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## **COMPLIANCE COST OF PERSONAL INCOME TAX**

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### **ABSTRACT**

The Compliance Cost of Taxation is the time and cost incurred by a tax payer in order to comply with tax regime of the state. These costs has been identified as one major costs during of taxation and has become one of the vital costs of taxation during the recent times in Indian Tax Regime. After the liberalisation of economy in the 1990s and opening the market to the international arena, the non compliance to a tax system by individual tax payers with regard to personal income tax has increased more than other countries with the open and free market economies. Thus it becomes indispensable to identify the cause behind such high non compliance in order to mitigate the major revenue source of the country. This paper extensively takes up the job of discussing one of the major reasons for non compliance, the compliance cost of taxation. The research Article work has been undertaken after the study of a research article published by Arindam Das Gupta on the Compliance Cost of Taxation which is one of the first commentaries on Compliance Costs incurred in Taxation in Post liberalised Economy after 1990. This research Article has also borrowed ideas discussed under the Report produced by the Kelkar Committee created by the finance Ministry of the Government of India as a Direct Tax Task Force. The context of the article has been limited to individuals' compliance with tax system no corporate and other legal persons. This Article tries to determine the impact of compliance cost in a larger scale by applying the determinants of compliance costs of taxation to different classifications of tax payers. And deduce certain trends from determinants of the compliance costs found and apply those trends find the cost of compliance to the overall demographic of the country. Finally, identifying significant ways with regard to the findings through which the compliance costs burden of the tax payers can be reduced.

## 1) Literature Review

**Tax Compliance Cost: Measurement and Policy by Cedric Sandford (1995) Fiscal Publications** – This Book edited by Cedric Sandford is a compendium various studies undertook on a specific talking point of Tax Compliance by a diverse array of studies and research done by various policy makers around the world from a conference held on the same cause as the title of the book on September 1994. The main theme of the conference was to cognize the application of tax compliance cost measurement in policy making.

**Compliance Cost and Taxation Impact Statement by Chris Evans and Michael Walpole (1996), Australian Tax Forum** – this book is essentially is compilation, review and commentary on Tax administration and procedure of OECD (Organisation for Economic Cooperation and Development) Countries. It also discuss about the component of compliance cost and its role in taxation with the context of Australian Tax system.

## 2) Introduction

The definition of tax compliance cost propounded by the imminent British economist specialising his works around the heads taxation and public finance Cedric Sandford through his book is as follows:-

“Tax compliance costs are the costs incurred by the taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities. They are costs over and above the actual payment of tax and over and above any distortion costs inherent in the nature of the tax.”<sup>1</sup>

The U.S. Internal Revenue Service (IRS) gives out an definition for the practice of taxpayer compliance includes the requirement that they file all required tax returns accurately and on time as set out in the Internal Revenue Code, together with relevant regulations and judicial rulings.<sup>2</sup>

Simply put the Taxpayer Compliance Burden or Compliance Cost of Personal Income tax can be described as the time and money spent by the tax payers to comply with the tax system. This includes all the costs incurred by the tax payer in order to ensure tax compliance which is inclusive of capital, labour and intermediate inputs expended by taxpayer. In certain cases it

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<sup>1</sup> Tax Compliance Costs: Measurement and Policy by Cedric Sandford (1995)

<sup>2</sup> Linkages between Compliance Costs and Taxpayer Compliance Research by John Hasseldine (2000)

can also be interpreted as fees charged by tax experts who advise for complying with the most advantageous tax regime to comply with in order to obtain maximum benefit for the person who is being assessed. Digging further in, we can deem that the financial and time cost expended in acquiring fiscal knowledge regarding taxation systems, cost of time lost in filing tax returns and storing the data, travel and lodging costs incurred while visiting revenue authorities, payments to professionals, advisers, incidental expenses such as postage and telephone might also be brought under the ambit of cost incurred in order to ensure Tax compliance. Cedric Sandford has also accentuated that the inclusion of psychic costs comprising of stress and agony in dealing with one's tax affairs, in particular for the poorer pensioners, widows and divorced and separated woman under the radar of cost incurred during tax compliance in one of his earlier works.<sup>3</sup>

The Extent of Compliance with Tax regime of a State legislation by an individual by far can be deemed as the most important factor determining the Compliance Cost of Taxation. Ordinarily the intent of a taxpayer is to stick to the lowest possible tax he should pay to a tax regime in order to withhold to the money he made through his occupation, business or profession. This intent of the tax payers naturally leads them to spending a lot in the form of cost of Compliance to taxation. Thus it is safe to adjudge that the tax payer's attitude towards compliance with a tax regime and assessment of a tax structure determine the extent of compliance to a tax regime by an individual. And this extent of compliance to a tax regime when addressed collectively will be a component to look at when the study of measurement of Tax Compliance is undertaken.

