a comprehensive human resource strategy (HRS) covering important issues such as training systems design and delivery, career development and effective performance appraisal. The development of the strategic plan presents both an opportunity to develop a formal HRS and risk if one is not prepared. It is an opportunity because the major elements of an HRS can be either incorporated into the strategy or a separate HR document appended to it. It presents a risk because by its very nature, the strategic plan will lead to significant change management issues flowing from the modernization activities that it will drive.

The key elements of an HR strategy were set out in the previous mission report and are still relevant.

Recommendation

⇒ Develop a comprehensive human resource management strategy

V. LARGE TAXPAYER UNIT

Introduction

The IMF has assisted the STI with the development, implementation and reform of the LTU over several missions commencing with long-term advice in 1998 and 1999, and short term missions in 2000 and 2004[10].

This mission has reviewed the advice given over the course of those missions and has concluded that it is comprehensive and generally still fully valid. Therefore, this mission has focused on an evaluation of the current situation and has updated certain prior recommendations rather than presenting, again, a full model of a typical LTU.

[10] (1) Mr. Pierre Vandenberg he. was assigned to Chisinau from April 1998 to December 1999; (2) *Moldova: Priorities for Improving the Large Taxpayer Unit and Strengthening Tax Administration*. Olivier Benon, Seth Terkper and Richard Cournyea (August 2000); (3) *Moldova: Further Modernization of the LTU and the VAT*. Graham Holland, Seth Terkper, Frank Bosch and Ger Fuchs (August 2004)

Rationale for an LTU

Although a full design is not repeated here, it is useful, however, to restate the fundamental justification for implementing an LTU. The experience of many tax administrations is that when all taxes are taken into account (income tax, VAT, and withholding taxes on wages and investment income) a small proportion of taxpayers are responsible for a major proportion of a country's tax revenue. Typically, large taxpayers have quite complex tax affairs, due to one or more of the following factors:

- they often comprise distinct and geographically-scattered operating entities;
- they undertake a diverse range of business activities and/or are involved in types of businesses that frequently raise complex or novel tax law interpretation issues;
- for some taxpayers, many transactions are undertaken with "off-shore" related parties, introducing the potential for profit-shifting practices;
- they have a high volume of transactions in the course of day-to-day business operations that have tax consequences;
- they employ complex financing arrangements and/or other tax minimizing mechanisms; and
- they use high-profile professional tax advisers, part of whose brief is to minimize the exposure of the business to taxation.

This combination of features (i.e., large revenue potential, propensity to use tax minimizing practices, and complexity of their affairs) inevitably means that these taxpayers present a high level of risk to effective tax administration. Any noncompliance can have enormous potential for tax revenue losses if it goes undetected. The dedicated LTUs are designed to optimize the tax authority's ability to closely monitor and control *all* the tax affairs of such taxpayers.

A key point to be reflected when addressing LTU design issues is that because of the above factors, the businesses covered by the LTU are not simply the largest of the taxpayers, they also operate differently from smaller businesses. Therefore, the approach to the management of the businesses should not be considered as being simply an extension of the normal administration – ***large business are fundamentally different from smaller businesses and therefore they require a different management and operational approach.***

Current situation

Organizational. The Moldovan LTU currently manages the tax affairs of 355 large taxpayers which, in total, account for about 48 percent of national revenue. The unit is responsible for nearly all operational issues for its taxpayers, including taxpayer services, audit and enforcement (arrears collection). Return processing is managed on its behalf by the centralized data processing centre. Table 7 shows the total collections from LTU taxpayers for 2003 and 2005.

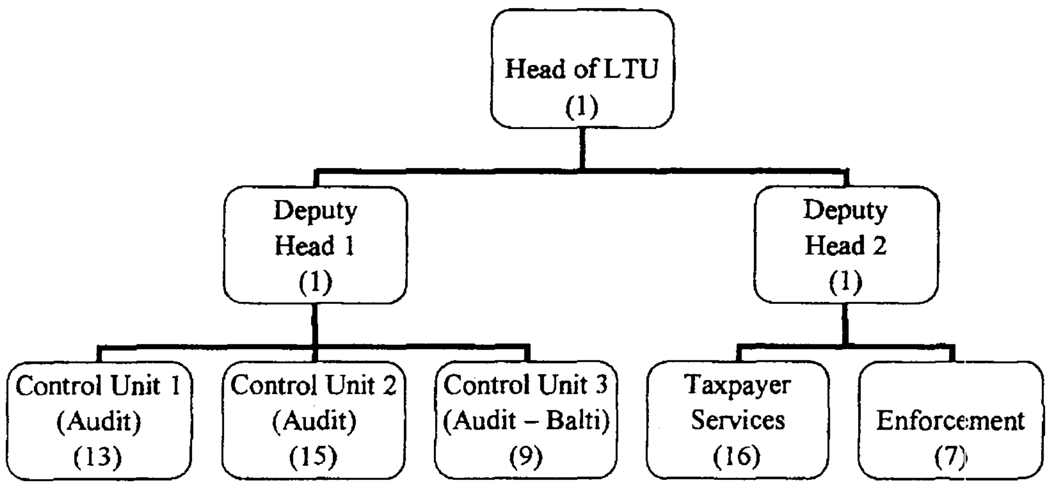
Table 7. Tax Collections by the LTU
(MDL millions)

Tax type	Collected 2003	Percent 2003	Collected 2005	Percent 2005
Income Tax	469.7	30.6	343.0	15.9
VAT	532.0	34.8	868.1	40.2
Excise Taxes	137.6	9.0	226.6	10.5
Withholding	205.5	13.4	428.8	19.9
Land Tax	8.1	0.5	11.6	0.5
Real Estate	5.4	0.3	7.5	0.4
Other	170.8	11.2	271.8	12.6
Total	1529.1	100.0	2157.4	100.0

Source: LTU

Although most core taxpayer functions are managed by the LTU, a number of support functions are managed on its behalf by the headquarters. For example, services related to appeals, audit case selection, recruitment, training, work methods and procedure design are all provided by headquarters. There is no formal industrial specialization within the unit and also no dedicated functional units for risk analysis, quality assurance or return processing. The structure of the LTU is therefore simple, as shown in Figure 4.

Figure 4. Structure of the LTU



The addition of the second deputy followed earlier IMF recommendation regarding the need to remove the responsibility for enforcement activities from the taxpayer services staff. This is a good result, which is fully supported by the mission. A total of 63 staff work in the unit, and these are distributed as shown in Figure 4. Staff levels are appropriate for the number of taxpayers being managed.

Most Chisinau based LTU staff are located in a single building in Moldova, some having new furniture in recently refurbished rooms. New computer equipment has been supplied. The position is an improvement over that noted by past IMF missions. However, the standard of accommodation provided to the LTU officers (as well as to STI officers in general) is till not good either by international standards, or in comparison with that provided to the STI counterparts in other departments such as Customs and the CECC. While the mission recognizes the government's practical limitations concerning funds, it has to be recognized that there is a minimum standard accommodation and furnishings in which staff should be expected to work to achieve reasonable levels of productivity, and to provide basic services to taxpayers. The headquarters, LTU and local office sites visited by the mission fell well below such standard.

As noted, some improvements have been made on the level and quality of computer hardware, but the level of IT support still falls well below that of a modern LTU – in terms of the ratio of computers to staff, the availability of laptops and the sophistication of the software. Other equipment, such as photocopiers and taxpayer services facilities remain below standard.

Audit results and approach

The STI has adopted an audit policy, for the LTU, under which every taxpayer should be audited every 2 years and that, when audited, all years since the last audit should be covered and all aspects of the business should be included. Therefore, there is no risk assessment applied in case selection as effectively 100 percent of taxpayers are audited. There is some flexibility to extend the period between audits in special cases (e.g., for winners of the best taxpayer award) but these are relatively rare.

The headquarters audit unit conducts an annual computer based review of data held in respect of all taxpayers (including large taxpayers) and these data provides some indications of the aspects of a business which ought to be examined, but if all aspects of the business are considered anyway, this does not amount to practical risk assessment.

Table 8 indicates the audit activity level for recent years. In this table, the column indicating the number of audits completed includes both comprehensive audits and limited scope audits (such as VAT refund checks).

Table 8. LTU audit activity

Year	Number of Taxpayers Audited	Number of Audits Completed	Cases with identified tax discrepancies	Audit strike rate (in percent)
2002	232	426	313	73.4
2003	263	562	385	68.5
2004	?	565	342	60.5
2005	249	531	320	60.0

Source: LTU and Fund staff calculations

Table 9. shows the average additional tax assessed and penalties imposed per audit.

Table 9. LTU results of audit activity

Year	Number of Audits Completed	Average Discrepancy (MDL 000s)	Average Penalty (MDL 000s)
2002	426	166.2	129.8
2003	562	88.3	85.9
2004	565	136.8	49.9
2005	531	88.7	60.3

Source: LTU

Arrears collection

The LTU has full control of the collection of arrears from its taxpayers. Significant efforts have been made to reduce the amounts owing in recent years. As indicated by table10, these have resulted in a significant, and continuing, improvement in the debt level over the last 5 years.

Table 10. Arrears for Large Taxpayers
(MDL millions)

Year	Number of Large Taxpayers	Total Arrears (MDL millions)
2001	480	287.8
2002	360	164.9
2003	360	149.7
2005	355	101.0

Source: LTU

The mission has been informed that the reductions (at least in the past two years) have been achieved through actual collections rather than through the use of amnesties. We have also been informed that there have been no amnesties in place in recent years and that when they have been used, the debt write offs permitted related to penalties only – not core tax.

