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International Conference on Accounting Studies (ICAS) 2017
18-20 September 2017, Putrajaya, Malaysia

Theoretical Issues for Tax Compliance Costs Study

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Abstract

The art of taxation consists in so plucking the goose as to obtain the most significant possible amount of feathers with the smallest possible amount of hissing. The amount of hissing in taxation could be measured and monitored through the estimation of compliance costs. Issues related to tax compliance costs are therefore relevant to be discussed in order to come out with a good model for tax compliance costs estimation. This paper aims to review issues related to income tax compliance costs estimation for personal taxpayers. Specifically, the issues reviewed in this paper are related to the items to be included in compliance costs estimation components and the valuation of time in compliance costs estimation. It is hoped that this study can contribute as a basis for developing a compliance costs estimation model in general.

Keywords: Compliance costs, personal income tax, time valuation, Malaysia.

1. INTRODUCTION

The imposition of taxes by the government in order to finance public services should be achieved in the least costly manner possible either on the part of the administrator or the taxpayers' side (Vaillancourt & Clemens, 2008). This is because the costs can reduce the resources available to the citizen and distort their behaviour. There is a famous quotation on taxation from Jean-Baptiste Colbert (1619 –1683), the Finance Minister of France from 1665 to 1683 under the rule of King Louis XIV, which says that "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing". In other words, the amount of hissing includes the tax itself and the compliance costs. Estimates of compliance costs are therefore imperative in order to measure the economy of tax collection (Smith, 1776).

In addition, compliance costs are also regarded as the most informative measure of tax complexity compared to other ways such as cutting the number of pages or words in the tax code or forms (Slemrod, 2004). High compliance costs may affect voluntary compliance behaviour (Jenkins & Forlemu, 1993) as this is an indication of the high complexity of a tax system. Therefore, to be competitive in a global market, governments must have a concern about the level of compliance costs and an objective to reduce them. However, the estimation of compliance costs varies according to countries.

Countries such as Australia, the UK and New Zealand have adopted compliance costs assessment or tax impact statements as a regular component of policy-making (Sandford, 1995; Evans & Walpole, 1997) in order to ensure that tax compliance costs are minimal. In Australia, the model to estimate the compliance costs has been first developed by Pope, Fyle and Duncanson (1990). The model was refined by Evans, Ritchie, Tran-Nam, & Walpole, (1997). In the United States (US), the compliance costs are also estimated annually for each type of taxes collected

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based on a prescribed model. The model was first developed by IBM and the Internal Revenue Services (IRS) in the US (Guyton, O'Hare, Stavrianos, & Toder, 2003) and then was refined by Goolsbee (2004).

According to Pope (1993b), there are six phases in the development of the compliance costs of taxation as a policy area. Phase one is the period in which the compliance costs are unrecognised and hidden; phase two is called "professional, qualitative recognition" whereby tax practitioners and academics recognise the compliance costs being imposed on taxpayers and speak and write publicly on the subject. The third phase is the "estimation and evaluation" phase whereby compliance costs are estimated and quantified in monetary terms from taxpayer data. The fourth phase is the "policy recognition" phase followed by the "effective policy measure" phase, and the final phase is the continuous monitoring of compliance costs, as well as the administrative costs.

Although there are quite some compliance costs studies in Malaysia, currently, there is no specific model has been utilised by the Inland Revenue Board of Malaysia in estimating the compliance costs of personal taxpayers in Malaysia. This indicates that the policy recognition phase as highlighted by Pope (1993b) above is yet to be achieved by Malaysia. Therefore, it is timely to review issues related to compliance costs. The objective of this paper is to review on issues related to income tax compliance costs estimation. Specifically, this paper discusses three main issues; which are (1) items to be included as compliance costs components, (2) valuation of time and (3) reporting the compliance costs. It is hoped that this study can contribute as a basis for developing a compliance costs estimation model for personal income tax (PIT) payers.

2. COMPONENTS OF COMPLIANCE COSTS

Smith (1776, Book V, Chapter II, Part II, 'Of Taxes') laid down four maxims of a good tax system: equality (equity), certainty, the convenience of payment, and economy of collection. On the economy of the collection, Smith (1776, pp. 645-646) wrote that:

> "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state…By subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression; and though taxation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it."

The statements highlight two key points, namely, (1) the cost of collection should be "as little as possible", and that (2) it should be free of "unnecessary trouble, vexation, and oppression" (Haig, 1935, p. 324). The first point relates to the quantitative measure of compliance costs, while the second is concerned with psychological costs.

