

The administrative and compliance costs of taxation: lessons from the United Kingdom

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The administrative and compliance costs of taxation¹ have tended to be neglected by policy makers, administrators and economists, but for some taxes they can be of vital importance. This is true of the United Kingdom VAT and proposed New Zealand goods and services tax. This paper deals principally with the compliance, and to a lesser extent the administrative, costs of the United Kingdom VAT, and seeks to draw out some lessons from the United Kingdom experience which may be of use to New Zealand.

I. THE UNITED KINGDOM VAT

The United Kingdom value added tax (VAT) was introduced in 1973. It is in essence a tax on consumption in the home market. Its complication lies in the fact that it is collected multi-stage — at all stages in the chain of production and distribution. Each “registered trader” (a term to describe “taxable persons” at all stages in production, not just the wholesale or retail stage) pays tax on his “inputs” (the raw materials, machinery and services that he buys in) and charges tax on his “outputs”, handing over to Customs and Excise the difference between output and input tax. This is the so-called “invoice method”, with the “tax point” being indicated on the invoice. VAT is charged on imports when they enter the country.

As introduced in 1973 the United Kingdom VAT had a standard rate of 10% on all goods and services except those which were zero-rated or exempt or were sold by exempted traders. All exports were zero-rated. When a product is zero-rated no output tax is paid and the supplier of a zero-rated product can recover any input tax paid, either by setting it off against VAT due to Customs and Excise on positively rated products, or by means of a repayment.

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1 Administrative costs of taxation are the costs incurred by the revenue authorities in running a tax system — the official costs of operating a tax. Compliance costs are a less wellknown concept — the costs incurred by taxpayers or by third parties (e.g. businesses collecting PAYE income tax from their employees) in complying with the requirements of a tax. Such costs are in addition to the actual tax revenue handed over and in addition to any distortion costs.

Zero-rated goods include, besides exports, foodstuffs, books and newspapers, fuel, new building, public transport and children's clothes.

Exempt activities included the renting of land and buildings, insurance, postal services (where provided by the Post Office), gaming, financial services, education, medical services, burials and cremations.

In addition, traders with a turnover (in 1973) of £5,000 were exempt. This threshold has been increased since then more or less in line with the retail price index and now stands at over £18,000. Provision is made for voluntary registration.

The difference between zero-rating and exemption is important. A trader supplying zero-rated goods is part of the VAT system; an exempt trader is not. A zero-rated trader can recover tax on his inputs from Customs and Excise; an exempt trader cannot. He can pass his input tax on in price to his customers, but he cannot invoice it as tax.

It is virtually always better to be zero-rated than exempt. It may be better to be standard rated than exempt, if the trader sells to registered traders, for registered traders will want to buy from other registered traders so that they can recover their input tax.

Since the introduction of VAT in the United Kingdom a number of changes have taken place of which the most important have been —

1. Standard rate reduced to 8% in 1974.
2. The introduction of a higher rate tax in 1974 for a limited range of luxury goods.
3. The abolition of the higher rate in 1979 with the standard rate being raised to 15% as part of a package to reduce income tax.
4. Moves to widen the tax base.

II. COSTS OF ADMINISTRATION AND COMPLIANCE OF UNITED KINGDOM VAT, 1977-78

The United Kingdom is the only country in which an attempt has been made at a comprehensive study of both the administrative and compliance costs of VAT. During 1978-80 a research team at the Centre for Fiscal Studies, University of Bath, studied the administrative and compliance costs for the financial year 1977-78, a year which saw no changes in the structure of the tax and in which, therefore, the compliance costs could be regarded as representing the "regular" costs of compliance.

Information on administrative costs was derived mainly from published sources, but with some supplementation from survey data. The data for the estimates of compliance costs was obtained from a mail sample survey of registered VAT traders supplemented by interviews with traders and accountants and other professional advisers.

The study was undertaken with the co-operation of Customs and Excise but was entirely independent of them. The representativeness of the sample was

ensured by being drawn from the VAT register on a stratified basis by size and business sectors, but in a manner which ensured the anonymity of the respondents. The size of the sample was just over 9,000. A response rate of 31% yielded just under 3,000 usable returns. Various internal and external checks served to establish the general accuracy of the responses. Estimates of aggregate compliance costs were derived by grossing up the mean compliance costs by size group within each of nine business sectors in relation to the known numbers in each size by sector group in the total population of VAT registered traders. The compliance costs consisted mainly of fees paid to staff doing VAT work, the value of the time of proprietors etc. who did their own VAT work and fees to accountants or other professional advisors for work on VAT. The main findings from this stage of the study were as follows —

1. Aggregate compliance costs were a little under £400 million or about 9% of tax revenue.

2. The burden of compliance on different businesses varied according to many factors — e.g. the rate mix of their products, their business sector, and their system of accounting. The predominant influence, however, was size of firm. Compliance costs were extremely regressive in their incidence, bearing much more heavily, proportionately, on small firms than on large. Using taxable turnover as the measure of size, the smaller firms had compliance costs which were over 30 times as high as the largest firms. Thus, in 1977-78 on average it cost firms in the £20,000 to £40,000 turnover range £12.30 in compliance costs for every £1,000 of goods sold. For firms of over £1 million turnover the cost was 40p for every £1,000 of goods sold.

