An Introduction To State Tax Administration

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I. Introduction: What and Why?

What?

This is a layperson's introduction to state tax administration. My goal is to provide a concise, readable, nontechnical, and somewhat irreverent orientation for newly appointed tax agency leaders. Although the anticipated audience is the small community of leaders in American state and local tax administration, tax practitioners and other domestic and international public managers may find some of the material of interest and practical use. Don't worry: We'll avoid the intricacies of tax policy and tax-related technologies for now.

Why?

Although there is plenty of technical material on tax law and policy available, and university shelves groan under the weight of thick volumes on public administration (which I've never read), I am not aware of a generalized and accessible resource on state tax administration per se. Let's blaze the trail.

II. Welcome to Tax Administration!

What Have You Gotten Yourself Into?

So, you are now a tax administrator. Congratulations, and welcome to an elite society of folks who can clear any cocktail party with an honest answer to the polite question, "Tell me, what do you do?"

Yet the question is a good one. What does "tax administrator" mean, and why does it matter? The glib answer is that "tax administrator" is just a fancy way of saying "tax collector," not exactly a revered role through recorded history. Thankfully, however, modern American tax administration is a mostly honorable calling that only occasionally resembles its Roman and medieval antecedents (although it's possible that some tax administrators still privately pine for the good old days of stocks, racks, and the like).

For our purposes, the most important innovation in tax administration over the past few hundred years is that the modern tax system relies on voluntary compliance. More than 90 percent of all revenue collected at the state, local, and national levels in the United States comes in voluntarily, not through enforced collections. That means modern tax administration is largely about supporting voluntary compliance, a service function as distinguished from an enforcement function. And that means you — the tax administrator — have gotten yourself into the service business.

A Helicopter Tour of Tax Administration

This will be a short tour because helicopters are really expensive.

The chart (next page) presents the major functions of tax administration along a "compliance continuum." Items above the line — from drafting legislation to criminal enforcement — represent functions or activities of a tax agency. Items below the line represent concomitant functions or activities of taxpayers. Although an oversimplification, the linear presentation helps to illustrate the relationships between the functions and activities and between taxpayers and a tax agency.

Now let's look at a tax agency's functions and activities:

Drafting and negotiating legislation — Every tax system begins with the statutory imposition of a tax. Typically, tax agency lawyers draft technical bill language on request from a chief executive, a budget office, legislators, and even outside interest groups (including lobbyists). Regardless of whether the tax agency agrees with the substance, it is in the agency's strong interest to help in the drafting of tax legislation to ensure that the ultimate result can be administered and that it works seamlessly with existing law.

Publishing forms, instructions, and guidance — One can't expect taxpayers to comply with their tax obligations voluntarily without providing them with

The Compliance Continuum

Tax Agency	Draft and negotiate tax legislation	Publish forms, instructions, and guidance	Assist and educate taxpayers	Capture return data and process payments	Resolve exceptions	Issue bills and resolve protests	Audit	Collect	Litigate	Criminal enforcement
Taxpayer		Review instructions	Ask questions	File returns and make payments	Answer questions arising from exceptions	Review bills and file protests	Undergo audit	Collection defense	Litigation defense	Criminal enforcement defense

More taxpayers affected at lower cost — **Fewer taxpayers affected at higher cost**

← **Increasing Voluntary Compliance** ←

Source: N.Y. State Department of Taxation and Finance.

the basic means to do so. Clear and concise forms and instructions are a prerequisite. Also, most tax agencies regularly issue various forms of guidance, such as regulations, explanatory memorandums and bulletins, special notices, letter rulings, advisory opinions, and so forth. The quantity, quality, and timeliness of guidance are critical to the agency's relationship with taxpayers and tax professionals.

Subject to judicial review, regulations, issued under an often lengthy process of formal notice and comment, have the force and effect of law. Agencies typically use fewer formal memorandums and notices to announce an official position on a matter of policy or procedure. Letter rulings or advisory opinions are issued to individual taxpayers (or their representatives) in response to inquiries regarding the application of law to a specific set of facts. They are binding on the agency in relation to the requesting taxpayer, assuming no material alteration or misrepresentation of fact. Most jurisdictions publish those private rulings; some jurisdictions permit anonymous requests and the presentation of hypothetical facts.

Assisting and educating taxpayers — Even allowing for the best possible guidance, a tax agency will have to provide a means for taxpayers to get answers to their questions. That requires maintaining multiple means or channels of communication, such as fielding phone calls, responding to e-mail and regular mail, and performing outreach to specific taxpayer communities (for example, nonnative English speakers or a particular industry sector). One challenge in this area is recruiting and training a qualified staff. Handling inquiry volume peaks — each tax type may have its own peak processing and payment cycle — may require hiring temporary staff, cross-training for different tax types, or both.

Capturing return data and processing payments — This is it: A tax agency's core function! It may sound simple, but it isn't. The typical state agency will process millions of returns a year. For each return that means capturing a dozen or more critical data elements (taxpayer identification number, reporting period (for example, a tax year), payment period, amount owed, amount paid, and so forth) *and* receiving and posting any associated payments. Matching up the data and payments to specific taxpayer accounts requires high-volume precision. Thanks to technology, tax agencies no longer have to maintain enormous warehouses of people keying all this data and cashing checks by hand — at least not in most instances.

Resolving exceptions — When you deal in billions of bits, expect at least some rate of error. Tax processing systems apply a series of edits on tax return and payment data that identify problems, such as a poor check image that is not machine-readable, that make it impossible to process a return or payment accurately. That in turn prevents the system from reconciling or settling the taxpayer's account. The system therefore "kicks out" the problematic return or payment as an exception, which the tax agency attempts to fix or resolve. Resolving exceptions involves a wide range of activities and resources, from manual review of returns and payments to simple adjustments in a processing tolerance. Adjusting tolerances (a fancy way of saying that you adjust your computer system to ignore some minor problems) is tricky but sometimes clearly appropriate. For example, you might want to adjust tolerances to avoid sending tens of thousands of delinquency bills and underpayment penalty assessments if a popular tax preparation software package unexpectedly generates a minor mathematical error. However, small amounts can add up and any adjustment in tolerances can pose a risk of failing to detect fraud. Naturally, any human intervention in resolving exceptions — for example, moving a misapplied payment from one taxpayer account to another — also presents a significant control risk.

