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THE COSTS AND BENEFITS OF COMPLYING WITH THE TAX SYSTEM AND THEIR IMPACT ON THE FINANCIAL MANAGEMENT OF THE SMALL FIRM

PHIL LIGNIER*

Empirical research carried out in different countries provides strong evidence that tax compliance costs impact more heavily on small firms. In addition, results showed that the regressivity of tax compliance costs according to size was even more accentuated after taking into consideration the effects of the cash flow and tax deductibility benefits of tax compliance. However, it has been suggested in the literature that business taxpayers could also be deriving managerial benefits as a result of complying with tax. These managerial benefits are expected to come in the form of a better knowledge of financial affairs and the improved decision-making that will be brought about by the more stringent record keeping imposed by tax requirements. The existing evidence indicates that these managerial benefits could be significant, particularly in smaller firms where accounting systems are initially undeveloped. The paper argues that the incidence of tax compliance activities on small businesses is still incompletely understood. Very little explanatory research has attempted to study the relationships between potential influencing factors and the magnitude of tax compliance costs. Likewise, the managerial benefits of tax compliance are still largely unexplored. It is argued that fresh empirical data and further investigation are needed in order to identify the conditions in which managerial benefits may be derived and to measure their impact on the financial management of the small firm.

I INTRODUCTION

Over recent decades, the cost of complying with taxation obligations has generated widespread interest among academics, government policy makers and business organisations. Most authors trace this renewed interest to the work undertaken by Cedric Sandford in the United Kingdom and overseas during the 1970s and 1980s.¹ In Australia, the cost of tax compliance has been the object of a significant number of research projects, many of them initiated and coordinated by the Australian Taxation Studies Program ('ATAX').² The growing complexity of tax systems, the introduction of Goods and Services Tax ('GST') or Value Added Tax ('VAT') legislative regimes — generally associated with high compliance costs — and the increased emphasis placed on self-assessment are among the reasons generally put forward to explain the increasing interest in compliance costs research.³

One essential characteristic of tax compliance costs revealed by empirical research is their regressive nature in relation to business size.⁴ Consequently, the financial burden of tax compliance appears to be much heavier for small firms than it is for large entities.

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¹ Sandford's seminal works include C Sandford, 'Improving the methodologies' in C Sandford (ed), *Tax compliance costs measurement and policy* (1995); C Sandford, M Godwin and P Hardwick, *Administrative and compliance costs of taxation* (1989); C Sandford et al, *Costs & benefits of VAT* (1981).

² C Evans, 'Studying the studies: an overview of recent research into taxation operation costs' (2003) 1 *eJournal of Taxation* 64.

³ Ibid; C Sandford, 'Improving the methodologies' in C Sandford (ed), *Tax compliance costs measurement and policy* (1995).

⁴ See, eg, C Evans et al, 'A report into the incremental costs of taxpayer compliance' (Australian Taxation Office, 1996); C Sandford and J Hasseldine, 'The compliance costs of business taxes in New Zealand' (Institute of Policy Studies, 1992); Yellow Pages, 'Working overtime: A National survey of the paperwork burden of small business' (Background Paper 3, Small Business Deregulation Task Force, 1996).

Sandford further argued that the operation of a tax system generates costs, but also benefits the taxpayer. In particular, he identified managerial benefits in the form of a better knowledge of financial affairs and improved decision-making brought about by compliance work and better record keeping.⁵ Managerial benefits have been discussed in a number of papers,⁶ however to date there is scant empirical evidence regarding their importance.

The burden imposed by tax compliance on small business has been documented and analysed by the Small Business Deregulation Task Force ('Bell Task Force') in Australia.⁷ Following the publication of the Bell report, a number of governmental initiatives, such as the preparation of Regulation Impact Statements, and the Simplified Tax System were introduced in an effort to alleviate the incidence of tax compliance on small businesses. However, almost ten years after the Bell report, many authors argue that small businesses, particularly micro-businesses are still faced with significant tax compliance costs.⁸

This paper examines the costs and benefits resulting from tax compliance activities in the context of Small and Medium Enterprises ('SMEs') for which particular attention is justified on several grounds. First, significant empirical research has established that the burden of tax compliance costs is felt more acutely by small businesses. Second, managerial benefits derived as a result of tax compliance activities are more likely to arise in smaller firms, because their accounting information systems are generally less developed. Both costs and benefits of complying with tax are being considered, however the emphasis in this paper is on managerial benefits which have been identified by some authors as an under-researched area.⁹

