Complexity in the Australian Tax and Transfer System

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Objectives of My Contribution

1. Lay out guidelines regarding how to think about tax simplification policy.
2. Debunk some pervasive, but flawed, reasoning.
3. Apply the guidelines to tax policy in Australia, broadly speaking.
4. Focus on personal income tax system.
Preliminaries

• Simplicity is not a goal in itself; it is desirable if it enhances the well-being of Australians, or the distribution of same.
• To the extent it uses resources or prevents their efficient use, complexity decreases well-being.
• There is no such thing as a “pure” tax simplification.
• Due to the difficulty of measuring changes in well-being, analysis has focused on summary measures of complexity.
How Complex Is It?

• Best, but flawed, measure is the cost of collection (= adm + comp costs).
• Administrative costs are notably higher than the US, but close to OECD average.
• Compliance costs, always much higher than administrative costs, seem comparable to US and UK, but measurement difficulties make it much harder to know for sure.
• Fraction using preparers (72% in 2006) may be a world high.
More on Costs of Collection

- ATO has a relatively wide scope of responsibilities.
- Compliance cost will be shifted like explicit costs.
- Openness exacerbates the cost of all inefficiencies, including costs of collection.
- Some costs are impossible to quantify: e.g., loss of privacy, loss of policy transparency.
What is “Optimal” Complexity? Lessons from Economic Theory

Behold the marginal efficiency cost of funds (MECF), which is equal to:

\[
\frac{(1 + x_i + c_i)}{(1 - a_i)}
\]

where \( x_i \) is the marginal distortion cost, and \( c_i \) and \( a_i \) are the marginal administrative and compliance cost, all per dollar of revenue raised.

- The higher is MECF, the less efficient is the policy instrument.
1. Equalize MECF across All Policies.

- Avoid policies with high $a_i$, $c_i$, or $x_i$.
- It may be desirable to make compromises in income measurement (which generally increases $x_i$) in order to reduce $a_i$ or $c_i$.
- For example, don’t tax the imputed rent from owner-occupied housing.
- *Marginal* costs matter, not average.
2. Don’t Maximize Net Revenue

• Expanding enforcement until MR = MC is not an efficient policy.
• It embodies an apples-oranges fallacy.
• Expanding enforcement (e.g., hiring more auditors or using more computers) uses real resources, but the extra revenue collected is not a real resource gain; it is a (possibly beneficial) transfer.
3. Both Adm and Comp Costs Matter, But the Former Matter More

- Note in the MECF formula that adm and comp costs do not enter symmetrically.
- Adm costs come out of costly-to-raise revenue.
- Thus, a citizen-centered tax policy will certainly consider comp costs, even though they do not show up in any government budget, but adm costs should get a higher weight.
4. Social Costs May Diverge from Private Costs

- E.g., when comp costs are deductible, private costs are less than social costs.
- Fines for evasion are private, but not social, costs.
Justifiable Reasons for Complexity

1. To achieve progressivity
2. Differences in measure of well-being for tax and transfer policy: “ability to pay” versus “deserving to receive”
   --can lead to inefficient churning
3. Defensible tax expenditures
4. Optimally effective enforcement
5. Incoherence of income tax
Keys to a Cost-Efficient Tax System

1. Information reporting
2. Withholding
3. Involving business as a tax collection agent, to remit tax and transmit information
4. Utilizing technology, e.g. pre-filling
Issues in the Role of Businesses in Tax Systems

• Utilizing large businesses is especially efficient.

• It may be efficient to exempt (or offer a simplified regime to) small businesses in order to saveadm and comp costs, but note the cost of inefficiently incentivizing small scale.

• Offering payments to businesses to offset comp costs is generally not appropriate.
Political Origins of Complexity

1. Desire to finely calibrate rewards to marginal voters.
2. To take advantage of cognitive limitations to reduce *perceived* tax burden.
3. Constitutional constraints such as federalism.
Political Consequences of Complexity

1. Citizens may under-estimate the true cost of government.
2. Generally, transparency suffers, and computerization may exacerbate the problem.
3. Ponder role of business-based systems in transparency: efficient but hidden?
Policy Process Procedures

1. Compliance cost assessments are well-intentioned, but have not been shown to affect policy much.

2. Complexity-related performance targets are problematic, as they often fail to appropriately reflect tradeoffs/priorities; also, comp costs are difficult to measure.

3. Transparency and citizen involvement are good things.
Impressions of Tax Complexity in Australia

Positive aspects:
1. Extensive e-filing and pre-filling.
2. Simplified returns for some individuals and businesses.
3. Culture of recognizing compliance costs and transparency.
Promising Areas for Simplification

1. Coordinate measures of well-being between tax and transfer programs.
2. Unify/harmonize across multiple transfers.
3. Harmonize policy across states and between states and federal government.
4. Be open to rough justice.
5. Restrict the number of objectives of tax policy.