Issuing bills and resolving protests — The function of processing return and payment data identifies overpayments or delinquencies for individual taxpayer accounts. Processing systems then generate and mail refunds and bills (or notices). Most taxpayers accept refunds happily, but of course some will dispute or protest a bill. Resolving those protests requires trained staff to either explain the basis of the delinquency or in some cases correct the agency's error, such as a misapplied payment. Despite functional similarities with resolving exceptions, resolving protests is qualitatively and legally distinct because it marks the beginning of the tax agency's dispute resolution process.

Auditing — Now we're entering the postprocessing range of compliance functions that include auditing, collection, and criminal enforcement. And the star of the compliance show is usually auditing.

Every major tax agency maintains an audit function that includes two basic kinds of audits: field audits and desk or correspondence audits. Field audits involve sending teams of auditors "into the field" to examine books and records. They typically concern several complex issues and larger amounts; the significant resources and time (often several years) required for each audit necessarily limits the number of field audits. By contrast, desk auditing is a high-volume function conducted through the mail and involving a limited number of less complex issues and smaller amounts. Desk audits typically focus on issues that arise from internal inconsistencies or errors in or "on the face of a tax return."

Tax agencies use computerized audit selection systems to identify candidates for both field and desk audit. In the case of desk audits, modern systems can identify issues, recalculate the amount owed, and send the taxpayer a notice with a bill for a proposed adjustment, including applicable penalties, without human intervention. If the taxpayer pays the bill, fine. Alternatively, the taxpayer may normally protest the bill and send in evidence that supports his or her position.

At one time, state desk audit operations focused almost exclusively on "federal changes," that is, billing taxpayers for additional tax identified as a function of a federal tax audit or an amended federal return. Most state income taxes use federal adjusted gross income (FAGI) as a computational starting point, so changes in FAGI usually flow through to state tax liabilities. More recently, however, state audit operations have ventured into "above-the-line" audits that take a fresh look at the taxpayer's computation of FAGI. Also, desk audit units often review claims for tax credits, an increasingly significant function given the surging popularity of using tax codes to deliver transfer payments (for example, the earned income tax credit) and economic development incentives (for example, investment tax credits).

Although most senior tax agency managers will piously declare that auditing taxpayers is largely a control function designed to support voluntary compliance, most audit staff suspect that it's really about collecting money. Or is it about both?

Collecting — Contrary to some stories, a modern tax agency's collection function only rarely involves jackbooted storm troopers breaking down doors in the dead of night and seizing a destitute family's heirloom portrait of Great Aunt Millie. Although levy and seizure of property remains a last (and usually hugely inefficient) resort, the reality is that tax collecting has evolved into a sophisticated function that involves mass mailings and telephone banks staffed by trained operators who sit in front of computer screens with access to taxpayers' account information. Collection managers increasingly use financial analysis, risk management, and problem resolution techniques. For instance, because a significant proportion of total tax delinquencies are ultimately worthless or uncollectible, it behooves the tax agency to focus its limited collection resources on those taxpayers who can pay. Similarly, it may not be in the tax agency's long-term interest to drive a delinquent taxpayer out of business by insisting on full and immediate payment rather than a compromise or structured payment.

Although tax collection bears some resemblance to its private-sector counterpart — and, indeed, few tax agencies are outsourcing collection to private companies — there are important distinctions. For example, a tax agency must adhere to strict rules of due process in assessing and enforcing a tax debt, and tax return information is subject to strict rules of confidentiality.

> ***Establishing criminal enforcement's relationship with its compliance cousins, civil enforcement and collections, can be a challenge.***

Despite my efforts to dress it up, collecting taxes is not and never will be a glamorous or fun business. As a tax administrator, expect to face a continuing challenge in recruiting and retaining qualified collections staff.

Litigating — Litigation is an inevitable byproduct of the normal disputes that arise in the course of tax administration. Most jurisdictions maintain a range of informal and formal dispute resolution processes, from internal protest resolution (see above) to the courts or specialized tribunals. Some tax agencies maintain their own legal staff; others rely on outside counsel or agencies such as an attorney general's office. Taxpayer motives for litigating run the gamut from legitimate objections on principle to purely tactical gambits for delay. Similarly, the tax agency must carefully weigh litigation versus compromise: Sometimes, when the facts of a case are ambivalent, it's better to give up a small amount of revenue without a fight rather than risk setting a damaging precedent that could cost tens of millions.

Criminal enforcement — Most, but not all, tax agencies include a criminal enforcement unit. Although criminal enforcement is a logical and an important component of the compliance function, many jurisdictions hobble their criminal tax enforcement through several forms of neglect. First, state and local tax statutes rarely include clear enforcement procedures and appropriate penalties for criminal tax evasion. Second, local prosecutors often shy away from tax cases because they are not violent offenses and can be extremely complicated and resource-intensive. Few prosecutors have the in-house expertise to handle complex criminal tax evasion.

Establishing criminal enforcement's relationship with its compliance cousins, civil enforcement and collections, can be a challenge. One reason is that legal standards of procedure and proof are (and should be) different for civil and criminal matters, making coordination and transfers of cases between units more complicated than one might anticipate. Also, criminal enforcement units present unique human resource and management issues, such as weapons training and the need to maintain a chain of evidence. Finally, policing units, wherever they may be placed for administrative purposes, have a distinct culture that does not always mesh with civil administration.

From the Trees, the Forest Emerges

Now that you've completed your helicopter tour, it's a good time to step back and consider how all these component functions of tax administration fit together. Returning to the notion that modern tax systems depend on voluntary compliance, let's revisit the illustration that began this section. Note that activities on the left side of the compliance continuum involve a high degree of voluntary compliance and relatively efficient revenue collection, while activities on the right side involve less voluntary compliance and inherently less efficient revenue collection.

What's the point? Actually, there are two points.

First, the compliance continuum makes it obvious that every function — indeed, every single job — at a tax agency is ultimately about voluntary compliance, even support services such as technology and human resources. That insight is surprisingly alien to many tax agencies that have strong "silo-based" organizational legacies.

Second, part of your job as leader of a tax administration is to find ways of moving your agency's interactions with taxpayers "up" the compliance continuum (from right to left) toward greater voluntary compliance.

