Optimum Tax Compliance Costs and Tax Simplification

Background

It is not difficult to demonstrate that the costs of complying with tax systems are often high or that modern tax systems are very complex. However the purposes of tax systems and the complex environment in which they have to be administered often necessarily involve high compliance costs and that at least some tax provisions will be far from simple. The problem is to balance reform in these areas with other important considerations. The theoretical framework of this research was derived from the two main approaches to explaining taxpayer behaviour in the context of tax compliance. The first of these approaches is based on ‘economic rationality’ – the view that individuals act largely, if not exclusively, in their own self-interest usually narrowly defined and draws mainly on economic analysis. The second approach may be termed the ‘responsible citizen approach’ – the view that individuals’ behaviour is determined by a wider range of variables and this approach draws on findings from other academic disciplines such as psychology and sociology.

Objectives

As stated in the Research Proposal (paragraph 1) the purpose of the project was to identify the main factors that should be considered in developing a model of optimum tax compliance costs and to integrate compliance research into mainstream tax research. As also stated (paragraph 2), the project would work towards generating a more strategic approach to developing tax compliance policy than has been employed before and build on work already undertaken by Simon James. Such an approach should also form the basis of a more sophisticated approach to tax simplification than has normally been seen previously. This work would result in 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 would go beyond simple assumptions regarding relationships between detection, penalties, tax rates and tax compliance narrowly defined by taking account of the extensive research into taxpayer behaviour, the aims and objectives of policy and the constraints and other relevant considerations involved in operating a tax system such as economic efficiency, incentives to work, save and invest, the perceived fairness of a tax system, taxpayers’ views and beliefs, tax incidence, macroeconomic aspects and international factors.

Methods

As stated in the Research Proposal, a great deal of data in this area has already been collected and the purpose of this project was not to generate further empirical evidence...
but to analyse existing work and direct it specifically towards the development of tax policy. Apart from the interviews this was essentially a desk study. Most of the research time was therefore taken up in collecting and analysing publications on compliance in terms of their contribution within the research framework describe above and specifically with reference to policy considerations. A systematic way of collecting the material proved to be the compilation of a Bibliography of Tax Compliance and Tax Compliance Costs. A second reason for proceeding in this way was that existing reviews of the field proved very useful and formally compiling the Bibliography would assist other present and future researchers in this area, particularly as some of the contributions are not easily accessible. It has therefore been offered to the ESRC Data Archive. Other methods employed included semi-structured interviews with academics, tax practitioners and officials, a survey of the current concerns of UK tax advisers appearing in the main practitioner journal Tax Adviser, published monthly by the Chartered Institute of Taxation. Papers reporting on the work of the project were also presented at a think tank in London and universities in Australia, the UK and the USA and full use was made of these opportunities to solicit helpful responses from those attending.

In interviewing relevant experts it was found that, after preliminary discussions in the early stages of the project, it was very useful at a later stage to use semi-structured interviews on the basis of one or sometimes two of the papers prepared as part of the project (listed below under Outputs) sent to the respondents well in advance. This generated a number of useful responses that could not have been anticipated by the researchers in devising more specific questions.

As indicated in the grant application, Australia was a particularly suitable country in which to examine progress in both the areas of compliance and tax simplification. Australia and the UK share a common fiscal heritage in many ways but it is particularly relevant that the Australian Taxation Office (ATO) has taken an innovative approach to tax compliance in a number of ways but particularly in developing its 'Compliance Model' and a major initiative has been undertaken regarding the simplification of tax law. Australia is one of the countries in which a great deal of tax compliance research has been undertaken including, but by no means exclusively, that coming from two research centres - the Australian School of Taxation at the University of New South Wales in Sydney and the Centre of Tax System Integrity at the Australian National University in Canberra. The Tax Administration Conference organized by the Australian Taxation Studies Programme in April 2006 was used for preliminary discussions with researchers in the field – including those from countries other than Australia, and the relevant senior official at the ATO.

