Cities that Work

IGC International Growth Centre

POLICY BRIEF

Enhancing local tax revenues: private or public collection?

Astrid Haas and Priya Manwaring

This brief explores the costs and benefits of outsourcing tax collection to private companies, learning from experiences of developing cities in their efforts to raise revenues. It outlines key enabling conditions for effective private collection, and revenue sources for which these conditions are most likely to hold. Finally, it considers the relationship between tax collection and compliance.

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Enhancing local tax revenues: private or public collection?

In a context of rapidly rising urban needs and insufficient revenues to meet investment needs, local governments in cities are increasingly looking to outsourcing tax collection to private companies.

There are a number of potential advantages to this – profit motives and additional capacity in many cases mean that private companies have the ability and incentive to expand tax collection. Under particular types of contracts, this can be done in such a way that governments are assured a more regular stream of revenue.

However, privatising tax collection also comes with significant potential costs - including inflated or uncompetitive costs, corruption, and erosion of state legitimacy.

Successful cases of outsourcing depend on a range of very particular conditions. To be effective, local governments need to implement competitive and transparent tendering processes to reduce opportunities for corruption, invest in detailed revenue projections, effective design and enforcement of contracts, and implement systems to reduce overzealous collection, inefficiency and corruption of private collection.

Without these enabling conditions, internal capacity development to facilitate tax collection by local government agencies is likely to be the best option for developing citiese.

1. **Private tax collection is not always the best option for enhancing local revenues.**
   While private contracting offers some potential benefits, in many cases the financial and political costs of outsourcing outweigh its benefits.

2. **It may be easier to build capacity in collection than in monitoring and enforcing private contracts.**
   Outsourcing to private collectors risks undermining the very government capacity that would be needed to effectively monitor and enforce private collection contracts.

3. **Outsourcing collection of taxes to private firms will not necessarily improve compliance with taxation on the part of taxpayers.**
   Key to improving tax compliance is instead active policy to increase transparency of tax collection, expand revenues, and, crucially, spending these revenues effectively on public investmentss.

The importance of improving tax collection

For cities to become engines of growth and economic transformation, coordinated public policy is needed, both to enhance the positive effects of interaction between firms and individuals in cities, and to tackle the potential downsides of density.

The problem for many developing cities is that **municipal revenues are insufficient** to finance the necessary investments in public infrastructure, services and well targeted policies that can deliver long term growth and rising living standards for a city. In some cases, low levels of revenue collection mean that a large percentage of revenues are spent on recurrent expenditures . Most capital investments are largely financed either by central government or development partners. As urban populations in sub-Saharan Africa and South Asia rapidly grow, demands on public investment will only continue to rise. In this context, strategies to enhance municipal revenues are a vital precondition for productive and livable urban development.

Low levels of revenue collection mean that a large percentage of local revenues are spent on recurrent expenditures

A significant source of revenue leakage for city governments is **low collection rates of potential tax revenues**. Weak administration of tax collection alongside strong political resistance to payment mean that in South Africa, for example, the 'tax gap' between actual and potential tax revenues collected is estimated to be between 15-30% of revenues[i].

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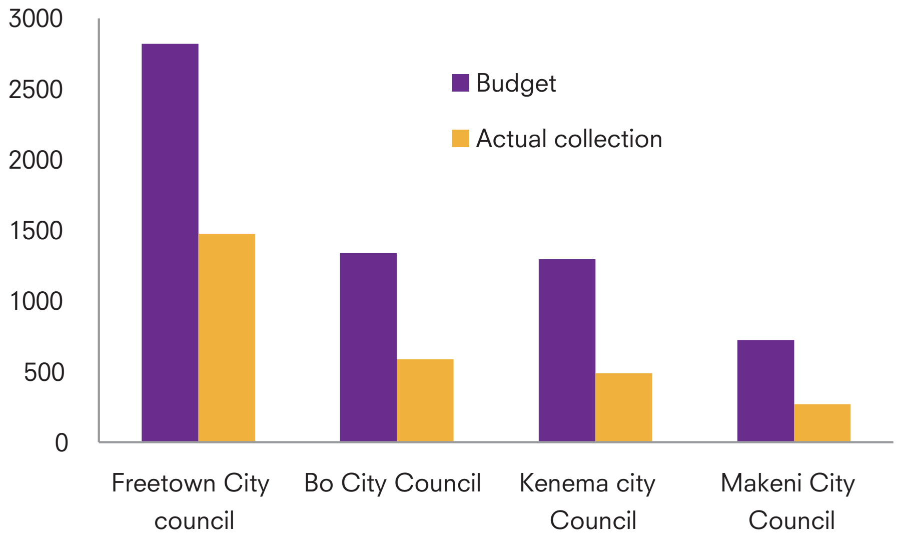
Efficient and effective tax collection is key to raising revenues from taxation, preventing unfair distribution of the tax burden and allowing taxation to be seen as legitimate to the public at large.

