11.0 Introduction

In this chapter I offer, from an outsider’s perspective, some observations about tax complexity in Australia. The outsider’s perspective offers the promise of a fresh viewpoint unencumbered by an intimate familiarity with the status quo and the economic, political and social pressures that have led to it. It also means I may have misunderstood some aspects of the Australian tax system and may be naive about the prospects of changing it. I can, though, bring to bear the lessons of much time spent pondering tax complexity and simplification in the abstract and addressing concretely these issues for real tax systems, mostly in the United States. Where appropriate I will draw on those experiences, and compare the Australian tax system to others with which I have some familiarity.

I have learned enough about the Australian tax system to know that there is much sentiment that the level of tax complexity is now excessive. The background paper prepared by the Australian Treasury, Architecture of Australia’s Tax and Transfer System (henceforth Architecture), refers to evidence of a widespread consensus on this matter, and asserts that tax complexity is ‘likely to be above the level that is optimal for the society as a whole’ (p. xxi). As is true in other countries, most such judgments do not clearly lay out by what standard (excessive) complexity is to be evaluated. For this reason, one objective of this chapter is to shed some light on the standard by which tax complexity should be assessed. Another objective is to apply the standard to some aspects of the Australian tax system. I will admit from the outset that, even armed with such a standard, the information needed to confidently apply the criterion so as to make definitive policy recommendations is generally not available. Nevertheless, I believe that consideration of consistent standards can inform the Australian policy debate about tax complexity.

I will be consequentialist and welfarist in my approach, evaluating tax policies on the basis of their consequences for Australians’ well-being. In other words, I will take a citizen-centered approach. This means that I will not evaluate tax policy on the basis of whether a policy or policy reform appears to more or less satisfy an abstract principle. Although in public finance textbooks simplicity is generally listed as a separate criterion for evaluating a good tax system—along with equity, efficiency, and (sometimes) revenue adequacy—simplicity is not really a separate objective. In other words, if tax complexity is bad, it is bad either because it uses up, or causes the wasteful misallocation of, resources that could otherwise be used for goods and services that people value, thereby making them worse off, or because it adversely affects the distribution of individual well-being.

The ideal welfarist analysis of tax complexity would assess the impact of a given aspect of a tax system—or a proposed change—by its effect on the welfare of all members of the society. If everyone is better off, this is a tax system aspect worth keeping, or adopting. If, as is likely, there are some winners and some losers from a given policy change, one would then have to apply standards of social justice to judge whether the change is desirable. In reality, this kind of information is never available, and policy evaluations must rely on relevant, but not decisive, summary indicators that measure aggregate costs and benefits of policy proposals. Moreover, there is rarely a tax policy change that is a ‘pure’ simplification. Most proposals labelled as simplification also change the price of, and reward to, various activities and also alter the distribution of the tax burden. For example, consider the effect of allowing Australian taxpayers the option of claiming a ‘standard deduction’ for gifts and donations instead of having to itemise their actual gifts and donations. This would reduce the number of households that itemised these deductions and lessen the attendant record-keeping requirements. As such, it might be advocated as a simplifying measure. It would also reduce the tax liability of those households whose itemisable donations fall short of the standard deduction; to maintain tax revenue, other households would have to pay increased taxes. In addition, the net-of-tax ‘price’ of making donations would be increased for those who no longer itemise their contributions, and decreased for those who continue to itemise but now face a higher marginal tax rate. This would have implications for the magnitude and nature of total contributions. Consider next the example of a reform that simplifies instructions about how to receive a particular offset, but leaves the law itself unchanged. This sounds like a pure simplification, but it also redistributes disposable income because households that did not receive the offset because the instructions were too complicated would now get it. To maintain revenue, some additional change in the system would be necessary. In the end, some households would benefit, others would be worse off.

11.1 How Complex Is It?

11.1.1 The Cost of Collection

One often-used and often-useful summary measure of the cost of tax complexity is the total resource cost of collecting the revenue (also called the cost of collection or operating costs). This is a natural complement to economists’ standard measure of the distortion costs of taxation (also known as excess burden or deadweight loss) as an indicator of the efficiency cost of taxation. The cost of collection is
the sum of the tax authority’s budget (administrative costs) and the value of the time and expenses incurred both by taxpayers themselves and by third parties such as employers who withhold and remit tax on behalf of their employees and provide information reports (compliance costs).

Certain characteristics of the cost of collection as a summary measure of complexity should be noted. First, this index does not distinguish between involuntary costs that must be incurred to comply with the tax law and discretionary costs that are incurred voluntarily to facilitate avoidance or even evasion of tax liability. In most applications, this is appropriate because regardless of motive the costs are opportunity costs to the society. Second, the resource cost refers to the social rather than the private cost of collecting taxes, which in some cases diverge. For example, to the extent that taxpayers can deduct monetary costs of compliance in computing taxable income, as in Australia, private costs are less than social costs. When employers earn interest on withheld employee taxes because they need not remit tax immediately to the tax authority, private costs to that party will fall short of social costs. When one of the expected private costs of tax evasion is a monetary fine, private costs exceed social costs, as the fine represents a transfer of resources rather than a waste of resources.

As already admitted, the resource cost of collection is almost never a sufficient statistic for evaluating the impact of tax complexity. As an example, consider how it informs the following ‘simplification’ proposal: relax the record-keeping and calculation requirements of a particular offset, so that only half as many taxpayer resources (time and money) as before are required to qualify for the credit. Suppose that, in response, the number of people who apply for and receive the credit quadruples. If judged solely on the cost measure, the tax system has become more complicated—total costs double, after all. The policy question, though, is whether the process of simplification is worthwhile, and to assess that we must also consider the welfare consequences of the offset being made available to more households who ‘deserve’ it (and maybe also to some who do not). With this brief introduction, I turn now to what is known about the collection costs of the Australian tax system.

(a) Administrative Costs
According to the OECD (2004, Table 24), the ratio of administrative costs to net revenue collections in Australia was 1.05 per cent in 2004. This is nearly double the US figure of 0.56 per cent, but close to the overall OECD average and close to, for example, the figure listed for the United Kingdom. The Annual Report 2007–08 of the Australian Tax Office provides more and updated information on administrative costs. Figure 3.2.6 of the report shows administrative cost ratios declining gradually since 2000–01. In 2007–08 the ‘cost to collect’ was 0.84 per cent excluding GST administrative costs and collections, and about 0.95 per cent including them.

(b) Compliance Costs
Past research overwhelmingly suggests that for most taxes, and especially for income taxes, compliance costs greatly exceed administrative costs and therefore comprise most of the cost of collection. Australia offers no exception to this rule. It is also true that measuring compliance costs is subject to much more uncertainty compared to measuring administrative costs.

Architecture refers to the (only) two major studies of the cost of complying with the main Australian taxes, both of which are now substantially outdated. Evans et al. (1997) concluded, based on 1994–95 survey data that, as a percentage of tax revenue, compliance costs were 4.0 for individuals, 9.4 for business taxpayers, and 7.0 overall. Pope (1994), based on 1990–91 data, calculated these numbers as 9.2, 6.6, and 11.9. Note that the scope of taxes in the categories is not identical across the two studies. An OECD study (OECD 2001) of eleven member countries on the compliance costs faced by small and medium-sized businesses, using a standardised methodology, concluded that these costs in Australia were slightly below the unweighted average.

Three things are worthy of note about these findings. The first is that even the lowest of these estimates is consistent with the fact that compliance costs far exceed administrative costs. Second, the overall percentages bracket the 10 per cent figure which I believe is the best estimate of the US income tax compliance costs as a fraction of revenue raised. Third, these costs are of the same order of magnitude as the efficiency (also known as deadweight), costs due to distorted behaviour that are the bread and butter of economists’ analyses of tax systems.