First, the paper introduces key definitions and concepts associated with tax compliance costs and benefits. Next, the costs incurred by SMEs while complying with tax are examined and analysed. Then, potential managerial benefits derived as a result of tax compliance activities are considered. This section will discuss the concept of managerial benefits, identify particular forms of managerial benefits and examine the empirical evidence on their significance. In the following section, theoretical issues relating to the measurement of tax compliance costs and benefits are discussed. Finally, areas that warrant further research are identified.

II DEFINITIONS AND CONCEPTS

A *What are Tax Compliance Costs?*

Throughout the tax literature, the term 'tax compliance costs', and its numerous related concepts, have been given a variety of definitions. One of the earliest definitions was proposed by Johnston who identified tax compliance costs as '[t]he reduction in the corporation's operating costs, exclusive of the tax itself, which would result if the federal tax were eliminated.'¹⁰ Sandford, Godwin and Hardwick described tax compliance costs as 'those costs incurred by taxpayers and third parties such as businesses in complying with a given structure

⁵ C Sandford, M Godwin and P Hardwick, *Administrative and Compliance Costs of Taxation* (1989) 89.

⁶ Eg C Sandford et al, *Costs and Benefits of VAT* (1981); Binh Tran-Nam et al, 'Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia' (2000) 53(2) *National Tax Journal* 229.

⁷ M Dirkis and B Bondfield, 'Small business: the first casualty of tax reform compliance costs' (Taxation Institute of Australia, 2004).

⁸ C Coleman and C Evans, 'Tax Compliance Issues for Small Business in Australia' in N Warren (ed) *Taxing Small Business: Developing Good Tax Policies Conference Series No 23* (2003).

⁹ B Binh Tran-Nam, 'Tax compliance costs methodology - a research agenda for the future' in C Evans, J Pope and J Hasseldine (eds), *Tax compliance costs: A Festschrift for Cedric Sandford* (2001).

¹⁰ K S Johnston *Corporations' Federal Income Tax Compliance Costs* (Monograph No 10 thesis, Ohio State University, 1963) 5.

and level of tax.’¹¹ A few years later, Sandford gave a more comprehensive definition of tax compliance costs similar to Johnston’s, asserting that they are: ‘Costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities ... over and above the actual payment of tax; costs which would disappear if the tax was abolished.’¹²

As will be discussed later, the definition of tax compliance costs adopted has important implications on such issues as the disentanglement of tax and accounting costs and the identification of managerial benefits. The literature also introduces several key semantic concepts related to tax compliance. Although there seems to be a general consensus on the meaning of many of these concepts, slight differences in terminology can be noted.

Sandford, Godwin and Hardwick defined ‘taxation operating costs’ as the sum of public sector costs and private sector costs.¹³ Public sector costs correspond to administrative costs borne by the tax authorities while administering the tax code and other costs such the costs associated with the enactment of the legislation.¹⁴ Private sector costs are incurred by taxpayers and third parties while meeting the requirements of the tax system.¹⁵

Also of note are the ‘social costs of compliance’ (‘SCC’) which can be divided into the costs borne directly by the taxpayer (‘taxpayer compliance costs’) and economic efficiency costs.¹⁶ Economic efficiency costs result from the distortion in the pattern of consumption caused by the existence of a particular tax (‘distortion costs’).¹⁷

B *Gross and Net Compliance Costs*

Most published research adheres to the convention established by Sandford and distinguishes between gross compliance costs and net compliance costs.¹⁸ Net compliance costs are equal to gross compliance costs less tax compliance benefits. Benefits from tax compliance include cash flow benefits, tax deductibility benefits and managerial benefits.¹⁹

Some commentators have expressed doubts as to the validity of the term ‘net compliance costs.’ It has been contended, for instance, that cash flow benefits do not arise because of compliance and that gross compliance costs are a more appropriate measure to use as they reflect the economic resource cost of complying with the tax system.²⁰ Pope, Fayle and Chen, on the other hand, argued that net compliance costs are a good indicator of the effective burden of complying with the tax system.²¹

¹¹ Sandford, Godwin and Hardwick, above n 5, 10.

