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## Compliance Costs and Efficiency of Tax Administration

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***"It was only for the good of his subjects that he collected taxes from them, just as the Sun draws moisture from the Earth to give it back a thousand-fold"***

***Kalidas in Raghuvansh***



**TAXATION** has a very rich history and legacy in India and is rooted from the period of Manu Smriti and Arthsashtra. According to Manu Smriti, the king should arrange the collection of taxes in such a manner that the tax payer did not feel the pinch of paying taxes. Manu says *"As the leech, the calf and bee take their food little by little even so must the king draw from his realm moderate annual taxes.* Manu, however, cautioned the king against excessive taxation and stated that both extremes should be avoided namely either complete absence of taxes or exorbitant taxation. Kautilya's concept of taxation emphasised equity and justice in taxation. The affluent had to pay higher taxes as compared to the poor. Arthashastra authored by Kautilya, mentioned that each tax was specific and there was no scope for arbitrariness. He says that *just as a fruit must be plucked as soon as it is ripe, tax should be collected as soon as it is due.* According to him, the power of the government depended upon the strength of its treasury. He states - *"From the treasury, comes the power of the government, and the Earth whose ornament is the treasury, is acquired by means of the Treasury and Army"*. It is remarkable that the present day tax system derives its inspiration from that and is in many ways similar to the system of taxation in vogue about 2300 years ago.

The modern taxation system in India was however introduced in the year 1860 by James Wilson, during the British rule and presently Income Tax Act 1961, is the legal framework to collect taxes in the country. The authority of the government to levy taxes in India is enshrined in the Article 246 of the Constitution of India, allocating the powers to levy taxes to the Union Government and State governments, more particularly as per the scheme laid down under VIIth schedule, in the form of Union List, State List and Concurrent List. Attempts towards setting up a fair tax system have always been a big challenge for developing countries like India. An ideal tax system is expected to raise necessary and timely revenue for the government without adversely affecting the investment decisions or the economic activity. However, it is not an easy task to establish an efficient tax system in a developing country like India where large number of people are still engaged in unorganized or informal sector where cash transactions dominate the economic activity. The principal objective of tax policy in a developing market economy should be to raise revenues in an equitable manner and with minimum unintended changes in relative prices and allocation of resources as per the famous canons of taxation.

The process of tax collection involves various costs e.g. compliance costs borne by the taxpayer, costs incurred by third parties, costs borne by the government as administrative expenditure as also amount paid to the banks for collection of taxes and costs borne by the economy itself in terms of distortion created in investment decisions etc. This compliance costs of taxation is called as dead weight loss. Efficiency of tax collection directly connects to the costs of tax collection and indicates efficiency if the cost per unit of tax collected declines over time.

It is cardinal principle of taxation that a person should incur bare minimum costs over and above taxes paid by him. However in reality, compliance costs are quite significant and at times so prohibitive that it interferes with the regular compliance process. Higher are the costs more likelihood of a person avoiding compliance. Another important factor is probability of detection of such non-compliance by tax administration and consequently taking punitive action; higher is the probability better is the compliance. However compliance costs is an area of growing concern for all the countries including India they are the *"hidden costs of taxation"*. As per the principles of taxation a taxpayer be subjected minimum costs over and above taxes paid by him. Therefore the role of governments and revenue

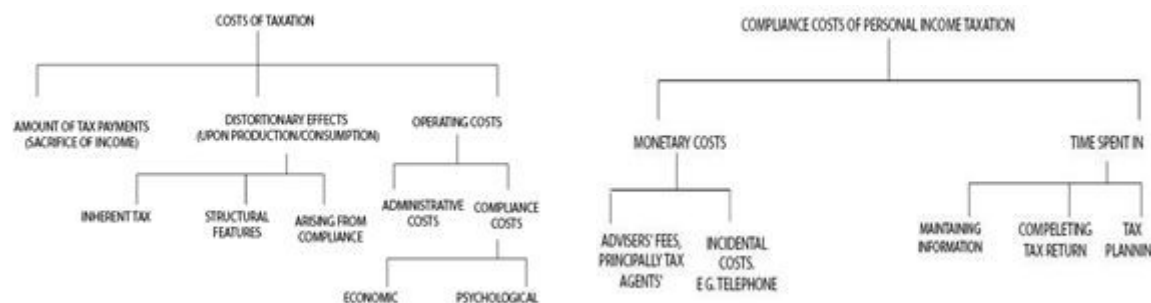
authorities in tackling the operating costs of the tax system has become very important.