1 The ATO Annual Report 2007–08 (p. 11) provides more recent figures on the number of employees in tax administration.

2 See Slemrod (2004) for the source of the 10 per cent figure. Due to differing methodologies, comparing compliance cost estimates across countries is an inexact science. Indeed, the dean of compliance cost measurement, Cedric Sandford, once said that international comparisons are ‘more likely to mislead than enlighten’ (Sandford 1995, p. 405).
Taxation Statistics 2006–07 (Australian Tax Office 2009, pp. 140–1) notes that the cost of managing tax is available as a deduction for all. In 2005–06, 5.14 million lodgers claimed it, with an average cost of $268.21 and a total cost of $1.38 billion. The deductible cost includes agent expenses and interest charges; the former, but not the latter, represents a resource cost of collecting taxes.

(c) Who Bears the Cost of Collection?
The question of who bears the burden of the administrative cost of collecting tax revenue is no different than the question of who bears the burden of any government expenditure: this is determined by the incidence of the overall tax structure (and deficit), and perhaps by the incidence of any government expenditure crowded out by the tax authority’s budget.

The question of who bears compliance costs is more interesting. It is also more susceptible to misunderstanding because there is a simple answer that is generally not correct. The simple answer is that the cost is borne by the party that initially incurs the expense—the individual taxpayer who pays for an accountant and spends time poring over tax self-help manuals, and the business that has tax accountants and lawyers on the payroll, contracts out for additional help and must keep records and do calculations just for tax reasons. The obvious answer is generally incorrect because, as is the case for explicit taxes, the burden of compliance costs will generally be somewhat shifted through changes in prices. For example, if manufacturers of cigarettes initially incur an especially high compliance cost due to excise taxes, in equilibrium this will be reflected in somewhat higher cigarette prices to consumers, offsetting to some extent the decline in the profits of the manufacturers. It might also be shifted to tobacco farmers. Thus, one cannot presume that the initial bearers of a compliance cost will be worse off by an equivalent amount. However, as is also the case with explicit taxes and other costs, if a business incurs more compliance cost (with no offsetting private benefit) than its competitor businesses, then the idiosyncratic portion of the cost is likely to be reflected in lower profits—and more of a burden borne—than otherwise.

In this context it is important to distinguish two common, but distinct, usages of the term ‘regressivity’. The most common, and most appropriate, meaning refers to the distribution of a tax burden across households with differing levels of well-being, generally measured by income. According to this meaning, a tax burden is regressive if its burden relative to income is lower for higher-income households, and is progressive if the relative burden is higher for higher-income households. The other usage has to do with the size of businesses: a tax burden is denoted regressive if it is lower, relative to the size of the business (measured in any number of ways), for larger businesses. Using the term regressivity with respect to business size is potentially misleading because it need not imply regressivity according to its standard meaning. After all, there is no reason to believe, a priori, that the owners of small businesses (or those who work for them or otherwise might be made worse off by a particularly high compliance burden) are relatively low-income individuals. As discussed later, regressivity in this sense may have important efficiency implications, but should not be associated with the same kind of vertical equity implications one normally associates with regressive taxes.

11.1.2 The Cost of Doing Business, and Living, in Australia
Some observers have suggested that the true cost of tax complexity to the Australian economy exceeds the resource cost of collection because it detracts from the attractiveness of doing business in Australia and hurts its competitiveness in the global economy. This statement is broadly correct, but imprecise. A compliance cost can reduce the after-tax profitability of a new Australian business venture in the same way as an explicit tax; to the extent it dissuades some people from going ahead with such a venture, there is an additional cost. (And, unlike explicit taxes, the compliance costs raise no revenue!) That part is true. What is imprecise is the role in the argument of Australia being a small, open economy and the invocation of the buzz-word ‘competitiveness’. Being a small and open economy doesn’t fundamentally change the cost-benefit calculus of tax design, which applies to large, closed economies as well.1 But openness does to some extent exacerbate the cost of any inefficiencies due to policy missteps, whether generated by the private sector or the public sector. Comparisons with the tax systems of other countries can put issues in some perspective, and may highlight best practices that should be considered in Australia, but do not in themselves offer any insight into evaluation. There may be good reasons why Australian tax policy is different to policy in other countries.

11.1.3 Other Indicators of Complexity
I conclude that the total resource cost of collection is an often-useful, and probably the best shorthand, measure of tax complexity. I also note that it is not without flaws, one of which is that the compliance cost component, which is by far the bigger piece, must be estimated using imprecise survey methodologies. As is often the case, one can find more precisely measured indicators that are less meaningful. A popular example is the length, variously measured, of the tax code. Architecture reports that the Australian income tax law extended to 526 pages in 1975, six times its original length in 1936, but less than a tenth of what it would be in 2008 (i.e. 5,743 pages). Counting words and pages in the tax code is also a common pastime in the United States. There the number of words in the federal income tax code rose from 172,000 in 1955 to 1,286,000 in 2005, and the number of words in federal tax regulations increased from 547,000 to 5,778,000 over the same period.4 The problem with the number of words or pages as a measure of complexity is that, although more pages and more words in the tax code and tax regulations are

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3 This argument is elaborated on in Slemrod (1992).
4 These figures are found in <http://www.taxfoundation.org/research/show/1961.html> accessed on 7 April 2009.
symptomatic of more complexity, it is also true that more words may clarify otherwise uncertain areas of the tax law, and thus reduce complexity in some cases.

One might also consider the number of different taxes as an indicator of complexity, and Architecture notes that at all levels of government there are over 125 different taxes in Australia. One cause of a proliferation of different taxes is the structure of federalism and the subsequent assignment of revenue-raising powers; this issue is addressed elsewhere as part of the Australia's Future Tax System (AFTS) Review. The number of different taxes likely adds to the cost of collection, especially to the extent that there are fixed per-tax administrative and compliance costs. But the extra cost has not been quantified, nor is there a sense of whether the 125 figure is extraordinarily high or low compared to other countries. It is also worth noting which taxes Australia does not have. It does not have a wealth tax, nor an estate or inheritance tax. Most strikingly, it does not have a federal payroll tax (but does have a mandated superannuation guarantee); in the United States and most other countries, this is among the simplest of taxes.

A somewhat more promising indicator of tax complexity is the extent of use of professional tax assistance. In 2006 in Australia, 72 per cent of individuals used a tax agent to lodge their income tax return (Australian Tax Office 2008a, p. 11). Although comparable percentages for other countries are not widely available, I'd guess that this is one of the highest percentages anywhere. Indeed, before encountering this figure, I thought the United States must be the world 'leader' in this department, where the percentage in 2006 was 62, and has been steadily rising for decades. But note that making judgments on the basis of this percentage is tricky. For example, the costs of tax return preparation are deductible for all Australians, while six out of seven claim work expenses. The instructions that accompany the tax form provide a long list of cases where taxpayers can't calculate their tax liability. A fairly trivial indicator of tax complexity, but interesting to this outside observer in part because of its absence in the United States, is the 'notice of assessment' under which the individual taxpayer provides the information relevant for calculating tax liability but does not actually make the calculation; a notice of assessment is sent to the taxpayer later. The instructions that accompany the tax form provide a long list of cases where taxpayers can't calculate their tax liability.

11.2 Lessons from Optimal Tax Theory on How to Think about 'Optimal' Complexity

Collecting helpful and not-so-helpful measures of tax complexity will not provide answers to the policy questions at hand: whether, and which, aspects of the tax system are

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5 This fraction has declined gradually since 1999, when it peaked at 78 per cent. Of those who prepared their own return, over 60 per cent lodged using e-tax. Thus, about 90 per cent of returns were lodged electronically.

