AGENCY COSTS AND TAX COMPLIANCE — SHOULD WE CARE ABOUT ACCOUNTANTS?

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Administration, Compliance and Governability Program
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ABSTRACT

In this paper we argue that the costs of compliance born by taxpayers are important for two reasons. First they constitute a deadweight loss which should not be ignored when assessing the costs of a tax system. Second they may interact with other features of the tax system and thereby affect the degree of compliance. This argument is discussed in relation to the existing theoretical literature on tax compliance. Compliance costs are largely hidden, except for the costs of hiring tax agents. We report some results of a survey of tax agents in the UK which suggests that they find that they cannot pass on all the recent increases in costs of compliance to their customers. The implications of this finding are discussed.

Agency Costs and Tax Compliance — Should We Care about Accountants?

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1. Introduction

This paper has two purposes and it is preliminary in relation to both of them. The first purpose is to present some results from a survey of compliance costs as perceived by tax accountants in the UK. Before presenting some survey results, we give an argument as to why compliance costs are worth studying and give an outline of how we think the costs of compliance should fit in to a general framework of a tax system. This will incorporate the role of tax accountants in the relationship between the tax-payer and the tax authorities. The rest of this introduction gives a brief outline of the design of this survey. Since many of the concerns of the survey reflect the peculiarities of the UK tax system we also give a brief description of some of these.

In the second half of 1992 Sue Green conducted a survey of accountants who work in the tax area. The purpose of the survey was to discover which features of the current UK tax system tax accountants believe have a relatively high impact on compliance costs. It also asked questions about the impact of recent or suggested reforms of the tax system and about accountants' relations with the bureaucrats who administer the tax system. The survey was confined to the direct tax system.

Respondents received by mail a booklet of questions of over 60 pages. Approximately 5,800 booklets were mailed to the entire membership of the tax faculty of the Institute of Chartered Accountants. Members of the tax faculty pay a subscription and receive information about tax matters, so that it is reasonable to assume that the members are to some extent tax specialists.

The survey's response rate was about 24 per cent (just under 1,400) which was felt to be quite satisfactory given the time involved in completing

the questionnaire. It turns out that the sample of respondents was biased towards more senior members of the faculty (over 70 per cent were at partner or equivalent level), and over two thirds had experience of tax for ten years of more. The sample selection procedure was also biased in favour of accountants who worked in accounting practices (88 per cent) as opposed to industry. These biases were considered an advantage in some respects as they suggest that the results of the survey will be taken more seriously by the Inland Revenue on the grounds that the respondents "know what they are talking about".

It should be stressed that the survey was financed by the faculty itself. It was conducted in response to the many members of the faculty who were concerned at the increasing complexity of tax regulations and, as a result, the increasing cost of compliance. This may seem surprising in that tax accountants can be regarded as making money out of the complexity of the tax system and the higher compliance costs they induce. We will return to this question below.

The system of direct taxation in the UK is comparatively old. It was first started during the Napoleonic wars and at least one important feature of the original tax system remains in place today. This is the system of schedules by which income from different sources — income from employment, self-employed income, rent, interest etc. are taxed under quite different rules by different offices of the Inland Revenue. Offsets against one kind of income are not allowed against other kinds of income etc.

There is as yet no self assessment, or (officially at least) random auditing in the direct tax system, although it is planned to introduce self assessment for company taxation in the next few years. The Inland Revenue makes an assessment, and then the tax-payer can attempt to reduce it. The effects of introducing self assessment on compliance costs is one of the principal themes of the questionnaire but is not covered in this paper.

The Inland Revenue is, like most organs of the British government a powerful (it has a great deal of discretion on how tax rules are applied) and secretive bureaucracy. Most tax accountants have dealt with it throughout their professional lives. However another bureaucracy has also become important recently in the raising of direct taxation. This is the Department of Social Security (DSS) which raises a wage tax as a form of social insurance called the National Insurance Contribution (NIC). This tax was introduced in the first decade of this century and was intended as a contribution to social insurance. This contribution element has long since

been abandoned — social security is financed as a pay as you go scheme. The NIC remains.