Taxpayer Services

Earlier missions have expressed concern that the service component of the taxpayer services staff function was being compromised by requiring them to undertake a range of compliance tasks. However, as noted above, there is now a clear structural separation between the deliveries of taxpayer services functions and the enforcement activity. In setting up this new structure, services staff were given a specific focus on delivering assistance and advice to taxpayers and the enforcement tasks were removed to a different division within the LTU. Job descriptions have been changed and the duties conflict now appears to have been resolved.

The mission has also been informed that greater attention is being given to senior level contacts with large taxpayers in order to receive feedback The head of the LTU regularly meets large taxpayers not only at the conclusion of audits, but also through meetings with business associations, attendance at conferences and through arranging seminars on topical issues.

Issues

The structure of the LTU lacks analytical and technical units and expertise. As noted earlier in this section, large taxpayers are fundamentally different from other businesses because of the way they operate, the areas in which they operate and the level of support and assistance they receive from the legal and accounting fraternity. They have opportunities to engage in tax minimization practices that are totally denied to smaller businesses. Therefore, as also indicated earlier, the STI management of the LTU should not be seen solely as an extension of the general administration, but as something different. It is not just a simple question of there being a larger scale of operation, it is about a different way of operating. Thus, some of the practices, which work well for small to medium sized businesses, are simply not adequate for the largest.

This does not mean that all tax administration activities need to be replicated within the LTU. The unit is too small for that to be cost-effective. Some functions ought, quite naturally, to be performed by headquarters on behalf of the LTU. For example, the return processing activity ought not to be replicated within the LTU. In addition, support services such as appeals are best provided by headquarters. However, there are other functions, which do need to be located within the LTU, specifically:

Quality Review Team (QRT). Earlier missions have emphasized the need to introduce some formal, quasi-independent method of reviewing the quality of the audits conducted by the control units. The importance of this type of function is that often the most common complaint of large businesses against tax offices relates to the quality of the judgment being applied during audits and the lack of consistency of decision-making. The head of the unit therefore needs to have assurance that the audits are being conducted to a high quality standard, according to the audit rules and requirements and also that there has been no collusion between the taxpayer and the auditor.

To assist with meeting these aims, the more advanced LTUs have established a small quality review unit, reporting to the head, which has the responsibility for reviewing the completed audits to ensure that they have been conducted in a timely fashion; that they have been conducted in accordance with a proper audit plan; and that the reporting is clear and of a high quality etc. The team does not repeat the audit work itself, but conducts a peer review of the process and outcomes from which it assesses the overall quality.

Intelligence, risk analysis and planning. The mission understands that there is a current intention to add an additional functional unit to handle data analysis and planning. The mission supports this initiative, and notes that the responsibilities of the division should be broad enough to cover:

- gathering a wide range of information about large taxpayers from internal and external sources (including data from audits of other taxpayers, published reports and information, statistical data, media reports etc).

- analyzing and interpreting that data to enable industry overviews and individual taxpayer analyses to be developed.

- assistance to auditors with the development of appropriate audit plans for specific taxpayers (e.g. assisting with the identification of risk areas and the development of the approach to the audit and preparation of questionnaires etc).

- assisting the head to develop a proper risk based audit program for the LTU

In the mission's view, this unit should report either to the head of the LTU or to the deputy with responsibility for the control units.

The mission also considers that the establishment of this unit will provide an opportunity for the LTU to take over responsibility for designing its own selection criteria and perform its own risk analysis separately from that performed by the headquarters audit unit.

A key deliverable of the new division should be the preparation, is association with the auditors, of a "tax risk analysis report", for each taxpayer, which will be used to assist both in the selection of cases for audit and in the development of the audit plan for each selected case[11].

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[11] These reports would included an analysis of all of the information accumulated over time from sources such as press report, companies published annual reports (from within Moldova and overseas) stock exchange pronouncements, internal information, company publicity material etc). As an indication of the normal content of such reports, a copy of the index of a typical report is attached at appendix IV.

Specialist Technical Unit. In the mission's view, the unique nature of the issues faced by the LTU means that its specialist legal interpretation and technical support needs cannot readily be met by the headquarters general legal and methodological units. One of the key aims of establishing an LTU is to recognize that the issues arising in that unit are different from those arising for other taxpayers and that there is a need to develop specialization and a centre of expertise to enable them to be properly dealt with.

For example, virtually all of the complex international tax issues involving treaties, thin capitalization, transfer pricing, advance pricing agreements, head office management charges etc arise only in relation to taxpayers managed by the LTU. It is unnecessary and ineffective to expect the general headquarters staff (responsible for providing guidance related to the entire taxpaying population) to become specialists in the highly complex issues that affect only the top 355 taxpayers.

The universal experience of all the most effective large taxpayer units is that it is simply not possible for generalist tax lawyers and advisers within the department to develop the high level of expertise necessary to satisfy the LTU needs. Therefore, best practice is always to ensure that the LTU has its own lawyers and technical advisers who can develop the highest levels of expertise and thus start to match the level of advice, which the private sector provides to the large businesses.

There is no formal industrial specialization within the control units. The LTU has given some consideration to the development of specialization within the control units. Its analysis has indicated that its taxpayers are grouped by industry as shown in table 11.

Prior missions have given prominence to this issue and seen it as being important that structured industrial specialization be introduced into the LTU. The head of the LTU has explained to this mission that although there is no formal specialization, certain officers within the control units tend to specialize in certain industries. The STI view has therefore been that no formal or structural specialization is necessary given: (1) the small number of taxpayers; (2) the wide range of industries represented; and (3) the level of informal specialization. The mission understands the LTU view and has some sympathy with the position being taken. In addition, the mission is more concerned with the substance of the issue than its form and would not propose formal specialization simply because it is the norm.

Table 11 Allocation of LTU taxpayers by principle industry

Industry	Number of taxpayers	Percent
Manufacturing	67	19.0
Wine	27	7.7
Trade	45	12.9
Construction	23	6.7
Transport and telecom	30	8.7
Energy	17	5.0
Finance	18	5.3
Gas	7	2.2
Other	121	34.1

Source: LTU

Most countries have introduced formal/structural specialization as a mechanism for improving the depth of understanding that the unit has of specific industries. Put in its simplest terms, the narrower the range of industries that an auditor has to deal with, the greater can be his depth of knowledge and understanding of the peculiar features of that group. Greater understanding leads directly to more effective audit and therefore increased compliance and revenue.

The mission does not have the depth of knowledge of the Moldovan business sector to comment conclusively on this issue. However, our view is that if there has already been some informal allocation of industrial responsibility areas, then management has already accepted, to a degree, the benefits of specialization.

Our view is that this could be simply institutionalized by formalizing some industrial specialization within the Chisinau control units. All of the other units (taxpayer services, enforcement and any new risk and analysis units) would continue to service all taxpayer classes. The basic structure of the LTU would therefore remain the same although a small number of audit teams would be created with special responsibilities. An example of a possible grouping of audit teams would be: (1) manufacturing and trade; (2) wine and other agricultural businesses; (3) construction; (4) energy and gas; (5) finance; and (6) all other industries.

The number of taxpayers managed by the LTU is low by international standards, but is probably about right for Moldova today. Earlier missions have proposed that the number of taxpayers administered by the LTU be increased so that a greater proportion of total revenue is controlled by the unit. Since those recommendations were last made, the STI has conducted further analysis of their database and has concluded that the number of taxpayers in the unit should not be increased.

The 355 taxpayer currently allocated to the LTU accounted for around 48 percent of the revenue collected by the STI in 2005. This is an increased percentage from that achieved in 2004 (42.5 percent from 362 taxpayers) and is similar to the proportion achieved in 1999 with a larger taxpayer base. (48 percent from 529 taxpayers).

The STI has calculated that extending the taxpayer base by another 120 taxpayers would, for 2005, have only increased the proportion of tax covered by about1 percent indicating that there is a rapid fall off in the size of taxpayers beyond the current threshold. While the mission has not been able to independently verify this assessment, we note that the review was conducted from actual tax records by the Director and the head of the LTU and we therefore do not dispute the finding. Therefore, in the mission's view, there would be no benefit in increasing the number of taxpayers, and it is accepted that, at this stage, it should remain unchanged.

Risk assessment is not applied to select cases for audit. As noted above, in effect all aspects of all tax returns filed by large taxpayers are audited. This is in direct contrast to the approach taken by the best managed LTUs in which risk assessment will be applied in order to ensure that only the taxpayers who are most likely to be non-compliant are audited. The mission considers that the approach adopted in Moldova is wasteful in that it results in scarce, skilled auditors spending much of their time conducting audit for little or no result.

Evidence of this is to be found in the data showing the proportion of audits which result in no adjustment. Table 8 showed that in 2005 only 60 percent of files audited resulted in an adjustment (down from over 73 percent in 2002). While there is probably more than one possible explanation for such a low rate of discrepancy cases (for example it could be that the audits are not being performed properly), the mission regards the low strike rate as prima facie evidence that there are fundamental problems with the case selection system.
A further possible indication of a failure of the case selection system is shown in table 9, which indicates a confused but generally reducing level of collections from audit.

