

**HOW FAR SHOULD TAX RESEARCH TAKE ACCOUNT OF THE
WIDER CONTEXT? THE CASES OF TAX COMPLIANCE AND
TAX SIMPLIFICATION**

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1. Introduction

The optimum level of compliance costs is not zero. The simplest tax system is not necessarily the best tax system. Tax systems have to achieve a range of aims and objectives and to do so in a complex and changing economic and social environment. Ease of compliance and simplicity, important though they are, are not always the most important issues. However, even some otherwise excellent pieces of research do not perhaps take sufficient account of the relationships between different aspects of tax systems and the environments in which they have to operate in drawing conclusions about improvements in taxation. For example, quite correctly, Sandford *et al.* (1989, p. 203) saw that administration and compliance costs were linked and should not be considered in isolation. They went on to conclude that: ‘Perhaps the best that can be done is to suggest that the objective might be phrased in terms of minimizing operating costs in obtaining a given revenue from a given tax structure.’ Clearly the authors appreciate that there may be a trade-off between operating costs and particular tax structures, but the relationships between these costs and the different aspects of a tax system are not examined. Similarly commentators on tax simplification often do not take sufficient account of the importance of other matters. For instance, an early paper entitled ‘Tax Simplification’ in the *Accounting Review* ended: ‘The results will largely be measured by the number of pages remaining in the Code’ (Bachrach, 1945, p. 103). That would certainly be a simple measure of tax reform with respect to tax simplification but probably not the most useful and certainly not a good measure of improvement of the tax system as a whole.

An approach that takes a wider perspective – including the range of government policies which are sometimes at least partly implemented through the tax system – may result in conclusions that can be quite different. For instance, tax compliance is often discussed in terms of minimizing compliance costs. However if, for example, the purpose of a particular tax is to discourage a certain activity such as the use of alcohol or tobacco or even possibly the consumption of fatty foods on health grounds (O’Donoghue and Rabin, 2006), then the conclusion may no longer be that compliance costs, or operating costs in total, should be minimized – indeed higher compliance costs might help achieve the objective.

The authors are very grateful for the opportunity to present this paper and to discuss some of the issues involved with their current research into these matters. Our experience has been that showing individuals a paper has been very productive since they can easily establish the scope of the project and the issues involved. The purpose of this research is to identify the main factors that should be considered in developing a model of optimum tax compliance costs taking account of the wider context and to integrate compliance research into mainstream tax research. This would help to develop a more coherent framework with which to understand the extensive and growing compliance literature and its place in the context of tax policy more generally. It is then possible to develop a more systematic or strategic approach to tax compliance policy than has been employed before and such an approach should also form the basis of a more sophisticated approach to tax

simplification. It is, of course, necessary to go beyond simple assumptions regarding relationships between penalties and tax compliance narrowly defined by taking account of the wider purposes and considerations involved in operating a tax system such as economic efficiency, incentives to work, save and invest, the perceived fairness of a tax system, tax incidence, macroeconomic aspects, international considerations and taxpayer beliefs and behaviour. Such an approach is likely to be more successful than previous work in this area that has tended to concentrate on narrow issues such as simply minimizing compliance costs or simplifying the language of tax law without taking much, if any, account of the many other important dimensions of tax systems.

Of course, tax research cannot be expected to take full account of every relevant aspect all the time. The knowledge of researchers is limited and research in depth might have to be limited in scope. Therefore, an important question is how far research should include the wider context in developing conclusions. In a preliminary survey by the present authors of the research on compliance and simplification, it seems that much of the work could make a stronger contribution if it were linked to wider issues.

To take a wider view Section 2 discusses contributions from Economics – the general theory of the second best and optimal taxation – which give an indication of the complexity of the matters involved. Section 3 turns to compliance and Section 4 to tax simplification. Section 5 is concerned with developing a strategy for improvement based on a wider approach and Section 6 draws some conclusions.

2. Contributions from Economic Analysis

Economic analysis has a great deal to offer the wider approach to taxation. Two particular areas are the general theory of the second best and optimal taxation. Public choice theory also has much to offer but the implications of that analysis will be left to a later paper.

The General Theory of the Second Best

One of the themes in this wider approach to compliance and simplification is the interdependence between different economic, as well as political and social, variables and realities. A very important insight, probably not very well known outside mainstream economics, is the theory of the second best. This relates to the fact that the variables in an economic system interact so that changing one part will have effects on other variables that are not even directly involved in the initial change. This can mean that a reform designed to achieve an economic improvement, far from actually doing so, might even make things worse. This does not seem to be consistent with normal intuition but it might be illustrated with a simple example where two economic distortions are offsetting each other. Suppose a monopolist – as single seller of some good or service - might wish to exploit its market power and push the price up but has only one customer who has the market power to keep the price down and the result might be something like the optimum price. However, to remove either the economic power of the monopolist or its customer

without removing both could result in the market price moving away from the optimal. As a tax example, it is often suggested that taxes should be imposed to counteract external effects – say pollution – or some other environmental concern. This may be true if the external effect causes the price to give the wrong economic signal about the full cost of the output including the external costs. The tax could be used to represent the social cost in the market which would then be guided in the right direction. This is not the only possibility though. It may be that existing distortions have already tended to influence the price in this way and if tax policy makers have not considered all aspects of the change before implementing it, the disadvantages of the resulting tax may outweigh the advantages.