Until recently the marginal rate for this tax was zero for wage incomes above a certain threshold. This threshold was close to mean income and so many tax accountants found that they did not have to deal with NIC. This has now changed and the tax is levied at a constant marginal rate on all income from employment. This change has meant that tax accountants have had to deal with a new bureaucracy with quite different rules and traditions. Again the tax regulations (write offs, deferrals etc) for NIC are quite different from those allowed for the various categories of income tax.

The chief reason why these two similar taxes remain in place appears to be a mixture of bureaucratic inertia and the fact that politicians have made the "basic rate" of income tax into a symbol of their success in reducing taxes. If the two taxes were amalgamated while revenue stayed constant, the "basic rate" would have to increase by about 10 percentage points. It is perhaps worth making one final point about these two different bureaucracies. As far as the survey of tax compliance costs is concerned the Inland Revenue, to our surprise, welcomed and supported the survey. The DSS had reservations about the survey. Given a straight-forward interpretation of the results (see below), these reservations were well founded.

It turns out that these particular historical features of the direct tax system in the UK make an important and obvious contribution to the complexity of the system and thereby to the costs of compliance. A last peculiarity of the UK tax system which is relevant to this paper is the attitude of the tax authorities towards avoidance. Traditionally avoidance has been allowed by the authorities although various legislative changes are often made to decrease it. Tax accountants therefore spend much of their time in tax planning and creating new avoidance schemes. Britain has yet to go through the kind of public process which appears to have occurred in Australia in the seventies and eighties (see Levi 1988), whereby widespread tax avoidance becomes condemned in a public arena. Case law on this matter appears to be changing but no general legal power to prevent avoidance is available to the authorities. Historical anomalies which are partly perpetuated by bureaucratic self-interest and political myopia, and the tolerance of tax avoidance are not the only reasons why a tax system becomes complex and why compliance costs can be important. These issues will be taken up in the next three sections. The role of tax accountants is

discussed in section 5, Section 6 discusses in more detail the relationship between complexity and compliance costs and reviews some time-series evidence on the possible increase in complexity of UK tax regulations. Section 7 concludes the paper.

2. The importance of compliance costs

The economic analysis of tax, while it pays a great deal of attention to compliance and to evasion, generally ignores the costs of compliance. This paper argues that this is mistaken and that to understand the way in which tax systems behave, it is necessary to take tax-payer compliance costs into account. Tax systems should be analysed where possible as a set of interacting relationships between tax-payers and the government (including government policy towards expenditure as well as tax) and between tax payers themselves. Accountants (tax agents) may also play an important role in the behaviour of both the authorities and of tax-payers.

The partial equilibrium analysis of most formal economic models of tax evasion generally fail to take into account these relationships. As a result they produce unconvincing results. More general equilibrium models do better in this regard and provide some insight into the way in which tax systems can behave. In addition, they also suggest that tax systems may have multiple equilibria and unstable disequilibrium properties. Formal economic models also fail to take into account the complexity of most tax systems. Tax schedules are still regarded as linear and debates about tax reform (at least in the UK) are often couched in terms of reform of the rate structure. In fact tax systems contain numerous rules about deferments, write offs, allowances etc which are hard to capture theoretically but which play an important part in the creation of compliance costs.[1]

Compliance costs have been ignored in the past by economists for a number of reasons. If the main components of compliance costs are fixed, even if compliance costs are large in total, they will be small at the margin, which is the important consideration from the point of view of most economic theory. The fixed cost element in compliance will affect tax payers only at a boundary point, for example, the margin between registration for a tax and non-registration. In the UK compliance costs may

[1] An exception to this is the literature in the US on effective tax rates (see Fullerton 1986 and the following papers in that symposium). The study of effective tax rates is not so well developed in the UK.

affect registration for the main indirect tax (VAT) where firms or self-employed individuals do not have to register until they reach a certain size.

Secondly, if compliance costs do vary at the margin with tax rates, it may be argued that their effect is simply to raise tax rates by the amount of compliance costs. Alternatively if they vary at the margin in a way not related to the tax rate, then they induce a random element into tax rates. Thus concentrating on tax rates is sufficient. Compliance costs only serve to increase effective tax rates.