¹² C C Sandford, ‘The Rise and rise of tax compliance costs’ in C Sandford (ed), *Tax compliance costs measurement and policy* (1995) .

¹³ Sandford, Godwin and Hardwick, above n 5, 22.

¹⁴ Ibid 6.

¹⁵ Ibid 9.

¹⁶ B Binh Tran-Nam et al, ‘Tax compliance costs: Research methodology and empirical evidence from Australia’ (2000) 53(2) *National Tax Journal* 229.

¹⁷ Ibid.

¹⁸ See Sandford, Godwin and Hardwick, above n 5, 13–14.

¹⁹ Ibid.

²⁰ See I Wallschutzky, ‘The Compliance Costs of Taxes on Businesses and Individuals: A Review of the Evidence’ (Paper presented at the Compliance Costs of Business Taxation Workshop, Melbourne, [1990]); G. Smith, ‘Future developments in the taxation system’ (Paper presented at the Compliance Costs of Business Taxation Workshop, Melbourne, 1990) .

²¹ J Pope, R Fayle and D Chen, *The compliance costs of companies’ Income Tax in Australia* (1994).

C Other Classifications of Compliance Costs

The distinction between *avoidable* (corresponding to activities such as tax planning) and *unavoidable* costs has also been widely discussed in the literature.²² The question regarding the inclusion of avoidable costs in the evaluation of tax compliance costs has not received a conclusive answer as yet.

The literature also differentiates between *commencement*, *start-up* or *transitional* costs and *regular* or *recurrent* costs. Commencement costs may include expenses such as initial training or computer hardware and software.²³ Commencement costs pose a problem to the researcher since they occur once and make inter-temporal comparisons difficult. Tran-Nam et al also refer to *explicit* costs (i.e. involving direct payment by the taxpayer) in contrast to *implicit* (e.g. taxpayer's own time and unpaid helpers).²⁴

Finally, *psychic* or *psychological* costs first mentioned by Sandford have been attributed to the anxiety and frustration caused by complying with tax.²⁵ These costs are difficult to measure or quantify, however their existence is recognised in many research papers and government reports.²⁶ Research is currently being undertaken on this issue.²⁷

D Tax Deductibility Benefits

Tax deductibility benefits result from the fact that business taxpayers will be entitled to deductions for some of their compliance costs.²⁸ Such benefits were first considered by Johnston who computed the before-tax and after-tax compliance costs of the corporations which he studied.²⁹ While the reduction of tax payable will benefit the taxpayer, the aggregate value of tax deductibility benefits does not represent a benefit for the economy as a whole as it will be offset by revenue losses to the tax authorities.³⁰ The value of the tax deductibility benefit will depend on the marginal tax rate of the individual taxpayer or the corporate tax rate in the case of companies. The assumption made in most research is that the taxpayers are well informed and optimising and that they will claim the full tax deduction to which they are entitled.³¹

E Cash Flow Benefits

Cash flow benefits arise because of the difference between the time when money is collected by the taxpayer and the time when the tax is actually handed over to the tax authorities.³² As in the case of tax deductibility benefits, cash flow benefits are merely a transfer of costs between the taxpayer and the tax authorities.³³ The value of cash flow benefits depends on four variables:

²² See Johnston, above n 10; Sandford, Godwin and Hardwick, above n 5; J J Pope, R Fayle and M Duncason, *The compliance costs of Personal Income Taxation in Australia 1986-87* (1990).

²³ Sandford, Godwin and Hardwick, above n 6, 16.

²⁴ Tran-Nam et al, above n 16, 236.

²⁵ Sandford, Godwin and Hardwick, above n 5, 18.

²⁶ See, eg, S Saumen Chattopadhyay and Arindan Das-Gupta, 'The compliance costs of the personal income tax and its determinants' (National Institute of Public Finance and Policy, 2002); Business NZ and KPMG, 'Summary report of the Business New Zealand- KMPG compliance costs survey' (Business New Zealand, 2004).

²⁷ R Woellner et al, 'Taxation or vexation: measuring the psychological costs of tax compliance' in C Evans, J Pope and J Hasseldine (eds), *Tax compliance costs : A Festschrift for Cedric Sandford* (2001).

²⁸ Tran-Nam et al, above n 16, 238.