In relation to quantifiable compliance costs, Sandford (1973, p. 8) defined compliance costs as the costs "…arising from the requirements of the tax system, which are incurred by the taxpayer or by some third party such as an employer, over and above actual tax payments". This definition is widely used in major compliance cost studies although researchers agree that unquantifiable psychological costs are also part of the compliance costs (see, for example, Slemrod & Sorum, 1984; Pope, Fayle, & Duncanson, 1990; Allers, 1994; Evans, Ritchie, Tran-Nam, & Walpole, 1997). Broadening the definition of quantifiable costs, Blumenthal and Slemrod (1992, p. 185) defined compliance costs for personal income tax payers as "…the value of the time spent on task related to filing individual income tax returns as well as to any expenditures on goods or services for that same purpose".

Although the psychological costs are less tangible or quantifiable, an attempt to measure psychological costs was carried out by Woellner, Coleman, McKerchar, Walpole, and Zetler (2001). Their objective was to estimate the psychological costs for a new drafting style of the Income Tax Assessment Act 1997 (ITAA 1997) in Australia. They utilised three methods of data collection: read-aloud protocol with videotaping, focus groups, and case study. However, they discovered that their data collection methods needed to be improved before any attempt could be made to distinguish the costs of complying with the previous tax legislation (ITAA 1936) and the ITAA 1997. They did not derive any monetary estimate. Another study by Diaz and Delgado (1995) evaluated the Spanish taxpayers' psychological costs using four indicators: taxpayers' perceptions towards time dedicated to compliance, items or aspects most disliked by taxpayers, the state of mind upon finishing the complete process, and the conversational time occupied by the topic of filing tax returns. However, they also did not attempt to estimate these psychological costs in monetary terms. Thus, it can be concluded that the psychological costs measures are the area in compliance costs estimation that still need refinement by researchers.

The quantifiable items for PIT compliance costs consist of money and time costs. Sandford (1973, p. 9) explains that the monetary costs include primarily the professional advisers' fees, miscellaneous costs (which comprised of postage costs, telephone bills, travelling expenses and the purchase of taxation materials to help taxpayers complete the return), and litigation costs. This classification by Sandford (1973) is widely accepted by compliance costs researchers (see, for example, Slemrod & Sorum, 1984; Pope et al., 1990; Blumenthal & Slemrod, 1992; Evans et al., 1997).

The role of information technology was not relevant for PIT payers when Sandford identified the components of costs in 1973, but now it is important. In a recent study in Canada, Vaillancourt (2010, p. 7) asked questions such as "How much did you pay for this software that you purchased and installed on your computer?". This question was classified as IT expenditure. In addition, the monetary costs, which normally classified as miscellaneous expenses, is more appropriate to be divided into IT and non-IT expenditure, if the effect of the e-filing system on compliance costs are to be measured more accurately.

Time costs are indirect monetary costs. These costs include time for completing tax returns, collecting and filling in necessary data, acquiring tax knowledge, consulting with a tax professional, corresponding with the tax authorities or with any paid/unpaid adviser, and travelling to the office of the tax professional or the tax authority (Sandford, 1973, p. 9). Blumenthal and Slemrod (1992, p. 185) included in their estimate of PIT compliance costs the time spent reading the instructions and deciding which form to use, gathering and maintaining records of income sources and records for deductions, and time for researching the income tax literature in order to try and identify tax-saving provisions from which the taxpayer might benefit. They also included time spent with a tax professional and time for tax planning in their estimation. However, Slemrod and Sorum (1984) and Blumenthal and Slemrod (1992) excluded litigation costs in their estimation of PIT compliance costs for the USA.

Pope (1993a, pp. 305-308) did not itemise the time spent according to tax activities. Instead, he asked the respondents to estimate the overall time based on the respondents' judgement of their compliance time except for time spent on tax audits and appeals as there were separate questions on these matters. However, due to "the absence of memory-jolting enumeration" such an approach may result in an incomplete list (Vaillancourt, 1989, p. 22). Depending on the objective of having a compliance costs estimate, sometimes it is better to list specific cost items or time questions for ease of comparison later. Listing the cost items is also useful in order not to miss a single item for time costs as imagined by the taxpayers since the costs included would vary among them. This approach can act as a detailed reminder of the various types of costs that can be incurred by taxpayers.