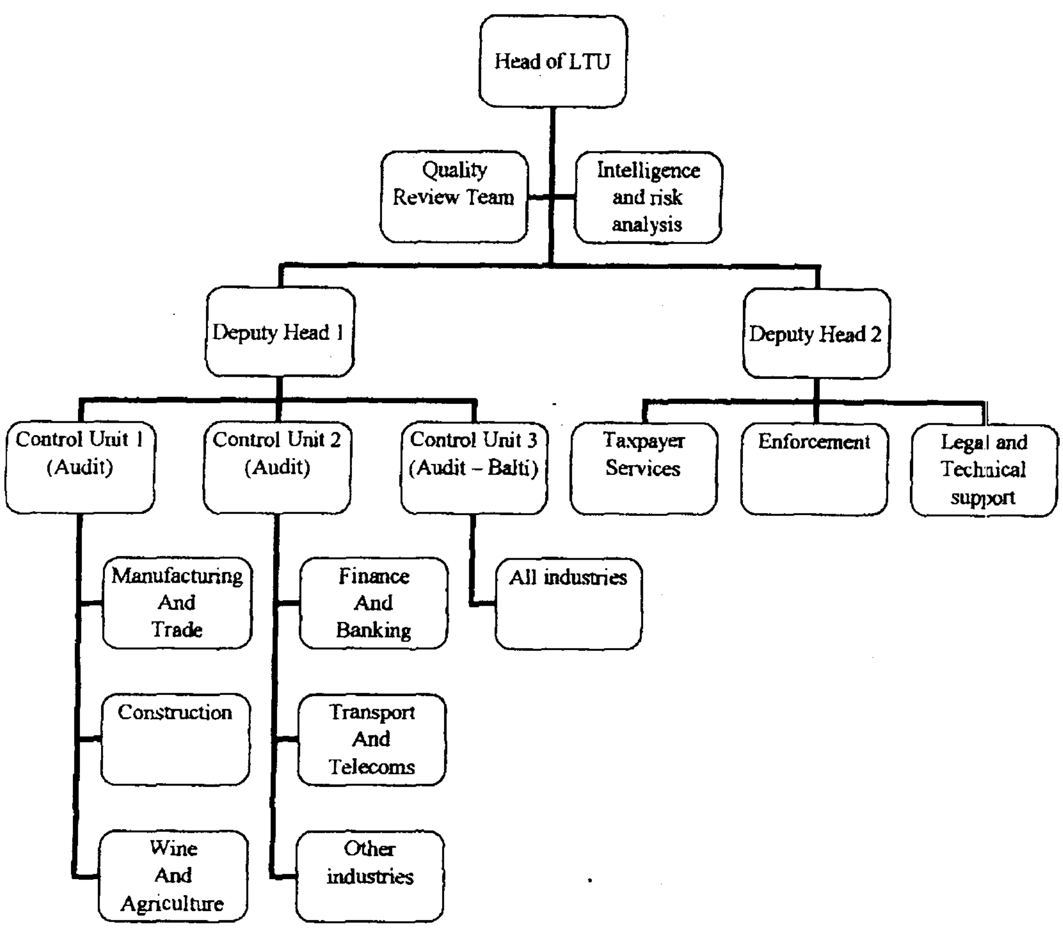
In a properly functioning audit system, risk assessment would be applied to the taxpayer base to identify and select for audit only those taxpayers for which there were clear indications that the true liability might be higher than in the returns filed. Non-discrepancy rates of above 5 – 10 percent would be unacceptable as being an indication either that the auditors were not doing the job properly or, more likely, that the case selection system was defective. No advanced administration has yet got to the point where its compliance enforcement activities are so effective that audits are showing declining returns. The mission cannot accept that this has been achieved in Moldova.

The mission is also concerned at the practice of auditing every year and every aspect of the case selected for audit. Once a taxpayer has been selected for audit, risk assessment (using all the data available to the organization) should be used to identify the specific areas of the taxpayers' activities and records where errors are most likely to have occurred and to focus the initial checks on those aspects of the most recent tax period. Only where there is evidence of serious error or fraud, would the audit be extended to cover all aspects of all years.

The mission therefore considers that, as a matter of urgency, consideration be given to fundamentally reviewing the large taxpayer audit activity so as to replace the current approach with one incorporating: (1) risk based selection of cases of cases to be audited; and (2) use of risk analysis to identify the issues and periods to be checked initially.

Organizational structure amendments flow from the above proposals. Some of the above proposals suggest that a change to the organizational structure would be appropriate for the LTU. Reflecting the above proposals, the structure in Figure 5 would appear to be appropriate.

Figure 5. Proposed LTU structure



Recommendations

- ⇒ Establish a quality review function in the LTU, through the creation of a small team reporting directly to the head of the unit.
- ⇒ Establish an intelligence, risk analysis and audit planning unit reporting directly to the head of the LTU
- ⇒ Create a specialist unit to provide legal interpretation and advice.
- ⇒ Introduce industrial specialization within the two Chisinau based control units
- ⇒ Review the approach to audit case selection, frequency of audit and techniques applied - following the creation of the intelligence and risk analysis unit.

VI. AUDIT

A. Current situation

The STI has approximately 600 resources engaged in audit (control) activities. The audit program includes complex, single issue and desk audits as well as refund verification. Table 12 outlines the number of audits performed and the resulting revenues for the years 2003 to 2005.

The Tax Control and Appeals Division (TCAD) in headquarters develops audit procedures, plans and strategies to be employed in the audit function. An audit plan is prepared annually covering full audits to be performed[12].

Cases for full audit are selected using a risk-based selection system whereby strategic factors are fed into computer along with statistical data and points are scored for each factor applicable to a taxpayer. Lists of these selected audit cases are compiled beginning with those accumulating the highest points and involving the greatest revenue.

A list of mandatory and discretionary (80 percent of which must be selected) audits is e-mailed to each territorial office (TO), and the list of selected audits is returned to

[12] For all other taxpayers than those managed by the LTU

headquarters for approval and incorporation in the national audit plan. Progress in the execution of the audit plan is overseen by 7 officers of the TCAD, each being assigned specific TOs.

Table 12. Audit activities and results 2002 to 2005

(million MDL)

	2002	2003	2004	2005
Large taxpayers:				
- Total audited turnover	188157	133046	21733	197948
- Number of finalized audits	232	263	565	249
- Number of new tax claims	212	226	342	162
- Additional taxes set	52	34	47	28
- Penalties through audits	14	8	17	19
- VAT refund audits	unknown	unknown	302	285
- reductions to VAT refunds			2.5	1.7
Other taxpayers:				
- Total audited turnover	149876	91782	6233	130482
- Number of finalized audits	24777	26448	33501	46023
- Number of new tax claims	11563	13818	19339	34049
- Additional taxes set	89	189	220	158
- Penalties through audits	119	137	87	116

Source: Moldovan authorities

The audit program of the STI involves a number of types of audits (see Table 13), including visits to new registered taxpayers, full, desk, single issue, and refund audits. Audits are conducted in accordance with guidelines provided by headquarters. Auditors have access to computers in the TO and at the commencement of an audit are provided information regarding the taxpayer reports and data from other sources. Audits of taxpayers with computerized records are conducted through review of hard copies of invoices and data reports requested from the taxpayer.

Table 13. Audit by type of audit, 2004-2005
(million MDL)

Type of finalized audits	2004			2005		
	Number of audits	% success	Additional tax	Number of audits	% success	Additional tax
Large Taxpayers						
Verification of registered entities	-	-	-	-	-	-
Examination by office	-	-	-	4	100	0.001
Audit on VAT refunds	302	57.3	2.5	285	53.7	1.7
Audit on a single issue	134	11.2	0.027	99	14.8	0.3
Full audit	129	99.2	61.3	143	100	44.5
Fraud investigations	-	-	-	-	-	-
Other Taxpayers						
Verification of registered entities	-	-	-	-	-	-
Examination by office	-	-	-	6885	92.0	3
Single issue audit (includes VAT refunds)	14271	58.0	36	21645	77.0	34
Full audit	9183	79.0	179	7445	82.0	145
Fraud investigations	-	-	-	-	-	-

Source: STI

B. Issues

Audit procedures do not provide for analysis, judgment or materiality. Current procedures are outdated, rely on extensive checking of documents and ledgers, searching for the last Lei, and completing all phases of an audit regardless of findings.

Modern tax administrations encourage auditors to take a more analytical approach, identify only material issues and terminate the audit at any point where the auditor decides nothing material remains. Experienced auditors are scarce in all tax administrations and should not be wasting time pursuing small (immaterial) amounts when better results may be achieved by applying that time to another case. Modern procedures require the auditors to evaluate the potential risks and issues as the audit progresses and to decide whether the audit should be terminated at that point or continued.

The auditors themselves are evaluated on how effectively they manage their time, wasting as little as possible in non-productive work. No doubt, this results in auditors missing some unreported liabilities and failing to find every last bit of revenue in each company they visit. But, overall results are much higher, both in terms of revenue generated and in the number of audits performed.

Developing auditors to conduct analytical audits and exercise judgment at every step involves flexible procedures, training, modern tools, good supervision, and performance measurement criteria that support these activities.

Many administrations require auditors to undertake extensive preparations[13] before commencing an audit; involve supervisors at decision points during the audit; provide software to perform integrity checks on taxpayers' accounts, extract samples and maintain working papers; and evaluate performance comparing results to time spent.
The STS needs to move audit activities in that direction but will require considerable assistance to achieve the required change in culture as well as procedures. The natural order for introducing these concepts may be to start by introducing methodologies that encourage and require analysis; then introduce the concept of materiality; and then identify decision points in the audit where the auditor is required to identify issues, evaluate their materiality and decide whether to terminate the audit.

