Chapter 13

Administration and compliance costs of taxation

Contents

13. ADMINISTRATION AND COMPLIANCE COSTS OF TAXATION

SUMMARY

Operating costs are a necessary part of raising revenue. The issue is what the appropriate level of operating costs should be. Operating costs are justified where the costs of raising the tax (including efficiency costs) are outweighed by the net benefits.

There have been few truly comparative international operating cost studies. The main reason for this is that cross-country comparisons are difficult to conduct and need to be treated with caution. Researchers have commented that international comparisons in this particular area are 'more likely to mislead than enlighten' (Sandford 1995, p 405).

As a result of these difficulties no summary is made of the various studies that estimate operating costs across countries. Instead, the focus of this chapter is to provide a discussion on operating costs and to highlight some of the difficulties in making international comparisons.

The report notes that the Board of Taxation has commenced a scoping study of tax compliance costs facing the small business sector in Australia, which will be presented to the Treasurer during the second half of 2006.

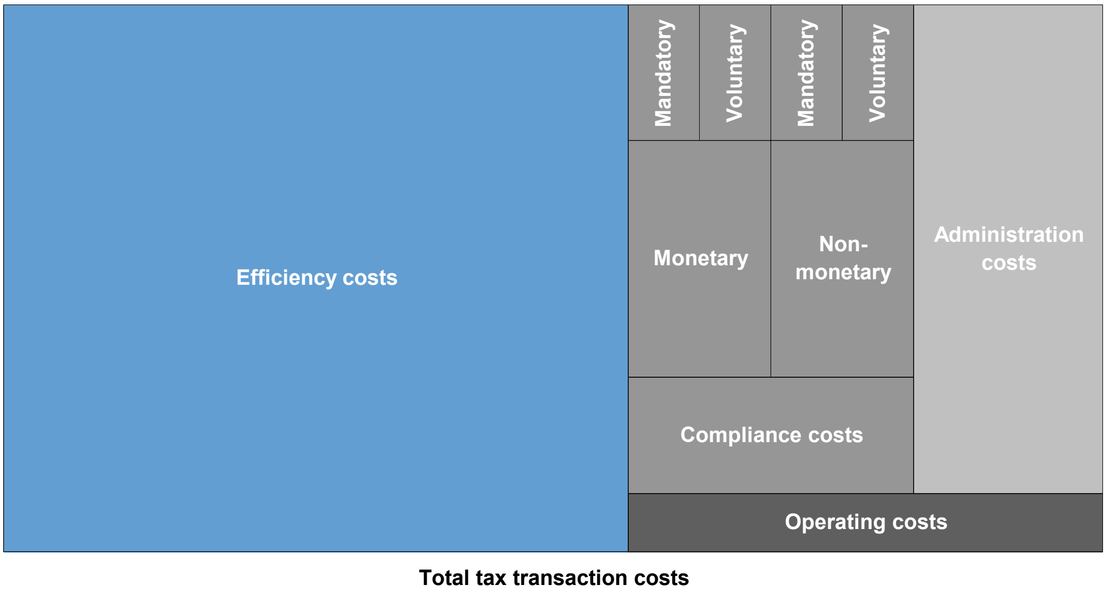
13.1 INTRODUCTION

The various measures of tax burden outlined in the previous chapters do not provide a complete picture of the impact of taxes on society or the economy. Collecting taxation revenue generates two types of costs: efficiency costs and operating costs. Efficiency costs refer to costs arising from distortions in the allocation of resources owing to the imposition of the tax, while operating costs refer to both:

- administration costs, which are the costs to the government of collecting revenue; and
- compliance costs, which are the costs (both monetary and non-monetary) incurred by taxpayers in meeting their tax obligations.

Chart 13.1 provides a schematic representation of the types of costs incurred in raising revenue. Previous chapters have focused on tax design features of the revenue system — each of which include aspects of efficiency. The focus of this chapter is on operating costs.

Chart 13.1: A breakdown of tax transaction costs



Source: Oliver and Bartley (2005).

Operating costs are a necessary part of raising revenue. The issue is what the appropriate level of operating costs should be. Operating costs are justified where the costs of raising the tax (including efficiency costs) are outweighed by the net benefits.

Compliance costs cover a range of both monetary and non-monetary costs. They include the costs of: acquiring the necessary knowledge of relevant aspects of the tax system; compiling records; acquiring and maintaining tax accounting systems and completing tax return forms; evaluating the tax effectiveness of alternative transactions or alternative methods of complying with the requirements of the law; and collecting and remitting taxes levied on employees and turnover. Monetary costs are those which are incorporated into a businesses' financial performance and are likely to be reflected in business profits. Non-monetary costs are less tangible costs that are less likely to be reflected in short term profits, but which may impact on short-term incentives and longer-term performance.