6 In the United Kingdom, 56 per cent of taxpayers subject to self-assessment, which is a minority of all taxpayers, make use of professional tax preparers, according to Lord Carter of Coles (2006, p. 9).

7 Stuntz (1995) illustrates this vividly with an example far from taxation—the use of contraception: ‘Just as a law banning the use of contraceptives would tend to encourage bedroom searches, so also would a ban on bedroom searches tend to discourage laws prohibiting contraceptives’.
excessively complex, and what might be done to address
the excessive complexity. For these questions, the theory
of optimal taxation provides some perspective, but alas falls
well short of practical guidance. In what follows I
summarise a few of the lessons of this theory for policy
regarding tax simplicity and complexity.

First, some background may be helpful. The optimal tax
framework for evaluating policy presumes that the best tax
system is the one that is best for citizens’ well-being (or
welfare), as they judge it. In describing this framework, it is
helpful to ignore distributional issues initially, and introduce
them later, allowing one to focus first on how to raise
revenue most efficiently (i.e. at minimum aggregate cost to
society). Presume that the tax authority has to raise a fixed
amount of revenue in order to fund public spending, and
do so using a combination of different tax instruments;
the task of the tax authority is then to choose which tax
instruments to use (and how much to use each of them) in
order to raise the required revenue at minimum cost to
society. This choice will depend on the efficiency cost of
each tax instrument, which describes how costly it is to
raise revenue using that instrument. Efficiency cost
incorporates all of the costs of taxation—the economist’s
standard measure of distortion costs plus the cost of
selection, consisting of administrative and compliance costs.

11.2.1 Equalise MECF across All Instruments

What characterises the optimal policy solution to this
problem? It turns out that an optimal policy will equalise
the ‘marginal efficiency cost of funds’ (henceforth MECF)
of any and all tax instruments that are employed. The MECF
of a particular tax instrument is defined as the marginal
(additional) cost to society of raising an additional dollar of
tax revenue using that tax instrument. In terms of collecting
revenue, a higher MECF means a less efficient tax
instrument. The equalise-MECF principle must characterise
an optimal policy because, if it doesn’t, the same revenue
can be raised at less social cost by reducing reliance on
high-MECF tax instruments and increasing reliance on low-
MECF instruments. For this analysis, a tax instrument refers
to any aspect of a tax system including, for example: the rate
tax applied to a particular base, the level of a standard
deduction, the penalty applied to detected evasion, or the
number of income tax audits performed.

The expression for the MECF for the ith tax instrument,
derived in Slemrod and Yitzhaki (1996), is equal to:
\[ MECF_i = \frac{1 + x_i + c_i}{1 - a_i} \]

where \( a_i \) and \( c_i \) are the marginal administrative and
compliance costs per dollar of revenue raised, and \( x_i \) is the
marginal distortion cost per dollar raised. Higher values of
\( x_i, a_i, \) or \( c_i \) each raise the MECF, because each increase the
social cost per dollar raised, either by directly using up
resources as in the case of \( a_i \) or \( c_i \) or, in the case of
distortion costs \( x_i \), by causing resources to be used in a
wasteful manner.

What implications does the equalise-MECF policy have
for the design and implementation of tax systems? The first
is that tax instruments with a high MECF should, all else
equal, have a less prominent place in the tax system than
those with a low MECF. This should be obvious from the fact
that an optimal policy raises revenue in the least costly way.
This may require some high-MECF tax instruments not to be
used at all. Alternatively, it may be possible to reduce the
MECF of these instruments by making compromises, such as
adjusting the tax base. One good example of this is the
exclusion of imputed rent from owner-occupied housing
from the income tax base, despite most economists agreeing
that, in the absence of collection cost considerations, it
should be included. The reason is, at least in part, that
imputed rent is too difficult (and therefore expensive, with
relatively high values of \( a_i \) and \( c_i \)) to measure.

It is also important to realise that the MECF of one tax
instrument may depend on the setting of other tax
instruments. For example, it seems likely that the probability
of being audited (one tax instrument) affects the amount
of evasion an individual would chance in response to an
increase in the income tax rate (another tax instrument). If
so, the audit probability tax instrument affects the MECF of
the income tax rate because evasion enters the formula for
the MECF. The implication of this is that the optimal setting
of one tax instrument cannot be determined without
reference to the settings of other tax instruments. It also
means that if one tax instrument is set sub-optimally, the
optimal settings for the other tax instruments will, in
general, not be the same as they are when all instruments
are set optimally. An important example concerns the
progressivity of the tax system. The optimal amount of
progressivity given a sub-optimal level of tax enforcement
can be below the globally (i.e. overall) optimal level of
progressivity: starting from the status quo, the best policy
response might be to increase progressivity and the extent
of enforcement. This is because more enforcement lowers
the MECF of raising the income tax rate, and therefore
makes it more attractive than otherwise.

One final, and critically important, lesson of this analysis
is that what matters for the evaluation of potential policy
changes are marginal administrative and compliance costs,
not total or average costs. This is relevant because much of
the empirical evidence about these costs concerns total
costs, and compelling evidence on the marginal cost arising
from particular policy initiatives is scarce.

Of course, tax policy is not only a question of how to
raise funds with minimal resource cost; in particular, the
distributional consequences of how a tax system is
implemented are also relevant. In the formulation of policy
any society implicitly makes tradeoffs across individuals,
a process which can be thought of as assigning a weight to
each individual’s welfare describing how important that

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8 The MECF analysis applies literally to incremental policy changes, but the intuition applies to non-incremental policy changes, as well.
9 The value of \( x_i \) is \( (x_i - MR_i)/MR_i \), where \( x_i \) is the change in revenue from an incremental change in instrument \( i \) if there were no behavioural responses, and \( MR_i \) is the change in revenue considering behavioural responses. The difference between \( x_i \) and \( MR_i \), the revenue “leakage” due to behavioural response is, without assumptions about externalities, a measure of the marginal efficiency, or distortion, cost from expanding tax system instrument \( i \).
welfare is from society's point of view. These weights may differ according to the level of welfare: the higher the weight on low-welfare individuals relative to high-welfare individuals, the more egalitarian is the social welfare function, and the more the society is willing to sacrifice aggregate welfare in favour of a more equal distribution of welfare across individuals.

The optimal policy allowing for distributional concerns involves adjusting the MECF, to reflect who bears the welfare gains and losses caused by a change in the tax instrument, as follows,

\[ MCF_i = DC_i \times MECF_i \]

where a higher value of \( DC_i \) (which stands for the 'distributional characteristic' of tax instrument \( i \)) indicates that welfare changes are concentrated among individuals with a higher marginal social welfare weight (generally lower-income individuals), reflecting the additional social cost of using a tax instrument with adverse distributional consequences (assuming a preference for equality, all else equal). The optimal policy now involves equating the MECF of each tax instrument rather than the MECF, and will—not surprisingly—involves lower reliance (than otherwise) on tax instruments whose burden is concentrated among the poor, and more on those whose burden is concentrated among the rich. Note, though, that systematic variation in the effect of any given tax system instrument between individuals at different points in the distribution can be approximately offset by changing the structure of tax rates (making income tax more progressive, for example). In contrast, variation in evasion and compliance costs between individuals at the same point in the distribution cannot be offset by changes in tax rates, raising the difficult issue of horizontal equity. As mentioned earlier, administrative costs have no distributional implications as, in effect, they can be spread across the whole population as desired.

