

THE COMPLIANCE AND ADMINISTRATIVE COSTS OF THE TVM: WHAT ARE THE IMPLICATIONS?*

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1 Introduction

It is interesting to speculate that if a conference had been convened 10 years ago to consider the possible introduction of the Tax Value Method (“TVM”), a paper or discussion on the operating cost impact of the proposal on users (governmental and non-governmental) of the tax system would almost certainly not have figured in the proceedings. Even five years ago in Australia it would have been difficult to excite serious interest in the operating cost implications. In contrast, the compliance and administrative costs of the proposal today have the ability to determine whether or not a fundamental change to Australia’s tax system will or will not take place. The so-called “hidden costs of taxation”¹ have indeed been brought into the open, even to the centre of the stage.

To some small extent this shift in public and governmental attitude reflects the results of the research activities and output designed to bring the matter to the attention of government². But research activity has more usually been reactive rather than proactive. More significantly the issue has been driven by a public (and particularly small business) reaction to the pace, volume and complexity of tax reform that has been so overwhelming that it can no longer be ignored. It is not an exaggeration to suggest that the fate of Governments can be strongly influenced, if not sealed, by issues relating to the operating costs of the tax system.

The TVM, popularly known as Option 2, was originally proposed in the Ralph Review of Business Taxation³. It is intended to provide a new structure for the income tax law. Fundamentally, it seeks to replace the existing definition of taxable income (as the difference between assessable income and deductions) under the Income Tax Assessment Act (“ITAA”) 1997 with a new and equivalent concept based on cash flows and changes in the tax values of assets and liabilities, combined with policy adjustments to taxable income. In doing this, it is claimed that the TVM will “build a more internally consistent framework for the income tax law, as a means of achieving improved simplicity, durability, transparency and certainty in the law”⁴.

Since the proposed TVM changes the way income tax is calculated but is not intended to change either the income tax liability or the tax timing (although it is conceded that some differences may ultimately appear), the adoption of TVM will be broadly revenue and efficiency neutral. Furthermore, since it is also claimed that individual taxpayers will be largely unaffected by TVM⁵, this kind of tax reform should also be broadly neutral with respect to equity. Thus, the primary **justification** for (or against) TVM from a tax policy perspective is the simplicity gain that flows from the TVM relative to the core rules of the ITAA 1997. To put it bluntly, TVM is only tenable if it reduces the operating costs of the income tax system.

The main purpose of this paper is to present a preliminary evaluation of the simplification impacts of the TVM. By its nature the paper can only be a work in progress. It is a scoping paper. It is largely based on intuition and plausible theoretical speculation (together with the authors’ experience obtained in their ongoing studies of tax compliance costs in Australia) rather than empirical analysis. The paper seeks to review the relevant conceptual issues and

¹ The term was used by C Sandford in 1973 as the title of a monograph written for the Institute of Fiscal Studies.

² For example, international conferences on compliance cost issues were held in Oxford, UK in 1994 and in Sydney, Australia, 2000. For full details see the follow-up texts for each: *Tax Compliance Costs: Measurement and Policy*, edited by C Sandford, Fiscal Publications 1995, and *Tax Compliance Costs: A Festschrift for Cedric Sandford*, edited by C Evans, J Pope and J Hasseldine, Prospect 2001.

³ Review of Business Taxation, *A Tax System Redesigned Report, July 1999 - Overview - Recommendations - Estimated Impacts*, AGPS 1999, section 4 at p. 155.

⁴ Explanatory Material to *Tax Value Method Working Draft* (Version 2, 6 July 2001) at para 3.3. Accessed at <http://www.taxboard.gov.au/taxvaluemethod.htm> 14 July 2001.

⁵ *Ibid* at para 1.10.

also to provide a sound theoretical framework that can be employed in future empirical and other testing.

There are a number of constraints that need to be recognised in the paper. The first has already been mentioned. There is, as yet, no empirical data that can point to simplification gains or losses as a result of the TVM. Some limited compliance testing has occurred, but the sample has been too limited and too biased (ie restricted thus far to large corporates with plans to expand to others) to enable meaningful compliance cost implications to be drawn. Indeed, the purpose of the pilot testing that has taken place is ostensibly **not** to consider compliance costs issues – it is to identify whether the TVM produces the same tax outcomes as the conventional approach and to identify how the TVM draft legislation copes with a range of transactions that might be faced by the business sector.

The lack of empirical data from within Australia is not the only constraint upon the paper. Normally, in considering the impact of proposed tax changes on the operating costs of the tax system, it would be possible to look to the evidence from other tax jurisdictions. This was certainly the case so far as the introduction of the Goods and Services Tax (“GST”) in Australia in 2000 was concerned⁶. But the TVM is unique. Some other countries may have considered the notion or something similar⁷, but none has implemented it. The overseas experience can therefore tell us nothing about the likely impact of the TVM upon the operating costs of the tax system.

The organisation of the remainder of this paper is as follows. Section 2 is concerned with conceptual issues. It examines the scope of tax operating costs, and identifies a number of dimensions that will need to be considered in evaluating how the TVM could impact upon those tax operating costs. Section 3 is concerned with how an assessment of the operating costs of the TVM might be undertaken. It provides an estimating framework and discusses some strategies for empirical testing. A theoretical formula for assessing the desirability of the TVM is also given. In the absence (as yet) of any quantitative data on the implications of TVM for the operating costs of the tax system, Section 3 also seeks to develop the framework for a more qualitative evaluation of the operating cost impact of the TVM. Some concluding remarks are then given in the final section.