Effective tax rates then will have a tendency to vary arbitrarily across different tax payers. This may have distributional consequences. As the recent experience in the UK of the poll tax shows (Smith 1991), variations in tax rates which cannot be attributed to justifiable differences between tax-payers can cause sufficient resentment for evasion to increase markedly. In the case of the poll tax, the tax was so unpopular and evasion was so widespread that the tax had to be abandoned. Partly as a result of this, the most electorally successful prime minister of the century fell from power. If compliance costs are regarded as a change in the effective tax rate, then changes in compliance costs are equivalent to changes in tax rates. Changing tax rates can (see below) have an impact on the level of evasion as well.

In the UK a further argument has been that compliance costs are only high for certain special groups of tax-payers — rich individuals and large companies on the one hand and the self employed and small businesses on the other. High compliance costs, it may be argued, do not matter for the rich (because they are rich), and it is fair that the self employed and small businesses can trade off high compliance costs with lower effective rates than the rest of the population. Ignoring the compliance costs of the rich and the large, ignores the ability of such agents to pass on the burden of their taxes (and their compliance costs) to other economically weaker agents in the economy. The study of tax incidence shows that those who pay the taxes are not necessarily those who bear the burden.

It may be reasonable to ignore the high compliance costs (and low effective tax rates) of the self-employed and small businesses when these did not play an important role in the economy. However it is now widely assumed that these groups will grow in importance in the future (indeed governments are encouraging them to do so), in which case it may become less easy to ignore both their low effective rates and their high compliance costs. As one respondent to the survey commented:

"The government state that they wish people to be self-employed and the Revenue do their utmost to treat them as employees."

The final reason for ignoring compliance costs is that they are very hard to measure. The only study of them in the UK is by Sandford et al (1989). Their conclusions were that on average they ranged from 2 to 5 per cent of taxes paid. This is not only a worryingly wide range, but it also ignores the distribution of compliance costs. For a discussion of some of the economic implications of their study see Collard (1989).

Obviously the fact that compliance costs are hard to measure is not a good reason for ignoring them. Apart from agency costs, compliance costs are largely hidden and private. This suits tax authorities in that they can ignore these costs and leave them out of consideration when questions concerning the efficiency and equity of taxes are raised. Economists who study tax systems should not collude with this process. In addition there are reasons for believing that because compliance costs interact with other features of the tax system they may play an important role in determining the kind of tax regime that a tax system finds itself in. In particular, high compliance costs may increase evasion and evasion, in turn, increases compliance costs. It would be in the interest of tax authorities to understand this kind of simultaneous process. The next two sections explore these ideas further.

3. Compliance costs and the rest of the tax system

The phrase "compliance costs" can mean a number of different things. Sandford et al distinguish between voluntary and compulsory compliance costs. The former is associated with the costs of what we will term "tax planning". This is the activity of planning future economic transactions in such a way as to minimise tax payments. This is sometimes called creating "tax efficiency" or alternatively engaging in "tax avoidance". Tax planning will have a role in the analysis below, but following Sandford et al we want to make a distinction between the costs of tax planning and the costs of compliance. The latter are costs that are "unavoidable" when individuals comply with tax law.

Compliance costs thus defined fall into two kinds. The first are the costs involved in assembling the information required to fill out a tax return accurately. These costs will depend partly on the kinds of accounting systems the individual or firm has in place and partly on the degree of complexity of the tax laws themselves. The second kind of cost is the cost of satisfying the

tax authority that the accounts submitted are indeed accurate. This may involve setting up particular kinds of accounting systems and/or collecting evidence which otherwise would not be needed.

Any tax will require resources to administer it. It is widely recognised that a "good" tax is cheap to administer. Tax authorities also have the option of passing on administration costs to tax payers and also to third parties. (Most withholding taxes are administered by employers who bear much of the cost of administration.) By doing so they can suggest that the costs of raising taxes are in fact less than they really are.

One source of compliance costs comes from tax authorities passing on administrative tasks to tax payers. A second source comes from the complexity of most tax regulations. Complexity is itself the consequence of a number of different factors. Complexity partly arises out of the need for taxes to be both efficient and equitable. Direct taxes are normally levied on net flows, and defining and measuring such flows (what can be legitimately netted in or out etc) gives rise to complexity. Complexity would thus appear to be an important feature of most tax systems. The only earlier discussion of this subject which we know is Slemrod (1989) who uses a rather different conceptualisation than the one we have adopted here.