11.2.2 Don't Maximise Net Revenue

One highly relevant lesson that follows from this framework concerns the appropriate amount of resources to devote to increasing the probability that evasion is detected, resulting in collection of the evaded tax, plus any penalty. This is relevant to the question at hand because the extent of enforcement is one important aspect of tax complexity. It turns out that one superficially intuitive rule—to increase the probability of detection until the increase in marginal revenue thus generated equals the marginal administrative cost, thus maximising net revenue collected—is incorrect. Thus it can never be optimal that \( \omega_i = 1 \), so that the marginal administrative cost of raising a dollar is itself one dollar. This is clear from the MECF formula: if \( \omega_i = 1 \), then the MECF of increasing administrative resources is infinite, which can never be part of an optimal policy. The problem with the intuitive rule is that, although the cost (e.g. of hiring more auditors to increase the evasion detection probability) is a true resource cost, the revenue brought in does not represent a net gain to the economy, but rather is a transfer from private (albeit non-compliant) citizens. The correct rule will imply a lower probability of detection than the one implied by the superficially intuitive rule.

This reasoning also makes clear that in general it is not optimal to expend resources to eradicate tax evasion, just as it is generally not optimal to station a police officer on every corner in an attempt to eliminate street crime. This is relevant for a discussion of ‘tax gap’ measures because the actual tax gap may be greater than or less than the optimal tax gap.

Another lesson is that, from one country's perspective, expending resources to crack down on cross-border income shifting is particularly attractive because any revenue collected does not come with an offsetting welfare loss to the taxpayer, as the taxpayer would have paid some tax to another tax authority. By ignoring the fiscal spill-overs, this policy is very attractive from one country's point of view, but not necessarily from a global welfare perspective.

11.2.3 Both Administrative and Compliance Costs Are Resource Costs but Administrative Costs Are Worse

Although only administrative costs enter government budgets, a citizen-centered tax system would, other things equal, minimise compliance costs as well. Reducing budget-visible administrative costs in a way that would greatly increase budget-invisible compliance costs is generally not optimal. Policy should not, though, be completely indifferent between the two categories of costs. Only administrative costs use revenue that is raised—with cost—from taxpayers, so these costs should be weighted relatively higher (by a weight equal to MECF, which is arguably between 1.2 and 1.4) than compliance costs. This is consistent with the expression for MECF; because \( c_i \) is added in the numerator and \( a_i \) is subtracted in the denominator, the key conceptual difference between compliance costs and administrative costs is explicit. As an example of this difference, note that a change in tax policy for which the marginal compliance cost equals the marginal revenue raised (i.e. \( c_i = 1 \)) might conceivably be optimal but, as discussed above, it would never be optimal to pursue a policy for which the marginal administrative cost equals or exceeds the marginal revenue collected (i.e. \( a_i \geq 1 \)) because such a policy imposes costs but raises no (or loses) net revenue.

11.2.4 Social Costs May Diverge from Private Costs

A central assumption of the optimal tax framework is that the private costs of taxation are equivalent to the social costs. In some cases, however, the private cost is clearly not identical to the social cost, and so the MECF formula must be appropriately adjusted. One example of this is when the behaviour of taxpayers causes some externality. An important case of this potential divergence concerns fines for tax evasion. A fine is viewed as a cost by the individual, but from society's point of view fines collected serve to reduce the amount of revenue that would otherwise have to be collected. This benefit is ignored by the individual,

\[ MCF_i = DC_i \times MECF_i \]

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Although only administrative costs enter government budgets, a citizen-centered tax system would, other things equal, minimise compliance costs as well. Reducing budget-visible administrative costs in a way that would greatly increase budget-invisible compliance costs is generally not optimal. Policy should not, though, be completely indifferent between the two categories of costs. Only administrative costs use revenue that is raised—with cost—from taxpayers, so these costs should be weighted relatively higher (by a weight equal to MECF, which is arguably between 1.2 and 1.4) than compliance costs. This is consistent with the expression for MECF; because \( c_i \) is added in the numerator and \( a_i \) is subtracted in the denominator, the key conceptual difference between compliance costs and administrative costs is explicit. As an example of this difference, note that a change in tax policy for which the marginal compliance cost equals the marginal revenue raised (i.e. \( c_i = 1 \)) might conceivably be optimal but, as discussed above, it would never be optimal to pursue a policy for which the marginal administrative cost equals or exceeds the marginal revenue collected (i.e. \( a_i \geq 1 \)) because such a policy imposes costs but raises no (or loses) net revenue.

11.2.4 Social Costs May Diverge from Private Costs

A central assumption of the optimal tax framework is that the private costs of taxation are equivalent to the social costs. In some cases, however, the private cost is clearly not identical to the social cost, and so the MECF formula must be appropriately adjusted. One example of this is when the behaviour of taxpayers causes some externality. An important case of this potential divergence concerns fines for tax evasion. A fine is viewed as a cost by the individual, but from society's point of view fines collected serve to reduce the amount of revenue that would otherwise have to be collected. This benefit is ignored by the individual,
hence the social cost is less than the private cost. Compared to adding inspectors, the increase in tax collections due to the increased deterrence of fines is achieved with no resource cost when financial penalties for detected evasion are increased. Note that this consideration by itself can make an increase in fines look like an attractive policy option. There are, though, reasons unrelated to efficiency cost minimisation that make it undesirable to increase fines for tax evasion without limit.

11.3 Justifiable Reasons for Complexity

So far I have discussed some broad indicators of the extent of tax complexity in Australia, and set out an analytical framework in which to evaluate tax policy. Next I return to the details of tax policy. In this section I discuss policy objectives that may lead to complexity.

11.3.1 Progressivity and Personalisation

In Australia and elsewhere, an important objective of the tax system is that an individual’s tax burden should be related (positively) to his level of well-being. Although this is sometimes referred to as the ability-to-pay principle, it generally follows from a welfarist, citizen-centered analysis that provided the marginal social value of an individual’s income is deemed to be higher, their level of well-being will be lower. The precise nature of the desired relationship between tax burden and level of well-being varies across countries, and is inevitably controversial within countries.

Certainly, though, the basic notion rules out apparently simple tax structures such as a head tax, that do not tie tax liability to one’s level of well-being. In terms of expressions (1) and (2) above, raising revenue with a simple (i.e. low \(a_i\) and \(c_i\), and therefore low \(MECF\)) tax instrument might not be optimal if that instrument has a particularly high value of \(DC\) because the burden falls disproportionately on low-income households.

Achieving some degree of connection between tax burden and level of well-being progressivity does not, however, necessarily require the use of inevitably more complex personal, or personalised, taxes (i.e. those that require obtaining, in a costly manner, information about individuals). For example, a uniform commodity tax would assign a tax burden that increases with permanent, or lifetime, income, and arguably is proportional to lifetime income. Differential commodity taxes can achieve more progressivity by taking advantage of differing income elasticities by levying a lower rate of tax on—-or providing a subsidy to—-goods, such as food, that are disproportionately consumed by lower-income households, and a higher rate on ‘luxury’ goods. In addition, a jurisdiction can levy differential taxes on sources of income that are on average received disproportionately by individuals with different levels of income, such as labour versus capital income. None of these taxes requires any information about the level of well-being of any particular taxpayer. But these measures are not well-targeted—some food is consumed by higher-income households, and some labour income is received by higher-income households—and most countries have decided that impersonal taxes are not adequate for delivering the level of desired tax burden progressivity.\(^{11}\)

In most countries, the major component of achieving progressivity is personalising tax liability to the circumstances of the individual recipient of the income, by applying a graduated structure of tax rates to some measure of income, generally an annual measure of income. Of course, measuring and monitoring the annual measure of personal income adds substantial complexity to a tax system. It requires information about the sum of income from all sources. In a system of joint filing (which Australia does not have), it requires information about all sources of income for both spouses.