Actual revenue collection vs. budgeted targets in City Councils in Sierra Leone, 2007



Note: It has not been possible to access budgeted collection targets for earlier years.
Source: Jibao and Prichard, 2013

Private or public tax collection

In this context, local governments are increasingly looking to **outsource tax collection** to private companies to improve the efficiency of tax collection. Private outsourcing of tax collection has been seen across a number of different revenue sources, including property taxes, parking fees and market fees. In Mwanza, Tanzania, for example, over a third of council revenues in 2006 were privately collected[ii].

However, while there are potential arguments for privatization, and some successes do exist, these **successes depend on a range of very particular conditions** that may not be met by many local authorities in developing cities.

Why would local governments want to outsource tax collection?

There are two potential advantages to local governments to outsourcing tax collection to private sector companies:

✓ **Higher revenue collection (and lower corruption at collection).** The potential for higher revenue collection comes from both the profit incentives and higher capacity of private firms[iii].

As profits and incomes of those managing tax collection depend directly on maximizing revenue collection and minimizing costs of collection, private firms are more likely to be incentivised to maximise revenue collection. This is coupled with the fact that private managers are often more able to incentivise collectors through performance related pay contracts and the threat of termination for poor performance. Private firm managers are also likely to have lower political incentives to collude with those liable for taxation than government officials, reducing revenue leakages from corruption.

At the same time, private firms may in many cases have greater staffing and financial capacity to undertake large scale tax collection as compared to local governments. As such, where local governments face credit constraints in expanding collection internally, outsourcing tax collection can significantly expand revenues[iv]. In Lagos, for example, limited resources of state revenue staff to collect and monitor tax payments in 2000 compelled the finance ministry to hire an external company, ABC Consulting, to manage tax payments using an electronic billing and payment system in exchange for a commission on these payments[iv].

Private firms may in many cases have greater staffing and financial capacity to undertake large scale tax collection

✓ **Lower costs of collection.** By outsourcing collection, administrative and staffing costs of tax collection are incurred by the private sector rather than by local governments. It is important to note that these costs will be passed on to local governments in the form of retained revenue collection by private firms to cover their costs. However, one potential benefit of private tax collection is the possibility of lower costs of private collection through, for example, greater flexibility in employment and in adoption of new technology for tax collection. The relative ease with which private

Costs incurred by private firms will be passed on to local governments in the form of retained tax revenues

firms may be able to take on short-term employees can be particularly valuable in cutting costs as many revenue sources are variable over the year, such as taxes on agricultural products, and staffing requirements can vary widely. In Mwanza City Council, Tanzania, staff numbers by private collectors of fish market fees varied from 25 collectors in peak season to 10 collectors in low season.

However, the benefit of lower costs to local governments depends on these reduced costs being translated into lower revenues retained by private firms.

TAX FARMING AND THE ALLOCATION OF COLLECTION RISK

Some private revenue collection contracts also have the added benefit of providing **more predictable revenue streams** to governments. Under 'tax farming' contracts, a collection contract specifies a particular level of revenue to be paid to governments by private partners each month regardless of actual collection revenues. This is in contrast with private outsourcing of collection that instead specifies a particular percentage of tax revenue collected to be paid to governments.

However, 'tax farming' contracts shift the entire risk associated with the amount of tax collected onto the private sector. Regardless of the amount collected, a fixed fee must be paid to governments. As such, it is likely that tax farming contracts will come with a **higher premium** to incentivise private firms to take on the risk of collection.

At the other extreme are contracts where private collectors collect taxation for a fixed fee. Though this is likely to reduce the premium demanded by private collectors due to lower risk, such contracts limit the incentives for private collectors to maximise revenue collection.

Disadvantages of private tax collection

However, with these potential benefits come a number of potential costs:

- **Inflated or uncompetitive (stated) costs of private collection.** Privatised tax collection will not automatically lead to reduced costs of collection. If tax collection is contracted to one private firm, this firm can take advantage of its monopoly power in contract negotiation to demand higher premiums for collection . This is particularly likely to be the case when private firms own the initial capital investments, data and systems needed to collect property taxes even after the contract has ended. As a result, without sufficient competitive pressures, cost efficiencies may fall and costs may actually become higher than the costs associated with public tax collection.

If tax collection is contracted to one private firm, this firm can take advantage of its monopoly power in contract negotiation to demand higher premiums for collection

Experience of the Internal Revenue Service in the United States reveals that in some cases private collection may be less efficient than when collected by government departments. Between 2006 - 2009, the IRS contracted out the collection of some undisputed past due taxes to private collection agencies (PCAs), before recalling these contracts for internal collection. Data on tax collection reveals that the IRS was significantly more effective at collecting tax liabilities than PCAs, collecting 62% more than PCAs in the first two years of case assignments[v].