In the following year interviews took place with tax agents in Newcastle, New South Wales and Perth as well as academics in the field at the Australian National University, Bond University, Curtin University, Murdoch University, the Australian School of Taxation in the Faculty of Law at the University of New South Wales, the University of Sydney, Queensland University of Technology, the University of Western Australia and, in New Zealand, the University of Waikato. In the UK interviews were also conducted on particular aspects with academics with the relevant expertise and discussions were held with chartered tax advisers, through the SW of England Branch of the Chartered Institute of Taxation.
A large number of useful responses were also received following papers presented at the think tank Policy Exchange, Westminster, on 27 November, 2006, which was attended by many expert and helpful individuals, Queensland University of Technology on 26 March, 2007, the University of Sydney on 2 May and the Australian School of Taxation, University of New South Wales, Sydney on 4 May. Conference papers also generated helpful responses – papers were presented at the Personal Income Tax Reform Symposium held on 2-3 April 2007, Australian School of Taxation, University of New South Wales, the 15th Annual Conference of the Society for the Advancement of Behavioral Economics at New York University on 15-18 May and the 16th Annual Conference of the Tax Research Network at the University of Sheffield on 6-7 September 2007.

Results

The results are presented under the following headings:

Tax compliance
Tax simplification
The process of tax reform
Developing a more systematic approach to tax reform
The case for an office of tax reform

Tax Compliance

In line with the objectives of the project, a considerable amount of material was collected and included in the Bibliography of Tax Compliance and Tax Compliance Costs. There has been a very substantial increase in contributions to the understanding of tax compliance from such areas from disciplines such as Economic Psychology and Behavioural Economics and, among other things, the project has confirmed the need to take account of what is already known in addition to generating further theoretical and empirical contributions. In decisions regarding tax compliance and noncompliance, the analysis of the literature demonstrates clearly that variables such as the probability of detection, penalties and tax rates analysed in the economic literature are important. However, it demonstrates that many other variables are also important - such as fairness, age, education, framing, peer influence, ethics. Furthermore, as discussed below, there are trade-offs between variables that make the process of deriving an appropriate policy regarding tax compliance potentially both a complex and difficult one. Although the relevant variables that should be taken into account in developing a model of optimal tax compliance have been identified, the research proposal did not set out to specify such a model precisely. Indeed, while it is clear what such a model should include, such a development would prove difficult in this area. It remains true, as Slemrod (1983) pointed out, that in applied public finance 'optimal' may signal an attempt to derive a precise mathematical expression for the socially most advantageous setting of a particular variable. One result of the analysis for this project is to support Alm’s (1996) view 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. In order to work towards such a contribution this project therefore also had to explore other avenues.

In terms of the theoretical framework of the project it was confirmed that the economic approach, relatively narrowly defined, provided many valuable contributions. However, a majority of the contemporary contributions to the tax compliance literature take a wider approach in considering additional variables in one way or another. It is possible that the present researchers might have been biased in the contributions they included for consideration (compiled in their Bibliography of Tax Compliance and Compliance Costs) but their conclusions to this effect are supported by other evidence. For example, the researchers analysed the entries in the annotated bibliography relating to voluntary tax compliance compiled by Ahmed et al. (2003) of the Centre for Tax System Integrity (CTSI) at the Australian National University. This compilation was restricted to contributions concerned with tax compliance or ideas relating to compliance published since 1960 though a few earlier publications were included if they were particularly relevant. The CTSI bibliography is divided into 10 sections and the analysis covered the first eight – section 9 consisted of CTSI working papers and section 10 edited collections. The results are shown in Table 1. Of the 467 contributions considered, 114 could be said to follow a relatively narrow economic approach but a further 229 were concerned with wider issues. Another 124 were concerned with other related matters such as the cash economy, regulatory compliance in general rather than tax compliance in particular and justice. Perhaps unsurprisingly, section 8 containing Econometric papers had by far the highest ratio of papers taking the narrower economic approach to those more concerned with wider issues. In contrast, the sections on the evaluation of the tax system and policy issues were dominated by contributions concerned with wider issues.
One of the aims of the project was to integrate tax compliance research into mainstream tax research. Musgrave’s (1959) classification provides a useful general framework for attempting to integrate the two basic approaches to tax compliance and this is illustrated in Figure 1. The allocation branch is concerned with issues of efficiency in resource allocation, and this is conventionally analysed by supposing that individuals act to maximise utility. Tax compliance is therefore also seen as a matter of economic rationality and taxpayers viewed as individuals who consider the pecuniary gains and losses from compliance or non-compliance. The distribution branch is concerned with issues of equity and incidence – how the effects of taxes are distributed. This would see taxation as an equity matter and might view the taxpayer in the more complex role of a member of society rather than simply a calculator of personal pecuniary gains and losses. Both approaches offer explanations of compliance behaviour and major contributions to the development of a compliance strategy.