In all countries, the measure of income used in income tax systems differs from the standard economist’s (Haig-Simons) definition of income, in part because of the difficulty of implementation of some of its features. Examples include: the exclusion from taxable income of the service flow from owner-occupied housing, depreciation allowances based on simple schedules rather than the actual decline in value of capital goods, and the taxation of capital gains upon realisation rather than accrual. These are examples where there is a tradeoff between simplicity and achieving a more precise measure of ability-to-pay.

There are many other policy choices where fine-tuning the measure of taxable income to ability-to-pay complicates the tax system. One case is the deductibility in the United States, but not in Australia, of extraordinary involuntary medical expenses. Another, more difficult, example is the deductibility, in many countries including the United States but not Australia, of mortgage interest payments.\(^{12}\) Of note is the fairly extensive system in Australia of subjecting to tax at the business level fringe benefits provided by employers to employees; this is the appropriate tax treatment according to the Haig-Simons definition of income, but undoubtedly causes non-trivial complexity. This system will reduce the inefficiency of over-reliance on compensation in the form of fringe benefits, but adds to collection costs.\(^{13}\) The US system of using a standard deduction that differs only by marital status, means that only about one-third of taxpayers itemise their deductions, which is a way to constrain complexity by accepting rough justice; Australia does not have a standard deduction.\(^{14}\)

11.3.2 Distinctions between Tax and Transfer

In many modern fiscal systems the intended net fiscal burden on an individual or family is not positive. Rather it is often

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\(^{11}\) Moreover, levying a differential tax rate on capital versus labour requires implementing costly-to-enforce distinctions between what is capital and what is labour.

\(^{12}\) It is a more difficult case because as long as the imputed service flow is not included in taxable income neither allowing interest deductibility nor disallowing it achieves the ‘ideal’ Haig-Simons measure of income emanating from owner-occupied housing.

\(^{13}\) In \(MECF\) language, starting from no taxation of fringe benefits, the policy instrument of subjecting them to tax may have a negative \(x_i\), but a relatively high \(a_i\) and \(c_i\).

\(^{14}\) See Slemrod and Yitzhaki (1994) for an analysis of the tradeoffs that arise in having a standard deduction.
negative or, in other words, the government intends to deliver a net transfer rather than impose a net burden to many, generally low income, individuals. Traditionally, these transfers were intended to be based on an individual's income, with more transfer going to those with lower income. This requires measuring income, the same as an income tax only with non-negative tax liabilities. In many countries these transfers are managed by an agency of government that is separate from the tax administration.

In recent decades, many income tax systems have incorporated some form of ‘earned income credit’ under which, over some range of lower incomes, the transfer increases as income increases, providing a marginal subsidy to working as opposed to an implicit tax. In this situation, measuring income entails somewhat different administrative issues—for instance, in the ‘phase-in’ range of income the incentive to the individual is to overstate income to qualify for a larger credit—rather than the traditional monitoring problem faced by the tax authority under which the individual’s incentive is to understate income subject tax.

Here one might distinguish between a ‘tax and transfer system’ with the words separated to emphasise that the two systems serve two distinct functions, and a ‘tax-and-transfer system’ where the hyphenation stresses their functional connection, including that there is much in the tax system designed to transfer money to particular constituencies.

In Australia, as often elsewhere, the criteria for assessing positive tax liability differs from the criteria for assessing transfers; in other words, the measurement of a taxpayer’s ‘ability-to-pay’ is not identical to the measurement of whether the taxpayer is ‘deserving-to-receive’. Clearly transfers are not treated simply as negative taxes. This complicates the tax-and-transfer system, as it requires the calculation and monitoring of (at least) two parallel measures of well-being, often, as discussed below in the context of churning, for the same taxpayer unit.

This is certainly true in the Australian system, and arguably more than in most other countries. In Australia, means testing for transfers operates on a family or individual basis, while the unit of assessment under the income tax system is generally the individual. A range of targeted, means-tested income support payments made on a fortnightly basis are delivered through the income tax system. Eligibility for pensions and allowances depends on ‘ordinary’ income, while family assistance depends on current-year ‘adjusted taxable income’. Taxable income permits a range of deductions, while ordinary income used for income support payments is a far more comprehensive definition of income. The differences between the tax system’s measure of well-being and the transfer system’s measure include the financial basis of assessment (income versus income and assets), the income unit (individual versus family), and the period of assessment (annual versus fortnightly). The existence of parallel measures of well-being adds complexity, perhaps considerable complexity, to the fiscal interaction between people and the government.

When gross transfers go to the same people that are subject to tax liability, known in Australia as ‘churning’, the potential for excessive administrative and compliance costs arises, especially when the basis for assessing eligibility, and the amount of tax and transfer varies across the systems. Whiteford (2005) and Harding Lloyd and Warren (2006) have argued that, among OECD countries, Australia has a relatively small churning problem. Be that as it may, it remains true that minimising churning, other things equal, reduces the cost of delivering a given tax-and-transfer distribution pattern.

11.3.3 Non-Revenue, Non-Progressivity Objectives

Complexity almost inevitably increases to the extent that the income tax system is used to subsidise certain behaviours and reward certain constituencies. For example, subsidising charitable donations to qualifying organisations via a deduction for charitable giving requires implementing a process for claiming and monitoring these donations. The justification for such a deduction must come from outside the framework presented here because it increases the cost of collection and at the same time reduces revenue; this would presumably be an externality argument, such that charity provides social benefits beyond those accruing to the giver.

Many, but certainly not all, of the non-revenue, non-progressivity objectives are reflected in tax expenditures. The 2008 Tax Expenditures Statement issued by the Australian Treasury calculates that about 300 separate tax expenditures in 2007–08 amounted to $73.7 billion, or 7.1 per cent of GDP. In comparison, the US tax expenditure budget for fiscal year 2006 was US$847 billion, or about 6.5 per cent of GDP. Note, though, that several revenue-costly deductions from the US income tax, for example state and local taxes and mortgage interest payments, are not available in the Australian income tax system.

11.3.4 Effectiveness of Enforcement

As already mentioned, one reason that the cost of collection is not a definitive measure of the effectiveness of the tax authority is that it does not take into account the extent to which the tax authority’s enforcement objectives are achieved. After all, a sloppily administered and enforced tax system can be run in a less costly manner than a well-administered and well-enforced system. The difference in ‘output’ is, though, difficult to measure. One output is a reduction in the size, and perhaps a change in the nature, of noncompliance. Although, in a consequentialist framework reducing the ‘tax gap’ is not a distinct objective, nonetheless tax noncompliance can reduce the aggregate welfare of citizens in a number of ways. It imposes efficiency costs. The most obvious costs are the resources taxpayers expend to implement and camouflage noncompliance, and the resources the tax authority expends to address it. In addition, it provides a socially inefficient incentive to engage in those activities for which it is relatively easy to evade taxes. For example, because the income from house painting can be done on a cash basis and is therefore harder for the tax authority to detect, this occupation is more attractive than otherwise. Although a supply of eager and cheap house painters undoubtedly is greeted warmly by prospective buyers of that service, the work of the extra people drawn to house painting, or any activity that facilitates tax evasion, would have higher value...
in some alternative occupation. The same argument applies to self-employment generally, as the enhanced opportunity for noncompliance inefficiently attracts people who would otherwise be employees. The opportunity for noncompliance can distort resource allocation in a variety of other ways, such as causing companies that otherwise would not find it attractive to set up a financial subsidiary, or set up operations in a tax haven, to facilitate or camouflage abusive avoidance or evasion. Thus, the resource costs of more enforcement to some extent reduce the distortion costs of the tax system.