Audit planning needs to be expanded to cover all significant audit activities and the strategic allocation of all audit resources. The current audit plan includes only full audits. A significant proportion of the audit resources are also spent on the other types of audits. Most countries recognize that the presence of a good audit program increases revenues in several ways:

- detection and assessment of underreported liabilities (mainly full audits);

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[13] Auditors are required to gather and review information on the taxpayer to be audited, prepare a plan outlining what issues they anticipate and what initial steps they will take, draft some questions they intend to address to the management and financial officer of the company and discuss these plans with their supervisor.

- reductions in refund claims (refund verification); and
- deterrence, that is the degree to which all taxpayers believe they may be audited and are encouraged to report full liabilities.

A proper audit plan recognizes the deterrent effect achieved through the broad coverage of desk, refund and single-issue audits as well as full audits. The proportion of resources to be devoted to each type of audit should be decided in the initial steps of the audit planning process. Then, having resource limits established for each type of audit, targets for the number of audits to be performed may be estimated. Such decisions at the outset permit management of the audit function to consciously shift resources between audit types to achieve the optimal revenue impact (direct and deterrent).

The data sources of the risk-based audit selection system should be increased, its analytical capabilities enhanced and evaluation criteria introduced. A good start has been made in establishing a risk-based audit selection system and some new risk criteria have been added each year. The data sources of the system should be increased to include such information as customs import data and VAT payments, government contracts, interest payments by financial institutions and other third party data.

The system should have the capacity to compare these factors to corresponding elements reported in returns and appropriate risk score attached. The outcome of selected audits should be documented in standard audit reports prepared by the auditors and used by the computerized risk-based system to evaluate which risk criteria are producing the best results.

In many countries, this feedback is achieved automatically through the computerized audit workload control system. Different weightings should be allocated to risk factors to reflect their true value in risk determination. And, the strategies reflected in the risk-based selection system should be reviewed at regular intervals to ensure current economic and market conditions are appropriately covered, ineffective factors eliminated and new risk factors developed and introduced.

Specialized units to investigate tax fraud should be established within the STI. As discussed in the FAD report of 2004[14] the STI should not rely upon the Committee for Combating Economic Crime (CCEC) to carry out all investigations of VAT and other tax fraud. While the respective roles of the STI and CCEC appear to be rationalized in respect to tax audit there is still a need to establish, within the audit function, a specialized unit to undertake investigations where tax fraud is suspected.

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[14] FAD report Moldova: Future Modernization of the LTU and VAT; Graham Holland et al; October, 2004.

Most modern tax administrations have such a unit and auditors encountering potential fraud in the course of an audit would suspend their audit and refer the matter to the fraud unit. This special unit is trained to gather evidence in a form suitable to use in prosecution and would develop the case up to the point where criminal prosecution is commenced. Naturally, such a unit would work in close coordination with the CCEC and prosecutorial authorities and may call upon the CCEC from time to time when their stronger powers of search and seizure are warranted.

Underreporting of tax liabilities in excess of MDL 9,000 is said to be a crime, whether intentional or not. According to discussion with the CCEC all such instances are offences under the Criminal Code and are to be referred to the CCEC. They are trying to get this value raised to MDL 50,000. In most instances, such cases referred to the CCEC do not get to court if the taxpayer agrees to pay the assessment and penalties and they are satisfied that unintentional errors were the cause.

In most countries, intent to defraud is the distinguishing feature that determines whether unreported tax liability is a criminal offence, not simply the amount of money involved.

The STI auditors encounter a great many audits that result in assessments of more than MDL 50,000 that involve only legitimate errors or differing interpretation of the law. It is completely inappropriate to confront such taxpayers with a choice between paying the assessment and penalties or facing criminal charges. These are simply tax assessments resulting from audits and the taxpayer's right to appeal the issues involved should not be overshadowed by concerns about criminal charges. The Criminal Code, or its current interpretation, should be amended to include intent in the criteria determining fraud.

The STI does not employ indirect methods of determining tax liability. Although there is comprehensive legislative authority for the use of indirect methods[15], attempts to assess tax liabilities on this basis[16] have not been upheld by the court.

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[15] Article 189 of Part 5 of the Tax Code provides for the use of indirect methods of determining tax liabilities where taxpayers fail to provide all or part of the books and records or tax reports. Article 225 provides a comprehensive list of sources and subjects that may be used in indirect methods.

[16] The STS attempted to establish overall underreporting of sales by a taxpayer by observing trade during several days and establishing that daily reported sales throughout the unobserved periods were significantly less than during the days they were observed.

Some countries and courts have a natural aversion to indirect methods of proof of tax liability. In such cases, it is extremely important that the tax administration demonstrate that the methods used incorporate a maximum of precision in the facts gathered and a minimum of assumptions. Many countries successfully apply indirect methods of proof when confronted by individuals who fail to file a tax return, in businesses where inadequate records are kept or suspicion of significant unrecorded sales exists. Indirect methods of proof utilize circumstantial evidence to prove that reported income or deductions are false; and are particularly useful techniques in cash economies.

The following four indirect methods commonly used to prove tax offences:

- The net worth method of proof;
- The expenditure method of proof;
- The bank deposit method of proof; and
- The retail mark-up method of proof.

The principles of each of these methods are described in Appendix V. The actual application of these methods involves highly technical and complex calculations. If such methods were to be adopted it would be necessary to engage expert assistance in developing the prescribed procedures and related training programs.

In view of the specialized nature of these methods of proof, it may be best to confine their application to specialized units placed strategically across the tax administration. All personnel in these units must be trained in their use, and as their use becomes more accepted this training could be extended to all auditors.

The current legislative authority appears broad enough to cover all the information sources and techniques employed in the four indirect methods discussed above. It is possible that the prior attempts to employ indirect methods of proof were rejected by the courts due to a lack of understanding or confidence in the methods employed. In this regard, it may be beneficial to include judges, prosecutors and investigators in the training program along with the initial auditors. Judicial consideration may then focus on whether one of the prescribed methods has been appropriately applied. The adoption of these indirect methods of proof, along with legal authority for these specific methods, would give the STI a powerful set of tools to combat tax offences.

C. Recommendations

- ⇒ Develop audit procedures and performance standards that encourage the performance of audits based on analysis, judgment and materiality.
- ⇒ Expand the annual audit plan to include all significant audit activities, including VAT refunds, and the strategic allocation of audit resources to each audit activity.
- ⇒ Expand the data used by the risk-based audit selection system to include third party information such as government contracts, withholdings, interest earned; and introduce weighting of risk criteria.
- ⇒ Develop and introduce into all territorial offices computerized workload control systems that will receive assigned caseload, allocate cases to auditors, track their progress, record results to be fed back into risk-based selection system, analyze time utilization, and prepare management reports.
- ⇒ Establish a mid-term objective to establish unit(s) in the STI to undertake investigation of cases where tax fraud is suspected.
- ⇒ Amend the Criminal Code to ensure that unintentional errors in tax liability determination are not regarded as criminal offences, regardless of the amount of tax involved.
- ⇒ Develop detailed procedures for the indirect methods of proof to be used by the STI and establish small units of auditors to be trained in the application of these measures.

VII. SELECTED TAX ADMINISTRATION ISSUES

A. Collection Enforcement

Current situation

Tax reports are presented at tax offices and forwarded to the processing center in Chisinau for entry into the tax accounting system. Tax payments are made at banks, payment data is transmitted to the Treasury and the STI for recording in tax accounts. Late filers and underpayments are identified by the central tax accounting system within 10 to 15 days and lists are transmitted to the respective territorial office (TO). Specialist units exist in each TO to pursue non-filers and unpaid taxes. There are no systems in the TOs to assign collection cases, record actions taken and prioritize debts. Table 14 shows the stock of tax arrears as at July 1, 2006, and at the end of the preceding three years.

Table 14. Arrears in tax payments, 2003-2006
(million MDL)

Year	Number of Debtors	Outstanding arrear as of the end of the year					
		Corp	Indiv	Excises	VAT	Other	Total
2006 *(01.06.2006)*	179747	154.0	51.0	35.4	533.7	801.5	1575.6
2005	181269	128.3	46.8	35.4	511.9	1134.5	1856.9
2004	133960	100.4	50.8	54.1	546.0	1148.7	1900.0
2003	341014	127.4	44.1	66.5	540.7	796.5	1575.2

Source: STI

Enforced collections procedures are set out in the Tax Code. The delinquent taxpayer receives a payment notice, is invited to visit the tax office to effect or arrange payment. Failing some arrangement for prompt payment an enforced withdrawal is made from the taxpayer's bank account. STI officials may approve installment arrangements for payment of the debt within one year. Penalty and interest[17] is applied to outstanding tax debts including those covered by installment arrangements. Remaining debt may be satisfied through seizure of assets, financial and physical and subsequent sale of physical assets. Table 15 provides information on the outstanding debt collected through various means from 2003 to 2006.

Table 15. Moldova: Yield from Enforcement Measures
(In millions of MDL)

Enforcement measure	2001	2002	2003	2004	2005	2006
Recovery through banks	978.1	725.9	175.5	116.6	121.8	55.6
Cash–recovery from taxpayers	58.2	37.1	30.1	29.3	40.0	23.0
Recovery through debtors	15.0	23.0	10.5	10.7	18.6	4.5
Seizures: value of asset	283.8	201.8	172.5	130.1	198.7	43.0
Voluntary payment	72.9	54.6	36.6	33.7	31.8	19.5
Sales of asset	9.8	4.4	9.5	6.5	9.5	3.1

Source: STI

[17] Article 228 of Part 5 of the Tax Code provides that outstanding tax debt is subject to Increase (interest) at the basic rate of the National Bank plus 5 points. Article 261 imposes a penalty on unpaid tax of 2 percent per month to a maximum of 24 percent.