III. Your Organization

Organizing the Organization

Tax agencies exhibit a wide range of organizational structures and strategies. Some are organized solely on a functional basis, some (including the Internal Revenue Service) are organized around distinct customer bases, some are organized on a decentralized or regional basis, and some are trying to outsource as many functions as possible to private-sector companies. Although each approach has its strong partisans, most tax administrators prefer a combined approach that leverages the best of each "pure" approach. And most also can't resist the temptation to tinker with their organization at various times.

Although tax administrators are not immune to management fads (remember total quality management?) or the temptation to market reorganization as management innovation, at least some of the restlessness arises because tax administrators are experimenting and trying to adapt their organizations to reflect broader changes in our society. Thirty years ago, it would have been hard to find a tax administrator who thought of taxpayers as customers with legitimate service expectations. Now it is the rule. Similarly, the increasing focus on customers and the explosion of new technologies have reduced the traditional barriers between tax administration functions, which in turn has had ramifications for how a tax agency recruits, trains, and manages personnel. Throw public-sector unions and civil service requirements into the mix, and you have a highly complicated management challenge.

Support Functions

For clarity's sake, the previous section's compliance continuum did not enumerate various support functions, such as technology, procurement, and human resources. Those are critical to any organization but not unique to tax administration. Rather than drag you through a lengthy description of each function, this section offers a heads-up on tax administration considerations that may apply.

Let's begin with a general observation. Although there are certainly tax-administration-specific nuances to each function, remember that, at least in theory, other agencies and private contractors can do much of this work. Whether you view that as a threat or opportunity, please consider whether the battle is ultimately worth drawing down your limited political capital.

The good news is that tax administration can deliver great management gratification. There are plenty of opportunities for innovation, and generally it's relatively easy to track the results.

Human Resources — Human resources includes functions such as personnel management (hiring and firing), civil service compliance, affirmative action, labor and employee relations (including discipline), payroll administration, and training. This area presents several tax-related challenges.

First, a paucity of undergraduate accounting degrees and salary competition from private firms and the IRS has made it difficult to recruit and train qualified candidates, especially minorities, for entry-level auditing positions. In response, tax agencies are devoting more resources to in-house training, and some are experimenting with internships and apprentice-type programs.

Second, as a general matter, civil service systems are not keeping up with the technology-driven evolution of real-life job functions in tax administration. The overall trend is away from clerical functions and toward knowledge worker functions, in which employees, using computers, interact with live data and make real-time decisions that affect taxpayers. That means there are retraining challenges or situations in which staff work "out of title," performing tasks that are outside the strict boundaries of their civil service job description (tasks and standards). When that happens, unions will naturally object or seek additional pay for the affected employee. For the agency, the chore of reclassifying civil service job titles can take years.

Third, seasonal fluctuations in return volumes may require hiring temporary staff to help with functions such as processing and taxpayer service. Although that presents recruitment and training challenges, the good news is that experienced seasonal or peak staff often return year after year.

Fourth, the fact that much of the work of a tax administration involves confidential tax information presents unique control issues. There is no avoiding that some of your employees will need routine access to confidential information. Management's responsibility is to support that access while maintaining a strict overall control environment that prevents unauthorized access, use, or disclosure of confidential information. The ramifications are even more significant when one considers that state tax agencies routinely handle and rely on confidential IRS information. The IRS takes data confidentiality very seriously and has threatened to deny access to states that mismanage federal data. Losing access to federal data would seriously damage a state tax agency's audit and compliance activities.

Technology has made accessing real-time data much easier, enabling customer service staff to resolve complex problems quickly and accurately. On the other hand, however, better access has driven greater demand for such access to data. Giving your staff more access to confidential data will inevitably increase your agency's control risks. One trend in control procedures is moving from "people-based" to "role-based" controls under which physical and logical (software-based) controls apply to specific functions and duties, not individual staff. That way, if John Smith is reassigned from job X to job Y, his control environment changes automatically without anyone having to remember to rescind one set of controls and apply another.

Finally, it is almost certain that political considerations will affect the structure and staffing of your network of district offices for audit, collections, and taxpayer service. If you want to make changes, expect nasty and ill-informed opposition. Also, don't overlook opportunities for mitigation. For instance, you may find that a relatively depressed community that does not justify intensive local audit coverage may be ideal for recruitment and retention of qualified professional staff. Many functions can be performed remotely, and in the grand scheme the benefits of high-quality staff vastly exceed the cost of occasional travel.

Procurement — Like most public organizations, tax agencies procure a vast array of products and services, from paint to printing. Some tax-specific challenges in this area again involve control of confidential tax information, particularly as agencies experiment with outsourcing functions such as processing of returns and payments, collections, and the development and support of information technology systems.

> ***Outsourcing places a heavy premium on testing, which can place a significant burden on your internal staff.***

Outsourcing places a heavy premium on testing, which can place a significant burden on your internal staff. Make sure to account for the internal costs of testing in your cost-benefit analysis and in assessing vendor proposals.

Another challenge is dealing with the constant stream of vendors — some referred through lobbyists and political channels — who claim that their product or service will increase revenue for your jurisdiction without raising taxes. Whether the product is address correction software or a new data warehousing tool, it's perfectly reasonable to review and evaluate the latest mousetrap. Just keep in mind, however, that fair and accurate evaluations require staff resources and time. As a senior manager, you may find yourself protecting your staff from unreasonable demands on their time.

Travel — It is likely that your audit program will require some degree of travel, either to visit the headquarters of taxpayers outside your jurisdiction or to optimize available staff. Young auditors without families sometimes welcome travel, while older ones with families may not. It takes some experience to make each trip as productive as possible.

Printing — Despite the advent of electronic filing and payment, tax agencies still do a lot of printing. Producing millions of forms, notices, and bills, frequently under demanding time constraints, requires precision. Some tax agencies outsource their printing; others do all their own printing, and even some for other agencies. One challenge is dealing with last-minute legislative changes.

Mail Processing — Mail processing is a science unto itself. You will almost certainly enjoy a close working relationship with your local post office. Challenges include managing all the returned items ("nixies"), updating address files, and maintaining an appropriate control environment.