Compliance costs may also be either mandatory or voluntary. Mandatory costs are those that taxpayers must incur to meet their statutory obligation such as reporting particular types of income or being able to substantiate deductions claimed. Voluntary costs are additional costs that the taxpayer may choose to incur to determine or minimise their tax liability. For example, taxpayers may choose to evaluate alternative methods of complying with the law to determine which produces the most favourable tax outcome. They may also seek advice to identify tax effective ways to structure transactions.

Administration costs form part of the costs of the public sector and cover the costs of implementing tax policy, and revenue collection by the revenue authority (for example, the Australian Taxation Office). They include the costs of collecting taxation revenue and providing assistance and guidance to taxpayers.

Although recognition of the existence and impact of tax operating costs is not new, research into determining the level of operating costs, and compliance costs more specifically, has emerged only over the past 20-25 years. Two major studies of taxpayer compliance costs have been conducted in Australia, both focused at the 'macro' level. These studies are, the

1997 ATAX study, for the Australian Taxation Office (ATO) by Evans, Ritchie, Tran-Nam and Walpole (1997, 1998), which is based on the 1994-95 fiscal year, and earlier studies by Pope et al (1990, 1991, 1992, 1993, 1994). There has been no major study in Australia following the introduction of *The New Tax System*.

13.2 COMPARING OPERATING COSTS ACROSS COUNTRIES

There have been few truly comparative international operating cost studies. The main reason for this is that cross-country comparisons are difficult to conduct and need to be treated with caution. This is particularly the case for comparisons that involve multiple countries over long periods. Sandford (1995, p 405) noted that international comparisons are 'more likely to mislead than enlighten'.

The difficulties in producing meaningful comparisons of tax operating costs across countries are well known and documented. Many things can affect the measurement of operating costs which have little to do with the actual operating costs in a given country, including:

- differences in data quality arising for example, from variations in response rates, validation procedures or questions;
- definitional issues arising from differences in perceptions on what constitutes a compliance cost;
- differences in tax structure including variations in tax relief or thresholds;
- the makeup of the tax population including variations in the number of self employed;
- differences in rates of tax which can have a significant impact on cost to revenue ratios;
- fluctuations in revenue collections over the business cycle; and
- preference for tax expenditures over direct expenditure. For example, where benefits are provided through the tax system compliance costs will increase and revenue will decrease (Sandford 1995, p 406).[1]

Many studies of tax operating costs focus solely on compliance costs, and exclude administration costs. Given there is scope to transfer costs between the private and public sectors, compliance costs could be reduced at the expense of administration costs by expanding the role of the tax office. Conversely administration costs could be reduced, for example through self assessment at the expense of compliance costs. As such, it is important to consider both compliance and administration costs.

International comparisons need to allow for the decision made on the distribution of costs between taxpayers and the tax administrator, and for the types of trade offs between these costs and other and other tax objectives.

---

1 Sandford raised these issues in relation to calculating the compliance costs to revenue ratio, however, they apply equally to other measures of tax operating costs.

Similarly, there may be trade-offs between achieving equitable or efficient outcomes and compliance and administration costs. In many cases, compliance or administration costs (or both) can be reduced using more 'rule of thumb' approaches, at the expense of achieving precisely equitable or efficient outcomes.

13.3 INTERNATIONAL COMPARISONS

The limitations outlined above do not mean international comparisons should not be made. The primary use of international comparisons of compliance cost has been to establish the reliability of internal assessments rather than to identify differences across countries. Evans (2003) provided a summary of administration and compliance costs studies undertaken over the past 20 years.

13.3.1 Compliance costs

One of the main findings by Evans (2003) was that compliance costs are significant for the main central government taxes such as personal income tax, corporate income tax and value added taxes (GST). Compliance costs for such taxes are generally found to be between 2 to 10 per cent of the revenue yield and in total are generally up to 2.5 per cent of GDP.