Taxpayers with outstanding debt have the option to apply to the Council of Creditors (CC) to restructure the debt. This restructuring freezes the principle of the debt for up to two years, without penalty or interest, on condition that the taxpayer pay current tax liabilities and satisfy agreed economic conditions such as increases in investment or staff levels. The CC is to discontinue these restructuring arrangements by December, 2006, and the STI will assume responsibility for overseeing the tax portion of existing agreements through to their expiry date.

Issues

More use should be made of the authority to seize accounts receivable. Because of the strong control that the STI has had in respect to taxpayers' bank accounts[18], much use is made of these accounts to satisfy tax debts. Amounts collected through the banks are decreasing significantly each year (see Table 15).

An over reliance on this collection tool may have resulted in growing reluctance by banks to respond to these STI orders. Some use is made of the power to demand payment from persons owing money to the tax debtor. However, the procedures suggest this measure relies on the cooperation by the tax debtor in furnishing a list of their debtors and the third party in making the payment.

In some countries payment demands issued to third parties (persons indebted to the tax debtor) do not require the cooperation or consent of either party and are the primary tool in enforced collections. Information on the largest customers of the taxpayer is gathered during each audit and demands may be sent to these customers requiring them to remit to the tax authority any amount owed to the taxpayer (up to the amount of the tax debt), or that becomes due to the taxpayer within 90 days of the demand. If the third party ignores the demand and pays an amount to the tax debtor instead, the law states that the third party shall be liable for that portion of the tax debt.

A description of the legal authority and procedures associated with this method of garnishing the accounts receivable of tax debtors is attached as Appendix VI. Adoption of similar provisions would provide the STI a further collection tool that may prove more effective than demands on banks.

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[18] Taxpayers must obtain permission from the STI before they may open a bank account and the STI has the authority to freeze these accounts and effect enforced withdrawals to satisfy tax debts.

Arrears of VAT and the income taxes are very high by international standards. VAT arrears represent approximately 33 percent of gross domestic VAT revenue while arrears of corporate income tax are about 19 percent of the gross revenue. On average, tax arrears as a percentage of tax revenue in OECD countries is less than 7 percent[19].

Apart from the use of third party demands described above, the enforced collections powers of these OECD countries are very much the same as those of the STI. Two significant differences between OECD tax administrations and the STI that may account for much of the lower ratio of tax arrears to tax revenue are:

- these modern tax administrations have the authority and procedures to write-off uncollectible debts, which relieves collections officers of cases with no chance of success; and

- the accounting systems in modern tax administrations identify those debts that are not actionable (assessments in dispute, debts subject to installment agreements, debts suspended pending outcome of bankruptcy proceedings, and uncollectible debts that are dormant pending write-off) as well as sorting debts according to their age, permitting enforced collections specialists to react quickly to new debts and focus first on cases with the highest opportunity for success.

Usually these modern systems include a caseload control module that helps management balance the workload among officers, records enforcement actions taken and results achieved.

The efficiency and effectiveness of enforced collections officers in the STI could be increased significantly if they and local managers were supported by similar systems. And, a mechanism should exist along with authority for STI to get uncollectible debts off their books entirely.

Penalties should not apply to arrears covered by installment agreements. At present, tax debtors entering into installment arrangements with the STI for payment of tax arrears continue to be subject to both penalty and interest (increase) in respect to the outstanding amount. Penalties are imposed to punish taxpayers for non-compliance with the laws.

However, once the taxpayer enters into, and as long as the taxpayer complies with, a deferral or installment agreement penalty should not be imposed. If the agreement is terminated for non-compliance then penalties should resume. Interest (increase) on the other hand should

[19] Source: IMF Working Paper Tax Arrears and collection Enforcement. December 31. 2001.

continue to apply throughout the installment agreement as it represents the economic value (cost to the government) for the use of the money involved.

Article 261 of Part 5 of the code should be amended to remove the penalty for tax arrears covered by deferral or installment agreement. Also, the time limit for agreement in Article 180 should be extended to two years instead of the current one year limit. These changes will be particularly important when the CC stops entering into restructuring of tax debts as these debts will be subject only to STI procedures, which should permit installment agreements up to two years and subject only to interest (increase).

All arrears should be treated equally. It is understood that the Budget Law of 2006 provides that arrears of the social fund may be frozen without payment of penalty or interest. This is too generous, as the government should always insist on recovering the interest to compensate for money it must borrow while awaiting payment of these social funds.
As a matter of principle all debts, whether they be taxes, social contributions or medical insurance premiums, should be treated the same in respect to penalty and interest application and installment arrangements.

Recommendations

⇒ Amend the article of the Tax Code authorizing payment demands to be made on persons (third parties) indebted to tax debtors to provide that if the third party pays money to the tax debtor after receiving a payment demand from the STI the third party will be liable to pay that amount to the state budget as if it were taxes.

⇒ Develop procedures for issuing third party demands and encourage greater use of this enforced collections power.

⇒ Enhance the tax accounting system to permit distinction of categories of non-actionable debts (assessments in dispute, debts subject to installment agreements, debts suspended pending outcome of bankruptcy proceedings, and uncollectible debts that are dormant pending write-off) and the aging of accounts receivable.

⇒ Provide a mechanism and authority for uncollectible tax debts to be removed from the accounts of the STI.

⇒ Amend Article 180 of Part 5 of the Tax Code to permit agreements to be extended up to two years.

⇒ Amend Article 261 of Part 5 of the Tax Code to suspend the application of penalty to tax arrears covered by an agreement under Article 180.

B. VAT Refunds

Current situation

The VAT in Moldova applies a general rate of 20 percent to all goods and services other than those subject to the reduced rate of 8 percent, zero-rate or exempt. The list of zero-rate goods and services has been expanded to include supplies by light industries[20] and on services (outputs) of science and innovation. Table 16 shows the amounts of VAT derived from domestic sales and imports as well as the amounts refunded for the years 2003 to 2005.

Through these years, VAT refunds have increased steadily, but lag behind the growth in VAT revenues, particularly in respect to VAT on imports. As a result, VAT refunds as a proportion of gross VAT revenues were 17.9 percent in 2005, significantly less than the approximately 38 percent average of advanced and transitional economies.

Table 16. VAT collection and reimbursement, 2003-2005
(million MDL)

Category	2003	2004	2005
1. VAT paid domestic	1175,8	1423,8	1556,9
2. VAT paid on imports	2373,5	2978,0	4051,3
3. Gross VAT (3 = 1 + 2)	3549,3	4401,8	5608,2
4. Reimbursed VAT	758,0	995,7	1006,1
5. Net VAT income (5 = 3 – 4)	2791,3	3406,1	4602,1
Reimbursements/Gross VAT (%)	21,4	22,6	17,9
Reimbursements /Net VAT (%)	27,2	29,2	21,9

Source: STI

VAT refunds are still restricted to taxpayers with excess credits who are engaged in zero-rate or reduced rate supplies. However, the old restrictions regarding frequency of claims[21] were removed in 2005 and anyone (involved in zero-rate or reduced rate) with excess VAT credits may claim refunds monthly. Table 17 provides information on the numbers of VAT claims and amounts refunded during 2003 to 2005.

[20] Light industries refer to factories performing custom fabrication of materials supplied by others (usually for re-export).

[21] VAT Taxpayers with excess credits of MDL1 million could claim refunds monthly; those with credits between MDL500,000 and MDL1 million could claim every 6 months: and others annually.

Table 17. Analysis of reimbursements VAT, 2003-2005
(million MDL)

Indicator	2003	2004	2005
Number of received claims for reimbursement	460	427	506
Total claimed amount	974,7	1158,7	1114,1
Reimbursed amount	758,0	995,7	1006,1
Reduction amount following audit	-216,7	-163,0	-108,0

Source: STI

Two categories of Trusted Taxpayers have been created to facilitate payments and save on audit resources expended. Refund claims from category 1 claimants are approved for 100 percent payment immediately, subject to an annual audit. Claims from category 2 claimants are approved for payment of 80 percent of the amount claimed with the balance to be paid after audits performed each 6 months. All other refund claims are subject to field audit prior to approval and payment.

Those qualifying as Trusted Taxpayers are decided by January 15^{th} each year. The STI is allowed 45 days to approve a refund, beyond which the claimant is to receive interest on the approved amount.

In 2004 less than 10 percent of VAT refund amounts were paid in cash to taxpayers as opposed to offset against other taxes. This proportion has improved significantly in 2006 as of the MDL513.8 million approved for refund up to July1, MDL361.7 million (62 percent) were paid to the accounts of claimants.

Issue

VAT revenue may be understated. VAT refunds as a percentage of gross VAT collection in Moldova has ranged between 22.6 percent and 17.9 percent during the past three years (see Table 16). Table 18 provides information on the value of VAT refunds in percent of gross VAT collections for a number of countries. The average percent of VAT refunds is approximately 38 percent in both advanced and transitional countries.

In general, VAT refunds in Moldova have been less in comparison to other transitional economies, but in 2005, they were significantly less. At the same time, there was a relatively large increase in VAT revenue from imports, 36 percent over 2004, compared to approximately 10 percent increase in domestic VAT revenue.