Records Management — Thankfully, electronic filing and imaging technology are slowly obviating the need to store and manage massive numbers of paper records such as tax returns. Each jurisdiction has its own record retention standards and procedures for certifying the sufficiency of electronic records or images. In addition to the usual control issues, one challenge is sustaining a sense of urgency in pushing the certification process along. It's easy to let the matter slip for another filing year or two. Also, watch for opportunities to integrate imaging into everyday processes, even if the initial cost of this casual imaging seems high. For example, it may be expensive to implement a process for imaging inbound audit correspondence, but the ability to access complete electronic folders from a desktop can supercharge your desk audit program.

Plant — For better or worse, your agency's plant will probably resemble that of other government agencies. There are only a few tax-specific considerations. First, you will need to provide a secure environment for in-person payment transactions. Second, you will almost certainly have to maintain a secure records storage facility. Third, you must have off-site backup for your information systems, the lifeblood of your organization.

IV. Constituents

Meet Your Constituents

Unless you are the elected tax commissioner of North Dakota, you are probably an appointed official who ultimately answers to one or more elected officials. If you think that status exempts you from performing constituent service, you're wrong. Every public servant, elected or not, has one or more constituencies, defined as communities of persons that have some personal, political, or economic interest in the public servant's work. Given the substance of tax administration — taking money away from people — you can be sure that you have a rich and diverse constituency.

The appointing authority. Your primary constituent is your appointing authority (for example, your governor or mayor). You work for this person. Your job is to execute his or her policies and priorities faithfully and effectively because, at the end of the day, he or she, not you, faces the voters. You have an obligation to represent and defend his or her views in public while reserving the right to advocate for a different approach in private.

Sounds simple, right? Not so fast.

> ***The odds are that your politician-boss's top priority for your agency is avoiding trouble and attention.***

For one thing, your elected boss's understanding of your role in his or her political hierarchy will almost certainly differ from yours. Whereas you will see your role as that of nobly executing your principal's policies, he or she will usually view your role as managing a significant source of political risk. Taxes are a very touchy subject, and much of the news about tax administration is controversial or downright bad. So the odds are that your politician-boss's top priority for your agency is avoiding trouble and attention. Similarly, his or her second priority is likely to maintain a little creative distance from the unpopular decisions you will have to make.

The appointing authority's staff. Depending on the size and traditions of your jurisdiction, your appointing authority's senior staff can be an important constituency. In some jurisdictions, the chief executive delegates day-to-day agency oversight to one or more staff members, who in turn monitor their respective agencies. In such cases the chief executive rarely, if ever, interacts with the head of tax administration. Other jurisdictions have a fully functioning cabinet, and the chief executive's staff serves more in a liaison capacity. Although risk avoidance will be a top priority under either scenario, you will find that dealing with your chief executive's staff has a couple of interesting wrinkles that warrant some advice.

First, be responsive even if you can't be helpful on the merits. A major component of senior staff's mission is to manage political issues on behalf of their principal before they become full-blown political problems. Part of managing sensitive issues is demonstrating to outsiders that you have the clout to make agencies (and agency heads) respond to politically sensitive inquiries and complaints, regardless of merit. It's a "saving face" thing. Good, experienced staff will expect you to play it straight with a dash of political finesse. They ought to appreciate that you're dealing with complex issues involving lots of money and should not try to second-guess your judgment. Indeed, some may find it a relief that they can't interfere in the minutia of a particular case because so much of tax administration is cloaked in confidentiality. In return for the latitude to go ahead and "do the right thing," you should to demonstrate that you are sensitive to the larger political context and that you respect the staff's role in the process.

Second, retain a little skepticism when staff informs you sotto voce that "the boss wants" something done. This is a time-honored staff power enhancement technique. In at least some instances, the boss has never heard of the matter, especially in the below-the-radar field of tax administration. That is not to say that the staff member is affirmatively or nefariously misrepresenting his or her principal's views; more likely, the comment represents the staff's informed and well-intentioned projection of their principal's views. Accordingly, your default setting should be to follow the directive (as long as it's legal and ethical) but if the matter is controversial try to confirm your principal's intentions quietly. Never embarrass the staff member.

Finally, deliver all politically sensitive intelligence, especially bad news, as soon as practicable. Staff charged with protecting an elected principal live and die by accurate, timely intelligence. If the information is positive, it's not yours to keep — remember who you work for — so don't hoard it. If the information is negative, make sure to avoid blindsiding your principal and his or her staff. Of course, there will be times when they won't welcome being informed because it extends responsibility. Err on the side of discrete disclosure anyway. Self-editing is both tricky and presumptuous.

Legislators and legislative staff. Depending on your jurisdiction's political traditions, legislators and legislative staff may play a major or minor role in the day-to-day business of tax administration. For your sake, let's hope it's the latter.

There are two main points of interaction: the budget process and constituent service. A later section will touch on the politics of budget-making; here we are concerned with managing relationships with your legislative branch.

Your jurisdiction's annual (or biannual) budget process will typically include a hearing process, in which you will be invited to make a presentation on your agency's budget request. If you're lucky, you may actually receive a few questions on your proposed budget. More likely, legislators will use the opportunity to pose a wide-ranging series of unrelated (and often misinformed) questions touching on potentially controversial issues. That's normal and perfectly appropriate, especially in jurisdictions where the legislative branch doesn't exercise regular oversight over your agency. The truth is that most state and local legislative bodies are at a hopeless disadvantage in overseeing tax administration, partly because of the cloak of confidentiality and partly because so much of the subject matter is administrative and technical. The best strategy is to prepare for any and all questions. Indeed, embrace the preparation process as a useful exercise in internal coordination. Also, if you have an opportunity to offer an opening statement, consider using the opportunity to raise and address the most difficult or controversial issues upfront. That way, you can preempt and mitigate dramatic hostile disclosures.

Regardless of whether the legislators play an active role in the budget process, remember that their fiscal staff is almost certainly heavily involved. They are the ones who review, evaluate, and brief their members on your agency's budget request. They review and amend the draft legislation that accompanies your request, and they prepare questions for the hearing. Some will be highly skilled in dealing with tax-related legislation. In short, they are likely to be far more important to your agency day to day than many of their principals. Treat them accordingly, but be mindful that staff priorities sometimes diverge from member priorities. Staff overreaching is a widespread but rarely acknowledged feature of legislative life. Whatever you do, don't get in the middle of member-staff power struggles.