2 Identifying the operating costs of the income tax system

What should be included in tax operating costs?

The term “tax operating costs” needs to be defined. Consistent with its use in the tax literature, it is taken to mean the sum of compliance costs and administrative costs. Compliance costs are the costs that taxpayers face as a result of complying with their taxation obligations. Typically they include the costs of labour/time consumed in completion of tax activities, the costs of expertise purchased to assist with completion of tax activities, and incidental expenses incurred in completion of tax activities. Compliance costs arguably also include some measure of the psychological cost that is induced by the operation of the tax system, although this has thus far proved difficult to quantify⁸. As noted later in the paper, there are also a number of other

⁶ Although it needs to be said that the lessons from overseas so far as the operating cost implications of the GST are concerned were often ignored. On this, see for example, Minimising the Compliance Costs of a GST, by C Sandford in *Tax Administration: Facing the Challenges of the Future* edited by C Evans and A Greenbaum, Prospect 1998 (chapter 9).

⁷ See, for example, the paper by D Katz of the New Zealand Treasury entitled *Treasury's 1996-98 Cash-Flow Tax Project: Overview*, Working Paper no. 99/1.

Accessed at <http://www.treasury.govt.nz/workingpapers/1999/> 14 July 2001.

⁸ C Evans “The Operating Costs of Taxation: A Review of the Research”, *Journal of the Institute of Economic Affairs*, Vol 21, No. 2, 2001, at p. 5.

qualifications and sub-divisions that need to be taken into account in any definition of compliance costs, but the working definition arrived at above will suffice for present purposes.

Inevitably, most of the discussion on the operating cost of the TVM has tended to focus on the tax compliance costs/benefits, and especially upon the implementation costs to business taxpayers. This is understandable because the proposed TVM will, in the first instance, directly affect business taxpayers. TVM will also affect individual taxpayers, albeit to a far lesser extent. The focus on compliance costs is made explicit in the TVM Working Draft, which states that "..., it is important that the Tax Value Method does not add to the costs of compliance"⁹.

Considering tax compliance costs alone is not sufficient, however. It is clear that TVM will also affect the administration of income tax. Thus, for completeness, it is also necessary to include administrative costs of TVM in its assessment, especially because it has been well established that compliance and administrative costs tend to be transferable.

Administrative costs comprise the costs of running and maintaining revenue agencies, including salaries of staff, and pensions, accommodation and other expenses relating to those staff. They can also comprise the costs of legislative enactment relating to the tax system (from initial policy formulation through to statutory or other rule enactment) and the judicial costs of administration of the tax dispute system. Typically calculations of administrative costs in the literature have focused on the costs of revenue agencies and ignored legislative and juridical costs. But there is no inherent reason (other than simplicity of measurement) why this should be the case¹⁰, and in this paper administrative costs are taken to include tax legislative and juridical costs.

Within the realm of these operating costs there are a number of further distinctions that can be relevant in determining the impact of the TVM. More particularly, it is necessary to consider distinctions between:

- Transitional and recurrent administrative and compliance costs;
- Social and taxpayer compliance costs;
- Computational and planning compliance costs; and
- Monetary and psychological compliance costs.

Transitional and recurrent operating costs and benefits

The literature on tax operating costs distinguishes a number of cost categories that are common to both compliance and administrative costs¹¹. They are:

- commencement (or start-up) costs;
- temporary costs; and
- recurrent (or regular) costs.

Typically, a commencement cost might include the initial training of staff to deal with the proposed tax change. A temporary cost might be the additional time required by staff to comply with the new regulations whilst they are still becoming familiar with the nuances of the tax change. And a recurrent cost might be the time that staff take to comply with the tax change once they are familiar with it. In this paper, the term "transitional costs" will be used to include both commencement and temporary costs. Lumping commencement and temporary costs

⁹ Explanatory Material to *Tax Value Method Working Draft* (Version 2, 6 July 2001) at para 3.3. *op cit*.

¹⁰ See, for example, B Tran-Nam "Tax, Reform and Tax Simplification: Some Conceptual Issues and a Preliminary Assessment", *Sydney Law Review*, Vol 21, 1999 at p. 511.

¹¹ See C Sandford, M Godwin and P Hardwick, *Administrative and Compliance Costs of Taxation*, Fiscal Publications 1989, pp. 16-18.

together is primarily an expedience, although it can be justified if learning the TVM core rules can be completed reasonably quickly by existing taxpayers (which is by no means a certain outcome).

The distinction between transitional and recurrent operating costs is possibly the most important conceptual distinction that needs to be made. The Chairman of the Board of Taxation has noted that “if in the course of our proceedings we find that the transitional costs will be too high, then we will stop it”¹². It is therefore clearly vital to assess the transitional operating costs of the TVM as these represent a once-off cost that has to be taken into account. But it is equally important to estimate or establish the recurrent operating costs of the TVM. If these are more than the recurrent operating costs of the existing income tax system, the change cannot be justified from this perspective (and it is difficult to see how the change can otherwise be argued to be beneficial). Alternatively, if there are recurrent operating cost savings as a result of the introduction of the TVM, then the case for TVM can be that much stronger (although the savings will still need to be weighed against the transitional operating costs).