Although the act of non compliance with a tax regime by an individual tax payer is usually deliberate and consciously done, sometimes non compliance can also be unintentional or merely done by a virtue of mistake. There might be various reasons for unintentional non-compliance ranging from an accounting error due to carelessness or omission or misinterpretation of law governing taxation. Moreover, the complexity and ambiguity of a taxing system plays a key role in the commission of this unintentional errors and omission. The mere aspect of acquiring the required fiscal knowledge of the taxing system and the effort needed to acquire the knowledge becomes difficult master or even learn owing to the above mentioned reasons, in turn facilitating for more noncompliance with a tax regime.

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<sup>3</sup> Administrative and Compliance Taxation by Cedric Sandford, Michael Godwin, Peter Hardwick (1989)

### 3) Classification of Compliance Costs of Taxation

The elements of Compliance Costs listed above are grouped under the following three categories in order to ease the measurement of tax compliance. These are the computational costs, planning costs and advisory costs as listed by various economists including Amin Ali Talib.<sup>4</sup> The measurements of these costs are quintessential as the application of economic and tax policies essentially depend on how much cost each head represents. For instance, a government's tax policy facilitating Simplification would reduce the Computation costs but will max out the advisory cost to be incurred in order to make the best assessment of tax owing to the uncertainty in the taxing system.

Another system of classification approach which can prove crucial is the classification of compliance cost of taxation is the classification based on stages of implementation of tax legislation. Commencement Costs, Temporary Costs and the Regular Costs are the cost of compliance which will occur to an assessee when looked at with approach of classification based on stages of implementation of Tax Legislation as listed out by Evans and Walpole.<sup>5</sup> The Commencement Cost is the cost of compliance incurred when new tax legislation is introduced in state. The Temporary Cost of compliance is the cost of compliance incurred while the adaption into a tax regime takes place. This is both incurred by the tax collectors or the revenue officers and the tax payers. The regular cost of compliance is the cost of compliance occurring habitually while complying with the tax regime. This classification also serves a very important purpose for example if the tax legislation of a particular state is frequently changed or revised it opens a gate of expending a lot of cost of compliance under the head of commencement costs and temporary costs.

One other system of classification of Compliance Cost of Taxation was proposed by Mike Eland based of the September 1994 conference on measurement of Tax Compliance Costs. This system of classification basically divides the Compliance Cost of Taxation into two namely the Recurrent and Non Recurrent.<sup>6</sup> The former is the compliance cost ordinarily expended while filing for taxes such as the cost incurred on the maintenance of accounting systems and certain records, completion of tax returns and dealing with visits from customs officers. While the latter normally encompasses the cost incurred on time spent in planning

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<sup>4</sup> Compliance Cost of Taxation by Amin Ali Talib (1996)

<sup>5</sup> Compliance Cost and Taxation impact Statement by Chris Evans and Michael Walpole (1996)

<sup>6</sup> Tax Compliance Costs: the Problems and the Practice – Customs and Excise by Mike Eland (1995)

and preparing for the new tax generally, changes to existing administrative systems, training of staff and any consequential printing and stationary costs while complying with the assessee's wants and conveniences.

#### 4) Determinants of Tax Compliance

The extent of non compliance with Tax regime as mentioned earlier is largely affected by the attitude of the tax payer towards the taxing System, Tax Legislation and revenue officers by extension the government. And as mentioned earlier, a tax payer generally tends to evade or show non compliance to a taxing regime.

(a) While looking to exhibit non compliance to a taxing system an individual tax payer consider feasibility of the choices of tax evasion they have and the probability and quantum of punishment or penalty of the tax evasion so done which effectively boils down to the **efficiency in tax enforcement**.<sup>7</sup> This in turn determined by the environment that is the kind of occupation, business or profession an individual is pursuing. The tax law enforcement in our country is not immune to corruption in its administration. This is individually the biggest factor affecting the voluntary noncompliance with a tax regime.