Normally a very high proportion of VAT paid on imports results in input credits on domestic VAT returns. It is possible that, due to the restrictions on VAT refunds, net VAT revenues are being overstated and there is a growing pool of excess VAT credits that constitute future claims against VAT revenue.

Table 18. Value of VAT Refunds - Advanced, Transitional and Emerging Countries
(in percent of gross VAT collections)

Advanced Economies		Transitional Economies		Emerging Economies	
Canada	50.3	Bulgaria	21.5	Chile	28.8
France	21.2	Hungary	48.2	Columbia	4.1
Ireland	24.9	Latvia	49.1	Indonesia	12.4
Netherlands	50.0	Romania	24.7	Mexico	32.1
New Zealand	35.5	Russia	44.6	Morocco	5.1
Sweden	48.6	Slovak Rep.	53.9	Peru	19.8
United Kingdom	40.9	Ukraine	24.1	South Africa	39.5

Source: IMF Working Paper "VAT Refunds: A Review of Country Experience" 11/2005

All taxpayers with excess VAT credits should be permitted to claim refund. Taxpayers are required to perpetually carry forward, the excess input tax credits for transactions outside the zero and preferential rate regimes—until they can be recovered from future output VAT.

Some countries limit this practice to a period up to six months, which is considered time enough for many credits to have been absorbed. Requiring purchasers of capital goods to offset these credits against output tax adds to investment costs and may discourage investment in Moldova, particularly where large investment is involved before actual production starts.

Trusted Taxpayers in category 2 should receive prompt payment of their full refund entitlement. Category 2 claimants must wait up to 6 months for the audit to approve the remaining 20 percent of their claim. This is less favorable than the treatment accorded claimants that do not qualify as trusted[22]. Qualification for category 2 represents a high degree of permanence and reliability and certainly suggests that these claimants will not disappear in the following months. Their claims should be subjected to desk review to determine the claim is consistent with the nature and amounts normally claimed and 100 percent of the approved amount should be paid within 15 days. Subsequent adjustments, if necessary, may be made during the next audit.

[22] Refund claims, other than from trusted taxpayers, who are subject to audit, are normally approved for payment within 30 days.

Upper limits should be set for the automatic payment of claims by trusted taxpayers. The prompt payment of refunds claimed by trusted taxpayers is certainly a desirable feature but some further safeguard may be needed. The refund pattern of each trusted taxpayer should be analyzed and average amount claimed in each quarter of the year established. If a claim from any trusted taxpayer exceeds 125 percent of their average claim for that period, the claim should be set aside for review before approval. The matter may be resolved through a telephone call to the claimant, but extraordinarily large claims should not be paid automatically.

Customs should not be refunding VAT to importers. At present, if an importer returns imported goods (faulty, not according to order) to suppliers they may obtain refund of the duties and taxes paid upon importation of the goods. However, if the importer is a VAT taxpayer, input credit may have been taken in the VAT return covering the month in which the importation took place. It is unreasonable to expect that the VAT taxpayer will voluntarily adjust reported VAT liabilities when Customs refund the VAT. Instead, authority for Customs to refund VAT should be discontinued and all VAT claims of refund should be directed to the STI for verification and approval.

Too many audit resources are spent on VAT refunds. The current manual system based on the trusted taxpayer categories is certainly an improvement over the past practice of auditing all refunds. However, the practice of subjecting all other refund claims to an audit prior to payment is not commensurate with the revenue risks involved. Further measures are needed to free up scarce audit resources from VAT refund audits and utilize them in more productive audit work.

Implementation of a computerized risk-based system for selecting refunds for pre-payment or post-payment audits would provide for more effective use of audit resources. In respect to taxpayers like those in categories 1 and 2 the automated system would apply the criteria to each claimant based on their record at that moment (instead of annually) and would automatically calculate the norms and set upper limits for approval of their claims. The requirement for annual and semi-annual audits of trusted taxpayers would be discontinued and only those selected in the risk-based audit selection system (with variances from their normal refund pattern as one of the factors generating risk points) would be audited.

The risk-based refund selection system would identify which remaining refund claims should be subject to field audit, desk audit or screening prior to approval. The criteria fed into the system are adjusted regularly. And the results (reasons and amounts of refund reductions) are reported to the system so that selection criteria may be evaluated and adjusted to improve selections. The proportion of claims approved through field audit as opposed to desk audit or screening would be adjusted to conform to the volume of audit resources provided for this activity in the national audit plan (discussed above).

Recommendations

⇒ Customs cease processing refund claims for VAT paid on imported goods and refer all such claims to the STI for approval.

⇒ Permit all taxpayers with excess VAT credits to claim a refund.

⇒ Refund claims for category 2 trusted taxpayers be subjected to desk review with 100 percent payment of the approved amount within 15 days.

⇒ The practice of auditing 100 percent of refund claims, other than trusted taxpayers, be replaced with a risk-based selection of refunds to be audited to the extent permitted by resources allocated in the audit plan.

C. Other Tax Administration Issues

Newly formed businesses intending to exceed annual sales of MDL200,000 should be allowed to register for VAT. At present, businesses cannot register for VAT until they actually surpass MDL200,000 in sales in a year. Without VAT registration, these businesses are not entitled to input credits. And, even if refund for capital purchases were granted as discussed above, newly formed businesses would not be able to claim refund until registered.

This must significantly discourage foreign investors, particularly anyone contemplating an enterprise with large front-end investment. Most countries permit businesses with significant investments and sales potential in excess of the VAT threshold to voluntarily register at the outset.

Input credits claimed for imported goods should be automatically compared to Customs data. At present VAT taxpayers claiming input tax credits for domestic purchases in VAT reports are required to submit a list of invoices for each domestic purchase. Considerable resources are spent by the STI keying the invoice data into the tax accounting system for verification.

Given that VAT collected on imports is more than 70 percent of total VAT (See Table 15 above) the amount of input credits claimed in respect to imports must be at least as great as that of domestic purchases. Yet these input credit claims are rarely checked with source data in Customs.

All amounts paid by taxpayers on imports are recorded in the ASYCUDA system employed by customs and available to STI. A program could be developed to automatically compare the amount of VAT claimed in the monthly VAT returns of each taxpayer with the aggregate of VAT paid on all import entries in the corresponding period by that taxpayer. Once in place this process of cross-checking input tax claimed on imports in VAT reports with actual VAT paid to Customs would require very little in the way of resources.

This cross-checking could be linked to the risk-based audit selection system so that irregularities identified result in risk demerit points being applied to the taxpayer involved. The weighting attributed to these risk points should increase with the magnitude of the irregularity so that audit action is accelerated.

Developmental output of the functional units in headquarters is inadequate. At present, headquarters staff is preoccupied with overseeing daily operations at the expense of important developmental responsibilities. This appears particularly so in the audit area. For example, a major responsibility of audit headquarters is to ensure that audit resources in the field have the training, procedures and equipment needed to successfully carry out their duties now and in the future. This includes examination of factors such as economic trends, evolving technologies, changes in accounting methods, growth in electronic trade and communications; and identifying the impacts these will have on tax administration in general and the activities of the function for which they are responsible in particular over the next five or more years.

Also, the practices, systems and tools employed by other successful tax administrations should be explored to identify means of improving current performance. This is true for the headquarters units responsible for returns and payment processing and enforced collections as well.

There is little evidence of these sorts of planning and developments. The day-to-day oversight of field operations by these headquarters functional units should be reduced significantly or new resources added to headquarters to undertake these long-term developmental responsibilities.

Similarly, the design and development capacity of the Information Technology (IT) unit needs to be strengthened dramatically. The nine staff currently available for design and programming is fully occupied maintaining and enhancing existing systems and will be insufficient to support reform in an appropriate manner.

Information Technology experts play such an import role in modern tax administrations, not only in the systems they provide but also in their direct involvement in assisting auditors test taxpayers computerized accounts. The planning and execution of a reform of the tax administration requires dedicated IT staff to avoid the pitfalls associated with automating processes along the lines of their manual operation or adjusting stand-alone systems because there are not the resources to redesign an integrated system.

Recommendations

⇒ Permit voluntary registration for newly formed businesses with sufficient investment and intent to achieve sales in excess of the VAT registration threshold.

⇒ Develop and apply systems to automatically compare monthly VAT input credits for imports claimed by taxpayers with the aggregate of VAT paid to Customs for imports by that taxpayer in the same period as recorded in the Customs database.

⇒ Establish distinct developmental units within the headquarters functions for Audit, enforced collections and returns processing, to identify, develop and introduce the training, procedures, systems and tools needed to ensure effective performance of field operations.

⇒ Ensure the IT unit in headquarters has sufficient design and programming staff to carry out systems reform.

APPENDIX I.