From time to time, legislators will contact you on behalf of their constituents. Most requests involve firms or individuals who have complained to their office about your agency's completely unreasonable or unfair audit, collection activity, or other compliance action. Other matters may involve firms that are competing for public contracts or applying for economic development benefits.

Either way, don't be surprised if the legislator — who hears just one side of the matter, from someone who is a voter, contributor, or major employer — fails to leap to your agency's defense. In response, you have two tasks. First, you have to investigate the underlying facts to make sure that your agency has acted appropriately. Usually that will involve passing the complaint along to the applicable unit head with a request for an explanation, and following up with questions. Sometimes — not often — you will uncover mistakes or worse. Second, you need to respond to the legislator in a manner that permits the legislator to appear relevant and responsive to his or her constituent. Most legislators understand that constituents' complaints are not always meritorious and will accept a negative answer, albeit without enthusiasm. They can always blame you and move on to the next issue. However, they won't forgive your failure to respond at all, because that makes them look ineffective before a constituent. The emperor must have clothes!

The Budget Office. It goes without saying that your agency needs adequate resources to perform its mission. The uninitiated might assume that a revenue-collection agency would have no trouble working with budget office staff and securing resources. The reality, however, is that many tax agency leaders — starting with the IRS commissioner — find that managing relations with their jurisdiction's budget office can be a challenging, often mystifying experience.

Generations of tax agency heads have pondered a basic logical conundrum: if (a) my jurisdiction desperately needs more money to meet demands for services, and (b) we know that there is a significant "tax gap" related to under-reporting and underpayment, and (c) we can collect more money with more staff, then (d) why won't the budget office give us more money to hire staff?

Similarly, if (i) we know that more than 90 percent of revenue comes in voluntarily, while less than 10 percent comes in through audit and enforcement, and thus (ii) statistically, given the relative volumes, a very small uptick in voluntary compliance will generate a huge amount of revenue, and (iii) better information systems, staff training, guidance, and customer services will all enhance voluntary compliance, then (iv) why is it that budget officers always favor incremental spending on compliance programs and starve spending that supports voluntary compliance? From the tax agency's point of view, this risks overemphasizing relatively inefficient revenue-raising functions at the expense of more efficient revenue-raising functions.

As cold comfort, I offer several highly subjective hypotheses.

First, tax agencies face a version of the left-brain/right-brain problem. Specifically, most budget agencies maintain an organizational distinction between a spending or program unit that is responsible for limiting expenses (left brain) and revenue unit that is responsible for revenue projections, revenue accounting, and often tax policy (right brain). A tax agency has to deal with both sides. The problem is that two sides often don't communicate or agree, and the left brain in this case is usually more powerful.

Second, budget officers just don't buy the "why not boost voluntary compliance?" argument. Deep in their hearts, they believe that revenue collections will rise and fall on their own as a function of tax rates and economic activity, and that good tax administration has at best a marginal impact on the total amount collected. Tax agencies have so far lacked the hard data to refute this presumption.

Third, the tendency to focus marginal budget dollars on compliance functions reflects several political realities. At the obvious level, revenue-hungry legislators would rather vote to "catch tax cheats" than to enhance staff training. At the next level, budget officers are more confident of tracking the impact of (and thus justifying) marginal spending on compliance activities as opposed to general tax administration. This plays a subtle but critically important role in the politics of budget-making. In most jurisdictions, closing a "gap" is the central focus of — or problem to be solved in — budget negotiations. In this context, what counts is spending cuts and revenue enhancements *at the margin* rather than in baseline budgets or forecasts. On the spending side, a cut in spending can be "scored" as such and helps close the gap (and solve the problem). On the revenue side, however, it's virtually impossible to score an increase in revenue from voluntary compliance that can be isolated from tax rates and economic performance. Thus, as a practical matter, investing in voluntary compliance doesn't help a budget agency solve its immediate political problem, which is closing the gap. It follows that such spending will be a low priority.

Before leaving the subject of budget offices, it bears mention that in most jurisdictions the budget office's revenue unit and the tax agency's analytical staff routinely share revenue accounting data. This results in a very close and mutually beneficial working relationship. No matter what happens in the context of budget-making, maintaining this relationship and protecting the integrity of the data exchange should be a top priority.

Practitioners. State and local tax accounting and legal professionals are a significant constituency for every tax administration. They are the only constituents who actually make a living through regular interaction with your agency on technical and compliance issues, a feature that has both positive and negative features.

On the positive side, many tax practitioners will strive to maintain a good-faith partnership with your agency. They generally have the expertise to deal with complicated issues relatively efficiently and appreciate your agency's role in the process (which, of course, sustains them). Many practitioners are also involved in professional organizations (state and local bar tax committees, CPA societies) that offer useful recommendations and commentary on legal and process issues. You will likely find yourself invited to speak at those organizations' periodic meetings and relying on their professional feedback on new policies and procedures. Some will become friends.

On the negative side, however, no amount of partnership can obviate the ultimately adversarial core relationship between practitioners and tax administrators. That is by design. Practitioners have a professional duty to advocate on behalf of their client, even if their client is dead wrong. Try not to be too disappointed if practitioners place their clients ahead of their supposed partnership with your agency. It's just business.

That adversarial component affects the role practitioners play in the politics of tax administration. As an outside constituency with acknowledged expertise in technical law issues, they enjoy and deserve considerable credibility among politicians and journalists. As such they can help validate and support your legislative proposals, especially technical amendments.

However, politicians and journalists often assume that expertise in tax law extends to tax administration, so they will readily believe practitioners who criticize your agency's performance, even if the underlying complaint actually concerns an issue of interpretation or policy rather than a management failure. Practitioners' view into your agency's functioning is limited to their experience with disputes, an externality of tax administration. That can lead to unfair judgments. For example, practitioners may claim that your agency's high win-to-loss ratio in litigation is evidence of endemic unfairness. They won't believe your counterarguments that it reflects careful audit selection and good case management.

Taxpayers. It should be obvious that taxpayers constitute your largest and most important constituency. After all, everything you and your colleagues do is ultimately about helping taxpayers understand and meet their tax obligations voluntarily. Yet the sheer size and diversity of this constituency begs some additional comment.