(b) The **tax burden** is one other direct determinant of Compliance to a Taxing Regime. In particular heavy tax rates discourage the tax payer from complying with the tax system. Though theoretically indeterminate in its impact, all studies we are aware of have, to date, found a negative impact on tax compliance.<sup>8</sup>

(c) **Development in technological aspect** such as E-transactions through Banking channels have considerably brought down the cost of tax compliance and have also make monitoring of tax compliance by individuals highly facile. But it is also significant to mention that such sophisticated financial systems have also lubricated the process of crossing international borders and opened up new pathway for tax evasion.

(d) **The sheer size of transactions and the number of transaction** can be a indispensable factor in determining the Compliance cost incurred while writing of income taxes. If

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<sup>7</sup> The Effects of Tax Reform on Tax Evasion by Ian Wallschutsky (1988)

<sup>8</sup> Voluntary tax compliance behaviour of Spanish income tax payers by de Juan, Ana, Miguel A. Lasheras and Rafaela Mayo (1994)

development is associated with scale economies in the size of transactions, this will tend to reduce non-compliance.<sup>9</sup>

(e) The **distribution of wealth** among individual in a country is one other factor determining Compliance cost of taxation. High industrial concentration means the existence of fewer large taxpayers in the economy. And the monitoring process of these few tax payers is relatively easier than monitoring a lot of small tax payers owning many small industries or businesses.

(f) The **timing of tax liabilities** that is the frequency with which the taxes have to be paid to the Government is another notable determinant of Compliance Cost of Taxation. For instance when a person running a business which yield irregular income when taxed frequently for example monthly may be shift the attitude of the particular tax payer towards non compliance.

(g) Determinants of Tax Avoidance including **unnecessary Deductions and exemptions, ambiguous provisions** in the tax code also directly affect tax compliance. For example, existence of necessary deductions and unnecessary exemption affects psychology of the taxpayer and drive the way from Non Compliance of Tax Payment.

(h) Certain "**Cultural**" **factors** may significantly influence taxpayer attitudes Compliance or Non Compliance to a Tax System. This includes aspects such as fiscal knowledge, income and social class, risk aversion, race, age, sex, occupation, peer attitudes to evasion and bribe payment, deference to authority, and acquaintance with tax offenders.<sup>10</sup>

(i) Besides Deliberate Misrepresentation, as already discussed the **Complexity of Taxing System** influences non-compliance by inducing misinterpretation of rules, omissions and unintentional errors.

(j) The **Tax payer's perception** towards the efficient disposal of the individual's tax money the government psychologically shapes to the tax payers' mind for complying with tax regime of the government. For example, if the government uses taxes efficiently to provide a desirable mix of public goods the tax payer may show more compliance toward the tax regime.

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<sup>9</sup> A Theory of Hard to Tax Group by Arindham Das Gupta (1994)

<sup>10</sup> Why People Pay Taxes: Tax Compliance and Enforcement by Joel Slemrod (1992)

(k) **Improved Taxpayer Service** and deliberate imposition of high cost of Compliance Costs to taxes by the taxing regime in promoting compliance have also been confirmed to affect the tax Compliance of an individual.

(m) The existence of a **well developed accounting profession and of tax preparers** may encourage tax avoidance among tax payer especially of the high tax paying businessman niche in turn inducing the attitude toward non compliance with Taxing System.

(n) The follow up **costs of Administrative Proceedings** including prosecutions, appeals, Scrutiny Assessments are usually an unnecessary cost to incur and a prudent tax payer will try to avoid those costs.

## 5) Trends in Compliance Cost of Taxation

Based on an empirical research undertook by one of the most celebrated Indian Economist Arindam Das Gupta who specializes on Taxation and Public Finance,<sup>11</sup> Certain trends have been invariably found to be followed across the whole Indian Tax Regime. Those trends also comply with impact of the determinants of Compliance Costs of Taxation and in furtherance Determinants of Non- Compliance to a Tax Regime of a State. These results are essentially the results of tax compliance assessed after the reform of the economic policies during the 1990's and opening up the economy to globalisation. This concurrence of Trends of Tax Compliance in the Indian scenario with determinants determined after various researches undertook where the sampling base was a foreign economy shows that the Indian Economy has mirrored the approach of economic administration shouldered a western foreign economy and increasing advanced towards a more open market economy leading way to globalisation.

