

Summary of the 'Tax supervision – made to measure. *Flexible when possible, strict where necessary*' report

The tasks assigned to the Committee were to (1) carry out an evaluation of the Tax and Customs Administration's horizontal monitoring, (2) identify any bottlenecks and vulnerabilities in this approach and (3) submit proposals for its further development. The increasing regulatory pressure results in a heavier administrative burden and higher implementation costs. A reduction of the regulatory pressure is the best approach to keep this burden under control. The government is also implementing improvements in efficiency and effectiveness – for example, by means of horizontal monitoring – in an endeavour to limit the burden.

Adjusted compliance risk management strategy

On the introduction of horizontal monitoring, in 2005, the Tax and Customs Administration made a strategic change to its supervisory philosophy. This new approach is based on the concept that compliance with the regulations can be promoted by placing greater trust in taxpayers and assigning them their personal responsibility. The Tax and Customs Administration is prepared to invest in this relationship of trust by concluding agreements in which the Tax and Customs Administration and taxpayers lay down the requisite working agreements. This relationship is based on 'trust', 'transparency' and 'mutual understanding'. This relationship of trust is elevated to the level of 'justifiable trust' by making use of the taxpayer's administrative organisation and internal control, supplemented with internal audits and accountants' audits.

Segmentation

The Tax and Customs Administration opted for a design of horizontal monitoring which is based on segmentation into Very Large Businesses, Medium-Sized Businesses and Small and Medium-Sized Enterprises. Very Large Businesses are, by their very nature, governed by the most stringent corporate governance requirements (such as the SOx, Netherlands Corporate Governance Code and the Netherlands Authority for the Financial Market's reporting supervision). Very Large Businesses which comply with these requirements meet the criteria for the conclusion of an individual agreement with the Tax and Customs Administration that lays down the arrangements for the supervisory relationship.

The large group of Small and Medium-Sized Enterprises lies at the opposite end of the spectrum. A statutory supervisory structure of the aforementioned nature is not available for this group: consequently, in view of the large number of taxpayers in this group, individual agreements are not an option. However, Small and Medium-Sized Enterprises can benefit from the advantages offered by horizontal monitoring by participating in an agreement concluded with a financial service provider. Measures will then be required to achieve 'justifiable trust' which compensate for the lack of the reliability guarantees that Very Large Businesses can readily provide. These measures will need to be implemented throughout the Tax and Customs Administration's entire chain, from financial service provider right through to the taxpayer (client or business).

The Tax and Customs Administration is evidently having struggling with Medium-Sized Businesses, in particular: firstly, individual account management costs a great deal of capacity and, secondly, this group of businesses needs to make great efforts in developing adequate tax control frameworks.

Medium-Sized Businesses compelled to meet the same standards as the Very Large Businesses segment shall need to incur costs of a level that may result in horizontal monitoring losing its appeal. However, the alternative – adopting the same approach to part of the Medium-Sized Businesses segment as that adopted for the Small and Medium-Sized Enterprises segment – also has its disadvantages. The Tax and Customs Administration now (2012) wishes to find a practical solution for this ‘struggle’ by merging the upper range of the Medium-Sized Businesses segment with the Very Large Businesses segment and bringing the lower range under the service provider agreements governing the Small and Medium-Sized Enterprises segment. However, this – as such understandable – decision will need appropriate substantiation. Taxpayers and financial service providers will be prepared to invest in sustainable relationships based on trust that enhance compliance only when the reasons for the decision are both clear and recognisable.

Conclusions for the Very Large Businesses and Medium-Sized Businesses segments

Sufficient reliability guarantees have been incorporated for the Very Large Businesses segment. However, the Committee has concluded that this is not the case for the Medium-Sized Businesses segment: the tax control framework, ‘onion-skin’ model and other internal control measures do not currently provide adequate assurances. As a result, it is not possible to state that the Tax and Customs Administration actually observes the principles governing horizontal monitoring in the Medium-Sized Businesses segment. Moreover, the Tax and Customs Administration is unable to demonstrate that the burden and costs have declined for either the taxpayers or the Tax and Customs Administration.

Conclusions for the Small and Medium-Sized Enterprises segment

As stated earlier, the relationship of trust with the Small and Medium-Sized Enterprises segment is not developed directly with the taxpayers, but rather with their financial service providers. It is essential financial service providers organise their processes in a manner that results in acceptable returns from their clients. As a result, horizontal monitoring in the Small and Medium-Sized Enterprises differs fundamentally from the identically-named supervisory form implemented for the Very Large Businesses and Medium-Sized Businesses segments. The Tax and Customs Administration can rely on tax control frameworks even less in this segment: for this reason it is necessary to seek compensatory measures. The Tax and Customs Administration has implemented this compensation in the form of meta-supervision of the financial service provider’s quality assurance system. This meta-supervision also needs to extend to reality checks in the form of audits of random samples of returns.