IMPLEMENTATION OF PREVIOUS KEY 2004 FAD RECOMMENDATIONS

Recommendations	Status
Strategic Management	
Establish a modernization team and a steering committee.	Staff has been assigned to work on the development of the initial strategic plan, but a full time modernization or planning unit has not been established. The Director and his deputies operate as a steering committee.
Develop a modernization plan incorporating objectives, milestones, timetables, and resource needs.	An initial strategic plan is nearing completion. The plan identifies major organizational development task and includes a timeline and indicative resourcing needs. The next edition of the plan will be extended to reflect more long-term strategic needs.
Prototype strategic planning in the LTU. Establish in the long term an organization- wide strategic management system incorporating a multi year strategic plan and key organizational statements.	This recommendation has been overtaken by the development of the strategic plan. LTU needs are being incorporates into the overall STI plan.
Secure ministerial commitment to the modernization plan.	The Minister of Finance is involved in the strategic plan approval process.
Organization	
Restructure the STI HQ and ensure all key functions are reflected and that coordination is improved.	Restructuring has not commenced. This is appropriate as it is necessary for the new strategic direction to be resolved before selecting the appropriate organizational structure
Establish regional responsibility areas and realign the reporting lines of the district offices so that they report through those regional areas rather than directly to headquarters.	Not achieved. As with the organizational structure changes, this should flow from the strategic planning activity
The LTU should be organized as a full-fledged unit to include tax	Mainly achieved. However, further specialization is still required.

administrations issues:	
Audit	
Reintroduce VAT advisory and control (issue-oriented) audits on a pilot base in the LTU and eventually role the audit methods out to all STI offices.	Advisory audits for new taxpayers and single-issue audits are being performed in all STI offices.
Develop comprehensive risk analysis and audit case selection programs; implement them first on a pilot basis. Eventually role them out to all STI offices.	A central risk-based audit selection system for full audits has been introduced based upon comparison of tax return data to other sources. Weighting of the risk factors, distinct criteria for large taxpayers, and further information sources need to be added
Implement a risk management, case selection and enforcement program in all STI offices.	Full audit cases to be conducted in STI offices are selected in the central risk-based system and communicated to the offices.
Collection Enforcement	
Apply garnishment powers selectively as part of other collection enforcement measures and not as the primary means of recovering tax arrears.	Little change in this area.
End the use of tax amnesties and amend the law to allow the STI to develop a more selective debt write-off policy.	No tax amnesties have been introduced and procedures are being developed to permit Tax office managers to move uncollectible debts to a dormant status.
Staffing	
Develop an HR strategy and code of conduct for STI staff.	Not yet achieved. The development of the strategic plan provides an opportunity to either incorporate or append an HR strategy.

Large taxpayers' management	
Gradually increase the number of taxpayers administered by the LTU so that it collects a minimum of 60-70 percent of total revenue.	Not achieved. However, further information supplied by the LTU indicates that the Moldovan commercial environment does not yet follow international norms and that a very large number of companies would need to be transferred into the unit to achieve this result.
Assign responsibility for conducting tax audits for one or two key sectors of the economy to each control team.	Not achieved. The proposal is still valid and has been repeated.
Review the role of the LTU service staff to ensure their primary function is on provisions of services, rather than compliance enforcement.	Achieved. The responsibility areas of the taxpayer services unit have been redefined and a separate enforcement unit has been created. Further structural separation from control activities has been achieved by establishing an additional LTU deputy head.
Implement a comprehensive training plan to address the specific training needs of staff in the LTU.	A comprehensive training plan has not been developed. However, specialized LTU and audit training is now being delivered by the Dutch tax administration. This goes some way to meeting the needs of the LTU, but a comprehensive plan is still required.
Ensure that the LTU staff has adequate access to on-site legal and technical support.	Legal and technical support is still provided from headquarters. The proposal is still valid and has been repeated.
Provide more suitable accommodation and adequate equipment for the LTU.	Some improvements have been made to accommodation and the number of functioning computers. However, the accommodation is still well below an acceptable standard.
Develop and implement methods and procedures to deal with the more complex issues faced with auditing large taxpayers.	Not achieved. Audit procedures are still managed from headquarters and are essentially the same as for all other taxpayers. The proposal is still valid and has been repeated.

VAT refund	
Dissolve the national VAT refund committees and replace its control function with internal audit verification.	The national VAT refund committee no long is involved in the approval of refund claims.
Increase the budget provisions for VAT refunds.	More than 60 percent of VAT refunds are being paid into the accounts of taxpayers and officials advise that they are not constrained by the budget provision.
Enhance initially the coordination between the CCEC and STI to control the special VAT fraud schemes. Eventually develop sufficient capacity within the STI and transfer responsibility from the CCEC.	The respective roles of the STI and CCEC appear clearer now. Change in the Criminal Code (or its interpretation) is needed to remove the requirement that all cases involving more than MDL 9,000 underreported tax be referred to the CCEC. No progress has been made in establishing fraud investigation capacity in the STI
Other VAT issues	
Do not extend the VAT concessions (domestic zero and multiple rates and general amnesties.	Further (minor) zero-rate provisions have been added.
Repeal all domestic zero and preferential low rates and replace them with exemption for basic goods and services, subject to a threshold for consumption of utilities by households.	Not achieved.

APPENDIX II.

Mission Statements

Canada

To promote compliance with Canada's tax, trade, and border legislation, and regulations through communication, quality service, and responsible enforcement, thereby contributing to the economic and social well-being of Canadians.

Hong Kong

We are committed to: Collecting revenue efficiently and cost-effectively; providing courteous and effective service to the taxpaying public; promote compliance through rigorous enforcement of law, education and publicity programs, and enable staff to acquire the necessary knowledge, skills and attitude so that they can contribute their best to the achievement of our vision.

Isle of Man

The Division exists to carry out the following functions; to collect at the right time correct amount of tax due; to implement treasury policy; to assist in the development of economy; and to assist in meeting social priorities

Philippines

Our mission is to raise revenues for the government through effective and efficient collection of taxes, quality service to taxpayers, and impartial and uniform enforcement of tax laws.

Sri Lanka

To collect tax under the law by encouraging voluntary compliance and by deterring tax evasion and tax avoidance, and to maintain public confidence in the integrity and efficiency of the tax system by administering tax and related legislation fairly, uniformly and courteously.

Vision Statements

Canada

Our vision of the future is to be recognized and respected by clients for our integrity, fairness, and innovation in administering high-quality, affordable programs. Our progressive stance will encourage new inter-governmental and international partnerships, fostering greater government efficiency and a stronger economic union.

Hong Kong

We aim to be an excellent tax administration that plays an important part in promoting Hong Kong's prosperity and stability.

Philippines

Satisfied taxpayers; efficient and effective tax administration; streamlined and more productive organization; professional, highly skilled, morally upright, motivated and satisfied employees; agency with fiscal and administrative flexibility; and improved image of the agency.

Values Statements

Canada

Every day, we are involved with thousands of Canadians from every walk of life. We work to make sure our behavior toward clients and colleagues is guided by these values:

***Integrity** is the cornerstone of our administration, ensuring that we treat people fairly and apply the law fairly. Integrity requires that we act with honesty and openness.*

***Professionalism** is the key to success in achieving our mission, reflecting an ongoing commitment to the highest standards of achievement. Professionalism requires that we act with dedication and skill.*

***Respect** is the basis for our dealings with colleagues and clients, being sensitive and responsive to the rights of individuals. Respect requires that we act with courtesy and consideration at all times.*

***Co-operation** is the foundation for meeting the challenges of the future and building partnerships aimed at realizing common goals.*

Hong Kong

Our core values are: professionalism; efficiency; responsiveness; fairness; effectiveness; courtesy; and teamwork.

Isle of Man

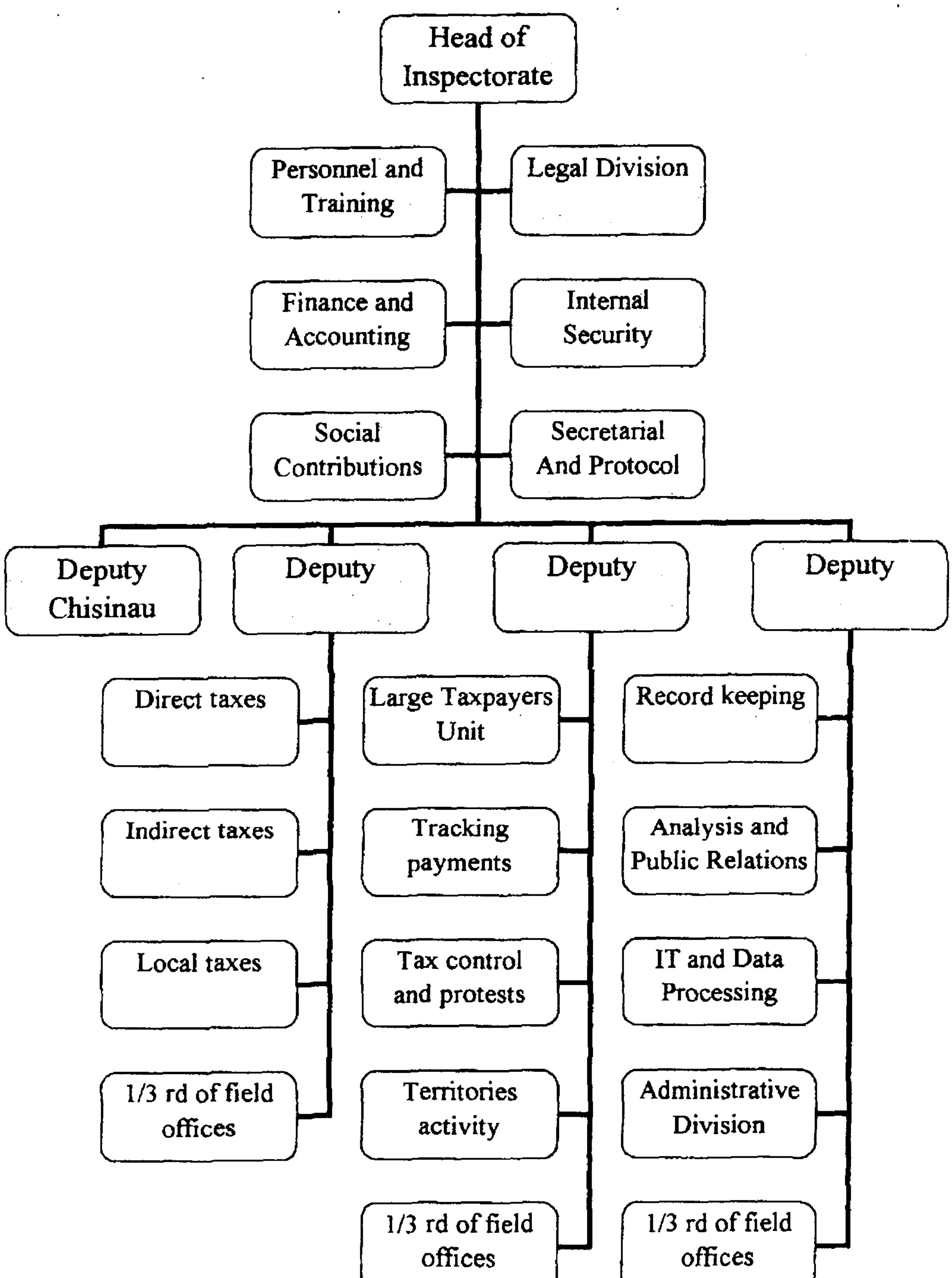
Corporate values are about the way we like to do things and be seen to be doing them. For the Income Tax Division they consist of: treating each person in a fair and consistent manner; at all times observing strict confidentiality about a person's tax affairs; having respect for the people we serve and an understanding of their needs; being responsive to political needs; adopting a professional approach with is service orientated; acting with probity in all matters; being adaptable and recognizing change as an opportunity to exercise innovative skills; operating within an internal structure of co-operation, team spirit and self development; and recognizing the need to strive for excellence within a framework of value for money