Are taxpayers customers? One popular recent trend in tax administration is referring to taxpayers as "customers." More than management fad semantics, that trend has played a valuable role in helping tax agencies evolve their institutional culture toward greater emphasis on customer service and voluntary compliance. Having grown up in a consumer-oriented, service economy, many staff members instinctively welcome the customer service paradigm.

> ***Most of your customers would prefer no interaction with you at all. Moreover, the term 'customer' misleadingly implies rights without concomitant responsibilities. A taxpayer has clear legal responsibilities.***

That said, it's possible to oversell the concept of taxpayers as customers. After all, your agency's interaction with its "customers" is rarely voluntary in the traditional willing buyer/willing seller sense. Most of your customers would prefer no interaction with you at all. Moreover, the term "customer" misleadingly implies rights without concomitant responsibilities. A taxpayer has clear legal responsibilities.

Communicating with the citizenry. You can't help taxpayers meet their obligations without communicating with them. The increasing diversity of the taxpayer population is making that basic task ever more complex.

First, of course, is the debate over whether to offer non-English services and written material. Most tax agencies strive to offer some non-English (typically Spanish) taxpayer assistance services, although recruiting qualified bilingual staff can be a challenge. Progress with written materials has been slower. Cost is a major consideration: Accurate and timely translation is expensive and, frankly, most tax agencies have trouble keeping their English-language materials up to date. Moreover, additional languages make quality control and risk management more challenging.

Second, the taxpayer population's diversification extends far beyond language or ethnicity. For instance, advances in communications technology are changing the way people socialize, learn, obtain news and information, and yes, pay taxes. Although we are just beginning to see an effect on tax administration, it is already plain that younger taxpayers — if they don't use a professional tax preparer — are more inclined to use tax preparation software with built-in questionnaires than to sit at their kitchen table, read through an 80-page instruction booklet, and fill out a paper form. That raises several questions. Who actually reads your instructions and uses your forms? It's probably a combination of "real" taxpayers, professional tax preparers, and developers of tax preparation software. In that case, does it make sense to keep offering the same substance and form of communication for every audience?

To be, or not to be, a taxpayer. No discussion of taxpayers as constituents would be complete without noting the recent political push to exempt low-income individuals from income tax filing requirements. The rationale is that these individuals don't or shouldn't owe tax, and that making them file a return is a waste of time and administrative resources. That may be good politics, but it's statistically wrong to assume that today's low-income person will never be subject to tax in future years. It's harder to return someone to the tax rolls than it is to maintain them on the rolls. Moreover, as a matter of public policy, do we really want members of our society to lose that kind of civic connection to their government? Finally, the rhetoric is a little misleading: Low-income individuals must file a return to qualify for important benefits such as the earned income tax credit.

Vendors. Every significant government agency procures a wide range of products and services from private-sector firms, either directly or indirectly through a centralized procurement agency. If your agency has any substantial role in issuing bids (generally for commodities) and requests for proposals (generally for customized products and services), be aware that vendors are becoming an important constituency as vendors take on ever more significant roles in delivering services and interacting with the public.

Traditionally, there was a distinction in public administration between contract agencies that delivered the bulk of their services through contracts with outside (usually nonprofit) vendors and line agencies that delivered services to the public directly. That distinction had important political implications. Vendors to contract agencies have always been an organized, motivated, visible, and hence powerful lobby for spending on contracts. By contrast, vendors to line agencies — sellers of supplies and like commodities — have had a lower political profile.

Once upon a time, tax agencies were prototypical line agencies: Tax agency staff printed and mailed returns, opened the mail, processed returns and payments, answered telephones, and collected tax debts. Not any more. Over the past couple of decades, there has been a slow but steady trend toward contracting out functions such as printing, processing, taxpayer service, and even collection work. Moreover, even short of full-blown contracting out, vendors are increasingly embedding themselves as "partners" in government service delivery.

> ***Every vendor incursion into service delivery creates a self-sustaining constituency for the service in question. That's not always a good thing.***

Setting aside for later the merits of contracting out, every vendor incursion into service delivery creates a self-sustaining constituency for the service in question. That's not always a good thing. Moreover, contracting out changes your organization's political risk profile. Inevitably, and regardless of your degree of control, the public will attribute a vendor's mistakes to your agency. The bureaucracy's natural reaction is to manage that risk by imposing higher standards and more exacting reporting requirements on contractors. Higher standards are often appropriate, but there is always a risk of imposing standards that inappropriately constrain the bidding pool or drive up costs beyond the point of diminishing returns. In my experience, most bureaucracies place a higher value on risk mitigation than service enhancement or cost control.

Your staff. Your agency's career staff members are a crucial constituency. Who are they? What do they want? How do they fit into the realization of your vision for the agency?

For starters, understand the nature of your relationship. Unless you are leading a very small agency, you can't hope to get to know every employee personally. Nonetheless, many employees will feel that they have a quasi-personal relationship with you. Although the comings and goings of political appointees are of little real consequence to the rank and file, you may be surprised to learn the extent to which your staff scrutinizes your every word and action, almost like following a sports team, complete with analogous positive and negative commentary. It's up to you to manage that dynamic in the best interests of your agency's mission.

It's easier to manage the relationship if you understand the staff's perspective. Most tax agency rank-and-file staff members are career civil servants. By definition, that means at some point each individual made a clear choice to prioritize job security, lifestyle, or serving the public ahead of financial risk-taking and commensurate remuneration. That doesn't mean they are necessarily risk-averse or lack ambition, only that they are functioning in an environment that is distinct from the private sector in important ways.

So how do you lead civil servants? It should be obvious that command authority without willing compliance is usually of limited usefulness. It's true that some great leaders manage to push their agenda forward through fear, intimidation, and sheer force of will. But for the rest of us mortals it's worth remembering that civil servants can be ingenious in frustrating their political masters' directives. Thus, the odds are that you will have to resort to a range of strategies to persuade your staff to adopt and implement your vision.

You can't hope to persuade your staff to execute your priorities unless you communicate and institutionalize your priorities. Once you have settled on core priorities, share your vision with the rank and file at every opportunity, whether through internal newsletters, announcements, or personal appearances. The message should be simple but compelling. With enough repetition nearly everyone will gain a rudimentary understanding. Even if they don't understand or agree with you, they will appreciate that you have a sense of direction and are bothering to share it with them.