More generally the theory of the second best states that it ‘is *not* true that a situation in which more, but not all, of the optimum conditions are fulfilled is necessarily, or is even likely to be, superior to a situation in which fewer are fulfilled’ (Lipsey and Lancaster, 1956, p. 12). Indeed the general theory of the second best holds that if one of the Paretian optima cannot be achieved then a second best optimum can be reached by departing from all the other optimum conditions. Furthermore, nothing can be said in general about the direction or the magnitude of the secondary deviations from optimum conditions made necessary by the inability to achieve the original optimum condition. Lipsey and Lancaster actually illustrate this with a tax example. They suppose that a tax is imposed on one good only and the revenue raised is returned as a gift to the purchasers so the only result is to distort relative prices. Given this distortion, the only general thing that can be said is that a second best optimum could only be achieved by a system of taxes on other goods and services, some of which may be more than, some less than, the original tax and in some cases a subsidy might be required.

As already indicated, the tax system is not an independent entity and imperfections in the tax system may have implications for the pattern of public expenditure. For example, Balestrino and Galmarini (2003) argued that imperfect income tax compliance implies it is desirable that the supply of public goods should be distorted downwards. At a more detailed level an infinite amount of such analysis is possible. For example, West and Williams (2007) estimate the parameters required to calculate the optimal second-best gasoline tax.

The general theory of the second best is not good news for those happy with just a narrow view of a taxation and tax reform. Incorporating a wider analysis into tax reform is naturally much more complex than following a simplistic approach and Harry Johnson (1970) added his own particular view:

The fundamental problem is that, as with all second-best arguments, determination of the conditions under which a second-best policy actually leads to an improvement of social welfare requires detailed theoretical and empirical investigation by a first-best economist. Unfortunately, policy is generally formulated by fourth-best economists and administered by third-best economists; it is therefore very unlikely that a second-best welfare optimum will result from policies based on second-best arguments (Johnson, 1970).

Such levity aside, the implication of second best analysis is that the failure to consider a much wider range of factors than is currently the norm might mean that an 'improvement' in tax compliance or simplification does not lead to an overall improvement at all. When the wider context is included, the overall disadvantages may be greater than the more obvious benefits of the initial change.

The literature on optimal taxation adds further insights and is therefore also described briefly.

Optimal Taxation

The work on optimal taxation is relevant because the literature is concerned with tax structures that take account of both the requirements of economic efficiency and the need to be fair between one taxpayer and another. It is concerned with questions such as whether income or commodity taxes should be used and how should tax rates vary across commodities. The equity dimension relates to the question of how progressive the tax system should be. To some extent, of course, there is a trade-off between the two criteria of efficiency and equity. A tax system that is economically efficient may not be considered fair and vice versa and the purpose of much of the optimal taxation literature is to find the best balance between the two. Having said that, it is not always easy to model what is considered to be fair and there have been difficulties in incorporating important variables.

One of the earliest and most famous contributions was Ramsey's (1927) which concluded that uniform commodity taxes were rarely optimal, though it might be noted that the analysis abstracted from the costs of operating different tax rates. There is now a considerable literature on optimal taxation though Broome's (1975) parody suggests that it should not always be taken literally. Frey (1976, p. 32) pointed out that optimal taxation will only be introduced if it is acceptable within the political-economic process. Feldstein (1977) criticized the literature for concentrating too much on the features of the optimum and too little on the process of attaining it. An accessible summary is provided by Heady (1993) who also raised the specific question of the contribution optimal taxation could make to practical tax policy. Although that literature clearly offers some important insights, it cannot help in all areas of tax policy.

Indeed the difficulty of applying much of the work in optimal taxation to policy issues is a constant theme. Alm (1996) suggested that previous attempts to derive an 'optimal tax system' were largely irrelevant to practical tax design since they ignored a range of considerations involving fiscal and social institutions. He argued that many of the relevant institutional features could be included in an optimal tax framework but acknowledged that it would never be able to incorporate all of the 'incredible complexity' that must be considered in the design and reform of tax systems.