Transitional costs

In principle, there are four areas of transitional operating costs associated with the proposed TVM:

- design, drafting and legislative enactment administrative costs, including costs incurred by the Federal Treasury and by the Board of Taxation;
- administrative costs incurred by the Australian Taxation Office (“ATO”);
- juridical costs of dispute resolution related to the implementation phase; and
- compliance costs.

Transitional costs for the design, drafting and enactment of TVM refer to resources expended by society in the events leading to the enactment of the TVM legislation. These include that part of the costs of the Ralph Business Taxation Review that can be attributed to the TVM proposal as well as subsequently incurred costs. These costs are extremely difficult to quantify with any degree of accuracy and have traditionally been ignored in the literature.

The ATO’s administrative costs of implementing the TVM will include:

- the costs of preparing, producing and distributing information (internally and externally) regarding the TVM;
- the training of staff within relevant business lines such as Individual Non-Business, Small Business and Large Business & International (both staff time and costs of external consultants, if any);
- the provision of advice to taxpayers during the early stage of the introduction of TVM; and
- updating of software and modification of income tax databases.

One of the arguments in favour of the introduction of the TVM is that it will produce an income tax base that is more certain. Certainty should reduce the need for costly and time-consuming legal resolution of differences. Thus it is claimed that recurrent administrative and compliance costs should be reduced by less recourse to the courts and tribunals. Whether or not this is true will obviously need to be tested. But there will almost certainly be some transitional juridical cost as the new system is “bedded down”, and these transitional costs will also need to be assessed.

¹² R Warburton in a speech to the Institute of Chartered Accountants in Australia on Tuesday 8 May 2001, quoted in *Australian Financial Review*, p. 5, 9 May 2001. He went on to say that “at this stage we believe the benefits will outweigh the transitional costs, but we need to prove that”.

The transitional compliance costs of implementing the TVM refer to the resources expended by the economy in its preparation for complying with the TVM. The proposed TVM has implications for all sectors of the economy including individuals, government agencies, business enterprises, etc. Income taxpayers in their capacity as individuals will need to learn about TVM but their costs of preparing for the TVM will likely be very small for each taxpayer. The business sector is diffuse, and even includes non-profit organisations (eg, religious and charitable institutions, universities, etc) that are entirely exempt from income tax. These organisations may nevertheless incur transitional costs due to the need to learn about the TVM legislation.

Transitional compliance costs can therefore typically include:

- the costs of learning about TVM and its implications (both staff time and costs of external trainers);
- payment for advice from external tax advisers;
- acquisition of new or updated tax software to accommodate the change; and
- other necessary modifications of accounting and business systems.

Tax professionals will have to learn about TVM although not all of them will be able to capture their full costs of learning via paid advice to clients. The transitional compliance costs should, in principle, include the learning costs of those tax professionals who are unable to pass them on to clients.

Recurrent costs

It has been suggested by the Ralph Review¹³ and by Government¹⁴ that the replacement of the core rules of the ITAA 1997 by the TVM will produce benefits to taxpayers, tax professionals, tax administrators and tax judges in the long run. If this does prove to be the case, the economy should experience savings in both recurrent administrative costs and recurrent compliance costs. Any evaluation of the impact of the TVM on the operating costs of the direct tax system must therefore assess recurrent costs as well as transitional costs.

Social compliance costs and taxpayer compliance costs

Conceptually a distinction can also be made between the “social” and the “taxpayer” compliance costs of the proposed TVM¹⁵. The social compliance costs of the TVM refer to the costs incurred by the entire economy in complying with the TVM legislation. Taxpayer compliance costs refer to the costs incurred by taxpayers in complying with the TVM after taking into account offsetting benefits (if any) such as cash subsidies, tax deductibility, cash flow and managerial benefits.

The distinction between social and taxpayer compliance costs has generated debate regarding the use of compliance costs in evaluating the simplification impact of tax reform. In its Regulation Impact Statement accompanying the main GST Bills the Government appeared to evaluate the simplification impact of the GST in terms of the estimated increase in taxpayer compliance costs¹⁶. It has been argued elsewhere that while taxpayer compliance costs are relevant from the taxpayers’ perspective, they do not provide a sound basis for evaluating tax changes¹⁷. To take an extreme example, suppose that the Government fully compensated all taxpayers for their costs of preparing for the TVM. In this case, the taxpayer transitional

¹³ Review of Business Taxation *op cit* at p. 163.

¹⁴ Explanatory Material to *Tax Value Method Working Draft op cit* at para 3.25.

¹⁵ For a more detailed discussion, refer to C Evans, K Ritchie, B Tran-Nam and M Walpole, *A Report into Taxpayer Costs of Compliance*, AGPS 1997, pp. 4-5.

¹⁶ Treasury (1998), “Regulation Impact Statement for the Introduction of a Goods and Services Tax”, *A New Tax System Bills 1998* (Cth), p. 8.