Box 13.1: Compliance costs faced by small and medium sized business — OECD study

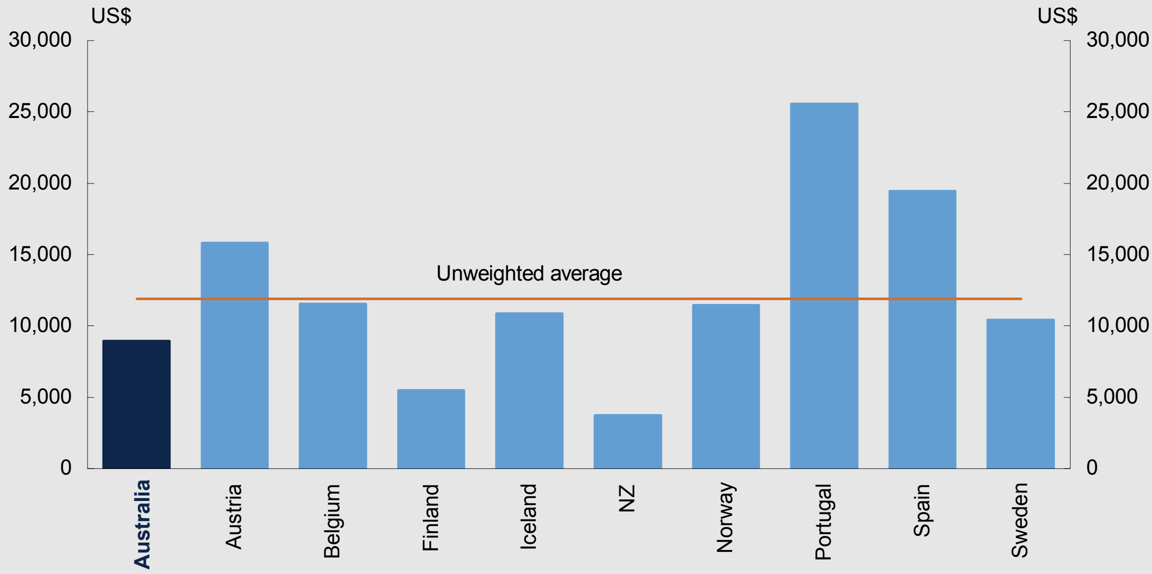
In 1998-99, the OECD undertook a study on the administrative and regulatory burdens faced by small and medium enterprises (SMEs) (OECD, 2001). The study covered 11 countries, Australia, Austria, Belgium, Finland, Iceland, Mexico, New Zealand, Norway, Portugal, Spain and Sweden.[2] The OECD study was able to overcome some of the limitations identified in section 13.2: it used a standardised methodology across all countries. Despite this, limitations still exist and the results should be treated with care, in particular, the study is based on 1998-99 data and does not reflect any possible significant changes in tax systems across OECD countries since that time.

The OECD study was not limited to tax compliance costs. Rather, it included three areas of regulation: tax, employment and environmental regulation.

As shown in Chart 13.2, tax compliance costs per SME varied significantly across the countries surveyed. The highest was Portugal which had an average compliance cost per SME of US$25,545, the lowest was New Zealand which had an average of US$3,706 per SME. Australia's average tax compliance costs per SME at the time of the survey were estimated to be around US$8,922.

Chart 13.2: Tax compliance costs — average per SME

Selected OECD countries, 1998-99 (US dollars)



Source: Australian Treasury estimates based on OECD unpublished data.

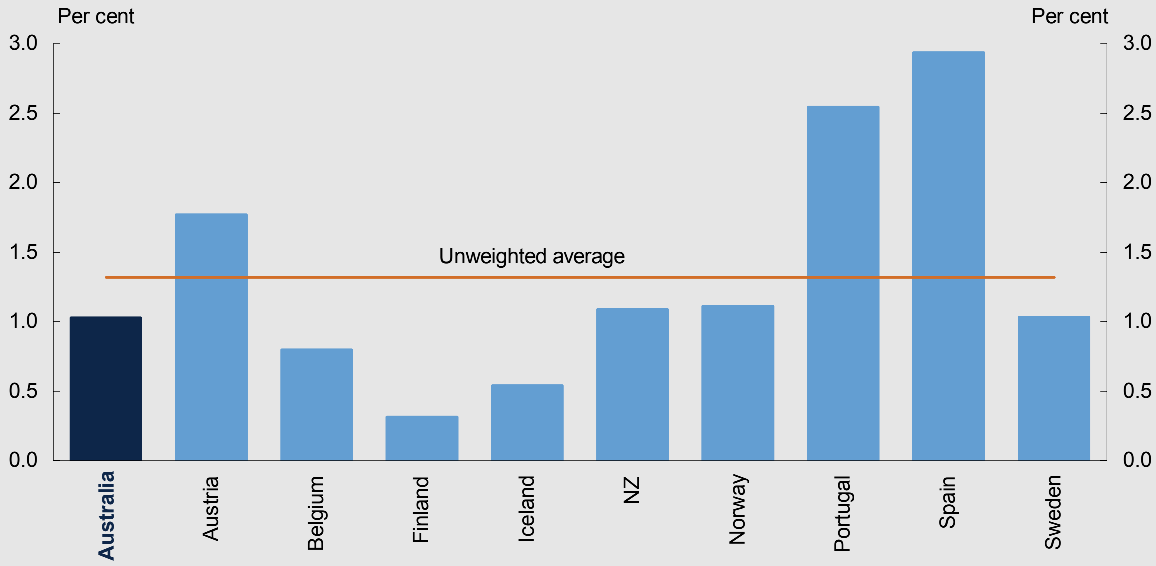
Chart 13.3, illustrates tax compliance as a percentage of GDP. It shows that all countries commit a significant proportion of their economic resources to tax compliance. Based on the OECD data, it is estimated that tax compliance costs incurred by SMEs in Australia was around 1 per cent of GDP, slightly below the average of 1.3 per cent in 1998-99.