Nevertheless optimal taxation continues to develop and often in the right direction. Gradstein (1999) examined political mechanisms that ensure efficiency enhancing

restraints on taxation. In the context of the present paper, the discussion of optimal taxation and evasion is particularly relevant. As with other areas the analysis results in important insights but not to precise policy prescriptions. Cremer and Gahvari (1994) suggest that the optimum marginal tax rate is lower in the presence of tax evasion but this depends on their particular assumptions. An increase in tax rates may improve economic efficiency as it might cause some labour to move into the illegal labour market which may be less economically distorted than the legitimate one. However, as Sandmo (2005, p. 658) points out, there are some serious implications in viewing ‘anti-social behaviour’ as a social gain in this way. There is the theoretical but rather crude insight that the probability of detection in the form of an increased frequency of audits and penalties for evasion are substitutes. Concern in minimizing compliance costs might indicate a preference for the latter. However, on equity grounds, if no other, that approach may lead to unacceptably high penalties for the few who are caught for crimes committed by many individuals who escape unscathed. In any case the decision to evade may well be heavily influenced by behavioural rather than economic factors narrowly defined (James *et al.*, 2001). The recent study by O’Donoghue and Rabin (2006) used the optimal taxation framework to examine ‘sin taxes’ – such as those on unhealthy foods that people might consume more than they should because they lack self-control or some other problem. The existence of merit goods or merit bads where the government and individuals have different ideas of the individual’s optimal consumption was raised by Musgrave (1959) and discussed ever since. In a sense an individual’s consumption that does not take full account of future harm might be thought of as an internal externality with respect to that individual’s future health – or an ‘internality’ as Heston *et al.* (1993) put it. O’Donoghue and Rabin show that introducing taxes on unhealthy items and returning the proceeds to the taxpayers can increase economic welfare, but such a conclusion can be reached without using optimal taxation analysis. The authors also acknowledge that the analysis has numerous limitations. This is generally in line with the nature of the optimal taxation approach and so the policy implications are also limited.

The optimal taxation approach once again reinforces the point that it is a difficult and complex process to develop changes to the tax system where the advantages outweigh the disadvantages. Yet it is also clear that giving the wider context less attention than it deserves is not the way to proceed.

3. Compliance

There is now a huge body of research on tax compliance (see for example, Fischer, *et al.* 1992, Richardson, and Sawyer, 2001 and Ahmed, *et al.* 2003). In particular, there has been a constant stream of studies estimating actual compliance costs but often without considering compliance costs as part of wider tax policy. For instance such studies generally imply that all would be well if only compliance costs were low and progressive rather than high and regressive. As indicated above, whether this is correct or not depends on a range of factors and if a tax is being used to discourage a particular form of behaviour then higher rather than lower compliance costs might even be desirable. As an example with respect to the issue of progressivity, it does not follow that each part of the tax system has to be equally progressive, or indeed even that every part of it individually has to be progressive at all. It certainly does not require that compliance costs always have to be progressive.

It may be, of course, that some research is deliberately focused only on a small aspect – such as a particular estimate of compliance costs in a specific context - to be concerned about such wider issues. An example is the study by Shekidele (2001) of excise duties in Tanzania but there is some discussion of the background and perhaps it should have included these matters since it might affect the conclusions. Sometimes researchers are aware of trade-offs between different parts of the tax system but do not seem to follow this through in full. For example, Serra (2003, p. 374) states that the goal of the tax administration should be to minimize collection costs for a given tax structure and tax administration budget and that joint minimization of tax evasion and costs of compliance can be used as a proxy for minimizing collection costs which would be very difficult to observe directly. He argues that the compliance rate could serve as the effectiveness indicator for the compliance maximization objective (p. 374). Serra's argument for maximizing tax compliance is that minimizing tax collection costs should be a goal of the tax administration and that tax collection costs generally fall when there is a higher rate of compliance (p. 375). He is aware of the trade-offs of different aspects of the tax system as he goes on to say that higher compliance means the government could have either lower tax rates or administrative costs and the optimum response is likely to be a combination of the two. Nevertheless he adds that the precise relationship between compliance and collection costs depends on the way compliance maximization is achieved (p. 376). It is also acknowledged in the conclusion that the compliance rate is not appropriate as an indicator of the effectiveness of tax administration since tax compliance is influenced by factors other than the tax administration – such as high economic growth – and because tax enforcement could increase compliance costs. Serra therefore concludes that a second objective for the tax administration should be 'to minimize compliance costs'.

The cost benefit approach to tax compliance has been described elsewhere and there is a huge literature which is summarized in James *et al.* (2005). The question of what issues should be taken into account is the subject of the present study and we should welcome contributions. With respect to the compliance literature, we are analyzing the studies

included in the three surveys mentioned above - Fischer, *et al.* (1992) Richardson and Sawyer (2001) and Ahmed *et al.* (2003) together with research published after these studies were completed.

We are refining the questions but basically the four issues are:

1. Does the research ignore altogether other important and relevant aspects of the tax system?
2. Does it acknowledge that such factors could alter the conclusions of the research?
3. Does it take other matters seriously into account?
4. Which factors does it take seriously into account?

We are also summarizing the tax policy and related literature for evidence of the nature and importance of other factors on optimal compliance and simplification.