¹⁷ B Tran-Nam “Assessing the Revenue and Simplification Impacts of the Government’s Tax Reform”, *Journal of Australian Taxation* 2, 1999, p. 337.

compliance costs with regard to the TVM would be zero. Surely, this does not demonstrate the desirability or otherwise of the proposed TVM from a compliance cost perspective! In summary, the merits or otherwise of the TVM must be assessed on the basis of social compliance costs/benefits, and **not** taxpayer compliance costs/benefits.

Computational costs and tax planning costs

Compliance costs are sometimes divided into computational (unavoidable or involuntary) and tax planning (avoidable or voluntary) costs. Typically, computational compliance costs would comprise those costs necessarily incurred in determining tax liability – for example, the costs of calculating a capital gain. In contrast, tax planning costs might constitute payment for advice whereby a transaction could be structured so as to give rise to a concessionally taxed capital gain rather than a more heavily taxed income gain.

This distinction between computational and tax planning compliance costs, first made in the literature by Johnston¹⁸, has caused a controversy which has not yet been (and possibly will never be) fully resolved. Many tax administrators and policy makers continue to insist that only computational costs constitute legitimate measures of tax compliance costs.

The preferred view, both in the compliance costs literature and for the purposes of evaluating the impact of the TVM on compliance costs, is for a comprehensive definition of tax compliance costs which includes both computational and tax planning costs. The line between avoidable and unavoidable costs will always be blurred and it would be impossible to fully distinguish activities and costs related to tax planning and those related to satisfying the compliance demands of the tax system. Both sorts of expenses are legitimately incurred by taxpayers in complying with legislative requirements.

Applying the above view to TVM, the relevant questions to be answered are therefore:

- Does the replacement of the core rules of the ITAA 1997 by the TVM reduce tax computational costs only, tax planning costs only, or reduce both tax computational and tax planning costs?
- If the TVM reduces tax computational compliance costs only, what happens to the tax planning costs?
- If the TVM reduces tax planning costs only, what happens to the tax computational costs?

Each of these questions will need to be addressed in any evaluation of the impact on compliance costs of the introduction of the TVM.

Monetary costs and psychological costs

Most compliance costs are capable of estimation or valuation in monetary terms, though sometimes with difficulty¹⁹. The cost of tax advice from an external source is easily established. Most businesses can establish the staff costs related to the business' tax affairs. A value can also be placed on the time that a personal taxpayer or unpaid helper spends on her or his tax affairs. But there are compliance costs that are not so readily quantified in monetary terms. In particular account also needs to be taken of the psychological costs of complying with tax obligations.

¹⁸ K Johnston, *Corporations' Federal Income Tax Compliance Costs: A Study of Small, Medium-sized, and Large Corporations*, Bureau of Business Research Monograph No. 110, Ohio State University 1963, pp. 67-70.

¹⁹ See the discussion on this topic in B Tran-Nam, C Evans, K Ritchie and M Walpole, "Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia", *National Tax Journal* 53, 2000, at pp. 240-241.

Psychological costs in this context refer to the anxiety and frustration in learning about and coping with tax change. Unfortunately, no studies have yet managed to successfully quantify these psychological costs, although research in this area is now taking place²⁰.

But, as noted above with administrative costs, difficulty of estimation should not preclude some attempt at evaluating the psychological impact of the change. Such an evaluation does not have to be objective – we are well-used to operating on the basis of considered yet subjective evaluations in other areas. Clearly, therefore, an assessment of the psychological costs of the change to TVM should be a key aspect of evaluating the transitional and recurrent costs of introducing the TVM.

3 The proposed framework for empirical testing

Developing a quantitative and qualitative approach

Section 2 has identified that the TVM implications for both transitional and recurrent operating costs or benefits need to be identified, and that operating costs include both administrative and compliance costs. It has also established that the compliance cost element of those operating costs needs to be determined at the social rather than taxpayer level, needs to embrace computational and planning costs and, if possible, needs to take account of psychological costs as well as monetary costs. This section builds upon that analysis by suggesting methodologies – involving both quantitative and qualitative elements – for determining and evaluating the operating cost implications of the TVM.

The approach that is suggested initially identifies a benchmark against which measurement and evaluation can take place. It then tackles the process of quantification of transitional and incremental recurrent compliance costs or benefits, building on the case study methodology that is in the process of being used elsewhere in the TVM project. Transitional and recurrent administrative costs will need to be separately assembled from governmental base records. Finally it addresses issues relating to the qualitative value of the data that has been collected.

Establishing a benchmark

The process of measurement needs to start by assuming that the TVM will reduce the operating costs of the Australian income tax system once it is implemented. If this is not true, then there is little justification for introducing TVM in the first place. Since the recurrent benefits will extend indefinitely into the future (so long as TVM operates), we need to use present value arithmetic to establish a benchmark. This calls for a subjective time rate of social preference. This can be expressed as r (>-1), which, for practical purposes, can be approximated by the market rate of interest.

The TVM is then said to be simpler than the corresponding core rules of the ITAA 1997 if (and only if) the estimate of the transitional costs of the TVM is smaller than the present value of the discounted sum of existing and future recurrent operating benefits. This can be expressed precisely by algebra as follows.