As we have seen, one kind of complexity arises from entrenched interests within the tax system perpetuating what appear to be historical anomalies. The system of schedules for income tax in the UK is an example which we have already given. The historical justification given for these schedules is that, as a consequence, no one part of the Inland Revenue knows a tax-payer's total income. This was considered an important feature of the system when income tax was re-introduced in 1802 following the failure of the Treaty of Amiens to preserve peace in Europe (Sabine 1966). The new income tax schedules supposedly preserved the privacy of tax-payers.

Whether anyone really thinks this is still an advantage of the schedular system is not clear. However the schedular system does allow for the possibility of taxing income from different sources at different rates. This kind of differential tax rate was adopted by various labour governments. If introducing such differentials at comparatively low administrative costs is an important consideration, then it might be wrong to reduce the complexity of the tax system by abolishing the schedular system. A trade-off needs to be made, and one element in that calculation should be the costs of compliance that complexity induces.

One of the recent reforms to the UK tax system (the switch to so called independent taxation) may well have increased complexity and therefore compliance costs as well (see below). But it is hard to argue that this reform which means that, for the first time in the UK, the income of wives can be taxed separately from that of their husbands, is not an improvement in terms of equity. Complexity and increases in complexity are by no means all bad.

A different source of complexity is economic change. New kinds of ownership structure, new kinds of financial assets (often with an uncertain contingent element) and the increase in trans-national economic activity all may force the tax authorities to introduce more complex regulations. Here again complexity arises because of the need to preserve a degree of equity and efficiency in the tax system but some of this process of innovation may be a consequence of tax planning rather than "genuine" economic innovation.

Accountants may find that tax planning leads to a process of economic innovation which in turn leads the tax authorities to legislate in order to plug the resulting tax loophole. A consequence of this process (which is wasteful anyway) is that by increasing complexity it increases the compliance costs of other tax payers. The process is not only undesirable of itself but has a negative externality.

It may be hard to distinguish in practice genuine economic innovation from the final source of complexity; namely avoidance, evasion, and the fear of evasion. However there is a distinction that is being made here between complexity that arises from factors external to the tax system and those that arise from within it; such as the way in which the tax system is administered and the way in which it is regarded by those who participate in it. Societies in which evasion is considered to be rare will probably have as a result less complex tax regulations and therefore lower compliance costs, though, as we have seen, an important exception to this is when the low level of evasion is itself a consequence of the tax system being perceived as being fair and this in turn is a consequence of the complexity of the regulations.

Evasion can increase complexity, complexity increases compliance costs and high compliance costs may increase evasion. The tax system may evolve into an undesirable regime of high complexity, high evasion and high compliance costs. Alternatively this process can move in an opposite direction to a more efficient equilibrium where there is low evasion, less complexity and lower compliance costs. This process may not reach an equilibrium. The tax system may oscillate between different regimes.

The tax authorities may be able to control the direction in which the tax system is moving by responding to evasion in different ways, and by controlling the costs of compliance as well. Of those factors which are endogenous to the tax system, the level of evasion would thus appear to be an important determinant of level of compliance costs.

In the next section we discuss some formal economic models of evasion. They show that in addition to the relationship between the tax payer and the tax authorities, the attitude of tax payers to the public services provided by their taxes, and the relationship between tax payers themselves can have an important impact on evasion and on the kind of regime a tax system finds itself in.

4. The economic theory of evasion

There is now a large literature of formal economic models of tax evasion. None of these (as far as we know) takes into account compliance costs at least as far as the tax payer is concerned. Most of these models use partial equilibrium techniques to model the decisions of one individual while the behaviour of most of the other actors in the tax system is taken as given.

Perhaps not surprisingly such models give interesting but quite counter-intuitive conclusions. In order to generate models which give sensible results it is necessary either to take into account the welfare individuals receive from the public goods which their tax payments finance, or the reactions of other people in society to the level of evasion that any one individual chooses to engage in (or both). In other words as soon as these models stop being simply individualistic in a certain sense, they start to produce interesting conclusions. They also tend to exhibit other properties too — either instability or multiple equilibria.

Although economists have been interested in tax evasion at least since Adam Smith, a formal theory of tax evasion was first presented in a well known paper by Allingham and Sandmo (1972). They considered a single tax payer who maximises the expected utility of disposable income. If tax is evaded, disposable income is higher than without evasion. However there is a known probability that evasion will be detected and a penalty imposed. Tax evasion in this model is treated like a risky asset. Individuals must select a portfolio made up of a safe asset — income on which tax is paid, and a risky asset — income on which tax has been evaded.