The Development of Behavioral Models

One area that has been developed considerably is a more behavioural approach to tax compliance. This has a great deal to offer in terms of supplementing and extending mainstream economic analysis. It may be that there are better ways of achieving compliance than the narrow economic one of concentrating on the frequency and level of auditing and penalties for those caught misbehaving. Taking account of such factors might not only enable improvements to be made in compliance policy but also for there to be co-ordination with other government aims, objects and public expenditure programmes.

There are many contributions from different disciplines that suggest there is a range of other factors that might influence taxpayers' behaviour. For instance, work in sociology has identified a number of relevant variables such as social support, social influence, attitudes and certain background factors such as age, gender, race and culture. Psychology reinforces this approach and has even created its own branch of 'fiscal psychology' (Schmölders, 1959, Lewis, 1982). The contribution of psychology includes the finding that attitudes towards the State and revenue authorities are important factors as well as perceptions of equity in determining compliance decisions. Economic psychology also stresses the importance of attitudes, morals, values, and fiscal consciousness (Cullis and Lewis, 1997). The roles of individuals in society and accepted norms of behaviour have also been shown to have a strong influence (Wenzel, 2001a and 2001b). Braithwaite *et al.* (2003) examined such factors as the perception of justice and how social norms and laws can undermine each other.

The main theme of this approach is that individuals are not simply independent selfish utility maximisers (though this might be partly true) but that they also interact with other

human beings in ways which depend on different attitudes, beliefs, norms and rules. It also means that as taxpayers they can normally be expected to act as responsible citizens. That is, in normal circumstances, they should conform to reasonable obligations of the tax system without the extensive application of enforcement activity.

There are many detailed contributions to this approach - including some by economists. For example, Spicer and Lundstedt (1976) examined taxpayer norms and attitudes towards the tax system and tax offenders and Spicer (1986) non-maximising behaviour more recently. The importance of equity and fairness has also been a frequent theme (for example, Bordignon, 1993 and Cowell, 1992). Background factors such as cultural influence have been examined (Coleman and Freeman, 1997), so too have the implications of different political systems (Pommerehne *et al.*, 1994). More direct contributions to policy in this area have come from a number of authors. For example, one is an appeal to taxpayers' conscience (Hasseldine and Kaplan, 1992) and also to feelings of guilt and shame (Erard and Feinstein, 1994). Others have suggested more positive help for taxpayers (Hite, 1989) and different methods of achieving this - such as the use of television to change taxpayers' attitudes towards fairness and compliance (Roberts, 1994). It is also possible that taxpayers consider the benefits the community receives from government expenditures (Falkinger, 1988). There may therefore be scope to improve compliance by drawing attention to the benefits of public spending.

Many more papers could have been cited but the section gives an indication of the range of academic evidence that supports the behavioral approach.

4. Tax Simplification

In the area of tax simplification there have been authors who recognised that other factors might also be important. For example, Kaplow (1996) described a relatively simple framework which incorporated equity and efficiency matters with complexity and compliance. However there has also been a tendency in this area to overestimate the importance of just one aspect and the most vivid example is that view that the solution to the problem of complexity in the tax system is largely a matter of simplifying tax law. In examining this matter, academics should perhaps remember that there are some sound reasons why language might be complex and their own output may not necessarily be in the simplest form possible. An example comes from the Institute for Fiscal Studies in the UK which won a Golden Bull award from the Plain English Campaign¹ in 2006 for a website document description:

While the literature on nonclassical measurement error traditionally relies on the availability of an auxiliary dataset containing correctly measured observations, this paper establishes that the availability of instruments enables the identification of a large class of nonclassical nonlinear errors-in-variables models with continuously distributed variables.

It may well be possible to provide a more accessible description. There may also be more than a little truth in the observation attributed to Rutherford – that if a scientist cannot explain to the lady who cleans his laboratory what he is doing then he doesn't know what he is doing.

The Tax Law Approach

There is no doubt that some have found tax law to have a range of inadequacies. For example, in 2005 the Australian Taxation Office came second place in the Golden Bull awards² for Section 165-55 A *New Tax System (Goods and Services Tax) Act 1999*:

- For the purpose of making a declaration under this Subdivision, the Commissioner may:
- a) treat a particular event that actually happened as not having happened; and
 - b) treat a particular event that did not actually happen as having happened and, if appropriate, treat the event as:
 - i) having happened at a particular time; and
 - ii) having involved particular action by a particular entity; and
 - c) treat a particular event that actually happened as:
 - i) having happened at a time different from the time it actually happened; or
 - ii) having involved particular action by a particular entity (whether or not the event actually involved any action by that entity).

¹ <http://www.plainenglish.co.uk/bull06.htm#ifs> Accessed 27 January 2007

² Plain English Campaign (2005) <http://www.plainenglish.co.uk/bull05.htm#aus>. Accessed 23 October 2006.

In fairness, the role of the ATO is to administer the law, not to draft it, so the ‘credit’ for this distinction probably lies elsewhere.