---

2 Data for Mexico was not reported.

Box 13.1: Compliance costs faced by small and medium sized business — OECD study (continued)

Chart 13.3: Tax compliance costs as percentage of GDP
Selected OECD countries, 1998-99



Source: Australian Treasury estimates based on OECD unpublished data.

Measuring tax compliance costs as a percentage of annual turnover, Australia's rate of 0.4 per cent was the second lowest and around one percentage point lower than the average of the surveyed countries (1.7 per cent).

13.3.2 Administration costs

As noted previously the usefulness of an examination of compliance costs on its own is limited. Given the scope to transfer costs between the private and public sectors, compliance costs could be reduced at the expense of administration costs by expanding the role of the tax office. This section examines tax administration costs.

Administration costs are usually measured as part of the costs of the public sector. Even though this should provide a basis for making comparisons, the standard and comprehensiveness of measures varies over time and across governments (Evans 2003, pp 64-65). Revenue authorities around the world face differing environments in which they operate. Countries differ greatly in respect of their policy and legislative environment and their administrative practices and culture (OECD 2004, p 4). These are in addition to the limitations outlined in section 13.2.

There have been few studies into tax administration costs. Evans (2003), who provided a summary of over 60 major administration and compliance costs studies since 1980, identified only one solely concerned administration costs, while only around a quarter considered both administration and compliance costs.

Of the studies that included administration costs, Evans (2003) found that they rarely exceed 1 per cent of the revenue yield and were usually well below 1 per cent. Evans concluded that 'administrative costs are absolutely and relatively less burdensome than compliance costs' Evans (2003, p 72).

Box 13.2: Comparison of administration costs — OECD study

The OECD (2004) information series paper provides internationally comparative data on many aspects of tax systems and their administration throughout the OECD. The report provides a limited number of operation performance information that is often used in international comparisons of tax administration systems, including:

- the 'cost of collection' ratio, which is computed by comparing annual administration costs with revenue collected; and
- relative staffing levels.

The OECD study highlights the limitations with making international comparisons of tax administration costs using these approaches (OECD 2004, pp 24-26). Many of these qualifications were outlined in section 13.2. In particular, the OECD notes the data presented 'should be interpreted with considerable care and take account of the abnormal factors highlighted, as well as other differences in approach to revenue administration' (OECD 2004, p 26).

The following section is based on the 2004 OECD study, focusing on the cost of collection ratio for the OECD-10 (excluding Switzerland).

Table 13.1: Cost of collection ratio — OECD-10, 2000 to 2002

	Administration costs/net revenue collections (%)			Factors likely/known to influence reported ratio
	2000	2001	2002	
Australia	1.11	1.27	1.19	Start up/implementation costs of the GST for 2000/2001.
Canada	1.07	1.08	1.20	
Ireland	0.81	0.90	0.95	Includes customs costs and revenues (for example, VAT on imports); includes social security contributions.
Japan(a)	1.42	1.54	1.62	Relatively low burden (that is, less than 30 per cent); revenue base excludes separately collected social contributions; substantially reduced administrative workloads due to features of tax system (see OECD, 2004).
Netherlands	1.70	1.74	1.76	Costs include customs administration; revenue base includes social contributions.
New Zealand	1.44	1.21	1.17	
Spain	-	0.81	0.78	
Switzerland	-	-	-	
United Kingdom - IRD	1.10	1.11	1.15	Includes all staff of national contributions agency.
United States(b)	0.43	0.46	0.52	Revenue base includes social contributions.