The secret sauce that turns communication into action is syndication — getting other people, especially managers, to identify with and take ownership of your priorities. Many managers take professional pride in their work and will gladly offer you the benefit of their experience — unless, of course, you're too stuck-up to ask. The key is to leverage that professional pride by engaging these managers, listening to them, challenging them, and, whenever possible, aligning their priorities with yours. Sometimes that requires amending your priorities slightly; sometimes it requires pointing out how your priorities support theirs, or vice versa. In short, position yourself as an enabler rather than a preacher.

That is not to say you should lead by taking a poll of your staff and managers. On the contrary, it's your responsibility to set institutional objectives. I'm just suggesting that part of that process includes weaving the separate threads of your subordinates' priorities into a coherent whole. If you draw out the best in your managers, the chances are good that you will find that you agree on most priorities. Ignore the other stuff. After all, there's more than enough to do, and terms of office are too short to waste time arguing. And don't forget to share the credit for success.

Be aware of — but don't lose sleep over — the risk of staff manipulation. Staff members are human beings. In rendering supposedly objective advice, they will sometimes make mistakes, fail to research or consider all sides of an issue, or even allow an old personal grudge against a taxpayer or practitioner to influence their analysis or opinion. If a practitioner, for example, alleges that your staff is misleading you, take the matter seriously; most practitioners are loath to complain about staff for fear of poisoning future interactions with your agency (after all, they'll be dealing with the staff long after you've gone). At the same time, don't automatically assume the allegation's veracity. You owe it to your staff to conduct your own inquiry into the facts. If it turns out that the practitioner has a legitimate complaint, try to resolve the matter quietly without embarrassing the staff member, unless of course there was active malfeasance. Finally, remember to consider the opposite, if somewhat remote, risk: some practitioners might welcome an opportunity to become your confidant by painting the staff as a mutual enemy.

Finally, no discussion of staff would be complete without taking cognizance of the fact that some of your staff will enjoy very close, and often dependent, working relationships with staff at outside agencies and offices, especially those that coordinate and control activities across many agencies. For instance, your tax policy, accounting, and analysis staff will work very closely with the budget office's revenue staff, your contracting unit will work closely with your jurisdiction's central procurement unit, your legal staff will likely work closely with staff from your jurisdiction's chief legal officer (such as an attorney general) and/or your appointing authority's counsel. The point here is not to suggest that you should take extraordinary steps to avoid divided loyalties. If you did, you would probably fall on your face. Instead, leverage these relationships as opportunities to extend your agency's constituency base. When push comes to shove, the more people who understand your agency's operations and needs, the better. Support staff exchanges and ask your staff to facilitate introductions to their counterparts and key senior staff at control agencies. In addition to the direct benefits of establishing relationships, this will signal your confidence in your staff, buttressing their internal and external position.

V. Contextual Considerations

You are not an island.

Tax administration may be relatively technical and low-profile, but it is very much influenced by and a reflection of the forces shaping modern society. Indeed, part of the enjoyment of tax administration is managing your organization within the larger fiscal, policy, and political context. This section outlines that context.

The Fiscal Context — Fiscal Federalism

It's important to appreciate that our federal system of government has a powerful impact on the fiscal context of tax administration. Most states, and many localities, raise only a portion — perhaps half — of the money they actually spend. The rest comes from the federal or another level of government, as the case may be. That distinction is important for several reasons.

First, not all revenue is equal. Most revenue that a jurisdiction raises for itself is unrestricted for budget purposes, whereas money received from another level of government almost always comes with strings — program mandates, matching or maintenance-of-effort requirements, reporting requirements, and so on. If you were in charge of a jurisdiction, which kind of revenue would you prefer?

Second, our federal system has developed some fiscal traditions. At one level, that is manifest in slightly different tax bases. For example, most states and many localities administer a sales tax, yet the federal government does not. Similarly, the federal government does not administer transfer and ad valorem taxes on real property. Conversely, the federal government generally takes the lead regarding estate tax; indeed, before the recent (and temporary) phase down of the federal estate tax, most states keyed their estate tax to the maximum federal credit for state estate taxes.

At another, subtler level, there was a traditional understanding that the federal government should not intrude on (or preempt) the states' taxation powers. In theory, that meant Congress should not enact laws that, for example, impose national nexus standards for state business income taxes. But traditions are subject to evolution. In recent years, the business lobby has enjoyed some success in arguing that establishing national standards for state taxation levels the playing field, reduces burdensome complexity, and is essential to American firms' global competitiveness. They have a legitimate point. Trouble is, those arguments almost always promote legislation that reduces, rather than expands, the state and local tax base. That, in turn, makes it more challenging for states and localities to raise revenue equitably across the remaining pool of taxpayers.

State and Local Tax Practice Comes of Age

At one time, not so long ago, state and local tax was a sleepy backwater of accounting and legal practice. A small group of practitioners, usually former bureaucrats, settled matters for their clients with a few phone calls to old buddies in their former agencies and divided up the meager spoils. No more. Beginning in the late 1980s, several factors combined to make state and local tax practice lucrative, if not downright sexy.

First, the 1986 federal tax reform constrained some of the more interesting and lucrative federal tax planning opportunities, leading some ambitious practitioners to look for greener pastures. It wasn't long before those practitioners and their clients began to notice that a little state and local tax planning could go a long way, partly because many states and localities had relatively unsophisticated laws and compliance programs. As noted previously, at one time many states did little more than bill for federal changes.

Second, the inexorable growth in the size and scope of local government over the past few decades has led to ever-higher levels of taxation, to the point that state and local taxes have become a significant economic factor, especially in an increasingly global competitive context. Of course, high taxes are an incentive for aggressive tax planning and defending audits vigorously.

Finally, the last few decades have seen an explosion in the use of state and local tax incentives for economic development. Every well-intentioned attempt to restrict eligibility for a lucrative tax credit to "new" jobs, investment, or businesses results in a gantlet of complexity requiring the assistance of experienced advisers.

Why is that important? As state and local taxation has increased in importance, the traditional power relationship between tax agencies and taxpayers has evolved. Taxpayers and practitioners have become more sophisticated and aggressive and are more often on the offensive, regarding both politics and tax planning. State and local tax agencies are trying to meet that challenge by upgrading their compliance capacities, but never seem to catch up.