Let the subscript t refer to the tax accounting period (typically a year). Assume that the TVM is introduced at the beginning of period 1 and it operates for n periods. Then the TVM is viable, in the sense that its benefits exceed its costs, if and only if

²⁰ See, for example, the work currently being undertaken by R Woellner, C Coleman, M McKerchar, M Walpole and J Zetler, summarised in chapter 4 of *Tax Compliance Costs: A Festschrift for Cedric Sandford*, *op cit*.

$$TC < \sum_{t=1}^n \frac{ROC_t}{(1+r)^t} \quad (1)$$

where

TC = transitional operating costs of the TVM \equiv transitional administrative costs of the TVM + transitional social compliance costs of the TVM; and

ROC = reduction in recurrent income tax operating costs \equiv reduction in recurrent income tax administrative costs + reduction in recurrent income tax social compliance costs.

Note that:

- the magnitude of TC may take several periods to be fully realised (including periods before and after its introduction);
- each of the terms in the right hand side of the ROC equation may be positive (a reduction in recurrent operating costs), zero (no reduction) or negative (an increase in recurrent operating costs);
- it is assumed, without any loss of generality, that the saving benefits of the TVM for each tax accounting period are realised at the end of the period; and
- the cash flow and managerial benefits (if any) are offsetting benefits of recurrent compliance costs and do not feature in the calculation of transitional compliance costs.

While inequality (1) is conceptually satisfactory, unfortunately it has no practical value. This is because it is difficult enough to estimate the recurrent benefits (ie reduced operating costs) of the TVM for the current period, let alone for all future periods. This calls for a more sensible condition, which requires less information than (1). To this end, it is possible to use the present-value arithmetic to convert the transitional costs into an indefinite stream of equivalent annual costs. This is equivalent to assuming that the new tax structure is indefinitely (or sufficiently) long-lived. Under this approach, the TVM is said to be simpler than the ITAA 1997 if

$$rTC < ROC_t \quad t = 1, 2, \dots, n \quad (2)$$

where

rTC = annual equivalent of transitional costs of the TVM; and

ROC_t = reduction in income tax operating costs in the t -th period.

It is worthwhile noting that condition (2) is generally stronger than condition (1) in the sense that (1) implies (2) but the converse is not true. However, if it is assumed that $ROC_t > 0$ for $t = 1, 2, \dots, n$, then (1) and (2) are equivalent.

In a growing economy, the recurrent benefits tend to grow over time. Under this plausible assumption, condition (2) can be re-stated as requiring

$$rTC < ROC_1 \quad (2')$$

where ROC_1 = reduction in income tax operating costs in the current period.

Condition (2') can be equivalently expressed as follows. TVM simplifies the income tax system if

$$r < r_0 \quad (2'')$$

where r_0 ($\equiv ROC_1/TC$) can be thought of as the internal rate of return of the investment in TVM.

For numerical illustration of (2'), assume hypothetically that $r = 6\%$ per annum and $TC = \$3$ billion. Then the introduction of TVM can be supported if

$$ROC_1 > 6\% \times \$3 \text{ billion} = \$180 \text{ million.}$$

For a numerical illustration of (2''), suppose that $TC = \$3$ billion and $ROC_1 = \$150$ million. In this case $r_0 = \$150\text{m}/\$3\text{b} = 5\%$, i.e. the investment in TVM generates an internal rate of return of 5%. Then the introduction of TVM can be supported if

$$r < 5\%.$$

Quantifying the operating cost implications of the TVM

Measurement of operating costs has developed in technique and sophistication over the past 60 years, but still cannot claim to be more than a reasonable estimate²¹. In determining compliance costs, reliance will always need to be placed on asking taxpayers what they consider their compliance costs to be (or what they might be in the future). The dangers of over and under-estimation are clear, and the literature is full of the necessary warnings, qualifications and caveats that need to accompany estimates derived from taxpayer samples, however carefully assembled the sample may be.

When it comes to measuring the administrative costs of taxes or parts of the tax system, reliance often has to be placed on data provided by taxation authorities. As noted above, this information is often partial and does not usually include the legislative and juridical elements of tax administrative costs. It can also be difficult to extrapolate the administrative costs that relate to particular parts of the taxation system.

Two further problems compound the difficulties of quantifying the operating costs of introducing the TVM. In the first place, very little research has been undertaken into identifying transitional costs of tax change. The emphasis has traditionally been on quantifying recurrent costs. This was noticeable in the analysis of the introduction of the GST in Australia, despite the best efforts of researchers to turn the spotlight on to start-up costs²². And secondly, most serious research has been retrospective rather than prospective. In other words, the research has attempted to estimate compliance costs **after** the measure has been introduced, not **before** its introduction. Admittedly, tax administrators have attempted to estimate the likely compliance cost implications of proposals in the Regulation Impact Statements that comprise part of the Explanatory Memoranda that accompany tax law amendments. But those estimates are rudimentary at best, and sometimes downright wrong²³.

Given the critical role that the potential impact on transitional and recurrent operating costs will have in the decision about the introduction of the TVM, it is clear that any measurement will not be able to take place after introduction. It needs to be undertaken sooner rather than later, and to that extent an extra element of subjectivity is introduced. Taxpayers will not be able to estimate

²¹ For a review of the research on compliance costs that has taken place in the last 60 years, see Section 3 of *A Report into the Incremental Costs of Taxpayer Compliance*, by C Evans, K Ritchie, B Tran-Nam and M Walpole, AGPS 1997.