Plenty of legislation is also a general feature of modern tax systems. Peter Cussons³ measured the number of pages of primary federal tax legislation found that Australia had 7,750. This was less than India with 9,000 pages and the United Kingdom with 8,300 but more than Japan (7,200), the United States (5,100) and just about everywhere else. Of course the number of pages of primary legislation is only crudely related to the complexity of tax systems. Indeed it may be a perverse target for proponents of simplification. If shorter legislation were achieved by moving to a purposive basis there may be greater scope for litigation and confusion than if the law had been longer but more comprehensive in its scope. There is also secondary legislation in the form of regulations, case law, revenue authority interpretations and formal tax rulings.

Tax Law Reviews

In both Australia and the UK a response to these issues has been tax law review projects. In the UK the Tax Law Review Committee was set up in 1994 to rewrite tax legislation in plain English and examine explanatory documentation. In Australia the process began with a report produced by the Joint Committee of Public Accounts in 1993 and the Tax Law Improvement Project (TLIP) was set up with the task of improving the ‘understanding of the law, its expression and its readability’ (Tax Law Review Team, 1994). There is no doubt that improvements have been made though such attempts have not always been well received. For example, in Australia Geoffrey Lehmann referred to some of the rewritten law as ‘kindergarten babble’. He cited ‘Your assessable income includes income according to ordinary concepts, which is called ordinary income’. Warming to his theme, Lehmann (1995) suggested that ‘the rewrite of the core provisions has not resulted in simple legislation, but a loquacious, patronising and confused babble of educationalese. Reading it is like trying to wade through styrofoam mixed with treacle.’

There are reservations about simplifying tax law in this way. One is that rewriting the law may inadvertently change its meaning in places when over many years Courts have gone to considerable trouble to establishing precise meanings. In Australia there were arrangements to stop this happening – section 1-3 ITAA 1997 reads as follows:

³ ‘The increasing Burden of Tax Administration and Compliance’ in *Paying Taxes: The Global Picture*, PriceWaterhouseCoopers and the World Bank, <http://www.pwc.com/extweb/pwcpublications.nsf/docid/6FE224AC0BA720BB85257214004DA2E9> accessed 16 February 2007.

Section 1-3 Differences in style not to affect meaning.

1-3(1)

This Act contains provisions of the *Income Tax Assessment Act 1936* in a rewritten form.

1-3(2)

If:

- (a) that Act expressed an idea in a particular form of words; and
- (b) this Act appears to have expressed the same idea in a different form of words in order to use a clearer or simpler style; the ideas are not to be taken to be different just because different forms of words were used.

Although this addresses the problem, there is still scope for complexity, not least in that the former legislation still remains a point of reference. A second reservation is that taxpayers themselves do not normally read primary tax legislation and therefore there is no need to direct it at them.

There does seem to have been a view at the time that the tax law rewrites were the solution to the problem of excessive complexity but, certainly on their own, they are not. An initial part of the Australian rewrite duly appeared as the *Income Tax Act 1997*. In reviewing the position, Krever (2003) pointed out that a superficial look at that Act seemed to support the view that the complexity of the system was the fault of the drafters of earlier legislation. However he went on to say that taxpayers and their advisers soon discovered that, although the new legislation was easier to read and comprehend than what had gone before, the complexity was still there. In fact the process had exposed the true cause of the previous law's complexity – that is its 'wholly irrational and inconsistent policy base' (p. 493). Furthermore, TLIP seemed to have distracted attention from the normal process of revising tax legislation outside the project where problems continued and might even have increased. In the UK the Tax Law Review Committee's final report (1996) listed three types of complexity – linguistic, policy and compliance – and acknowledged that a comprehensive tax reform would have to address all three areas (paragraph 6.10). The Committee also stated that 'without policy changes the benefits from rewriting legislation are limited' (paragraph 12).

A recent Australian contribution has been the Taylor Report (2006) on reducing tax law complexity. The principal conclusion was that the fundamental principles the tax law was trying to express were obscured by excessively detailed operational rules and the report made a number of recommendations for improvement.

Although initiatives such as tax law improvement are to be welcomed, in both Australia and the UK they have been limited in that they were concerned with only part of the problem, complexity of language, and sometimes that is only a small part of the problem. There was no serious attempt to address the underlying complexity of the tax system and

the process of tax reform generally from which such complexity arises (James and Edwards, 2007). As in the case of compliance, what is needed is a much wider approach to these issues.

The Tax System Reflects General Trends

Complex legislation is not a problem of the tax system alone and a successful strategy to improve matters should take account of the general factors involved. A sobering book was published by Ross Clark (2006) on the explosion of regulations. Although he had plenty of examples for the title of his book, he chose *How to Label a Goat* - taken from the Sheep and Goats (Records, Identification and Movement)(Wales) Order 2006 regulating the size, shape and colour of ear tags on Welsh sheep and goats – it runs to 45 pages of densely written legalistic language. It is not an isolated example. In the year to 31 May 2006, Ross reports (p.5) that the UK Government passed 3,621 separate pieces of legislation – an average of more than 10 new sets of rules and regulations for every day of the year. On the basis of a sample of 10 per cent of this regulatory output, Ross estimated that the year's output alone was 72,400 pages of legislation and 26,200 of explanatory notes – a grand total estimated at 98,600 pages.