As a summary, the components of quantifiable compliance costs for PIT payers is illustrated in Figure 1 below:

QUANTIFIABLE COMPLIANCE COSTS	**Monetary Costs** The professional advisers' fees; Miscellaneous costs (which comprised of postage costs, telephone bills, travelling expenses and the purchase of taxation materials to help taxpayers complete the return); litigation costs; and IT expenditure.
	Time Costs Completing tax returns; collecting and filling in necessary data; acquiring tax knowledge; consulting with a tax professional; corresponding with the tax authorities or with any adviser; travelling to the office of the tax professional or the tax authority; reading the instructions and deciding which form to use; gathering and maintaining records of income sources and records for deductions; researching the income tax literature in order to try and identify tax-saving provisions from which the taxpayer might benefit; and time for tax planning.

Figure 1: Summary of quantifiable compliance costs components for PIT payers

3. VALUATION OF TIME

Issues on the valuation of time spent have been discussed widely especially by Sandford et al. (1989, pp. 35-47) and Pope (1995, pp. 114-118). The most popular question in the argument is whether the value of time spent in complying with income tax requirements is equal to working hours, overtime or leisure time.

Sandford (1973, pp. 171-177) points out that tax-related tasks can be undertaken during working hours or spare time. Most probably, the self-employed will consider their tax time is equal to their working time but, for other individuals, Sandford concluded that most would do their tax work in their non-work time. To value a person's spare time for tax purposes, Sandford based his estimates on studies of transport cost-benefit studies. He identified five main factors in valuing time, as follows:

1. Time spent on tax affairs depends very much on a taxpayer's attitudes. Since dealing with tax is not a pleasurable activity (like travelling), it is appropriate to put a higher time valuation on tax affairs than on time savings from travel.
2. The value of time varies among persons, a person's lifespan, uses, and hours of the day. Therefore, the value of time for tax affairs depends on when it is done; and taxpayers will normally do it when the opportunity cost is low.
3. Those with high compliance costs in Sandford's study were able to exchange the non-work for work time by estimating the extra income for extra hours they spent at work. Therefore, according to Sandford, it is appropriate to value the time of taxpayers with high compliance costs (for example, value at an overtime rate).
4. The value of time for tax affairs should not be given an average value for the total population. It is necessary to have a division between those who employed a paid tax professional and those who did not. Those who employed a paid tax professional are considered to be a group that prefers time to money while the other group prefers the opposite. Therefore, the time for those who hired a tax professional should be valued higher than those who did not employ one. However, this approach arguably would depend on the context and has not been used in any significant compliance cost studies.
5. The value of time could be determined by way of hypothetical questions for different types of taxpayers: for those who employed a paid tax professional ("How much are they willing to pay to rid themselves of tax affairs?") and those who did not ("At what hourly rate of pay are they willing to do such work?"), with overtime as the basis to value the leisure time.

Due to the above considerations, Sandford (1973, p. 176) concluded that the value to be placed on the time spent is the average payment per hour to be rid of all tax work (including respondents specifying nil), divided into those who employed a paid tax professionals and those who do not employ one. These values are meant to reflect the different attitudes of taxpayers. However, for those attitudes that cannot be identified (those who spent eight hours or less and did not employ a tax professional), the value of time was valued lower (25 percent lower) than the average wage rate in the UK for 1970. Sandford admitted that the values placed on time spent were "irreducible elements of arbitrariness and subjectivity".

Later, Sandford et al. (1989, pp. 35-39) identified four methods for the valuation of time: professional advisers' time (the fee), employees' time (wage rate), time of the self-employed (opportunity costs to the business), and leisure time (gross wage or after-tax wage or a proportion of wage rate or an overtime rate). Sandford et al. (1989, p. 38) also argued that the taxpayer's valuation is the best measure of the value of time; thus, this was used in reporting the average compliance costs. To increase the reliability of taxpayers' valuation of time, the official figures from the UK Survey of Personal Income were used as a cross-check for accuracy.

Taking a different approach to Sandford (1973), Slemrod and Sorum (1984, p. 465) assumed that time spent on tax affairs came at the expense of leisure rather than work for all types of respondents (whether they engaged a tax professional or not). They valued the leisure time for tax at the after-tax wage rate. The rate was gathered through a question that asked the respondents to state their before-tax wage rate which the researchers then converted into an after-tax wage rate. Due to many unusable responses to the question, Slemrod and Sorum used the imputation technique to replace the missing values and unusable responses. This method of valuation of time costs was also used by Blumenthal and Slemrod (1992, p. 188).

Vaillancourt (1989, p. 35) argued that the time spent on tax affairs should be valued at the gross wage rate. This was because the rate represented the actual output value of the time spent, whereas the net tax value was the value to that individual. For respondents who did not estimate their wage rate, the imputation technique similar to the one used by Slemrod and Sorum (1984) was also employed by Vaillancourt. This was important in order to maintain a sufficient number of cases for statistical analysis and to produce more valid results using techniques such as regression analysis (Hair et al., 2006). Vaillancourt (1989, p. 37) also used the average hourly earnings of employees in Canada, obtained from Statistics Canada as a cross-check value to the mean reported value.