²² See, for example, B Tran-Nam "The Implementation Costs of the GST in Australia: Concepts, Estimates and Implications", *Journal of Australian Taxation*, Vol. 3, 2000, pp. 331-343 and J Pope "Factors Affecting the Compliance Costs of the Goods and Services Tax in Australia", at pp. 153-154 of *Tax Compliance Costs: A Festschrift for Cedric Sandford*, *op cit*.

²³ For an analysis of the Australian experience with Regulation Impact Statements see chapter 4 of C Evans and M Walpole *Compliance Cost Control: An Analysis of Tax Impact Statements in the OECD*, ATRF, 1999.

their compliance costs (and administrators their administrative costs) on the basis of historical fact. Rather they will need to provide an estimate on the basis of an uncertain hypothetical.

Data collection

Having established the quantitative benchmark against which the implications of the TVM can be tested, it remains to obtain the data relating to both transitional and recurrent operating costs. The primary data required for empirical testing have to be derived from the stakeholders concerned – there is no reasonable proxy. Data about the compliance cost implications of a change to TVM need to be obtained from taxpayers, and data about the administrative cost implications will best be provided by the tax administration and other governmental agencies. Others (and particularly academic researchers or tax administrators) cannot guess or estimate on their behalf.

Methodologies for obtaining that data can vary. The two main methods for obtaining taxpayer data are by way of large-scale surveys (usually involving questionnaires) or by utilising a small number of in-depth case studies. Both methodologies have been used successfully to investigate compliance cost issues in the past, though both have shortcomings. The technical advantages and disadvantages are discussed at length in the literature²⁴.

The Board of Taxation has commenced some preliminary studies in the large business sector using the case-study method for three public corporations. It also anticipates testing the TVM on a limited number of medium sized enterprises (already under way) and with other entities in due course. As noted above, the purpose of the testing is not as yet to establish either transitional or recurrent compliance cost implications. It is to establish the viability and outcomes of the new approach. But it is important that those same entities also provide information on the implications of the change for their compliance costs, and that they do so on a systematic and consistent basis. This requires that a structured questionnaire or interview procedure be established so that the compliance cost implications can be appropriately monitored and, if possible, extrapolated to the broader community of taxpayers.

Extrapolation to the broader community on the basis of such a limited number of case studies, however carefully conceived, will not (unfortunately) provide an adequate estimation of the overall transitional and recurrent compliance cost implications of the TVM. The Office of Regulation Review²⁵ firmly criticised the outcomes of a case study analysis of compliance costs in Australia undertaken in the early 1990s by Wallschutzky and Gibson. Its report noted that:

“In-depth studies can be a good complement to large scale surveys or they can operate quite independently. They are useful for identifying ways of reducing compliance costs. Because of small samples, however, they are not usually able to produce reliable aggregate estimates of the costs of compliance for small business”²⁶.

The Board of Taxation may therefore be well advised to consider establishing a more extensive methodology to complement its in-depth studies. Because the change is prospective, a traditional large-scale survey based on questionnaires may not be appropriate. Respondents would have no knowledge or experience of operating under TVM to use as a basis for formulating an estimate of the likely compliance costs. A large-scale questionnaire based survey would only function effectively if TVM were introduced, and only after the introduction.

²⁴ Interested readers can refer to B Tran-Nam, C Evans, K Ritchie and M Walpole, “Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia”, *op cit*.

²⁵ S Rimmer and S Wilson, *Compliance Costs of Taxation in Australia*, Office of Regulation Review, 1996, at pp. 18-19.

²⁶ S Rimmer and S Wilson, *ibid*, at p. 10.

The Board of Taxation should therefore consider the possibility of significantly increasing the number of case studies it is currently conducting on a limited basis. In order to do this, it would need to be reassured that it had adequate coverage of all categories of taxpayers with potentially differing compliance cost profiles as a result of TVM. This entails careful stratification of the population for testing purposes.

Disaggregation of taxpayers

Since the TVM modifies the income tax law at its most fundamental level, it is clearly applicable to all taxpayers, including individuals, businesses, government business enterprises and foreign residents with Australian sourced income. To estimate the aggregate transitional compliance costs and the aggregate recurrent compliance changes by way of an extended suite of case studies, it would be necessary to draw a sample of taxpayers for detailed testing and then to extrapolate from the sample results in order to arrive at some population estimates.

It is clear, however, that different taxpayers would be likely to face different levels of transitional costs and recurrent benefits as a result of the introduction of the TVM. There exists a wide gap between a large, established business and a small sole trader in their relative ability to cope with the new legislation. And non-business taxpayers face different issues again related to the TVM.

In order to estimate the aggregate transitional costs and the aggregate recurrent benefits accurately, it will therefore be necessary to disaggregate taxpayers into more homogeneous groups within which taxpayers are likely to experience similar levels of transitional costs and recurrent benefits with respect to the proposed TVM. As a primary classification, taxpayers could be divided into:

- personal taxpayers without any exposure to business income; and
- business taxpayers.

Further classification of each of the above categories would also be necessary because different strata, measured, for example, on the basis of income levels or sources of income, are likely to encounter different patterns of TVM-induced costs and benefits. Each of the personal and business taxpayer categories could therefore be further sub-divided on the basis of additional criteria in order to establish reliable and accurate estimates of the average compliance costs and benefits faced by each group.