The highly diverse group of financial service providers employs a variety of forms of quality assurance, such as disciplinary proceedings and internal (desk) audits. The financial service provider’s quality assurance system determines the degree of justifiable trust the Tax and Customs Administration places in the provider: it will, for example, be self-explanatory that the Tax and Customs Administration can place more trust in financial service providers that have been issued a licence by the Netherlands Authority for the Financial Markets and operate under the Authority’s supervision than other service providers which are not governed by this form of statutory supervision. The Tax and Customs Administration has not made its approach to this diversity clear and, as a result, horizontal monitoring is not transparent for the parties working with the Tax and

Customs Administration. The Tax and Customs Administration staff is also confronted with the same problem: some feel that they need to work based on a message that is insufficiently clear to them. The Committee is not convinced that the taxpayers' administrative burden will be reduced – in fact, the Committee is of the opinion that this is unlikely. This is because the financial service providers can only vouch for the acceptability of returns when they perform more duties than in the past. Moreover, the financial service providers will need to observe the Tax and Customs Administration's Audit Approach that stipulates more stringent materiality and sampling standards than those customarily adopted by other parties, such as auditors. It is evident that the financial service providers will charge their clients for these extra duties. The Committee would have welcomed better accountability for the costs and benefits accompanying the introduction of horizontal monitoring in the Small and Medium-Sized Enterprises.

However, the above does *not* imply that the Tax and Customs Administration's decision to introduce horizontal monitoring was incorrect, although it *does* imply that the principles governing this segment differ from those originally adopted for horizontal monitoring (in the Very Large Businesses segment). A triangular relationship can be discerned in this segment in which the relationships between the horizontal monitoring interests of the Tax and Customs Administration, financial service provider and taxpayer (who is also the financial service provider's client) are not always clear. The Tax and Customs Administration will, if it is to succeed with Small and Medium-Sized Enterprises, need to make carefully-considered, continuous and substantial investments in the implementation of horizontal monitoring in this segment – a segment with a very different structure. Moreover this is highly desirable, since it is clear to the Committee that the Small and Medium-Sized Enterprises segment offers the Tax and Customs Administration the greatest potential savings – and certainly in terms of efficiency gains. There are about 600,000 taxpayers in this segment.

The position of horizontal monitoring in the Tax and Customs Administration's range of instruments

Following the successful pilot with Very Large Businesses the Tax and Customs Administration proceeded to the (too) rapid rollout of horizontal monitoring and, in the Committee's opinion, the Tax and Customs Administration staff were not offered an opportunity to keep up with the pace of the process. Although a group of staff have a favourable attitude towards horizontal monitoring, there is also a group who have not developed at the same pace as horizontal monitoring. They often have the impression that the Tax and Customs Administration no longer devotes any attention or time to other (vertical) forms of supervision. For this reason it is extremely important that the management makes the investments in the change in the organisation's culture required following a major policy change and that it manages this change in the culture in the appropriate manner. In the Committee's opinion this is being carried out too late and to an inadequate extent.

It is understandable that the Tax and Customs Administration management has promoted horizontal monitoring in an appealing manner. A different approach would probably have resulted in failure or in a too slow and troublesome implementation. As a result, the internal and external impression that horizontal monitoring was *the* (sole) supervision instrument of the future has persisted for too long. During recent years the Tax and Customs Administration has corrected this impression by explicitly positioning horizontal monitoring as an element of its supervisory approach, its 'compliance risk management strategy'. The Committee is of the opinion that this is a wise move. The objective of this strategy is to influence the behaviour of citizens and businesses in a manner such that the available

staff and resources can be deployed to achieve optimum compliance: *flexible when possible, strict where necessary*. The Tax and Customs Administration has a wide range of instruments at its disposal to achieve this objective, including the provision of service, vertical supervision, investigation – and horizontal monitoring.

From intuitive choices to a rational management model

The Tax and Customs Administration's introduction and further development of horizontal monitoring was primarily based on intuitive considerations. Solely a concise start document listing the principles had been prepared at the time of its introduction. In the first instance the horizontal monitoring concept was developed further during the implementation and its introduction was of the nature of an incremental process: horizontal monitoring was subsequently rolled out to encompass entire segments without supplementing the initial intuition with an appropriate compass in the form of a policy strategy based on rational substantiation. All in all, in the Committee's opinion the Tax and Customs Administration has persisted with its intuitive substantiation of horizontal monitoring for too long and it has devoted insufficient energy and effort to a management approach on the basis of adequate (management) information. The Committee also notes that at the time of horizontal monitoring's implementation there was no business case, no benchmark measurement had been carried out and no explicit performance indicators and/or critical success factors had been formulated, as a result of which an adequate management mechanism has been lacking to date. A business case was drawn up for the Small and Medium-Sized Enterprises segment only in April 2012 (and which, in the Committee's opinion, is not very convincing).

Effect measurement

The Committee's report included a comprehensive review of effectiveness and efficiency. The Committee was surprised to discover how little (relevant) information the Tax and Customs Administration has at its disposal to measure and manage the development and effect of horizontal monitoring. On several occasions it proved impossible either to obtain self-evident qualitative and quantitative policy information or to obtain this information on the basis of regular (management) information. This problem is due to the Tax and Customs Administration's navigating without a rational compass for too long and continuing to navigate on the basis of its intuition.