Complexity may itself induce noncompliance, although if the mechanism is simple misunderstanding of the rules, the mistakes should be approximately symmetric on both sides of ‘actual’ taxable income, which would undermine horizontal equity but not have a first-order effect on revenue collections. To the extent that complexity requires more administrative resources, it stretches a given tax authority budget, which would have implications for aggregate noncompliance.

11.3.5 Incoherence of the Income Tax

Another source of complexity for any income tax is the incoherence of the income concept itself. This is not a major issue for most taxpayers who receive mostly labour income, but does matter a lot for those who receive capital income. The incoherence inescapably leads to tax shelters, transactional complexity, and complex rules that try to limit the tax arbitrage gains from exploiting the incoherence. This issue is important in the choice between an income tax and a consumption tax, an issue treated elsewhere in the AFTS Review.

11.4 Tax Process Features that Reduce the Cost of Collection

11.4.1 Information Reporting

Information reporting is a central element of modern tax systems’ implementation because it can provide the tax authority with transaction-based information from an arm’s-length party with little or no incentive to falsify the data. Thus, a working system of information reporting discourages noncompliance by increasing the risk of detection for a given amount of tax authority resources; in terms of the MECF analysis, it reduces the term \( a \).

According to OECD (2004), all OECD countries require information reporting on wages and salaries. In all the OECD countries (except Greece) that do not have withholding for dividends, they have information reporting. Every country (except Luxembourg) that does not have withholding on interest has information reporting. According to OECD (2004, Table 12), the scope of information reporting in Australia is noticeably less broad than in comparable countries. Unlike the United States and United Kingdom, in Australia information reporting does not extend to rents, independent personal services, or sales of shares.

11.4.2 Remittance Responsibility and Withholding

Withholding refers to the remittance of tax by someone other than the person who by statute owes the tax. It facilitates administration by allowing the tax authority to concentrate its collection resources on a smaller number of remitters that for other reasons have in place relatively sophisticated financial systems. From the government’s perspective, withholding shifts at least some of the problem of remittance noncompliance from many taxpayers to (ideally) fewer withholding agents. If the agent withholds tax but does not remit it, the government may recover the tax from the agent.

The withholding agents should be fewer in number than the taxpayers on whose behalf they are remitting the tax. In addition, only those who have the necessary accounting and bookkeeping capabilities and are otherwise able to carry out the withholding should be designated as agents. In order to withhold the correct amount of tax from a single payment, a payer either must know the recipient’s total taxable income for the year and how much of the payment is net income or the withholding must be at a simple, set rate. In an employment situation, there is a continuing relationship between the employer and employee, and the employer usually knows the annual remuneration of the employee. A common source of tension is the conditions under which an employer is required to withhold (and perform other duties) for someone who works for the company—is the worker an employee or an independent contractor?

The Australian system follows this model. First of all, there is extensive withholding; in 2006–07 of $113.9 billion net income tax payable, $109.3 billion was withheld. More than 800,000 employers withheld and remitted tax on behalf of their employees. Second, the system relies on large businesses. Small businesses (defined as those with less than $25,000 of sales), which make up 65.5 per cent of all business entities, withhold only 5.2 per cent of the total income tax. Medium-size businesses (with sales greater than $25,000 but less than $1 million) make up 32.9 per cent of entities, but withhold just 27 per cent of tax. Large businesses, comprising 1.6 per cent of entities, withhold 67.8 per cent of tax. Remittance of specific excise taxes follows the same pattern. For example, according to Architecture (p. 278), there are fewer than ten payers of tobacco excise and around one hundred payers of fuel excise.

Employer withholding for wages and salaries is required in twenty-eight of thirty OECD countries, all except France and Switzerland.15 The use of withholding on other sources of income varies across the OECD; twenty-two countries have withholding on dividends and twenty-one have withholding on interest, including the United Kingdom but not the United States, which has it only if the taxpayer does not provide an identification number to the payer. Twelve of the thirty OECD countries have withholding on at least some independent personal services, and eleven have withholding on royalties and patents. According to OECD

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15 In France, there is withholding for social contributions but not for personal income tax. In Switzerland, aliens in possession of a work permit are subject to withholding.
(2004, Table 11), there is no withholding in Australia on dividends and interest, as in the United States.

Over-withholding may be essential for the successful administration of a self-assessment system because the prospect of a tax refund induces many taxpayers to file returns. This model is followed in many countries, including Australia and the United States, and leads to taxpayers generally submitting their tax returns quickly. Withholding assures that some tax is remitted in regard to the employees’ income, even if they fail to file returns or otherwise disregard their tax obligations. In addition, the tax authority needs to deal with fewer tax-remitting agents, and so can more easily police remittance, helping to reduce administration costs for a given level of compliance.

Withholding agents bear compliance costs, which are generally deductible in computing taxable income. Some countries provide explicit compensation to withholding agents or allow a time lag between the trigger for tax liability and when the remittance is due. Although these costs should be allowed as deductions in the same way as other costs of doing business, there is no good reason to provide compensation for compliance costs incurred. I return to this issue below in the discussion of the role of small businesses in the tax system.

11.4.3 The Role of Business

The discussion of information reports and withholding highlights the critical role of business in the operation of modern tax systems. The report of the influential UK Meade Committee (1978, p. 20) noted this, and remarked that in many cases the cheapest method of tax collection makes use of private individuals or businesses as ‘agents for the collection of tax’. It argued that this might lead to an insistence that the process be simple, and that ‘to leave to competing firms the task of tax collection may induce a healthy search for the most efficient methods of carrying out the operation’. The impetus behind the central role of business in tax remittance has been elegantly stated in Bird (2002): ‘The key to effective taxation is information, and the key to information in the modern economy is the corporation. The corporation is thus the modern fiscal state’s equivalent of the customs barrier at the border’. Collecting taxes from businesses makes use of the economy of scale of the tax authority dealing with a smaller number of larger units, many of which for other purposes have already developed sophisticated systems of record-keeping and accounting.

The central role of businesses in the tax remittance process is blurred by the loose language used to categorise which taxes are ‘business taxes’. The public positions of business associations often reveal that they are often adamant about cutting—or, certainly, not increasing—‘business taxes’. Clarifying the precise meaning of a ‘business tax’, and distinguishing among remitting taxes to the government, having a statutory liability to pay tax, and bearing the burden of a tax is especially important to an informed discussion of tax policy.

One measure of the central role of business in the US tax system is provided by Christensen, Cline and Neubig (2001), who calculated that in 1999 at all levels of government, businesses ‘paid, collected, and remitted’ 83.8 per cent of total taxes. Of the 83.8 per cent, Christensen, Cline and Neubig (2001) label 31.3 per cent as ‘tax liability of business’, 8.1 per cent as the ‘business as tax collector’, and 44.4 per cent as ‘business as withholding agent’.16 Strikingly, Shaw, Slemrod and Whiting (forthcoming) find that the percentage of all taxes remitted by business in the United Kingdom is also 84. I know of no similar calculation for Australia, but I suspect it is similarly high.

11.4.4 Size of Business

Like many countries, the Australian tax system features many special provisions/concessions for small businesses, including for a time until recently a simplified tax base for businesses below a certain size. A detailed examination of the justification for each of these is beyond the scope of this chapter, but as with other complexity issues any simplification initiative has other effects. In brief, though, collection cost considerations aside such measures are justified if and only if they correct a market failure, and are not justified as a means to offset real economic disadvantages of small-sized business operations. Intervening in the latter case will cause an inefficient use of resources. In particular, if there are real fixed costs to running a business, policy should not offset these costs. This caveat applies to providing compliance cost rebates to businesses.