VI. A Tax Policy Teaser

I know I promised to avoid the intricacies of tax policy in this article, but I can't resist offering a few insights that may help you orient yourself on the issues when the time comes.

The Bad News

Let's start with some bad news.

First, as a senior tax administrator, you may be tempted to assume you will have a major voice in formulating your jurisdiction's tax policies. Resist the temptation, especially if you serve a large jurisdiction with a powerful budget office. Why? For starters, budget officers guard that institutional territory jealously, knowing that it is a major source of power both internally and in dealing with your jurisdiction's legislative branch. Also, the sycophants who guard access to your chief executive almost certainly believe that tax policy is too politically sensitive to be left to mere "technicians" like tax administrators.

> ***Politicians don't care that each tax incentive adds a new layer of complexity or that each new exemption simply shifts the tax burden onto the ever-narrower remaining tax base.***

Second, it is hard to find anyone in or near government who doesn't believe that he or she is a tax policy expert. At best, those folks are expert in tax politics, not tax policy. Handling all those experts politely while attempting to prevent the imposition on unworkable legislation will be a constant challenge. You will come to appreciate the cliché that too many cooks spoil the broth.

Third, please brace yourself for the fact that absolutely no one outside academe and tax administration cares about "good" tax policy. No one. Setting aside ideological views regarding fairness, there is a surprisingly broad academic consensus that the optimal tax system features the broadest possible base while exerting the least possible influence on economic decision-making. In other words, taxation should strive to be frictionless. Trouble is, generations of politicians have discovered the joys of using the tax code to try to influence behavior or deliver specific benefits to specific constituencies. They simply don't care that each tax incentive adds a new layer of complexity or that each new exemption simply shifts the tax burden onto the ever-narrower remaining tax base. More on that below.

Tax Policy in a Perfect World

The world isn't perfect and neither is any tax system that you're likely to encounter. Nevertheless, if only to gain some appreciation as to how bad things usually are, it's worth spending a few moments reviewing simplified versions of five[1] generally accepted principles of a good tax system: sufficiency, stability, simplicity, neutrality, and transparency.

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[1]These are adopted from the AICPA — Tax Policy Concept Statements 1, "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals," *available at* http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf.

Sufficiency. A good tax system should provide sufficient revenue to fulfill the government's needs.

Stability. Taxes should provide a stable and predictable source of revenue. For example, income taxes are more volatile than real property taxes.

Simplicity. Tax codes should be easy to comply with and administer.

Neutrality. A tax system should impose minimal economic distortion and friction. In other words, the tax structure should be neutral regarding economic (for example, investment) decision-making.

Transparency. The imposition and impact of taxes — who ultimately pays — should not be obscured.

Perceptive readers will have noted that none of the above principles speak to the issue of fairness, the general idea that the imposition of tax should somehow reflect the taxpayer's ability to pay. Although most economists include fairness as a principle of good taxation, I held back to make a point: A lot of tax policy debate today arises from the constant struggle to reconcile the principle (read "goal") of fairness with other principles of good taxation, notably stability and simplicity. For example, the principle of stability recommends a real property tax, but most economists would say that property taxes are relatively unfair in that they do not necessarily reflect the taxpayer's ability to pay. Similarly, the goal of fairness favors progressive income taxes and means-testing for tax benefits, but a progressive income tax and means-testing always introduce vexing complexity into a tax system. When it comes to tax, simplicity is the enemy of fairness, and vice versa.

My Unified Field Theory of Tax Policy

There are plenty of issues in tax and legal policy to keep you occupied and confused. Given your high expectations for this introductory article, however, I feel compelled to offer a clarifying intellectual structure to help you place the issues into context.

So here it is: At their most elemental level, all tax policy issues involve one or all of the following core concepts: tax base, locus, and the time value of money. Those are the who/what, where, and when of taxation.

Tax base is simply the who/what — the taxpayer or the specific transaction, property, type or item of income that is subject to a tax or scheme of taxation. Obviously, who pays matters a great deal for economic, practical, and political reasons.

From an economic standpoint, an unequal or inefficient distribution of the tax burden introduces distortion. In recent years, the question of distortion has fueled raging debates over whether and how to tax new industries, such as Internet telephony, whether to accommodate further narrowing of the tax base, and how the tax system should respond to the trend toward deregulation in energy, telecommunications, and other important sectors.

From a practical perspective, it is generally more efficient to upstream the collection of taxes by defining the tax base at the highest (or narrowest) possible level in the distribution chain. In general, as you move higher up the chain, you encounter fewer and more sophisticated taxpayers with better financial records. For example, if you want to raise a given amount of money from beer, it is more efficient (and easier) to administer a high tax on beer brewers than a medium tax on beer distributors, just as it is easier to enforce a medium tax against beer distributors than a low tax against myriad retail liquor stores and bars. Similarly, withholding tax at the employer level is generally more reliable than employees' self-reporting and payment. Despite the practical advantages, imposing high rates on a narrow base is politically charged and introduces collateral policy issues, such as economic distortion and lack of transparency to the ultimate consumer.

> ***When it comes to tax, simplicity is the enemy of fairness, and vice versa.***

From a political perspective, beyond the obvious rich/poor dynamic, the issue of who pays tends to push tax policies away from transparency and simplicity, as politicians find ever more sophisticated ways of diffusing accountability for shifting tax burdens among constituencies.

Locus is not a technical tax term. I'm just using it as shorthand for the fact that location — where something happens or someone is — is incredibly important in taxation. Out of that arises a range of issues such as nexus, sourcing, allocation, combination, and transfer pricing.

The when is also of critical importance in taxation because of the *time value of money,* a technical term for the fact that the passage of time almost always has an effect on the value or purchasing power of a given unit of money. That basic concept permeates a range of mostly federal issues such as the treatment of and characterization of capital gains and the recognition or deferral of income. Indeed, it is a major culprit in increasing the complexity of the tax code at every level.

VII. Conclusion and Next Steps

This short introduction should get you on your way in state tax administration. Obviously, there's a whole lot more to it. As a state tax administrator, you will soon find yourself confronting a variety of legal, policy, management, and technology issues that are beyond our scope. Your next steps are simple: Welcome the challenge and be willing to learn from the good people you will be working with. ✰

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