The Disadvantages of Complexity

There are some fairly obvious costs to complexity – particularly in administration and the costs to the community of complying with the tax system.

The connection between complexity and compliance and administrative costs is itself complex, but generally the more complexity the higher the costs. Furthermore, estimates of compliance costs have limitations which are sometimes considerable. One in particular is that surveys of compliance costs often include only those who are economically active in a particular way. Those who do not participate, for example who do not run a small business because of the complexity of tax and other regulations, are often not included in compliance cost studies.

In addition, overly complex and obscure legislation might reduce the willingness of taxpayers to comply voluntarily with the requirements of the tax system. This is particularly important with a system of self-assessment. To the extent that complexity impedes clarity it may also make the estimation of future revenue and costs more difficult and will therefore make economic decision-making harder.

It may also generate unfairness, for example because not everyone is equally able to take advantage of the various complexities of a tax system. Finally, complexity makes useful discussion of tax policy and the introduction of improvements more difficult.

The benefits of simplicity are generally, of course, the opposite of the costs of complexity - to reduce the burden of compliance and probably improve the willingness to comply with the tax system. There is also a more general point: that the main purpose of most

taxes is to pay for public expenditure. A tax system that is unnecessarily complicated might reduce public support for the improvement of important public services.

Do Taxpayers want Simplification?

A simple tax system obviously avoids the drawbacks of a complex one and, other things being equal, a simple tax will normally be preferred to a more complex one. However, there are many other aspects to a tax system. For example, one of the most important characteristics of a tax is that it must be seen to be fair. A simple tax may not take sufficient account of personal circumstances to meet this criterion. A good illustration was the UK Community Charge, or 'poll tax'. It was simple in that it was basically a fixed charge for each person in a particular local authority jurisdiction. In terms of the economic criteria for a good tax, the poll tax also scored highly because it does not vary with economic behaviour and should not, therefore, cause people to do odd things for tax reasons. However, the tax failed on the criteria of fairness. The historical precedents were not encouraging. The Rising of 1381 originated from a hatred of the poll tax (Trevelyan, 1946). The Archbishop of Canterbury who, as Chancellor of the realm, represented the government was beheaded by Wat Tyler's men on Tower Hill and, quite remarkably, the rebels captured London itself. The modern version of the tax was introduced in Scotland in 1989 and in England and Wales in 1990. Nevertheless, as in the fourteenth century, its perceived unfairness demonstrated (Smith, 1991) the power of taxation to influence behaviour, led to serious civil disobedience (Mair and Damania, 1992) and was a factor in the events leading to the resignation of Mrs Margaret Thatcher as Prime Minister.

More generally, when it comes to matters of fairness in taxation complexity often wins over simplicity. In Australia there is currently a tax free threshold of \$6,000 then tax rates of 15%, 30% (at 25,000), 40% (at 75,000) and 45% (at 150,000). The tax system would be much simpler if there were a zero tax free threshold and a flat rate of tax. There could be a flat rate deduction at source for wages, interest, dividends etc. and many individuals would not then have to lodge a tax return. Such a system may not be regarded as being fair compared to what exists now. Also if Australia had the UK system of generally not allowing employees' tax deductions for work related expenses it would have a simpler system but it might not be considered so fair.

Reasons for Complexity

Good though simplicity is, there are other considerations. The primary purpose of taxation is usually to raise revenue to support public expenditure and often to redistribute income. Tax systems are also used to support a range of other government policies. It would be inconsistent if these aims were not taken into account in the taxing process itself. Hence the role of 'tax expenditures' where some fiscal advantage is conferred on a group of taxpayers or a particular activity by reducing tax liability rather than by a cash subsidy – a phenomenon first extensively analysed by Surrey (1973). The tax system may be used to impose a fiscal disadvantage on areas that are perceived to have disadvantages.

Hence taxes can be used to correct adverse ‘external effects’ such as pollution and ‘green taxes’ generally together with ‘sin taxes’ such as those on alcohol and tobacco. Necessarily such provisions involve discrimination in the taxation of different activities and therefore add to complexity in themselves.

However, it is not always easy to use the tax system to achieve the intended aims effectively. Taxpayers are not always passive and some who were not the intended beneficiaries of the concession might find they can also take advantage of it. The government may then try to attempt to stop them, so adding further layers of complexity. An example was the UK Parliament’s desire to avoid imposing value added tax on children’s clothes. This involved establishing the definition of a child. If it is simply the age of a child then clothes sold for large children could be used by small adults. If it is based on the size of the child then the concession would be available to small children but not to large ones. Similar problems arose in trying to exempt food from value added tax. Originally take-away meals were exempt from VAT but not meals eaten on the premises. Since this was open to abuse, the rule was changed so that hot take-away food from restaurants was brought into tax. Hence caviar as a cold food is exempt from VAT food but fish and chips are not.