If collecting taxes from small businesses imposes a higher social cost per dollar raised, perhaps they should be exempt from taxation, but these costs should not be subsidised for those businesses that remain in the system. This is contrary to the suggestion in Architecture (Box 8-3, p. 259) that small business tax concessions might be justified by the inherent disadvantages of being small ‘such as regressivity of compliance costs’.

It is easier to tax a transaction that involves a large company, which may well need the documentation for its own purposes, than to tax a small business, which may not require the same level of documentation. The large company will probably have systems in place which can more easily generate necessary tax information; for example, the payroll department will not usually see generating end-of-year tax returns as a major burden. For the small business, it can mean another evening on the kitchen table. Finally, market transactions establish arm’s-length prices, which greatly facilitate valuing the transaction.

All in all, there are certainly important fixed per-business cost elements in the relationships between businesses and the tax authority. Figuring out the tax obligations, as well as fulfilling them, has elements of fixed cost. And yes, these costs are imposed by the tax authority on business. Because of these fixed-cost elements, an optimal tax system might exempt (or offer special simplified regimes) to small businesses. The potential revenue to be collected may not be enough to offset the real per-firm resource cost of having to deal with it.17 There is a cost to such policies,
through, due to the incentive such a regime provides to firms to reduce (or maintain) their size below the otherwise most productive size in order to qualify for the exempt, or simplified system. The saving in administrative and compliance costs must be weighed against the production inefficiency caused. This tradeoff applies to the special tax regimes in the Australian income tax as well as to the tax-free thresholds that exempt a significant proportion of businesses and employees from the payroll tax.

11.4.5 Other Simplifying Tax System Aspects

The notion of exempting—or providing a special regime for—taxpayers with a relatively small potential tax liability can be applied with some modifications to the individual income tax. After all, most all countries’ individual income tax systems feature a filing threshold, which affects the progressivity of the tax burden but also exempts individuals or households with a small potential tax burden from having to deal with the tax authority. Australia is no exception here, having both a filing threshold and a short tax return for individuals. The upshot is that, in a population of 21 million, 11.8 million individuals lodged returns. OECD (2004, Table 30) reports that in Australia the ratio of registered taxpayers as a percentage of the labour force is 167.1; this compares to just 96.9 for the United Kingdom, and 149.7 for the United States; only three countries had higher percentages. One likely reason for this is the extensive use in Australia of the income tax system to deliver transfers; once this is widespread, the collection cost advantages of filing thresholds go away because low-income households must interact with the tax authority to establish and receive the transfers.

Australia is near the top among OECD countries in electronic filing take-up rates. For the individual income tax, the rate in 2006 was 90 per cent in Australia, compared to (in 2004) 17 per cent in the United Kingdom, and 47 per cent in the United States. For the corporate income tax, it was 88 per cent in Australia, compared to just 1 per cent in the United Kingdom and the United States. Not only is e-filing prevalent, but tax agents can access e-filing information via online reports, and pre-filling is also available online to people who use e-tax to lodge their returns; over 1 million of 1.9 million people who used e-tax chose to pre-fill them. The information available for pre-filling is increasing over time. The 2007 returns added bank interest and managed fund information from twenty-four financial institutions, and it is promised that in tax year 2008 returns will include even more information. Electronic transmittal of information is also used to improve enforcement. For example, when people report dividend income or rental income and do not report same or a capital gain the next year, they automatically get a message about possible capital gains consequences. The tax authority matches tax return data against information from government licensing bodies on luxury cars and boats. In all of these areas, Australia is a leader in improving the cost-effectiveness of the tax system.

11.5 Political Origins and Consequences of Tax Complexity

In Australia and other democracies, the tax system is the outcome of a political process. The structure of the political process is important in the area of tax complexity for at least two reasons. First, it may help to explain the origin of tax complexity. Second, it may illuminate the constraints in enacting tax-simplifying legislation. As I am even less an expert on the Australian political system than I am on the Australian tax system, I will approach this subject with a high level of generality, leaving it to the local experts to fill in the institutional detail that matters.

11.5.1 The Political Origins of Tax Complexity

Hettich and Winer (1999) argue that complex tax structures emerge as a by-product of the struggle for political office, in the course of which political parties are forced to propose and implement policies that discriminate or distinguish as carefully as possible among heterogeneous voters. In Hettich and Winer’s view, it is administrative costs that limit the desire of governments to discriminate fully among taxpayers. Indeed, in their book about the politics of taxation they say, provocatively, that ‘it is possible to have a flat [i.e. a simple] tax or to have democracy, but not both.’

Tax complexity may appeal to incumbent politicians if cognitive limitations are such that citizen/voters tend to underestimate a given tax burden if it is obfuscated. The laboratory experiments of Baron and McCaffery (2003) provide some evidence that this strategy can be successful, as they suggest that people tend to underestimate the total tax burden when it is spread among multiple taxes. This would help explain, but not help justify, the large number of different taxes in Australia and elsewhere.

The federal nature of the Australian political system adds an extra dimension to this issue. The assignment of tax instruments and revenues to different levels of government has arisen from a series of court decisions that considered the appropriate level of autonomy of the states and local governments, among other issues, but probably did not weigh heavily the efficiency of the overall tax collection system. Be that as it may, there is no question that lack of harmonisation across states increases the cost of multi-state businesses, in part because compliance costs can be affected by the number of agencies an individual has to deal with, especially when the tax bases and rules are not harmonised. Notably and importantly, states have been working to harmonise payroll tax arrangements (other than rates or exemption thresholds). Arguably, there is a role for the federal government to facilitate, and perhaps even subsidise, harmonisation of tax rules among the states and between the states and the federal government. Essentially such a subsidy would induce states to internalise the external benefits of a more harmonised and therefore potentially less complex and costly set of tax institutions.

18 Hettich and Winer (1999, p. 92).
19 McCaffery (1993) and Krishna and Slemrod (2003) discuss other examples of how income tax structures may take advantage of cognitive biases to reduce the perceived burden of taxation.
11.5.2 The Political Consequences of Tax Complexity

The tax system may affect, through the political process, the size and form of government activities that the tax system has to fund. If taxes are ‘hidden’, then taxpayer/voters may underestimate the true cost of government programs, and therefore vote for politicians and parties promising more such services. In general, the tax system may affect how voters perceive the cost of government, and thus the perceived marginal cost of expanding government activities. Voters are affected in their role as citizens and as earners of income. An important policy tension is that the operation and implementation of collection-cost-minimising tax systems generally does not involve citizens in their role as consumers, and may not involve them as earners in the case of final or exact withholding. But this may reduce the visibility of the tax burden.

The role of technology in this issue is worth pondering. Hettich and Winer (1999, p. 92) argue that ‘declines in the cost of administering a tax system, such as may occur with advances in computer technology, can be expected to lead to further complexity’. Indeed, it seems technologically feasible that the Australian income tax system (and that of other countries) could operate like the kind of frequent-flyer program that most airlines have now, where at any moment the customer can log on to the internet and get a statement on the status of their account, not only the net credits earned but also the transactions that affected the net amount. With the Australian income tax, as with a frequent-flyer program, a taxpayer could get debits for earning income and credits for a whole host of things, such as giving money to a charity, sending a child to university, depositing money into a special savings account, and so on.

The tax system process can affect the transparency of the fiscal relationship between individuals and the government. For example, consider the proliferation of software-prepared returns. A taxpayer using software can deal with any and all of the complications of tax liability calculations without having any sense of why and how the supplied information affects tax liability; in this way the system becomes less transparent, and—in my opinion—this kind of opaqueness is not good for democracy. If the taxpayer does not understand what is going on—if the workings of the system are not transparent—they are not in a position to correct, or at least query, apparent errors.