The model produces straight forward results in that evasion falls as the probability of detection and the size of the penalty increases. However if the

tax rate rises, the model produces ambiguous results. As one might expect in a model of this kind the effects of a change in the tax rate can be divided into income and substitution effects, and, in this case, these are of opposite sign. The effect of an increase in the tax rate makes the rate return on the risky asset higher, so that the substitution effect increases evasion. On the other hand, it is usually assumed that as income increases, absolute risk aversion falls. An increase in the tax rate reduces income and makes the risky asset (tax evasion) less attractive, so evasion falls.

It has been argued that under US tax rules, there will be no substitution effect, (Christiansen 1980) so that the model appears to produce the counter-intuitive result that an increase in the tax rate always decreases evasion. Since no writer has attempted to defend this conclusion, this has provoked a number of further papers. Two attempts to resolve this problem are particularly relevant here.

One strange feature of the Allingham and Sandmo model is that the tax payments once paid play no further role in the analysis. There are simply thrown away. Cowell and Gordon (1988) use exactly the same model but allow utility to depend on the amount of public goods which the tax payments finance as well as post-tax income. This change has two interesting effects.

First, while the effects of a change in the tax rate on the level of evasion remain ambiguous, the size of the income effect may be reduced. In this model an increase in taxes will increase the availability of public goods. If utility rises enough because of this, the income effect will be of the same sign as the substitution effect and, as a result, the level of evasion will increase as the tax rate rises. Whether this occurs depends on the individual's preferences regarding the provision of more public goods.

If tax-payers regard public goods as under-provided, then the extra riskiness of evasion will be offset by the increase in welfare due to the increase in public goods. In this case the level of evasion will rise as tax rates rise. On the other hand, if public goods are thought to be over-provided, then this effect will operate in the opposite direction. Reductions in tax rates will increase the level of evasion. A number of technical assumptions are needed to reach this conclusion. However Cowell and Gordon's paper is the first (and so far as we know the only) model which formally links evasion with attitudes towards public good provision.

This might seem too obvious a point to need emphasising, however it is often ignored in economic discussions. Some confirmation that this was

indeed an important consideration was provided in a recent paper by Alm, McClelland and Schulze (1992). Although one might wish to be cautious about inferring too much from a sample of undergraduates at the University of Colorado at Boulder, the authors conducted lab experiments on samples of such undergraduates to explore their "tax evasion behaviour". They found that there were a variety of responses from the undergraduates. One of these was that

"(f)inally, the results suggest that compliance occurs because some individuals value the public goods that their tax payments finance. An increase in the amount individuals receive from a given tax payment increases their compliance rate and individuals pay something in taxes to receive government services even when there is no chance of detection and punishment."

The second point raised by Cowell and Gordon is that when individuals value the public services for which their taxes pay, they have to take a view on the evasion behaviour of other taxpayers. Unless these conjectures about the behaviour of others are correct (and there is no particular reason why they should be), then individuals may find that the amount of public goods provided is not what they expected when they first optimised over the choice between evasion and compliance.

In a well defined equilibrium all conjectures are self-fulfilling, and this is the case which is analysed in Cowell and Gordon (1988). However in an earlier version of their paper (Cowell and Gordon 1986), they consider cases out of equilibrium. The formal techniques they use are not well suited to the analysis of the model in disequilibrium. However their results are of some interest. They depend on the relationship between two different responses. These are the change in an individual's chosen level of evasion in response to a change in public good provision and the change in public good provision due to a change in the level of evasion. The model can converge to a stable equilibrium. Alternatively it can be unstable and diverge to the boundary points where there is either complete compliance or complete evasion. It is of interest to note that the Cowell and Gordon model provides a formal precursor to an argument much more fully developed in Levi (1993).

Gordon (1989) has provided a different kind of argument as to why the level of evasion might increase with the tax rate. In this model individuals lose utility in proportion to the amount of tax they evade. Gordon describes this as a "private psychic cost of evasion". This again

reduces the size of the (negative) income effect when tax rates rise. In this model this is because, although tax evasion is more risky, the relative price of honesty has also risen when the tax rate rises.