The *efficiency* can be reviewed solely on the basis of the relationship between the available capacity and the financial resources, the activities carried out within the scope of horizontal monitoring and the results achieved by these activities (output management). However, it is also necessary to review whether the horizontal monitoring efforts made by the Tax and Customs Administration have been *effective* (outcome management) and are resulting in an improvement in compliance with tax regulations – and certainly in these times in which the same work needs to be carried out with fewer staff and fewer resources and the Tax and Customs Administration is compelled to make choices.

The manner in which the effectiveness of supervision is measured has not been made clear and the cost-effectiveness is not transparent: the necessary indicators need to be developed. In other words, horizontal monitoring is provided insufficient support from information systems that can assist in decision-making on the appropriate format of supervision and the measurement of the effects and efficiency of the selected form. Moreover, this lack of insight into the effects of horizontal monitoring

results in uncertainty about its effect on compliance with tax regulations and, consequently, on tax revenues.

Legitimacy

The legitimacy issue is, above all, a transparency issue within the Tax and Customs Administration's implementation practice. In the Committee's opinion the integration of horizontal monitoring in legislation is unnecessary. The introduction of detailed regulations at this stage would result in disadvantages that outweigh the advantages. However, this transparency can be further increased by the implementation of measures that clarify the tax inspector's role when making decisions, i.e. either as an administrative body reaching a decision on a return or as an implementer of horizontal monitoring involved in an agreement relationship. Taxpayers, financial service providers and other parties must always be aware of the capacity in which a member of the Tax and Customs Administration staff is acting.

International

There is also a great deal of interest in what is referred to as *enhanced relationship* at an OECD and EU level. Tax authorities all over the world are seeking effective and efficient supervisory models based on entering into relationships with taxpayers founded on trust and cooperation. Larger businesses in the international business community increasingly regard the emergence of enhanced relationship as a favourable development. In the Committee's opinion the Netherlands is playing a pioneering role in the development of enhanced relationships. Moreover, the Committee observed that the pace of the development of enhanced relationships in other states is slower than in the Netherlands. To date, the development of enhanced relationships in other states has been restricted to the (very) large businesses: the Netherlands is the sole state that has introduced this concept for Small and Medium-Sized Enterprises.

Reduction of costs / increase in burden

There is no doubt, the Tax and Customs Administration wishes to fulfil the qualitative and quantitative expectations of horizontal monitoring at the time it was introduced. This will, for example, require an overall insight into the costs and benefits for taxpayers taking part in horizontal monitoring either directly or indirectly via a financial service provider. The Tax and Customs Administration also needs an insight into the cost of a compliance agreement and the maintenance of a horizontal monitoring relationship for the management of its operations. In the current absence of this type of information there is a risk that taxpayers will experience horizontal monitoring primarily as a means of shifting the government's implementation costs – in the form of an additional supervisory or compliance burden – onto taxpayers and their financial service providers. Horizontal monitoring would then, in effect, constitute a transfer of the burden within the chain. Moreover, the Tax and Customs Administration staff are concerned that although the efficiency benefits offered by horizontal monitoring *will* materialise, the pressure imposed by the government economies will curtail the necessary associated intensification of the planned (vertical) supervision of taxpayers who do not participate in horizontal monitoring, in particular of non-bona fide taxpayers. As a result the volume of fraud could, on balance, increase. The Committee recommends that the Tax and Customs Administration convincingly demonstrates that the efficiency gains achieved from the improved relationship with taxpayers are converted into capacity that can be deployed to reinforce vertical

supervision as required. In addition, it will be necessary to combat the Tax and Customs Administration's loss of high-grade knowledge and, at the same time, bear in mind that the competences required for horizontal monitoring differ from those for vertical supervision.

The Committee drew attention to the fact that horizontal monitoring was introduced at a time when the economic conditions were much more favourable than at present. It is debatable whether we may continue to assume that a trust approach and compliance strategy based on relatively favourable conditions will achieve the same effect during an economic downturn. Nor is it possible to ignore the fact that all national government bodies, including the Tax and Customs Administration, are confronted with difficult targets and cost reductions. A major change in the culture, such as the introduction of horizontal monitoring, is not promoted when the change coincides with a large-scale reorganisation which some members of staff feel is having a great effect on their personal lives.

The core conclusion

The Tax and Customs Administration deserves praise for its fulfilment of a pioneering role and its timely appreciation of the need for a fundamental change to its supervisory philosophy. A similar transition in supervision is also taking place outside the Netherlands, albeit on a more limited scale. The Dutch example is attracting a great deal of interest and is regarded favourably. In essence, the Committee's report endorses the 'horizontal monitoring' concept and recommends that it be developed further. However, the Committee also states that a number of implementation issues exhibit room for the necessary improvements to solve or alleviate the bottlenecks and vulnerabilities it has identified. The Committee hopes that its report will be of assistance in making these improvements and that it has provided an additional impetus to horizontal monitoring.