In recent years there has been a greater sensitivity on the part of governments towards tax compliance burden. There has thus been a far greater emphasis upon understanding, measuring, monitoring and evaluating the impact of the burden of compliance with the tax system in OECD countries, namely Australia, the European Union, New Zealand, the UK and the USA. Sandford estimated the compliance costs of UK tax system in 1986-87 fairly significant at 3.91 percent of the tax revenue. In recent estimates of compliance costs of US individual income tax is many times higher than the budget of the tax administration agency \$ 35 billion compared to the total IRS budget of about \$ 6 billion" (Blumenthal and Slemrod, 1996). Such costs are significant in India as well, as concluded by Kelkar led Direct Tax Task Force (2002). As per Dasgupta (2014) costs borne by taxpayers amount to about 6.8 percent of the gross income of corporate taxpayers and even higher for personal income tax collections.

### Classification of Tax Transaction cost s :

The compliance costs comprise both economic and noneconomic costs. The economic costs consist of the monetary and time costs, in filing and dealing with the tax authorities. Non-economic costs include the psychological costs, like stress and anxiety generated from complying to a specific tax or a taxation related activity, such as a tax audit etc as shown in Figure 1 and Figure 2.

**Figure 1: Components of Taxation Costs Figure 2: Costs of Personal Income Tax**



Source: constructed by the author based upon Evans C.( 2006, 2007), and Pope J. ( 1992)

The costs incurred by the taxpayers in connection with meeting their tax obligations includes salary of accountant to maintain books of accounts, fees of tax audit and tax representation of a chartered accountant or a lawyer, costs for filing tax return and making other compliances etc. It is seen that tax compliance costs are typically high, 2 to 6 times higher than tax administrative costs. International comparisons show that they can amount to as much as 2.5% of GDP and are differentiated by the type of tax. At the same time, research has shown that the less complicated the tax system is and the more transparent is the tax administration, the lower are the costs of fulfillment of tax obligations incurred by taxpayers (Torgler& Schneider, 2007).

### Operating Costs of Tax System :

One of the first researchers to draw attention to the issue of the tax collection costs was Smith. He distinguishes between active costs (consisting in taking active measures to reduce the amount of taxes paid, which nowadays takes place e.g.in the case of employing a tax advisor) and passive costs (related to the settlement of tax liabilities resulting from legal acts) tax compliance costs. As regards different components costs, record keeping costs and advisor's fees form the bulk of costs of non-salaried individuals while advisors fees and tax planning costs dominate for salary earners. As per Das Gupta (2004), in India the time costs for average salaried taxpayer are much more and are 28 hours per salaried tax payer and 88 hours per non salary tax payer for complying with tax obligations of which the bulk of time was spent keeping records. Of different components, record-keeping by non-salary earners appears to be most burdensome and on average 10 times higher than salaried taxpayers. The studies suggest that compliance costs are typically anywhere between two percent and ten percent of the revenue collected or up to 2.5% of GDP and that it may be two to six times of administrative costs. The studies also suggests that administrative costs are less and that that they seldom exceed 1% and are usually well below 1%.

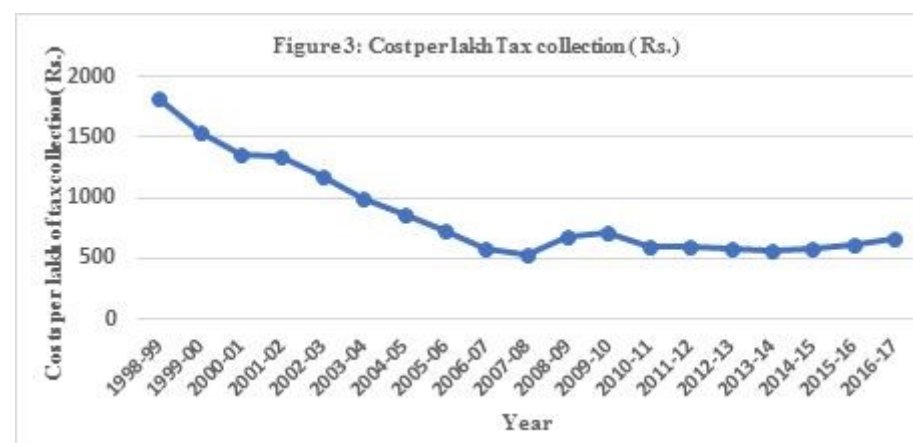
Public sector banks collect taxes and deposit them in the government treasury account at the Reserve Bank of India, Nagpur. Banks are compensated at the rate Rs. 11.80 per thousand rupees collected, which works out to 1.18 percent of taxes collected. The banks were paid an amount of Rs. 334 crore for 2000-01. However a major public sector bank in Mumbai estimated the cost actually incurred to

collect taxes and remit them to the government at Rs. 22-23 per thousand, which is two times of the rate of reimbursement at Rs. 11.80. The additional cost borne by the banks work out to Rs. 363 crore for 2000-01. This analysis is under taken from 1998 onwards as under.