Personal taxpayers

On *a priori* ground, personal taxpayers could be disaggregated on the basis of gross annual income (before allowable deductions). Past research has stratified personal taxpayers into three levels of income²⁷. However, there are arguments that the incremental compliance cost impact of the TVM will not relate so much to the level of income as to its nature. If this were the case, the stratification might also be effected by reference to the type of personal taxpayer (for example, employee, pensioner, self-funded retiree), or even by reference to the nature of the income – for example, whether capital gains were realised, other forms of investment or earned income etc.

If stratification were to take place on the basis of three levels of income, three types of taxpayer/income (employee, recipient of investment income and retiree), and whether or not the taxpayer was in receipt of capital gains, approximately 20 case studies would be necessary to provide adequate coverage of the distinctive categories of personal taxpayers.

²⁷ Low (income up to \$20,000 per annum), medium (income between \$20,000 and \$50,000 per annum) and high (income above \$50,000 per annum). This was the classification for personal taxpayers used in *A Report into Taxpayer Costs of Compliance*, *op cit*.

Business taxpayers

Business taxpayers could also be stratified on a number of different bases. For example (and again following earlier research) they could be disaggregated on the basis of:

- size of business measured by annual turnover exclusive of GST. Again three sizes might be sufficient: small (annual turnover exclusive of GST less than \$1 million), medium (annual turnover between \$1 million and \$10 million) and large (annual turnover above \$10 million);
- legal form of business (sole trader, partnership, trust, superannuation fund and company); and
- main business activities (agricultural and mining, manufacturing, services, finance, etc).

Stratifying the business taxpayer population on these bases (turnover, legal form and main business activity) could enable a more accurate and reliable estimation of transitional costs and recurrent benefits to emerge by a process of triangulation. Again, however, it would also be necessary to consider how the TVM is likely to impact upon different strata in determining the final classification for business taxpayers.

In the absence of final TVM legislation this is not an easy task. Certainly each of the three suggested criteria should be subject to careful scrutiny to confirm that they are appropriate dimensions for disaggregation. It might be the case, for example, that the legal form criterion is not so important. Arguably the TVM will not have any incremental compliance cost impact upon a business taxpayer regardless of the legal form operated by that business. For example, a sole trader with a turnover of less than, say, \$1 million, might not be affected by the TVM any differently from say an incorporated business with a similar turnover.

Conversely, other factors may be more important in the process of disaggregation. For example, the TVM compliance cost profile may be profoundly affected by the status of the business taxpayer. A listed company with onerous ASIC and other reporting requirements may find that it has very little additional preparatory work to complete to be able to “convert” its accounts from an ITAA 1997 version to a TVM version. A non-listed company may find its costs differ significantly. On similar lines, a fully computerised business may likely encounter a significantly different experience so far as coping with TVM is concerned compared to a business with purely manual accounting processes.

A suggested basis for business taxpayer stratification might therefore be:

- three levels of turnover, large medium and small;
- the large business category further sub-divided into listed and non-listed categories;
- the large business category and the medium business category further sub-divided into those businesses with primarily domestic operations, and those with operations domestic and overseas;
- the small business category further sub-divided into those businesses within the Simplified Tax System (“STS”) and those not within the STS;
- the small business category further sub-divided into those small businesses using computerised accounting records and those using manual accounting records;
- all of the above categories further sub-divided on the basis of three different fields of activity (essentially primary, manufacturing and services); and
- all of the above categories further sub-divided on the basis of whether or not they are exposed to capital gains.

On this basis, there would be a need for approximately 60 business taxpayer case studies to be conducted. Regardless of the number of observations involved, further steps – relating to the

qualitative integrity of the data and the extrapolation to the rest of society – will still need to take place.

Confirming the outcomes – the qualitative input

Extensive testing of the compliance cost implications of the TVM through a process of in-depth case studies will provide a platform for estimation of the magnitude and incidence of transitional and recurrent compliance costs. But on its own it will probably not be sufficiently robust for final decisions to be made. It may therefore be appropriate to set up panels, or focus groups, to consider the outcomes derived from the case studies. Such panels (there would be a number of them) could comprise representative taxpayers from the different taxpayer groups, accountants and tax advisers, representatives of professional associations, TVM Working Group members, and other key stakeholders. Each panel should, if necessary, initially receive information about TVM and how it operates. Subsequently, each panel would have the opportunity of considering the compliance cost outcomes derived from the extensive case study analysis. It is likely that questionnaires, or even structured interviews, would feature in this methodology. Again, there needs to be careful consideration of the number of panels, their composition, the manner of facilitation and the role they will be expected to perform.

Extrapolation to the economy

In order to evaluate the implications of the TVM on the operating costs of the Australian income tax system, the next stage would be to extrapolate the results obtained from the in-depth case studies. There are three possible scenarios that may emerge from the case studies:

- for each and every participant in the case studies, the savings in recurrent compliance costs outweigh the transitional costs;
- for each and every participant in the case studies, the savings in recurrent compliance costs are less than or equal to the transitional costs; or
- for some participants, the savings in recurrent compliance costs outweigh the transitional costs, while for others the savings in recurrent compliance costs are less than or equal to the transitional costs.