As such, *ex ante* estimates of the costs of collection of contracted firms with detailed breakdowns are extremely useful in helping guide decision making by local governments. These can be compared with estimates of the cost of collection if collection were to be done by local government internally and cost estimates from comparable tax collectors in other cities in determining the value of privatising collection to local governments.

- **High private premiums in the form of retained revenues**. If contracts are poorly designed, private outsourcing of collection can come with an excessive private premium in terms of the percentage of revenues retained by the private firm (over and above the costs they incur). In the case of the Ubungo Bus Terminal in Dar es Salaam, for example, 56% of revenues collected from entry fees were retained by private collectors in 2006, despite limited evidence of high collection costs[vi]. These retained revenues can be far higher than private costs of collection. For comparison, in Kampala, for example, the cost of collection for property tax is is estimated by Kampala Capital City Authority's Revenue Department to be approximately 10 – 12% of gross collection rates.

In Kampala, the cost of collection for property tax is approximately 10 – 12% of gross collection rates

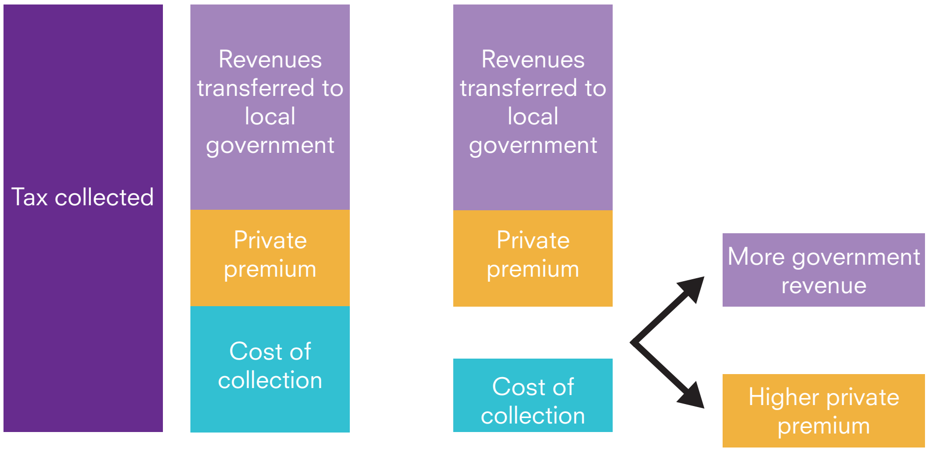
- **Opportunities for corruption between local governments and private firms**. Though corruption at the level of collection may be reduced through private collection, evidence from local governments in Tanzania and Uganda suggests that opportunities for corruption at the level of contract tendering are enhanced[vi,vii]. Both the firm selected to collect taxes and the amount agreed on as a private premium can be subject to corruption, with collusion between government/council officials and private firms to capture large profit margins.

- **Undermined local government legitimacy**. Private collection allows private firms to profit from taxes, and limits government accountability for tax collection. Both of these features of outsourcing can undermine the legitimacy of taxation as the price of public goods and services, making citizens less willing to comply with payment.

  At the same time, private firms have limited incentives to implement taxation in such a way that builds public support. Outsourcing can therefore lead to overzealous collection strategies by private firms to maximise profits, sometimes through informal mechanisms. Historical experience of private tax collection in France and the Netherlands shows that overzealous private collection can lead to heightened social discord and revolt[viii].

As a result, in Tanzania, for example, the impact of private collection of local government revenues since 1996 has been mixed – whilst in some councils, revenues from tax collection increased and became more predictable, in others, outsourcing collection was accompanied by high levels of corruption and large profit margins for private collectors at the cost of government revenues[ii].

Reduced costs of collection don't always mean lower costs to local government



Enabling conditions for effective private tax collection

Effective use of private firms for tax collection is only likely to improve revenue outcomes if some key enabling conditions are in place:

1. **Competitive and transparent tendering processes to reduce opportunities for corruption**. This involves making public information on the tendering processes and bids received for collection contracts, as well as monitoring of the tendering process by independent government agencies with the resources to effectively identify corruption.

2. **Detailed revenue projections** so that local governments are able to effectively contract the appropriate revenues expected from private collectors. Detailed, inflation adjusted projections are necessary to limit the extent to which the private sector is able to profit at the expense of government revenues. As a result of a lack of realistic assessments of revenue potential for markets in rural Uganda, a recent study has shown that local districts lose between 25 - 74% of total revenues collected to private collectors[vii]. More sophisticated projections may require outsourcing modelling to independent agencies.