The main question of interest here is how to integrate them in an overall analysis of compliance with the aim of generating policy insights. While there is a wealth of literature on various aspects of compliance, there is relatively little on how these aspects might be optimally combined with others in order to develop an overall analysis of compliance. To do this the different aims and objectives of tax policy need to be considered. Here this will be done only briefly. There are government policies that might be thought of as primarily economic in nature – in a similar way to the economic approach to compliance.

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Table 1 Analysis of Contributions Included in The Bibliography of Voluntary Tax Compliance compiled by the Centre for Tax System Integrity

<table>
<thead>
<tr>
<th>Parts of the Bibliography</th>
<th>Contributions following the narrower economic approach</th>
<th>Contributions concerned with wider issues</th>
<th>Contributions concerned with other related matters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Part 1 Evaluation of the tax system including fairness.</td>
<td>4</td>
<td>28</td>
<td>1</td>
</tr>
<tr>
<td>Part 2 Institutional Demands</td>
<td>17</td>
<td>43</td>
<td>9</td>
</tr>
<tr>
<td>Part 3 Sources of influence</td>
<td>9</td>
<td>36</td>
<td>5</td>
</tr>
<tr>
<td>Part 4 Cash economy</td>
<td>5</td>
<td>11</td>
<td>33</td>
</tr>
<tr>
<td>Part 5 Policy</td>
<td>7</td>
<td>39</td>
<td>11</td>
</tr>
<tr>
<td>Part 6 Theoretical contributions</td>
<td>32</td>
<td>57</td>
<td>18</td>
</tr>
<tr>
<td>Part 7 CTSI related contributions</td>
<td>5</td>
<td>8</td>
<td>45</td>
</tr>
<tr>
<td>Part 8 Econometric Papers</td>
<td>35</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>114</strong></td>
<td><strong>229</strong></td>
<td><strong>124</strong></td>
</tr>
</tbody>
</table>
Such policies are therefore included in the left hand side of Figure 1 where the linkages might be the strongest. Similarly – other government policies might be classified as much wider in nature and are therefore included in the right hand side of Figure 1. There will, of course, also be linkages between different policy objectives. However the issue is even more complex than this since the social, economic, legal and technological environment has also to be considered, nationally as well as internationally. A key dimension is that all these factors are subject to change and this is discussed further under the section on the process of tax reform below.
Figure 1 Integrating Approaches to Tax Compliance and Policy

Rationale for Public Sector Expenditure and Taxation

Allocation Branch

Issues of efficiency in resource allocation.

Tax compliance as a problem of economic rationality?

The taxpayer as a selfish calculator of pecuniary gains and losses?

Objectives primarily economic

Optimal compliance costs

The social, economic, legal, political and technological environment

Distribution Branch

Issues of equity, fairness and incidence.

Tax compliance as a problem of equity and fairness?

The taxpayer as a ‘good citizen’?