Thus, an argument against some reforms that reduce compliance costs is that the majority of the population will become less well informed about the tax-and-transfer system (because someone else does their tax calculations for them), so that they are less in a position to criticise the government in the face of poor tax-and-transfer policy. Undoubtedly, the growing complexity of the Australian income tax has contributed to the growing use of tax software, and the ubiquity of software reduces the marginal cost of complicating the tax system further. The same issue applies to the use of business-based taxes, including both a value-added tax and exact withholding system. Many conservatives in the United States maintain that not involving individuals in the tax remittance process by having them literally write cheques to the government reduces the perceived cost of government activity below its true cost, and thus leads to a bigger government than citizens would choose if confronted with its true cost.20

11.6 Policy Process Procedures

Australia is one of a number of countries that have instigated formal mechanisms for making compliance costs more visible during the policy process. The Netherlands has required qualitative compliance cost assessments (CCAs) for changes in tax legislation since 1985. For over two decades, the United Kingdom has required its officials to produce CCAs for all regulations affecting business, including tax regulations. In the United States, the Internal Revenue Service Restructuring and Reform Act of 1998 requires a ‘tax complexity analysis’ for any change in the tax law being considered by Congress that has widespread applicability to individuals or small businesses. This analysis includes an estimate of the cost to taxpayers of complying with the provision and a statement about whether taxpayers would be required to keep additional records. Although the objective—to induce compliance cost considerations early on in the policy process—is certainly well-motivated, I am unaware of any evidence that implementing these kinds of procedures has a material effect on the complexity, or compliance costs, of policy. Architecture (p. 180) reports that in 2006 the Taskforce on Reducing Regulatory Burdens on Business reported that the requirements had often been circumvented or treated as an afterthought.

Another policy process possibility is the use of complexity-related performance indicators or targets for the tax authority. As with CCAs, the objective of focusing attention on complexity issues is laudable. Some of the potential problems with concrete performance indicators and targets are common to their use in all organisations, some are common to their use in all government organisations, and some are particular to a tax authority. Of course, in a private business the ultimate objective is usually relatively unambiguous—to maximise the present value of profits or, equivalently, the value of the going concern. In a government department the overall objective is less tangible. In principle, it should make decisions to enhance the well-being of the citizens, but that is not plausibly measurable. Nevertheless, there are subsidiary objectives that are well defined. For example, if a given number of cheques can be processed with the same degree of accuracy using less employee-hours, then that is a desirable outcome. In other words, cost minimisation for a well-defined output should be pursued regardless of whether the ultimate objective is profits or social welfare.

20 Indeed, this reason was cited by the report of the 2005 President’s Advisory Panel on Federal Tax Reform as a reason why they did not recommend a VAT.

Some conservative legislators in the United States have introduced into Congress a Bill entitled the ‘Cost of Government Awareness Act’, which would eliminate withholding and instead require individuals to pay income taxes in monthly instalments. Whatever its benefits regarding changing the visibility of the tax burden, this would certainly increase the cost of collection.
One factor that is different for the tax authority compared to most other government agencies is the availability of something that has the superficial appearance of a quantitative output measure—revenue collected. The apparent availability of a measure of output denominated in dollars can lead to serious inefficiency (i.e. misallocation of resources) when applied to the question of the amount of resources the tax authority should be utilising for enforcement. As already discussed, the maximisation of revenue net of resource expenditures is an incorrect objective because revenue collected is a transfer rather than a resource gain, while the resources used to increase revenue—the personnel, computers, and other inputs to the process—are in fact real resource costs.

Performance targets ask that many indicators improve, but don’t give a good sense of tradeoffs/priorities. It is not uncommon for government to resist acknowledging tradeoffs. One potential pitfall of this is that the targets are not internally consistent. To illustrate this concern, consider a stylised example that focuses on efficiency. Recall from earlier that, ignoring distribution, it is optimal to increase reliance on tax instruments that have a low MECF. Now compare two policies that each use $1 of real resources. Policy A increases revenue by $20, while Policy B increases revenue by only $5. Then the value of a (marginal administrative cost per dollar raised) is 0.05 for Policy A, and is 0.20 for Policy B. If both x (marginal excess burden per dollar) and c (marginal compliance cost per dollar) were equal to zero, then the MECF is 1.05 and 1.25, respectively. If these were the two enforcement policy levers, A should be expanded, and B contracted.

There are some problems, though, with always choosing the policy with the lowest marginal administrative cost ratio. First of all, the calculation of the marginal administrative cost should include not only the direct revenue obtained from extra revenue and penalties, but also any additional revenue that comes in because the policy deters noncompliance. If extra revenue and penalties, but also any additional revenue should include not only the direct revenue obtained from the policy, then the ranking of policies will be unchanged (ignoring x and c, that is). But there is no reason to expect that this will be true. Another problem with evaluating policies on the basis of their marginal administrative cost ratios is that this ignores the compliance costs induced. But if the ratio of compliance to administrative costs varies across policies, then the ranking by their administrative cost will lead to misallocation. This is simply because assuming that the tax authority’s resources (i.e. its budget) are fixed does not mean that the policy’s use of society’s real resources is fixed, as the compliance costs may vary. Thus we can use the MECF framework to evaluate policies that substitute administrative for compliance costs, without changing revenue collected.

### 11.7 Summing Up

There’s no secret to achieving a radically simpler tax system. In an individual-based tax system, levy tax liability per person (or adult), and no other personal characteristic or decision. In simple terms, levy a head tax. What’s more, enforce the head tax causally, infrequently assessing whether the head tax liability has been remitted, and promising extremely large penalties on noncompliers, so large that no risk-averse citizen would be tempted to evade. That no modern country has adopted such a tax system suggests that citizens seek something more than the absolutely minimum cost of collection. They seek equity in assigning the burden of government and perhaps in assigning net benefits. Thus we are in the real world of tradeoffs where the simplest tax system is not the best. In this world, some complexity can be avoided by settling for rough justice in the assignment of tax burden.

Simplicity can be gained by relying on a business-based tax system such as one that levies tax proportional to value added, minimal exceptions allowed, and where no information on individuals is needed. This would levy a tax burden that is approximately proportional to individuals’ lifetime income. Even that distribution of burden would be unacceptable to many, probably most, citizens due to insufficient progressivity, so that a uniform value-added tax alone would not be appealing.

Starting from the Australian tax status quo any policy change aimed at simplification will also have efficiency, equity, and often political implications. Nevertheless, to an outsider there are several promising avenues toward simplicity. One is to coordinate the measure of well-being used to measure ability-to-pay for tax purposes and deserving-to-receive for transfer purposes. This would be beneficial in reducing the amount of tax-welfare churning. A second is to unify or harmonise across multiple transfers. A third is to harmonise tax policy across states and between the federal government and the states. Fourth and fifth are to be more willing to accept rough justice and restrict the number of objectives leading to tax expenditures.

To an outsider interested in a simpler, citizen-centered tax system there are many positive aspects of the Australian tax system. E-filing is widespread and the system has gradually allowed taxpayers to bring in relevant information from third parties, leading to a kind of pre-filing of returns. There are simplified returns for some individuals and businesses. The tax authority seems to be quite comfortable with recognising the compliance costs of taxation; indeed, in the latest (2006–07) issue of Taxation Statistics, there’s a new chapter on cost of taxation. Recently there was a systematic attempt to improve the readability of the tax code. There is a sense that the tax authority aspires to a relationship with taxpayers characterised by collaboration, trust, and openness.

Because the costs imposed by tax-and-transfer complexity can be large, the policy choices along this dimension are important. Economic analysis offers only limited guidance about how a country ought to make policy in the face of the tradeoffs this chapter highlights. It can, though, clarify the nature of the tradeoffs and expose imprecise reasoning and thereby inform future policy.

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