²⁹ Johnston, above n 10, 10–11.

³⁰ Tran-Nam et al, above n 16, 233.

³¹ Ibid.

³² Sandford, Godwin and Hardwick, above n 5, 13.

³³ Ibid.

the type of tax involved, the time lag between the receipt of the income and the payment of the tax, the use made of cash flow benefits and the interest rate.³⁴

The type of tax (direct or indirect), the design of the tax and the business cycle will determine when the amount of tax is collected and when it is paid.³⁵ This can be illustrated by the example of the Australian GST. The time lag and hence the size of the cash flow benefit derived from complying with GST will be dependent on the following determinants: the basis used for accounting for GST (cash or accrual); the periodicity of the GST return (monthly or quarterly); the delays in obtaining payment from customers; the delay in sending payment to suppliers.

Interest rates should be chosen with reference to some interest rate benchmark and to the use that will be made of the available cash.³⁶ For many small businesses with a bank overdraft, the overdraft rate (usually high) may be used as the reference rate.³⁷

F *Managerial Benefits*

Managerial benefits have already been introduced and are discussed in further detail later in this paper. At this stage, it can be said of managerial benefits that they arise because, as a result of tax compliance, businesses keep better accounting records and use these records for improved decision-making.³⁸ Even though the concept is straightforward, managerial benefits are, of their nature, elusive and their identification and their quantification pose problems.³⁹ According to Tran-Nam, this is the main reason why managerial benefits were generally ignored by researchers in their evaluation of net compliance costs.⁴⁰

III THE COSTS OF COMPLYING WITH TAX FOR SMALL BUSINESS

A *The Magnitude of Tax Compliance Costs: International Comparisons*

The evaluation of tax compliance costs has been the object of numerous studies and the overall findings are that tax compliance costs are large and that they fall disproportionately on small business taxpayers.⁴¹

The most recent comprehensive survey of tax compliance costs for business taxpayers in Australia was conducted in 1994–95. The research findings show an average compliance cost per business taxpayer of \$1898 (after deduction of tax deductibility benefits and cash flow benefits). Expressed as a per centage of tax revenue, net tax compliance costs of all Australian business taxpayers represented 9.4 per cent of total tax revenue.⁴²

Although international comparisons can help evaluate the relative importance of Australian findings, the different nature of the surveys make the interpretation of research outcomes very difficult.⁴³ The survey of New Zealand businesses in 1990–91 is probably one of the best benchmarks available. Expressed as a per centage of GDP,⁴⁴ the aggregate compliance was

³⁴ C Evans et al, 'A report into taxpayer costs of compliance' (Australian Taxation Office, 1997) Evans et al, *A Report into Taxpayer Costs of Compliance* (Australian Taxation Office, 1997) 14–15., 14–15.

³⁵ Sandford, Godwin and Hardwick, above n 5, 39.

³⁶ Evans et al., *A report into taxpayer costs of compliance*, above n 34, 13.

³⁷ Sandford and Hasseldine, above n 4, 11.

³⁸ Ibid 7.

³⁹ Sandford et al, above n 6.

⁴⁰ Tran-Nam, above n 9.

⁴¹ Sandford, 'The Rise and Rise of Tax Compliance Costs', above n 12, 5.

⁴² Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 53.

⁴³ Ibid 72–3.

⁴⁴ Because taxes in different countries are applied with different tax rates, ratios of tax compliance costs to GDP are more meaningful than ratios relative to tax revenue.

estimated at 2.5 per cent of the New Zealand GDP,⁴⁵ compared with social costs of tax compliance (before tax deductibility benefits and cash flow benefits) representing 1.95 per cent of GDP in Australia in 1994-95.⁴⁶

A few authors have commented on the inconsistencies that exist between different studies. For instance, Wallschutzky and Gibson concluded from their case study of 12 Australian businesses that compliance costs did not constitute a first order problem for small businesses.⁴⁷ Similarly, Pope's estimate of compliance costs with company tax in Australia was five times higher than Sandford's estimate of the compliance costs with the UK corporate tax.⁴⁸ However, these discrepancies have generally been attributed to conceptual and methodological problems which are beyond the scope of the present paper.