The basic features of the trend when segregated on the basis of type of tax payers are found to be Salaried Tax Payer have lower compliance costs to taxation while a Non Salaried Tax payers have comparatively higher Costs of tax compliance than that of Salaried Tax payer. The conjecture can be easily attributed to one major reason which is institutionalised and regularised record keeping and the reporting of the same. This both enhances and cuts costs on the preparation process of Tax filing and psychologically drives the tax payer away from tax evasion and Non-Compliance to a Tax Regime.

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<sup>11</sup> Compliance Cost of Personal Income Tax and its Determinants by Arindam Das Gupta and Saumen Chattopadhyay (2002) pg 39

One other important trend to be noted is that Compliance Cost of Taxation usually increases when the Income of the tax payer increases. This is generally because that the tax burden of the tax payer when moving from one tax slab to higher tax slab increases with which the compliance cost increase. But the rate of increase follows a decreasing trend as a level of saturation is reached.

Usually the tax payer from an urban area tends to pay a higher cost of compliance than that of a tax payer resident to rural or semi urban regions. This is largely attributed to the cultural factors and the complexity of the tax system. Generally, the compliance cost increases in urban region to due to the availability of certain deduction exclusively to urban and metropolitan cities increasing the complexity of the taxation and in turn increasing the compliance costs.

Tax payers educated on the taxing systems of the country usually happens to pay a reduced amount of tax when compared to the tax payers who are under educated or outright not aware of the tax system of the country. This is simply because of the complexity of the tax regime tends to increase the compliance costs of taxation. Also this also opens way to the tax experts and practitioners of accounting profession to flourish.

## **6) Conclusion and Suggestions**

All the data mentioned above including how the determinants of Compliance of tax regime work that is the application of each determinant to a tax regime and the general trends of compliance of taxes by an individual with reference to the demographics of the tax payers it is safe to conclude that the compliance cost of taxation in the Indian Tax Regime is extortionate. This is in Comparison with the international standards. This increases the Tax Burden of the individual tax payers and paves way for them to choose non compliance to the tax regime. Also we should forget the psychic costs involved with this issue which will further aggravate the already existing situation with non compliance of taxes. Further provoking the problem with non compliance of taxation is the issue of corruption. Wide spread corruption in the taxing and revenue departments of the government only encourage the ordinary tax payer to show non compliance to a tax regime. Cumbersome procedures, substantive legislative provision also loosely add to the existing problem. Thus it becomes the duty of government to resolve this issue so as individual's accountability is increased and the taxes are properly collected. In ensuring that hundred per cent compliance is shown by every individual tax payer in the country, the government can also secure more revenue in the form of taxes boosting the GDP



of the country and having more revenue at their disposal for public finance. The tax payer is also benefitted as the economy of the country is progressing and the buying power of each individual is enhanced and government is able to provide them with more welfare projects.

The report from the Kelkar Committee which is the Direct Tax Task Force created by the Government of India's Ministry of Finance in 2002 was authorised to look into the issue of Non Compliance of Taxation. Some of the important observations include Tax Structure Simplification, Institutional Reforms, Procedural Reform, Enhanced Monitoring and Client Feedback Procedures, Tax policy process reforms and Automation. This can very well be applied to today's scenario with Non Compliance of Taxing today as although here has been certain progress with the issue, the core problems remain unanswered. For instance, the corruption issues is mainly due to the (a) continued reliance on excessive discretion to low level officers who have limited accountability resulting in procedures and a mindset that is antitaxpayer; (b) a widespread culture of bribes and unhelpful treatment of taxpayers; (c) and an archaic organization structure, which is taxpayer based under a single officer system, rather than organized along modern, functional lines.<sup>12</sup> This issue can only be addressed by bringing in Institutional and Procedural Reforms.

Tax Structure Simplification will enhance tax compliance with the under educated tax payer who are not aware of Tax Regime while Automation will generally cut most of the intermediate costs and reduce the cost of tax compliance. Client Feedback Procedures will both reduce Corruption in the system and enhance the psychology of the tax payer to comply with the Tax System of the Country. On the whole a Tax Policy Process Reform in a stage by stage manner is the need of the country.

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<sup>12</sup> Id pg 66

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