Objectives wider in nature
**Tax Simplification**

There has also been much written together with practical experience on the subject of tax simplification. Although tax simplification appears to be a simple and straightforward issue, it is another complex matter. Even the meaning associated with tax simplification in the literature varies a great deal – at least seven different meanings can be identified. Furthermore simplification has been discussed with respect to different aspects such as the choice of the tax base, the legislation giving effect to the tax base and the actual administration of the tax system. There are, of course, clear advantages to a simpler tax system rather than a more complex one, other things being equal. However other things are not equal – as with compliance policy, there are also clear advantages in developing tax systems that are sufficiently sophisticated to take account of different aims and objectives of tax policy and the complexities of taxpayers’ circumstances – both for individuals and enterprises – and the complexities of the modern economic and social environment. There is also clear evidence – for example in the natural experiment provided in the UK with the rise and fall of the community charge – that taxpayers may not prefer a simple tax if it not perceived to be a fair tax. UK tax practitioners have made it clear that they favour simplification but not at the expense of certainty and fairness – a position repeated in the November 2007 issue of *Tax Adviser* – the Journal of the Chartered Institute of Taxation - by the President of the Institute. The experience of tax law rewrites in the Australia, New Zealand and the UK is that simplifying tax law does not contribute much to overall simplification if tax policy and the tax system remain as complicated as they were before. *Ad hoc* reforms limited to only one aspect of the issue do not seem to be the best way to proceed. To achieve significant progress in simplifying tax systems on a continuing basis, the matter has to be addressed as part of the process of developing tax policy and tax systems as a whole and also on a continuing basis.

**The Process of Tax Reform**

Reviewing countries’ previous experience of tax reform and academic contributions on the subject yielded much more evidence to support the principal researcher’s earlier work suggesting that tax reform was not ideally undertaken as a series of *ad hoc* specific changes but should be seen as a dynamic process.

Tax reform should be a continual process of adapting tax systems to changes in emphasis of aims and objectives and constant changes in the economic and social environment. Of course, there is a great deal of inertia. A way of modelling the dynamic process of tax reform, including the existence of inertia, is the use of forcefield analysis. This approach acknowledges the complex array of different interests and factors involved in the way tax systems develop and the nature of the political process itself. Forcefield analysis reflects the reality that at any time there will be all sorts of different pressures for change developing, and there will also be a variety of developing forms of resistance to change as illustrated in Figure 2.
The optimal outcome might be identified perhaps, as in this illustration, somewhere behind the resistance to change. Eventually the pressure for change might overcome the resisting forces, but the latter remain strong enough to deflect change from the optimal position and the result is an unsatisfactory compromise. This, of course, is only part of the continuous process of change so, as also indicated in Figure 2, the pressure and resistance to change as well as the optimal position also continue to develop.

This leads to the conclusion that some systematic method of coping with the complexities of such a process is required and that it should also be on a continuing basis.

Developing a More Systematic Approach to Tax Reform

The results of the research regarding the complexity of the issues of tax compliance and tax simplification and the limitations of tax reforms undertaken in recent years indicate there is considerable scope for improvement in the way tax reform is developed and implemented. One way of taking this further was to examine strategy and 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 – which seems to be important in achieving successful tax reform. Furthermore 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. 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. Furthermore subsequent monitoring is necessary to ensure the strategy continues to meet its original aims or requires modification to take account of subsequent changes.

There are certain distinct stages in developing such a strategic approach and one possible ten stage plan consists of:

1. Identify the aims of taxation
2. Establish different methods of achieving the aims
3. Analyse in terms of the economic criteria
4. Specify the administrative constraints
5. Identify different risks
6. Analyse behaviour
7. Examine the relationship with different policies
8. Develop strategies
9. Plan and implement strategies including intended outcomes
10. Monitor and evaluate the performance of the strategies against the plan

This is examined in more detail in the nominated outputs.