Gordon also considers the case where in addition to the private psychic cost of tax evasion, there is also a risk of incurring a reputation cost if an individual is caught evading. If the size of the reputation cost is related to the proportion of individuals who do not evade, and this proportion is known only with a lag, then Gordon shows that the tax system is governed by a non-linear first order difference equation. This will have multiple solutions.

It is not surprising that game theory has been used to model the relationship between the tax payer and the tax authorities. Again the point is that while in repeated games it is possible to get away from straightforward prisoner dilemma type results, in games in which the participants (tax payers) only play against the tax authorities and ignore the strategies of other tax payers, can yield results which should be taken seriously, but which at first sight appear implausible. Thus Greenberg (1984) has an elegant model which has the property that "in equilibrium ..... the percentage of individuals that cheat (evade) is arbitrarily small". Greenberg recognises that most tax authorities would be surprised by this. He speculates about what has gone wrong in terms of the possibility of uncertain outcomes when individuals are audited. He does not consider the relationship between tax payers or their preferences towards public goods

5. The Role of Accountants

In many ways accountants are like any other group of professionals who act as agents for their clients. In this sense they are similar to doctors and lawyers. They can be expected to carry out their clients' wishes to the extent that they do not conflict with their own long term objectives subject to various constraints such as competitive pressures.

Accountants provide a link between the taxpayer and the authorities and their relationship with both groups is obviously important. However they also need a certain level of competence on the part of the tax authorities in order to present to their clients a successful negotiation over their client's tax affairs. The results of the survey cast some doubt over whether that level of competence in relation to the complexity of tax regulations exists in the UK at the moment.

On the whole, the relations between the accountants surveyed and the inland revenue were usually relatively harmonious. For instance 92 per cent of survey respondents found that internal revenue staff were "helpful". On the other hand only 54 per cent found that they were "knowledgeable about technical issues". Adverse individual comments about the inland revenue include the following:

"Revenue long in the tooth; — complaints at the top have to be viewed in the context of ongoing damage to (the) relationship".

"It's a sad world."

"Too much correspondence goes missing; agents expected to re-create files and ... letters."

"the transfer of files from one tax office to another is fraught with problems and adventures. Routine matters are treated like hot potatoes with each district denying responsibility. This often creates expensive time-consuming telephone calls and costs (which) cannot be passed onto clients. You spend all day getting a district to accept that it is responsible for a case."

However if respondents have had some difficulties with the Internal Revenue service, this is nothing compared to their problems with the DSS. We have several pages of adverse comments. A few examples are:

"I have never met such rude and high-handed and unhelpful people as these. Very unprofessional to both clients and advisers."

"Slow, unhelpful and incompetent."

"Quite a useless quango. Other than very minute queries, everything has to be referred to Newcastle. Give them a pre-1948 query and the contributor is likely to be dead before the query is answered."

"The rules are usually extremely complicated and the staff have very limited knowledge of them but are very dogmatic in the way they answer queries."

"Inspectors have insufficient knowledge."

"Derogatory vocabulary insufficient to abuse."

These kinds of reactions are supported by the proportions of respondents who claimed that officials in the DSS were "helpful" and "knowledgeable about technical matters". Perhaps not surprisingly a majority of respondents felt that compliance costs would fall if the DSS and the Inland Revenue adopted similar procedures. However the furious reaction of some of the respondents to the DSS, suggests that a good working relationship between the tax authorities is important for tax accountants.

This is confirmed by answers to questions about who would benefit from various reform proposals which would reduce compliance costs. When these proposals concern the efficiency of the tax authorities (e.g., the greater use of computers or a simplification of the hierarchical structure of the internal revenue), tax accountants believe these would reduce their costs more than those of their clients. Accountants have an interest in not only good working relations with the tax authorities, but also in relatively efficient tax bureaucracies which can cope with the complexity of the tax structure.

Tax accountants also offer a new twist to the theory of professional behaviour in their role as tax planners. The role of doctors in creating supplier induced demand is well known (see the survey by Foley et al). Supplying patients with medical care which they do not need may have adverse economic and health repercussions for the patients who are treated in this way. Similarly accountants can create new avoidance schemes. These can be expected to reduce the tax liabilities of clients in the current period, but they may increase compliance costs (and future tax liabilities) for both clients and other taxpayers in the future.