3. The effect of the higher rate of tax was to add some 10% to the costs of compliance compared with what the figure would have been if all the higher rated goods had been standard rated.

4. Administrative costs (as published by Customs and Excise) at £85 million were 2% of tax revenue.

5. On the basis partly of published data and partly of survey data (relating to the frequency and length of VAT control visits to firms of different sizes) a rough and ready attempt was made to allocate administrative costs in 1977-78 to different sizes of firm. The outcome suggested that administrative costs were also disproportionately attributable to work in relation to small firms which generate little tax revenue.

6. Taking compliance and administrative costs together, the total costs of operating the tax system amounted to 11% of VAT revenue. Whilst the figures must be regarded as very approximate, it also appeared that some 40% of compliance costs and 55% of administrative costs were incurred by, or in respect of, some 69% of traders (under £50,000 turnover in 1977-78) who between them generated less than 5% of revenue.

III. SOME COMMENTS AND QUALIFICATIONS TO THE FINDINGS

A. The Effect of Zero Rating on Compliance and Administrative Costs

A significant proportion of both administrative and compliance costs relate to the wide range of zero-rated products (apart from exports) which yield no revenue.

B. Offsetting Benefits to Traders

The figures on compliance costs take no account of any benefits registered traders gain from the tax. (In other words, they represent gross compliance costs, not net compliance costs.) These benefits are of two main kinds — cash flow benefits and managerial benefits.

1. Cash flow benefits

Those traders who are not repayment traders are required to collect tax over a three month period (the collection period) and pay it over to Customs and Excise by the end of the following month (the grace period). Regular repayment traders are allowed to submit monthly returns and can expect to recover the tax about two weeks after submitting their claim. The trader who is not a repayment trader will therefore get a cash flow benefit as follows:

With a three month collection period, assuming an even flow of payments for inputs and receipts for outputs, the trader will be holding on average $1\frac{1}{2}$ months of VAT or $\frac{3}{24}$ of the annual VAT payment.

The one month grace period means that the trader will be holding three months VAT for one month every three months; this is the equivalent of one months VAT each month or $\frac{1}{12}$ of the annual VAT payment. Taking collection period ($\frac{3}{24}$) + grace period ($\frac{1}{12}$) the trader's average holding throughout the year will be $\frac{5}{24}$ the annual VAT payment. There are several features of this cash flow benefit:

- (a) Its value will depend on the level of interest rates in general and the credit/debit situation of the individual trader.
- (b) The distribution of the cash flow benefit depends partly on the commercial credit conditions (as the tax point is the invoice and not the payment date, save with cash payments).
- (c) The cash flow benefit, whilst a real benefit to the individual trader, is not a real resource saving to the economy as a whole. It is a transfer — in effect an interest-free loan from government to the business sector.

For repayment traders there is a cash flow disbenefit.

In total in 1977-78 the net cash flow benefit was valued at £73 million. The cash flow benefit for many of the big businesses exceeded their compliance cost, so that they had negative compliance costs.

2. Managerial benefits — particularly affecting smaller firms

As a result of VAT many small firms were required to keep better and fuller records than they would otherwise have kept. They may be able to use these records for improved decision making.

Of those firms surveyed with a taxable turnover of less than £100,000 (1977-78), 42% agreed that their purchase records were better kept as a result of VAT and 30% that their sales records were better kept. Few felt able to put a value on this benefit; a number (quite logically) gave a zero value. But some specific benefits

were identified as follows —

- 25% saved money by doing more of their own accounts;
- 8% enjoyed improved stock control;
- 6% claimed discounts more frequently;
- 5% had fewer bad debts;
- 4% claimed other miscellaneous advantages.

It is hardly possible to put a realistic aggregate money value on the managerial benefits of VAT, but they clearly should not be ignored as an offset to compliance costs. Moreover, unlike the cash flow benefit, the managerial benefits represent real resource savings.

IV. CHANGES SINCE 1977-78

Since the survey was undertaken a number of changes have affected administrative and compliance costs, particularly as a proportion of tax revenue: a simplification of VAT procedures, the abolition of the higher rate VAT, the raising of the standard rate, the effect of inflation on both VAT revenue and costs, and changes in interest rates affecting the value of the cash flow benefit. The following table sets out the 1977-78 costs and attempts, in a fairly approximate way, to up-date the figures to 1983-84.