   Independent projections can in turn also act to improve transparency of tendering and remove opportunities for collusion between government officials and private firms to capture excessive profit margins. These revenue projections can also help in the selection of *realistic* contracts. In some rural districts in Uganda, private contract bids that offer to collect over 10% of the 'reserve price', i.e. the estimated revenue potential from a market or site, are not considered as they are seen as likely to default.

As a result of a lack of realistic assessments of revenue potential for markets in rural Uganda, a recent study has shown that local districts lose between 25 - 74% of total revenues collected to private collectors

3. **Smaller, shorter term and more competitive contracts**. By designing shorter term yearly collection contracts that can be renewed based on performance, local governments can incentivise private firms to provide competitive services in terms of coverage and revenues retained. Contracts that specify local government ownership of capital can play an important role in limiting monopoly power of private collectors . In addition, policymakers can reduce bargaining power of private collectors by limiting the percentage of total government revenues they are responsible for collecting.

Contracts that specify local government ownership of capital can play an important role in limiting monopoly power of private collectors

4. **Contractual protections against large defaults**. In Tanzania, for example, many councils require private collection applicants to provide, alongside a detailed tender proposal, a bank guarantee to prevent contractors from defaulting on revenues owed. Similarly, a number of councils require regular weekly or fortnightly payment installments to prevent defaulting.

5. **Adequate monitoring of private collection and effective complaints procedures to prevent overzealousness of collection**

These enabling conditions in turn depend strongly on **local government capacity**

Without these enabling conditions, internal capacity development to facilitate tax collection by local government departments may be the best option for developing cities, particularly as this comes with the long run benefit of eliminating the private premium paid to collectors.

In Kampala, the establishment of the Kampala Capital City Authority (KCCA) in 2010 bought with it an overhaul of the existing tax collection system. Local government tax collection was previously outsourced to private collectors, but high levels of corruption and wide private profit margins meant that limited revenues reached the government. After tax collection was brought back in house, revenues from "road user fees" from minibus taxis doubled in one year[ix]. Partly as a result of these reforms, revenues at the KCCA have dramatically expanded by 89 percent after inflation, from US$9 million to $24 million between 2010 and 2015[ix].

What revenue sources are best suited to private tax collection?

Given the above, private collection may make more sense if:

- **Taxpayers have political influence.** Outsourcing of taxation to private firms may make more sense in cases where taxpayers have sufficient understanding of their tax liability and adequate channels of communication with government to report overzealous collection. These channels of communication can come from the political power of these groups. At the same time, politically powerful groups are likely to be those most likely to be able to collude with government collectors to avoid tax payment. As such, collection of customs tax, for example, may be more appropriate to outsource to private firms, as customs-paying taxpayers tend to be better organised and have more influence over policymaking than those liable for sales or excise taxes[iii].

- **Tax amounts are non-discretionary.** The collection of revenues such as known tax arrears, where the amount to collect has already been decided by government departments, may also be more amenable to private collection, as it is easier for governments to evaluate private revenue collection and there is limited potential for overzealous collection.

Collection and compliance

It is important to note that outsourcing collection of taxes to private firms will not necessarily improve compliance with taxation on the part of taxpayers – as discussed, private collection can actually serve to erode government legitimacy on which tax compliance is based . In many circumstances, citizens may feel that private firms profiting from taxes paid undermines the link between taxes paid and services provided by the government.

Private collection can actually serve to erode government legitimacy on which tax compliance is based

There are many reasons why citizens may not comply with taxes, including systems being too cumbersome, low tax morale and lack of clarity over tax obligations. Each of these require different policy solutions that are largely within the mandate of local government.

Key to improving tax compliance is improving transparency of tax collection and, crucially, tax expenditure. Linking taxation to visible public investments, alongside awareness campaigns, can help build public support by linking taxation to the tangible benefits they provide:

— In Fashola's first term in office, annual capital spending in Lagos rose from $600 million in 2006 to $1.7 billion in 2011 (in inflation adjusted 2012 figures)[iv]. These investments played an important part in maintaining support for further tax collection reforms in the city.

— In Liberia, tax administrators encourage tax compliance by using printed communications to explain tax obligations. At the same time, tax payments are directly connected to services; property owners are obligated to pay all outstanding tax liabilities before they are able to register their property, use property for a loan, and to use their property as proof of address for visa applications[x].

— In Bo City Council, surveys suggest that extensive efforts to improve public outreach and transparency of spending whilst investing in small scale public services has been associated with a property tax compliance rate of 93 percent[xi].

Where collection of revenues is outsourced to private firms, governments may need to make additional provisions to improve tax compliance. In Lagos, for example, compliance was enhanced by outsourcing tax collection to market associations with strong existing ties to civil society groups in an effort to enhance social pressures for tax compliance[xii].

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