Most of the respondents in the survey were engaged in tax planning as well as compliance work. However there was a significant relationship (at least 95% confidence) between those who worked mainly on compliance and those who found it "more time consuming to keep up to date than I used to". This suggests that the recent increases in complexity of the tax structure have increased agency costs in compliance but not in tax planning. There was also a significant (but less strong, at least 90% confidence) relationship between accountants who spent more of their time in tax planning and those respondents who did not think that various proposed simplifications to the schedular system would reduce compliance costs. This confirms the view that tax planners appeared to be less interested in reducing compliance costs than those actually engaged in compliance activity.

These results will no doubt bear more than one interpretation. One possible interpretation is that the burden of complexity and the poor relations accountants have with some of the tax authorities increases the cost of compliance. Tax accountants divide their time between compliance work and tax planning. In order to minimize costs they should do so in such a way that the rate of return to each activity is the same. If the rate of return to compliance work falls then accountants can be expected to engage in more tax planning.

6. The Increase in Complexity

We decided not to ask general questions about the complexity of the tax system (do you find the tax system too complex?) but confined our questions to specific aspects of the tax system and to proposals for reform. Two general questions were asked about the burden of recent legislative changes. 78 per cent agreed with the statement "I have found it time consuming to keep up to date" and 11 per cent claimed that "I do not feel I have been able to keep up to date". 70 per cent claimed that they found it "more time consuming than they used to to keep up to date with technical developments that are relevant to my work".

Since the survey respondents highlighted the problems posed by complexity and increasing complexity, we thought it would be of interest to investigate this question of increasing complexity a little further. Not only did it seem strange that accountants should be complaining about the complexity of the tax system, but British governments for the last 14 years have claimed that they wished to simplify the tax system and they have indeed done so.

There is no one obvious way of measuring the complexity of a tax system. The number of taxes, and the number of different rates at which each tax is levied are obvious candidates. Indeed much of the discussion of the simplification of the tax structure has concentrated on these variables. While the number of taxes is clearly of interest, the number of different rates would appear to have a comparatively weak relationship with complexity. A calculator or a computer should be able deal with the arithmetic problems posed by different rates easily enough.

Another way of measuring complexity is the number of legislative changes that are made each year. This is difficult to capture precisely but in Table 1 we give the total number of pages, the number of sections and the number of schedules of the Finance Acts passed by the British parliament between 1975-1992. Although obviously rather crude, these measures have been used by accountants to measure complexity (see Touche Ross 1986). A complication with the data on page numbers is that the page size and typography changed in 1987, making pages approximately 60 per cent larger in that and subsequent years.

The data in Table 1 show considerable amount of year to year variation. The smallest finance acts were passed in 1979, when there was a change over from Labour to Conservative administrations. However one feature of these data is that the size of Finance Acts has appeared to increase

Table 1
The size of Finance Acts passed by the British Parliament
1975-1992

	Pages	Sections	Schedules
1975	281	134	27
1976	179	132	15
1977	116	62	9
1978	107	80	13
1979	44	28	5
1980	176	122	20
1981	218	139	19
1982	195	157	22
1983	96	64	12
1984	262	128	23
1985	242	98	27
1986	265	114	23
1987*	352	176	25
1988	303	149	14
1989	457	188	17
1990	320	133	19
1991	308	124	19
1992	293	83	18

1979, 1983, 1992 and 1992 were election years
For 1987 and the following years the page size was increased by approximately 60 per cent. Page numbers have been adjusted to reflect this.
Sources: Finance Acts 1975-1992 HMSO London

over time. The means for the four years of labour governments are for pages 171, for sections 102 and for schedules 16. The corresponding figures for the conservative governments (1980 and after) were 262, 129 and 20 respectively. Touche Ross (1986) commented on the Finance Act of that year that it was "only slightly shorter than the magnum opus of 1965. It was however unprecedented in the volume and complexity of amendments." The 1965 Finance Act included a large measure of tax reform designed by the then recently elected Labour government. Some of the Acts during the 1980s

included some element of tax reform particularly the 1986 act. However the 1986 Act was followed by several larger finance acts. The legislative burden was also increased by the passage of two major consolidation acts: the Income and Corporation Taxes Act 1988 (1037 pages, 291 sections, 11 schedules) and the comparatively slim volume of the Taxation of Chargeable Gains Act 1992 (319 pages, 291 sections, 11 schedules). The finance acts do not include the largest item of tax reform which took place in this period, namely the substantial and disastrous changes to local taxation (the abolition of rates, the introduction of the poll tax, the abolition of the poll tax and the introduction of the council tax).