UK

The success of the Inland Revenue depends on us all sharing common values. In our relations with others: mutual respect; integrity; trusting people and earning their trust; being open and approachable; and treating everyone fairly. In working together: fostering teamwork; encouraging initiative and innovation; taking a pride in our work; and having determination to achieve our goals. All managers providing leadership by together giving: a clear direction;; encouragement and recognition; and visible support and training.

APPENDIX III.

Current STI Headquarters Structure



APPENDIX IV.

Example: Contents of A Tax Risk Analysis Report (TRAR)

1. General

Tax details
Summary of tax paid
Ownership structure
Management structure or personnel structure
Financial performance
Assets owned
Type of product or service supplied

2. Taxpayer profile

Size of economic activity
Market leader or trend setter?
Takeovers or mergers; consolidations/amalgamations
Cost structures
Capital intensity
Media or public perception
International influences
Technology
Forces driving taxpayer
Key customers

3. Industry profile

Size and structure
Key participants
Regulation/deregulation
Issues/trends
Rationalization
Growth
Product diversity
New industry
Barriers to entry/exit
Financial ratios
Tax risk tables

4. Macro profile

Economic activity – Domestic/overseas
Offshore influences
Expansion/concentration
Media exposure

5. Compliance risk

Compliance history: payments; return filing
Computerized tax systems
Compliance improvement strategy targets
Ripple effect of audit activity
Cost of compliance
Rulings reviews
Undertake industry survey
New legislation
Tax risks
Compliance trends
Methods of compliance improvement—

- Audit activity
- Customer education
- Legislation change to combat risk

6. Options for improving compliance

Issues identified as a result of the analysis

APPENDIX V.

Indirect Methods of proof of tax liabilities

The following are four examples of indirect methods of proof commonly used to prove tax liabilities.

Net Worth Method of Proof

The net worth method of proof compares an individual's or business's net worth at the beginning of a period with the net worth at the end of the period. "Net worth" being the total of the assets owned less the amount of debts or liabilities. For example, if an individual owned a house worth MDL 300000, a car worth MDL150,000, had MDL20,000 in cash and receivables and owed MDL 100,000 that individual's net worth would be MDL370,000. If one year later that individual had a net worth of MDL500,000, then it can be inferred that the individual had income of at least MDL130,000 in the year. A net worth investigation will also determine whether or not the increase in net worth came from taxable or non-taxable sources. Thus, the net worth method of proof can reach those individuals and businesses that obviously have considerable wealth but are not reporting income commensurate with that wealth.

The above example illustrates how the net worth method of proof is used to prove a person's income. The full details of this method of proof are quite technical and the steps needed to gather the evidence are frequently quite complex given that houses may appreciate and cars depreciate over the period. Nevertheless it is a powerful method of proving tax crimes. In many cases it is necessary to combine the net worth method of proof with the expenditure method (discussed below) to get a complete assessment of a person's income.

Expenditure Method of Proof

The expenditure method of proof is similar to the net worth method of proof. Under the expenditure method of proof the total expenditures of an individual during a taxable period are compared to income reported during the same period. The statistical departments in many countries can provide expenditure averages for individuals and different size families in various regions of the country. These figures may serve as proxies for actual expenditures that are not available. If the calculated expenditures exceed the income reported on a tax return and the individual cannot provide proof of loans or money received as gifts during the period, it may be inferred that the individual has not reported his/her full income on the tax return.

Bank Deposit Method of Proof

The bank deposit method of proof is usually used to prove the income of a business. The auditor will obtain all the bank accounts used by a business or individual. This will include wire transfers and similar intermittent transactions. The amounts deposited or wire transfers are analyzed in detail and compared to the amounts reported on the income tax return. If the total bank deposits and wire transfers exceed the income reported on the return, it may be inferred that the reported income was false. The bank deposit method of proof is also highly technical, frequently requiring complex analysis. In the U.S.A., it is the most common indirect method of proof used to prove income of businesses.

Retail Markup Method of Proof

The gross income of a retail or wholesale business can be reconstructed by determining the markup of the business. The markup is calculated by comparing the sale price of the items sold by the business with the price paid for the items. The markup, which is expressed as a percentage, is then applied to the entire cost of the goods sold by the business to determine if the gross sales reported by the business on the tax return are correct. Like the other methods of proof, this is a highly technical calculation that must take into matters such as changes in price of both the items purchased and sold, inventory spoilage, merchandise returns and similar factors. Nevertheless, it can be an effective tool in tax investigations.

APPENDIX VI.

Demanding Payment from Third Parties

One of the more liquid assets of taxpayers is their accounts receivable. This asset may be used to satisfy the tax arrears of a taxpayer through a process called "garnishment." The tax laws in many countries provide the tax administration with the authority to issue a demand to persons (third parties) that may be indebted to a taxpayer with tax arrears (the tax debtor) requiring them to pay directly to the tax administration any moneys owing to the tax debtor. These payments are applied against the arrears of the tax debtor. In the case of a bank or other financial institution, this demand may take the form of a payment order instructing the bank to debit the deposit account of the tax debtor and credit the state budget account.

The law covering garnishment also commonly provides that if a third party ignores the demand notice and pays a sum of money to the tax debtor, that person becomes liable to the state for that sum, as if it were an outstanding tax. That is, the third party becomes jointly liable for a portion of the tax debt if he contravenes the payment demand. And, the tax administration may enforce collection of the debt from the third party.

Garnishment is a strong measure and should be closely controlled to prevent abuse. The power should be restricted to the senior managers and they must sign each such demand. Each case where garnishment is used should be carefully documented and monitored by the head of the collections function in headquarters.

Legislative requirements

- Define the term "tax debtor" to mean a person that has outstanding tax, interest or penalty liabilities owed to the state.

- Provide that where the head of the tax administration has knowledge or suspects that a person is or will be, within 90 days, liable to pay an amount to a tax debtor, the head of the tax administration may demand that amount be paid to the tax administration (for deposit to the government budget account and credit against the tax arrears of the tax debtor).

- Prescribe the manner of delivery of the demand notice (personal delivery, registered mail or other means where receipt is acknowledged)

- Provide that if the third party pays an amount of money to the tax debtor after receiving the demand notice, the third party is liable to pay that amount to the state tax budget as if it were taxes.

- Provide authority for the Minister of Finance to delegate these powers to the incumbents of specified senior positions in the ministry, for example the Heads of Territorial Offices.

Administrative procedures

The administrative steps involved in carrying out third party demands arising from accounts receivable of a tax debtor are described below. These steps should be set out in clear procedures and the training program for the staff engaged in enforced collection.

- Request from the audit unit a list of the accounts receivable or main customers of the tax debtor. This is usually available in the audit file of the taxpayer; otherwise an audit visit will be necessary to obtain the information).

- Determine how many demand notices are necessary to reasonably secure the amount of arrears involved and to whom they are to be sent.

- Advise the tax debtor by telephone or visit that preparations are being made to issue the demand notices in five days if the arrears remain unpaid. Most businesses do not want their customers to know they are behind in their taxes and the mere threat of issuing the notices is often sufficient to prompt payment within the five-day period.

- Prepare the notice to be sent to each third party (copies for the tax debtor). A form letter should be developed citing the authority for the demand, the name of the tax debtor, the amount of tax arrears involved, and the consequences if the third party fails to comply.

- If, after the five days allowed, the debt remains unpaid, the notices are signed by someone with designated authority (the head of the tax office) and sent immediately to the third parties by registered mail.

- Moneys received from third parties are credited to the account of the tax debtor and deposited to the government budget account.

- Once sufficient funds are received, send a form letter to the third parties advising them that the demand is being withdrawn.

- Advise the tax debtor of the status of the tax account.