B *The Regressive Nature of Tax Compliance Costs*

The regressive nature of tax compliance costs was first identified by Bryden and has since been confirmed by a number of other studies both in Australia⁴⁹ and internationally.⁵⁰ The results of the Australian study are presented below. Table 1 ⁵¹ presents the estimated average tax compliance costs for Australian business taxpayers classified by firm size, while Table 2 ⁵² shows average tax compliance costs by size categories expressed as a per centage of turnover. The categories used for firm size were consistent with ATO annual turnover classifications: 'small' meaning turnover less than \$100 000; 'medium' meaning turnover between \$100 000 and \$9.99 million; and 'large' meaning turnover of \$10 million and over.

Table 1: Estimated Average Compliance Costs of Australian Business Taxpayers by Business Size 1994-95

	All Firms	Small*	Medium*	Large*
Social Costs of Compliance	\$3,624	\$1,707	\$8,784	\$91,864
Tax Deductibility Benefits	(\$999)	(\$358)	(\$2834)	(\$24,995)
Cash Flow Benefits	(\$727)	(\$113)	(\$1,016)	(\$96,963)
Net Compliance Costs	\$1,898	\$1,235	\$4,935	(\$30,052)

Table 2: Estimated Average Compliance Costs of Australian Business Taxpayers as a Per centage of Turnover by Business Size 1994-95

	Small	Medium	Large
Social Costs of Compliance	3.41 per cent	0.17 per cent	0.18 per cent
Net Compliance Cost	2.47 per cent	0.1 per cent	(0.06 per cent)

The figures indicate that regressivity was more accentuated after deduction of compliance benefits, particularly cash flow benefits. While small firms had average net compliance costs of

⁴⁵ J Hasseldine, 'Compliance costs of business taxes in New Zealand' in C Sandford (ed), *Tax compliance costs measurement and policy* (1995).

⁴⁶ Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 53.

⁴⁷ I Wallschutzky and B Gibson, 'Small business cost of tax compliance' (1993) 10 *Australian Tax Forum* 511.

⁴⁸ S Stephen Rimmer and Stuart Wilson, 'Compliance costs of taxation in Australia' (Office of Regulation Review, 1996).

⁴⁹ Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34.

⁵⁰ See Sandford, Godwin and Hardwick, above n 5, p 28-9.

⁵¹ *Ibid* 52.

⁵² *Ibid* 79, 81.

\$1235, the estimate was \$4935 for medium firms. Large firms obtained an average net benefit of \$30 000 from complying with their tax obligations.⁵³ Gross compliance costs or the social cost of compliance represented 3.41 per cent of the turnover of small businesses but only 0.18 per cent of the turnover of large businesses. Further, net compliance costs for small businesses were equal to 2.47 per cent of turnover but only 0.1 per cent of turnover for the medium size category.

These results were broadly consistent with outcomes from earlier surveys. Average gross tax compliance costs for UK businesses in 1986–87 were found to represent 3.66 per cent of turnover for businesses in the less than £100 000 (A\$238 000) category, 0.62 per cent in the £100 000 to £1m (A\$2.38 million) category and 0.17 per cent in the over £1 million group.⁵⁴ Mean gross compliance costs for New Zealand businesses surveyed in 1990–91 ranged from 6.5 per cent of turnover for businesses with an annual turnover between NZ\$30 000 (A\$27 900) and NZ\$100 000 (A\$93 000) to 0.03 per cent for firms with an annual turnover over NZ\$50 million (A\$46.5 million).⁵⁵

In the US, a survey of regulatory costs conducted by the Office of Advocacy revealed average tax compliance costs for all firms to be equivalent to US\$665 (A\$899) per employee.⁵⁶ Broken down by firm size, the cost per employee was US\$1202 (A\$1624) for firms with less than 20 employees, US\$625 (A\$845) for firms having between 20 and 499 employees and US\$562 (A\$759) for firms employing more than 500 people.

The above results obtained from large scale surveys undertaken in four different countries confirm the assumption that tax compliance costs are highly regressive with respect to firm size, with a compliance burden (expressed as a per centage of turnover) being on average twenty times heavier for small firms than it is for large firms. However, as the research from the US indicates, the regressivity seems to be less accentuated when size is measured in terms of number of employees.