**Table 4.1: Administrative Cost of Tax Collection in India**

Financial Year	Total tax Collection( in crores)	Total Cost( in crores)	Cost per lakh collection ( Rs.)	Percentage Cost ofTaxCollection
1998-99	46600	852	1828	1.83
1999-00	57959	894	1542	1.54
2000-01	68305	929	1360	1.36
2001-02	69198	933	1348	1.35
2002-03	83088	984	1184	1.18
2003-04	105088	1050	999	1.00
2004-05	132771	1138	857	0.86
2005-06	165216	1194	723	0.72
2006-07	230181	1349	586	0.59
2007-08	314330	1687	537	0.54
2008-09	333818	2248	673	0.67
2009-10	378063	2726	721	0.72
2010-11	446935	2698	604	0.60
2011-12	493959	2976	602	0.60
2012-13	558965	3283	587	0.59
2013-14	638591	3641	570	0.57
2014-15	695792	4101	589	0.59
2015-16	741945	4593	619	0.61
2016-17	849818	5578	656	0.66

Source: Administrative Handbook of Income Tax Department, 2018



Source : Constructed form Table 4.1

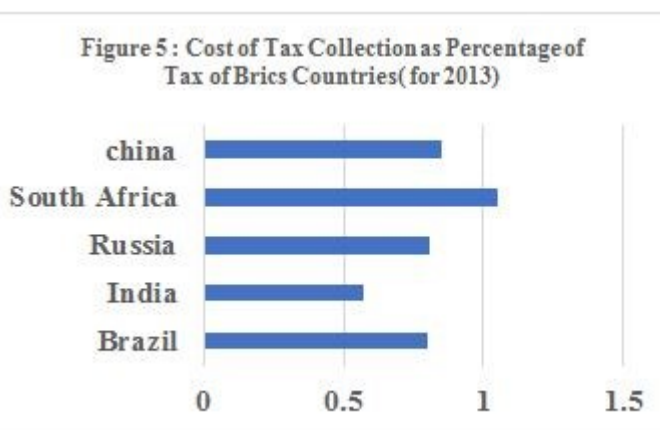
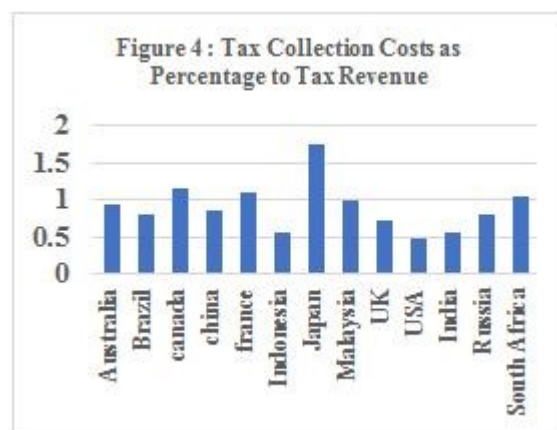
From the Table-1 and Figure-3, it is quite clear that the administrative cost of tax collection has been consistently falling over the period of time. From Rs. 1828 per lakh of tax collection in the year 1998-99, it gradually came down to Rs.999 in the year 2003-04 and to a lowest figure of Rs. 537 per lakh in the year 2007-08. There after there has been marginal increase in costs to Rs. 721 per lakh (as denoted by a bump in Figure 3) in the year 2009-10, which appears to be on account of one time capital expenditure incurred by the Income Tax Department on setting up of new CPC at Bangalore and CPC-TDS at Gaziabad. There after the costs have been stabilized to about Rs. 600 per lakh till now and is among the lowest in the similarly placed economies. In percentage terms also the cost has come down from 1.83% of tax collected in the year 1998-99 to about 0.60 % in the year 2007-08.

However, important point remains that the above costs do not include the cost of compliance to the tax payers and cost of compliance to the third parties. In this regard it will be relevant to compare the Indian costs of collection with its global peers which is tabulated in Table 2.