In the first case it is unambiguously clear that the proposed TVM simplifies the income tax system from a compliance cost perspective. In the second case the proposed TVM does not simplify the tax system and cannot be justified from a compliance cost perspective alone. In the third case it would be necessary to aggregate the in-depth case studies using the weights in the various cross distributions of taxpayers. These macro statistics are typically available from the ATO's tax returns databases.

Note that the discussion here is concerned with compliance costs. A more complete study would involve both compliance and administrative costs, as suggested previously.

4 Conclusions

So what are the tax operating cost implications of the proposed TVM? The short answer is that we have very little information thus far. Until empirical testing takes place, the debate about the impact of TVM on tax compliance and administrative costs can only take place at the level of assertion (at worst) and informed guesswork (at best). We are certainly not in a position to even begin to suggest a figure that might be an appropriate estimate of the operating costs of the TVM on a recurrent basis, let alone what the transitional costs might be.

But hopefully this paper has done two things. It has identified the boundaries of the debate, and it has suggested the beginnings of a methodology for arriving at a more considered appraisal of the operating cost implications.

The boundaries of the debate are straightforward. A number of simple propositions will capture them:

1. We need to consider both the administrative and the compliance costs of the TVM;
2. The administrative costs are not just the costs incurred by the ATO in relation to the TVM. To be comprehensive they must also include those TVM costs that relate to the legislative and judicial processes;
3. The compliance costs need to be calculated at the social level (and not at the aggregate level of taxpayer compliance costs). To be comprehensive they must include both tax computational and tax planning costs, and must also take into account the psychological costs of compliance;
4. Separate assessments need to be made of the transitional costs and the recurrent costs.
5. The recurrent costs of operating under the TVM need to be compared with the recurrent costs that would have been incurred without the TVM. If the TVM recurrent costs exceed or approximately equal the ITAA 1997 recurrent costs, the introduction of the TVM cannot be justified on the basis of the proposed simplification that should occur.
6. If the TVM recurrent costs are less than the recurrent costs that would have otherwise occurred under the ITAA 1997 approach (in other words there are TVM-induced operating cost benefits), those benefits must outweigh the transitional costs incurred in switching to the TVM.

The development of a methodology for determining the tax operating costs of the TVM is less straightforward. Separate measurements need to be made for the administrative and the compliance costs. The data for the administrative costs can only be assembled through a process of intensive questioning of the personnel of relevant governmental departments, together with the careful manipulation of available statistical information.

The data for the compliance costs can only be collected from taxpayers. Unfortunately most taxpayers are not aware of the TVM and so cannot begin to estimate the likely compliance cost impact that introducing the TVM would have. Large scale surveys of the kind that have proved most fruitful and robust in past estimates of compliance cost magnitude and incidence cannot therefore be used. There are also real dangers in attempting to extrapolate too broadly from a limited number of observations, no matter how in-depth the analysis has been.

This paper has therefore proposed a two-phase hybrid methodology for determining the transitional and recurrent compliance costs of the TVM. In the first phase it has proposed extending the case study approach, currently being used to assess the viability of TVM and its operation in relation to certain transactions, to a larger number of business and personal taxpayers. It is suggested that up to 80 case studies (60 for business taxpayers and 20 for personal taxpayers) would be appropriate to provide a reasonably reliable and defensible estimate which could, if necessary, be extrapolated out to the broader community of taxpayers. Careful disaggregation of the taxpayer population would be required in determining the sample case study population. Structured interviews would need to be used, and analysis conducted of the compliance cost implications of many of the same transactions that would have figured in the earlier viability testing.

In the second phase the reliability and reasonableness of the outcomes posited from the case study approach would be subjected to scrutiny by panels drawn from taxpayers, taxpayer representatives, tax professionals and administrators, business persons and academics. These panels would attempt to confirm or reject the estimates provided by reference to a series of criteria including knowledge of the TVM and existing tax system and (importantly) common-sense.

It was noted early in this paper that compliance costs and related issues have the power to bring down Governments. Given this political dimension, it might be appropriate to give the last say to a politician. A former Chancellor of the Exchequer, Lord Howe, is currently actively involved in a major Tax Law Rewrite Project in the UK. The brief of that project is to improve the quality and reduce the quantity of tax legislation. In short, it is to provide the sort of simplification that all Governments (and their electorates) crave, and which its proponents claim will be delivered by the TVM. In writing about simplification²⁸, Howe sounds a note of caution that we would be foolish to ignore in the Australian tax context, especially given the incessant reform that has occurred in recent years and the level of tax exhaustion felt by many. He notes²⁹:

“The choice of banner under which to achieve the next major mobilisation [of resources to pursue the goals of improvements in the quality of legislation and a reduction in the quantity of legislation] is not easy. “Simplification” alone will not be enough. For that task alone is, and will remain, intensively difficult. That is why I have suggested the two-pronged appeal: “Simplicity and Stability”. For it is much easier at least to understand the significance of “stability”. “For God’s sake”, it might be put, “stop messing us around – for heaven’s sake just leave us alone”.

There are large numbers of business and personal taxpayers in Australia who would loudly echo those final sentiments. But that, of course, is beyond the scope of this paper.

²⁸ Simplicity and Stability: the Politics of Tax Policy, *British Tax Review*, No. 2, 2001, pp. 113-123.

²⁹ *Ibid* at p.123.