More generally moves to limit tax avoidance are one of the biggest causes of tax complexity. Taxpayers, or frequently their advisers, find some opportunity to exploit some aspect of the tax system and the official response is often more complex legislation to restrict their ability to do so. Taxpayers then find ways round those measures by developing more complex ways to avoid the new rules and so it goes on.

Nevertheless, one of biggest reasons for complexity is the desire for fairness between taxpayers. The tax system has to be designed, at least to some extent, to fit the particular circumstances of taxpayers. This is reinforced by the sheer weight of taxation in modern industrial countries. At low levels taxation can be relatively simple, that is rough and ready with respect to taxpayers’ circumstances. As the amount of taxation grows then more people will be affected in more ways and it will have for this reason also to be more closely aligned to their circumstances if the burden is not to become unbearable.

Another factor is the nature of tax law itself. As already indicated, complexity arises because taxation reflects wider economic and social trends. There is not much doubt that one important trend in the environment in which taxation has to operate is the increasing complexity of socio-economic systems (James, 1999). Hence Prebble’s (1994) view is that complexity arises from trying to fit the law around the ‘natural facts of economic life’. And it does not always fit. To take a fairly central issue, Vickrey (1969) suggested that complications in the legislation and administration of income tax arise largely from the need to answer four types of question:

1. Is it income?
2. Whose income is it?
3. What kind of income is it?
4. When is it income?

Which leads into all sorts of wonderful discussions about the definition of income, capital gains, business profits and so on.

Surrey's (1969, p. 673) view was that tax law complexity arises from:

complex substantive tax rules with complex inter-relationships characterised by complex variations in the tax treatment of transactions often not differing greatly in substance or form, all of which are expressed in a complex statutory terminology and arrangement.

At least some of this, however, is clearly necessary. As Sir Ernest Gowers, a former Chairman of the Board of Inland Revenue, wrote in his *Complete Plain Words* (Gowers, 1954) though with respect to a different example of legal language:

[The] sentence is constructed with that mathematical arrangement of words which lawyers adopt to make their meaning unambiguous. Worked out as one would work out an equation, the sentence serves its purpose; as literature it is balderdash.

There is often an attempt to cater for every eventuality which, particularly in a complex and changing economic and social environment, can only lead to greater complexity. One possibility might be greater use of purposive law rather than 'black letter' law. Avery Jones (1969), for example, has argued for less detailed legislation in line with principles and 'not a continuation of the plague of tax rule madness'.

However, complexity can have advantages, particularly with developments in technology and in relation to certainty and clarity. For example, in recent years the Australian Tax Office has put its legal data base on its web site. This includes an enormous amount of material and, in the past, would often have been too difficult to access for most purposes. However, the search engines now allow guidance to be found quickly on the most obscure issues. Advances in technology have made what was once very complex now very simple to use.

So, what can be done? A good start can be made by examining what is meant by simplification. Even that is not particularly simple.

What is Simplification?

Cooper (1993) suggests there are at least 7 issues:

1. Predictability – in this context, a rule would be simple if that rule and its scope were easily and accurately understood by taxpayers and their advisers.
2. Proportionality. A rule would be simple if the complexity of the solution were no more than reasonably necessary to achieve the intended aim.
3. Consistency. This would apply where a rule deals with similar issues in the same way and without the need to make arbitrary distinctions.

4. Compliance. A rule would be simple if it were easy for taxpayers to comply without incurring excessive costs.
5. Administration. A rule would be simple if it were easy for a revenue authority to administer.
6. Co-ordination. A rule would be simple if it fitted appropriately with other tax rules; it would be complicated if its relationships with other rules were obscure.
7. Expression. A rule would be simple if it were clearly expressed.

Cooper also suggested that simplification could be seen as being at different levels. The first level is the choice of the tax base, whatever that may be. The second is the design of the rules to be applied to the tax base. The third is in the expression of those rules and the final level of complexity is the administrative requirements imposed on taxpayers.

This, of course, demonstrates the importance of ensuring that simplification at one level does not cause difficulties at other levels.

So What Can be Done?

Simplification at one level is possible though still needs to be co-ordinated with other levels and aspects of the system. The first author can recall attending a presentation where an academic graphic design specialist had offered to help the Revenue and redesigned part of an Inland Revenue form. This was before that aspect of the tax system had been computerised and the designer had improved one part of the form only. The result was impressive. Text had been moved around the form as well as good improvements in graphics, layout and presentation. Sadly, however, the designer had not troubled herself to understand the role of the form. In that pre-computerised document the four part form had been designed so that the completion of the top copy by the tax officer would simultaneously produce three carbon copies below - all different because they were designed for different purposes. The designer was very pleased with her work but did not discover that the only purpose of this exercise was public relations - to respond to her lobbying by giving her something to do! Unfortunately she had not taken a systematic approach to her proposals for improvement and her efforts were worthless – except as an object lesson of the importance knowing about what it is you are trying to improve.