The Case for an Office for Tax Reform

During the course of the research an idea emerged that might be of considerable value - whether an Office for Tax Reform with a degree of independence from day to day political decisions might be able to make an contribution to the process of tax reform on a continuing basis. A preliminary discussion appears in section 6 of the 2007 Australian Tax Forum article listed in the Outputs below. The Australian Board of Taxation has provided a useful model in some ways but the present suggestion would take that example much further. In the UK in 2006 the Tax Reform Commission suggested in its report Tax Matters: Reforming the Tax System (p. 111), that a Joint Parliamentary Select Committee should be created to improve parliamentary scrutiny of tax legislation as well as an Office of Tax Simplification which would report to the Select Committee. However, one of the conclusions of this project is that there is a prima facie case for setting up an institution with a much wider remit – that is to oversee all aspects of tax reform on a continuing basis.

There is evidence (for example, Arnone et al. 2007) that granting a degree of independence to central banks has contributed to improvements in the conduct of
monetary policy not only in the UK, US and Australia but in many countries. A pertinent question is whether a greater degree of institutional autonomy might also improve the conduct of some aspects of fiscal policy. Fiscal policy in many ways is so bound up in almost every conceivable way with the operation of the economy and government influence over it that it is hard to imagine any government passing operational control to an independent body in the way it has been with monetary policy. However, it is worth developing the possibility that an independent contribution to the development of tax policy could be advantageous. Currently most of the input in this area comes from miscellaneous contributions from both the public and private sectors and ad hoc enquiries. If an appropriate body were charged with the responsibility of collecting the information necessary to develop tax policy on a permanent basis, it could offer systematic and continuing guidance to the process of reforming taxation over time. An obvious example is in observing how inflation and economic growth is affecting the tax structure. Such a body could also take account of other factors such as economic growth and economic and social change more generally, both nationally and internationally. There may even be scope for some limited aspects of the tax system to be changed, in much the way interest rates are for monetary policy, without the need for direct government involvement. An example is the way some countries have linked tax thresholds to inflation.

There would be no shortage of work for such a body. The development and implementation of the ten stages outlined above would mean that much useful work could be done. Particular aspects include attempts at weighing up the importance of different aspects taxation. For example, how far should the tax system be tailored to individual circumstances and how far should simplicity be sought and complexity be limited. What seems very clear is that the present situation, in which pressure for change has to build up over time before change happens, is not the optimal arrangement. In addition to anticipating necessary change, such an independent authority could also assess ad hoc proposals systematically for suitability for implementation. Work on such a possibility is being continued.
Activities

Papers were presented on the following occasions:


Simon James ‘Tax Simplification is Not a Simple Issue, The Reasons for Difficulty and a Possibly Strategy’, invited presentation at the Faculty of Law, Queensland University of Technology, Brisbane, 26 March 2007.


Simon James and Alison Edwards, ‘Optimum Tax Compliance Costs and Tax Simplification’, invited presentation at the Australian School of Taxation, Faculty of Law, University of New South Wales, Sydney, 4 May 2007.


Outputs


Simon James and Alison Edwards, *A Bibliography of Tax Compliance and Tax Compliance Costs* – which has been offered to the ESRC Data Archive.


http://www.sobe.ex.ac.uk/research/management/discussion_papers/index.php?id=366

**Impacts**

Considerable interest has been shown in the work coming out of the project during all the activities listed above. For instance, following the presentation in Brisbane on tax simplification, a request was received from the office of the Honourable Justice Greenwood of the Federal Court of Australia to let him have further information.

Interest was also expressed about the possibility of future joint work by academics in New Zealand and the USA.

**Future Research Possibilities**

A number of factors that may be worth following up have been raised by UK tax practitioners.

The suggestion emerging from the project of an Office for Tax Reform could also be developed.

**Ethics**

Ethical considerations did not arise in the course of this research.

**“Society Today”**

The outputs have been posted on the website.
References