(a) Data as reported in 2002 annual report.
(b) Ratios indicated vary from IRS-published ratios of 0.39 (2000), 0.41 (2001), and 0.45 (2002) owing to use of 'net' and not 'gross' collections.
Source: OECD (2004).

Box 13.2: Comparison of administration costs — OECD study (continued)

Table 13.1, presents estimates of the cost of collection ratios from 2000 to 2002 for the OECD-10 (excluding Switzerland). It highlights the variation in the ratio across the nine countries. The Netherlands consistently had the highest ratio across the OECD-10 (1.7 per cent and above), while the United States had the lowest ratio over the period (from 0.43 to 0.52 per cent). Australia lies in between (from 1.11 to 1.27 per cent) although the estimates include the once-off start-up and implementation costs associated with the introduction of the GST.

13.4 MEASURES TO REDUCE COMPLIANCE COSTS

Studies into compliance costs have created substantial public interest. In response to these studies and concerns by small business in particular, governments have begun introducing measures to monitor compliance costs, limit incremental compliance costs and where possible, reduce existing compliance costs. Some of the initiatives that have been adopted by governments include:

- requirements that all new tax legislation be supported with a form of tax compliance cost impact statement;
- introduction of programmes and guidelines to improve the clarity of legislation;
- establishment of specific government bodies or external taskforces tasked with advising governments on the effectiveness of regulatory measures and identifying ways of minimising regulatory compliance;
- introduction of public consultation guidelines on the development and implementation of new policies;
- establishment (or development) of methods or models to measure the regulatory burden of new laws or regulations; and
- introduction of specific compliance cost reduction targets.

The measures are not targeted solely at tax legislation, but instead cover the broader regulatory and administrative burden faced by individuals and business.

In November 2005, the Board of Taxation commenced a scoping study of tax compliance costs facing the small business sector in Australia. The Board's report will take into account:

- the purpose and object of the law;
- the relationship between taxpayer compliance costs and government administration costs;
- costs incurred by business for non-tax reasons and any additional costs incurred by businesses or their advisors for tax reasons (tax compliance costs);
- transitional costs and ongoing tax compliance costs;

- taxpayer circumstances and commercial practices;
- other legislation; and
- any other matters the Board considers materially impact on small business tax compliance costs.

The final report will be presented to the Treasurer during the second half of 2006.

REFERENCES

Evans, C, 2003, 'Studying the Studies: An overview of recent research into taxation operating costs', *eJournal of Tax Research*, vol 1, no. 1, pp 64-92.

Evans, C, Ritchie, K, Tran-Nam, B and Walpole, M, 1997, *A report into Taxpayer Costs of Compliance*, AGPS, Canberra.

Evans, C, Ritchie, K, Tran-Nam, B and Walpole, M, 1998, 'Taxation Compliance Costs: Some Recent Empirical Work and International Comparisons' *Australian Tax Forum*, vol 14, no. 1, pp 93-122.

OECD, 2001, *Businesses' views on red tape: Administrative and regulatory burdens on small and medium sized enterprises*, OECD, Paris.

OECD, 2004, *Tax administration in OECD countries: Comparative information series (2004)*, OECD, Paris. *viewed 30 April 2006,* http://www.oecd.org/dataoecd/28/2/33866659.pdf.

Oliver, T and Bartley, S, 2005, 'Tax system complexity and compliance costs — some theoretical considerations', *Economic Roundup*, Winter 2005, pp 53-68.

Pope, J, Fayle R and Duncanson, M, 1990, *The compliance costs of personal income taxation in Australia 1986-87*, Australian Tax Research Foundation, Sydney.

Pope, J, Fayle R and Chen, DL 1991 *The compliance costs of public companies income taxation in Australia, 1986-97*, Australian Tax Research Foundation, Sydney.

Pope, J, Fayle R and Chen, DL, 1992, *The compliance costs of employment related taxation in Australia*, Australian Tax Research Foundation, Sydney.

Pope, J, Fayle R and Chen, DL, 1993, *The compliance costs of wholesales sales tax in Australia*, Australian Tax Research Foundation, Sydney.

Pope, J, Fayle R and Chen, DL, 1994, *The compliance costs of companies' income taxation in Australia*, Australian Tax Research Foundation, Sydney.

Sandford, S, 1995, *Tax Compliance Costs Measurement and Policy*, Fiscal Publications, Bath.