These finance acts represent (more or less) the legislative burden of a tax system engaging in the necessary adjustments needed to keep the tax system ticking over in an acceptable way. There does appear to be some decline in size after 1989, and a number of factors can be cited that caused particular difficulties in the 1980s. But even the size of the acts in 1991 and 1992 are fairly large. They are amongst the largest if not the largest pieces of legislation in each parliament. They clearly represent an enormous burden on the legislature. It may be questioned whether the members of the legislature have any idea about the details of many of the provisions.

Some of the changes in tax law are the result of poor initial drafting of previous changes. For example, one respondent in the survey stated that "Revenue/Parliament should stop changing the law when they lose a case or sue the draftsmen for negligence." Another stated that "new legislation should be debated and questions of interpretation made public." A third commented that "(r)evenue should give warning of impending use of anti-avoidance legislation." It would be surprising if these legislative changes did not add to the complexity of the tax structure and thus to the costs of tax compliance by tax-payers and their advisers.

We do not know precisely why each of these Finance Acts were so bulky. There was some genuine attempt at tax reform such as the move to independent taxation referred to above. 70 per cent of survey respondents (86 per cent of who were male) thought that this change had increased compliance costs incurred by their clients. There was also a rapid rate of economic change following the deregulation of finance markets and the increase in trans-national activity. However a number of proposals were made which were intended to plug tax loop-holes as well. It is impossible to give weights to each of these factors. It remains striking that a government

which has reduced tax rates, and which claims to wish to simplify the tax system should have ended up making so many legislative changes.

In addition we would remark that the government has persistently tried to reduce government expenditure and has often argued that publicly provided goods are of less value than privately provided ones. It is hard not to see the parallel between this tax regime and the one described by Cowell and Gordon in which falling tax rates induce higher levels of evasion if taxpayers feel that publicly provided goods are over-supplied.

As regards the reduction of compliance costs that would result from various proposals for reform, the survey provides a wealth of data on the effect of both small and large changes to the tax system. We hope that it may encourage the authorities to adopt reform policies which take compliance costs into account. For instance, 57 per cent of respondents felt that fees could be reduced by between 5 and 15 per cent if each taxpayer had only one point of contact with the inland revenue. This simple proposal compares very favourably with the more radical reform of abolishing the schedular system altogether. Only 43 per cent of respondents believed that this would reduce their fees by 10 per cent or more.

7. Conclusions

Tax systems impose compliance costs on tax payers which can often be ignored in the economic analysis of a tax system. They increase effective tax rates in arbitrary ways and thereby reduce the efficiency and the fairness of the tax system. They arise from a number of sources, of which the main one is the complexity of the system. Complexity itself is the result of history, bureaucratic inertia, the desire to design an efficient and equitable tax system, and the fear of avoidance and evasion. More complex systems can increase compliance costs and, under certain circumstances, evasion. This, in turn, can increase complexity. The way taxpayers react at each point in these various relationships depends, in part, on their preferences for a greater or smaller provision of publicly provided goods. It also depends on their conjectures about the behaviour of other taxpayers.

The agency costs of tax accountants are the most visible components of compliance costs. The survey of compliance costs will, we hope, identify areas of reform that will not reduce the efficiency or equity of the tax system, but will also reduce compliance costs as well. Accountants themselves have an interest in maintaining good working relations with a competent tax authority. There is some evidence that the complexity of tax

regulations in the UK has reached a point where accountants themselves feel that compliance costs have risen in ways in which they cannot pass on to their clients.

Finally, should we care about accountants? This question can be answered in two ways. If the tax system has reached the point where the rate of return to compliance activity is less than the return to tax planning, then accountants will devote more resources to the latter. This may increase costs for all taxpayers and as taxpayers we therefore have a (selfish) interest in caring about what they get up to. Secondly a theme of this paper is that tax systems can only be understood when our theories take account of the many actors that play a role in a tax system and how these actors view the activities of others. Accountants are certainly one of these. As social scientists we should certainly care about them.

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