It is possible to avoid large numbers of taxpayers having to complete a tax return at all. In the UK most taxpayers are not required to complete a tax return each year because the cumulative tax Pay-As-You-Earn system can withhold tax to a very high degree of accuracy (James and Wallschutzky, 1994). There has also been success with simplified returns such as the US 1040EZ. Furthermore, with advances in technology it is also becoming feasible to issue returns which already include information about the taxpayers' circumstances that has been supplied by third parties electronically (Highfield, 2006).

There is plenty of scope for the maintenance of good communications with taxpayers with improvements in forms, explanatory leaflets and so on (James, *et al.*, 1987). Others, for example Hite (1989), have also suggested more positive help for taxpayers.

Although there are, of course, reasons why tax law may be complex, there is often scope for simplifying it. Like many other people Lord Howe (1998) has pointed out that plain language law – which is clear and user-friendly - is obtainable and the key components are:

a clearer structure of what it is intended to achieve; much shorter sentences, clearer and better signposted definitions; modern design and layout and headings that help the user.

In the 1990s improving the language seemed to be the way forward and the tax law improvement projects were set up.

5. Developing A Strategy for Improvement

The way forward seems to be to develop a strategy for improvements and earlier attempts have been made in the case of compliance (James, 2005) and simplification (James and Wallschutzky, 1997).

The academic discipline that has paid most attention to the subject of developing strategy is Management. An essential input in the development of successful strategies is the systematic analysis and understanding of the factors involved. This includes the wider environment in which the activity is being conducted as well as the areas of immediate concern. A key part in the development of strategy is implementation. Henry Mintzberg (2004) is one of the most prominent management scholars in the area and believes that strategy is an interactive process requiring constant feedback between thought and action and that successful strategies evolve from experience. He also stresses the importance of strategists having expertise in the area and that they should not simply pontificate at a high level of abstraction and leave it to others to implement the strategies (and certainly not blame them for any shortcomings in the strategy). Other commentators such as Grant (2002) are also clear that the formulation and implementation of strategy go together. A well-designed strategy should take account of the process of implementation and it is through the implementation that a strategy can be refined and reformulated.

In terms of tax simplification the process may be summarised in four main areas:

- Evaluate the importance of different aims of tax policy.
- Incorporate simplification into the tax policy process itself.
- Develop a ‘simplification culture’.
- Monitor and review progress.

As already stated, simplification is not the sole aim of tax policy – indeed it is incidental to the main purposes of taxation. For long term improvement to be achieved, the relative

importance of simplification to other goals should be established – and this may change over time so the process must be a continuing one. In the UK the Inland Revenue (1995) has encouragingly discussed the creation of a ‘simplification “culture” within the Revenue which it is important to maintain and encourage.’ It is also desirable that such a culture should extend to the tax policymaking process as well. It is important to be able to measure the outcome to establish how far the aims have been achieved and whether they continue to be achieved. Different approaches to such measurement have been examined by Wallschutzky (1995).

6. Conclusions

Some tax research seems to take insufficient account of the wider context of their subject of study in developing their conclusions. There is a clear possibility that too narrowly focused conclusions could, if implemented, not only fail to achieve an overall improvement in the tax system but could actually make matters worse. This paper has concentrated on tax compliance and simplification. A policy to minimize compliance costs or to simplify the tax system without sufficient regard to other matters may not improve matters overall. For example, the work on simplifying tax law does not seem to have achieved a great deal in terms of tax simplification and is unlikely to do so unless it takes account of the subject as a whole.

This raises the original question of this paper, which is how far should tax research take account of the wider context. Comments would be very welcome.

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Appendix Comments on these Issues are Very Welcome

We are currently conducting a research project into ‘Optimum Tax Compliance Costs and Tax Simplification’ and welcome as many views on the issues as possible.

Summary of the Project

It is not difficult to demonstrate that the costs of complying with tax systems are often high or that tax systems are complex. However the purposes of tax systems and the environment in which they have to be administered often necessarily involve high compliance costs and that at least some tax provisions will be very complex. The issue is to balance reform in these areas with other important considerations. The aim of this project is therefore to identify the main factors that should be considered in developing a strategy regarding compliance and tax simplification taking account of the needs of taxpayers and tax systems more generally. Such an approach should, for example, improve understanding of how to improve tax compliance without resorting to methods that might be seen as heavy handed and punitive. An excessive reliance on such methods might reduce the willingness of taxpayers to comply voluntarily and undermine other government policies such as promoting economic enterprise in general and small businesses in particular. The project is based mainly on an analysis of the contribution of existing research together with the views of tax agencies and tax advisers.

All comments and contributions on these matters would be very welcome and should be sent to:

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