ESTIMATES OF COSTS OF OPERATING VAT, 1977-78 AND 1983-84

Years	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Revenue from VAT	Admin. costs	Compl. costs	Value of cash benefit*	Net compl. cost† (3)-(4)	Admin. costs	Compl. costs	Net compl. costs
	£bn	£m	£m	£m	£m	as % of tax revenue		
1977-78	4.2	85	392	73	319	2.0	9.3	7.6
1983-84	15.2	175	1030	355	675	1.1	6.8	4.4

* Interest rate of 7% 1977-78 (average bank minimum lending rate) and 9.3% 1983-84 (average bank Base Rate).

† No allowance for managerial benefits.

Administrative and compliance costs as a percentage of tax revenue have been much reduced mainly as a result of the higher standard rate of tax and hence tax yield. Whilst the aggregate figures look reasonable the disproportion between large and small firms remains.

V. THE EFFECTIVE INCIDENCE OF COMPLIANCE COSTS

Who really bears the costs of compliance? If all firms had positive net compliance costs in proportion to turnover the real incidence could be expected to be similar to that of an addition to the tax rate, with most, or all of it, being passed forward to the consumer. But such is not the case. Many large firms have negative net compliance costs while small firms are left with significant positive costs. In these circumstances, where large and small firms compete in the same market, the small firms are at a disadvantage. For them the costs of compliance may have to come out of profits or by a sacrifice of leisure time.

VI. LESSONS FROM THE U.K. EXPERIENCE

1. Administrative and compliance costs really matter.
2. The "educational programme" and preparatory work are very important.

In many ways Customs and Excise did a remarkable job in preparing traders for VAT. The tax was introduced after an unprecedented degree of consultation. But in retrospect three deficiencies can be perceived:

- (a) In the many discussions which took place with trade associations and the like, the very small firms tended not to be represented.
- (b) No real indication was given of the offsetting benefits of VAT and, in particular, how small firms might take advantage of them.
- (c) The VAT forms and literature could have been made simpler and more attractive.

3. The importance of a simple rate structure and a wide coverage. If, in the United Kingdom, zero-rated products (except for exports) were standard rated the proportion of compliance and administrative costs to tax revenue would fall. The tax would be simpler to operate. A single rate with a wide coverage minimises compliance costs. Such a tax also tends to minimise tax-produced distortions in production and consumption. The argument that zero-rating of products like food and clothes benefits the poor is misguided. It is true that zero-rating of such goods makes the tax progressive because the poor spend a larger proportion of their income on them than the better off. But the absolute benefit goes to the better off. Compensating the poor (or indeed over-compensating them) through public spending would be a more efficient way of helping them (the benefit being independent of their particular consumption pattern) and would leave a substantial margin of revenue for the Exchequer.

Denmark and Sweden have a broad based single rate tax and the Irish Tax Commission has recently recommended it for that country. The Chancellor of the Exchequer in the United Kingdom is seeking to widen the tax base there.

4. VAT is not a tax to be operated at very low rates. The higher the rates the lower the ratio of compliance and administrative costs to tax revenue. VAT requires a fairly extensive operating structure. Once in existence the costs are largely independent of the rate level.

5. Decisions on the administration of VAT with regard to the timing of payments and returns need to be taken with some care. In its collection and grace periods the United Kingdom is very generous compared with most European countries. There is much to be said for a differential payments system.

6. What can be done to help the smaller traders? It is on them that the burden of compliance costs is heaviest.

- (a) Why not set a high exemption limit? This is attractive. In the United Kingdom setting the small firms provide little revenue for high compliance and administrative costs. Yet this would not work well with the present United Kingdom VAT structure. Many firms seek voluntary registration because they supply products which are zero-rated or because they supply registered traders.

Also with United Kingdom VAT at 15%, in some economic activities, where the product supplied is mainly labour services and inputs are few or/and zero-rated, suppliers operating just below the exemption limit are given a significant competitive advantage. In any case, under the Sixth EEC Directive member states are not allowed to take measures to narrow the tax base.

New Zealand does not face such restrictions. With lower VAT rate and a wide coverage there would be a stronger case for a higher exemption limit than in the United Kingdom. Much depends on the size structure of New Zealand businesses.

(b) Special schemes? The United Kingdom has a number of special retail schemes designed to make VAT simpler for retailers to operate. Most other countries have special schemes for some kinds of small firms. One possibility would be to have a reasonably high exemption limit with firms below the threshold paying a fixed licence fee.

(c) Differential payment periods? This seems to be one of the more practical ways of helping the smaller firms and is adopted by several continental countries e.g. most firms might have a collection period of 3 months and a grace period of one month, as at present in the United Kingdom. But the smallest firms might be on annual accounting (possibly with quarterly payments on account of, say 1/5 of the previous year's VAT); and the largest on monthly accounting. This would help small firms in two ways. They would have lower compliance costs because of fewer returns to submit and the VAT return might be prepared along with the annual income tax return. They might also gain rather more cash flow benefit. Also monthly accounting would reduce the cash flow benefit of the large firms and hence their VAT induced competitive advantage.

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