**Table 2: Administrative costs for tax administration/net revenue collected**

Country	Administrative costs for tax administration/net revenue collected (as %age)								
	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>OECD countries</b>									
Australia	1.04	0.99	0.93	0.95	1.00	1.05	0.99	0.98	0.93
Canada	1.32	1.32	1.22	1.13	1.31	1.36	1.31	1.24	1.15
France	1.08	1.28	0.96	1.17	1.31	1.25	1.20	1.19	1.11
Germany	1.66	1.55	1.38	1.36	1.46	1.50	1.40	1.34	1.35
Japan	1.65	1.52	1.50	1.49	1.71	1.93	1.75	1.84	1.74
Korea	0.80	0.78	0.70	0.79	0.84	0.81	0.76	0.70	0.74
Turkey	0.87	0.84	0.83	0.85	0.93	0.78	0.76	0.78	0.64
United Kingdom	1.10	1.09	1.11	0.90	0.91	0.98	0.83	0.74	0.73
United States	<b>0.52</b>	<b>0.48</b>	<b>0.45</b>	<b>0.49</b>	<b>0.61</b>	<b>0.66</b>	<b>0.62</b>	<b>0.56</b>	<b>0.47</b>
<b>Non-OECD countries</b>									
Argentina	0.89	1.01	1.08	0.93	1.14	1.32	1.25	0.97	0.95
Brazil	-----Data not collected for these years---					1.02	0.91	0.88	0.8
China	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.86	0.85	0.83
<b>India</b>	<b>0.72</b>	<b>0.59</b>	<b>0.57</b>	<b>0.67</b>	<b>0.72</b>	<b>0.60</b>	<b>0.60</b>	<b>0.59</b>	<b>0.57</b>
Indonesia	n.a.	n.a.	n.a.	<b>0.64</b>	<b>0.58</b>	<b>0.48</b>	<b>0.55</b>	<b>0.60</b>	<b>0.56</b>
Malaysia	1.20	1.14	1.29	1.04	1.41	0.78	0.70	0.82	1.00
Russia	n.a.	n.a.	n.a.	1.16	1.39	1.10	0.90	0.79	0.81
South Africa	1.19	1.21	1.02	0.97	1.03	1.15	1.08	1.09	1.05

Source : OECD tax administration 2014



Source: compiled from OECD tax statistics 2014

As can be seen from the Figure 4, the Indian costs of tax collections are among the lowest (at 0.57%) among all the countries and that of USA (at 0.47%) and Indonesia (0.56%) are even lower than Indian costs. It is also seen that costs of Japan at 1.74% and Canada at 1.1% are the highest. Here it would be relevant to see Indian cost of tax collection vis a vis BRICS countries are the lowest (at 0.57%).

### **The Reasons of High Compliance Costs:**

Two particular factors stand out as major, over-riding determinants of compliance costs: change and complexity. It is well documented (KPMG Report, 2006) that change creates both increase in costs and uncertainty. Frequent changes in existing tax laws, or bringing of new legislation, can significantly impact the compliance burden. Complexity is clearly a major determinant of the compliance burden. There may be different forms of complexity at work. There are three types, or layers, of complexities, namely technical complexity, structural complexity and compliance complexity. The technical complexity relates to the level of comprehensibility of particular tax legislation. This technical complexity is a product of the policy considerations underlying the particular provision. There is also structural complexity or transactional complexity, which relates to the way in which laws are interpreted and applied, and which can affect the certainty and manipulability of provisions..

### **Way Forward:**

It is necessary that costs of taxation have to be minimized to create efficiency. A six pronged strategy therefore can be adopted to reduce the cost which includes; Tax structure simplification, institutional reform, procedural reform, automation, and monitoring and client feedback and tax policy process reform. Further simplified filing and paying procedure, doing away with requirement of return filing for salaried taxpayers, availability of information and guidance from tax department through web enabled methods and regular consultations with the stake holders have to be encouraged. It is also desirable that the tax department makes its position on key areas of disputes clear on annual basis, so that the same may be followed by the tax payers.

It is seen that the burden on small businesses and establishments is very high so effective presumptive schemes of taxation or a simplified turnover tax for small firms upto Rs. 5 crore annual turnover is desirable and the Government has done that. It is seen that greater recourse to TDS in the case of professionals will reduce their compliance costs as also scope for tax evasion. Automation of the tax department will help in a big way where techniques like data analytics and data mining and risk assessment tools can be used. It is recommended that annual report card of tax administration should focus not only on revenue collections or growth of taxes but also on taxpayer services and their satisfaction as also the efficiency factor.

**(The views expressed are strictly personal. )**



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