Allers (1994, p. 54) used a practical way to value the time spent by asking the respondents to value their own time for tax purposes, with Allers amending any extreme values (outliers). Allers also questioned whether time spent on tax compliance should be valued as a welfare loss or as resource cost to the economy. If the time valued by the respondents was for the former, the value not only reflected the time spent on tax compliance but also the psychological costs or "trouble, vexation and oppression" as first identified by Smith (1776). Therefore, according to Allers, by asking respondents how much they would be willing to pay to get rid of all the compliance costs of a specific tax, the question estimated the psychological costs of taxpayers. This approach was attempted by

Sandford (1973, p. 175) and Slemrod and Sorum (1984, p. 474, note 12), and is sometimes referred to as using "check questions".

Pope (1995, pp. 114-118) identified six methods of time valuation that had been utilised in previous studies. The methods were: reported values by respondents; reported values but subject to a minimum hourly rate; values that taxpayers were willing to pay to get rid of all compliance costs; before-tax wage rate; after-tax wage rate; and median values. In addition, the use of a national average wage rate as a basis was introduced by Sandford (1973, p. 177), Sandford et al. (1989) and Vaillancourt (1989, p. 77). Alternatively, Allers (1994, p. 55) suggested that the use of GDP per labour year may be used to value time.

For business taxpayers, Evans et al. (1997, pp. 38-40) used the market rate as a basis to value the different levels of employees' time. Using both approaches – namely, the reported values and the market values – would increase the reliability of the compliance cost estimates because they can be checked against each other (Sandford & Hasseldine, 1992, p. 25). The value of unpaid helper time is discussed in Evans et al. (1997, p. 11). Evans et al. reported the value of free help based on the same value as the taxpayer's own time. This approach is considered appropriate for PIT payers since the free helper is not considered to be a professional adviser. A summary of the methods outlined above, especially as discussed by Pope (1995, pp. 114-118), is presented in Table 1, with a note on studies that have employed the various methods.

Table 31: Methods of Time Valuation

Method	**Study**
1. Each individual's own valuation of time	Sandford (1973); Sandford et al. (1989)
2. As (1) but subject to a maximum hourly rate	Pope et al. (1990); Allers (1994)
3. What taxpayer would pay to be rid of all compliance costs	Sandford (1973); Slemrod & Sorum (1984)
4. The usual hourly wage rate before tax/gross	Vaillancourt (1989); Pope et al. (1990)
5. The after-tax wage rate	Slemrod & Sorum (1984); Blumenthal & Slemrod (1992)
6. The median value of time	Pope et al. (1990)
7. National wage rate	Sandford (1973); Sandford et al. (1989); Vaillancourt (1989)
8. GDP per labour year	Allers (1994)
9. Market rate for employees	Evans et al. (1997)

Source: Adapted from Pope (1995, pp. 114-117) and some additional information from later studies.

5. CONCLUSION

The review of compliance costs literature indicates a recent dearth of research in this area. Although studies in this area showed strong development between the 1980s and 1990s in many parts of the world, the research in this field, particularly on PIT payers, seems stagnant. There are a few countries that update their compliance costs estimates such as the USA and Canada. There are very limited studies on compliance costs of PIT payers in developing nations such as Malaysia. Overall, the compliance costs issue is neglected in many developing countries compared to developed countries.

Theoretical issues related to compliance costs such as components and classification of compliance cost items, valuation of time spent by taxpayers, and reporting the compliance costs have been addressed in this paper. The review of past literature indicates that there are areas that still need to be researched. For example, the psychological cost components or measures. The items to measure the compliance costs might vary according to the objective of the research. For example, if the research needs to examine the effect of electronic environment, certain costs components need to be included. Besides the component of compliance costs, the issue on how to value the time spent by taxpayers is also crucial. In particular developing country such as Malaysia, sometimes it is difficult to find published information. As a result, researchers in the compliance costs area need to be creative and innovative to find ways in valuing the time spent. On the reporting of compliance costs, it is necessary that the reported value can be used as a comparison value. This is to ensure that our level of compliance costs is reducing or at least at the same level of most of other countries.

It is hoped that the discussion of income tax compliance costs in this paper can contribute to the development of robust estimation model for future studies of compliance costs in general. Future studies can develop a comprehensive model of compliance costs for PIT payers and report the empirical evidence.

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