C *The Costs of Complying with Specific Taxes*

As highlighted previously, the Australian study was one of the few studies that analysed overall compliance costs for all taxes,⁵⁷ notwithstanding that most tax compliance costs research in Australia has measured the cost of complying with specific taxes: personal income tax, employment taxes, corporation tax and others.⁵⁸ GST has been the tax that has attracted by far the greatest interest, probably because it affects a large number of small business taxpayers and because it is expected that the transaction-based nature of GST/VAT will generate high compliance costs. The focus of GST studies in Australia has been on the start-up costs associated with the new tax.⁵⁹ Average start-up costs of GST for small business have been estimated

⁵³ At the time of this survey, GST was not applicable in Australia. Instead, some businesses had to comply with the Wholesale Sales Tax legislation which had a far more limited application. Considering the compliance costs associated with GST (see below), it is expected that if the survey were undertaken 10 years later, the average net compliance costs would have been significantly higher.

⁵⁴ Sandford, Godwin and Hardwick, above n 5, 199.

⁵⁵ Sandford and Hasseldine, above n 4, 108.

⁵⁶ The evaluation of Tax compliance costs relies on the method adopted by the Tax Foundation. W. M. Crain and T. D. Hopkins, 'The impact of regulatory costs on small firms' (The Office of Advocacy, US Small Business Administration, 2001).

⁵⁷ See also M Allers, Maarten Allers, *Administrative and compliance costs of taxation and public transfers in the Netherlands* (1994) which looked concurrently at all business taxes in the Netherlands.

⁵⁸ See extensive studies by Pope in this area: Pope, Fayle and Duncason, J Pope, R Fayle and M Duncason, *The compliance costs of Personal Income Taxation in Australia 1986-87* (1990) above n 22; J. Pope, R. Fayle and D. Chen, *The compliance costs of employment related taxation in Australia* (1993); J. Pope, R. Fayle and D. Chen, *The compliance costs of Wholesale Sales Tax in Australia*, Australian Tax Research Foundation (1993); J Pope, R Fayle and D Chen, *The compliance costs of companies' Income Tax in Australia* (1994).

⁵⁹ GST was introduced in Australia on 1 July 2000.

between \$5000 and \$7000.⁶⁰ More recently, a case study of 53 Australian SMEs evaluated the recurrent costs of complying with GST at \$2481 (gross compliance costs), but the compliance burden was reduced to \$1244 after taking into account tax deductibility benefits and cash flow benefits.⁶¹

Other taxes being considered were employment taxes and company tax. The main features of compliance costs relating to employment taxes were that internal costs, particularly time costs, constituted almost 90 per cent of overall compliance costs, and that the number of employees was the main driver of costs.⁶² However the ratio of compliance costs to tax remitted was found to decrease as the amount of tax remitted increased.⁶³

The cost of complying with company tax has been examined in several countries, yet only two studies, one in the UK and one in Australia included small companies. In both cases, compliance costs of corporate taxes were found to be highly regressive.⁶⁴

The investigation of compliance costs and administrative costs associated with a particular tax provides information that is of obvious interest to policy makers and the tax authorities. However as noted by Sandford,⁶⁵ looking concurrently at different taxes avoids the problem of allocating joint costs to different taxes where there are often too interrelated to be successfully examined in isolation. On the other hand, a comprehensive study of all taxes also raises the danger of double-counting as taxpayers may inadvertently allocate the same compliance cost to more than one tax activity.⁶⁶

D Factors Influencing Tax Compliance Costs

Several factors are considered to be potential determinants of tax compliance costs of business taxpayers; these include size, legal form and industry sector.

Even though the analysis by business size seems to be a feature of many tax compliance costs surveys, size was not always measured in the same way. Turnover is the most commonly adopted measure, however number of employees, amount of tax paid or asset size have also been used.⁶⁷ It is worth considering that particular measures might be better suited to predicting the compliance costs of specific taxes. For instance, the number of employees is found to be a determining factor of the compliance costs of employment taxes.⁶⁸ The compliance costs of other taxes such as VAT/GST, income tax and corporation tax have often been analysed according to

⁶⁰ See B Binh Tran-Nam and J Glover, 'Estimating the transitional compliance costs of the GST in Australia' (2002) 17(4) *Australian Tax Forum* 499.

⁶¹ Binh Tran-Nam, John Glover and Sarah Wilkin, 'The GST recurrent compliance costs/ benefits of small business in Australia: A case study approach' (Paper presented at the 16th Annual Australasian Tax Teachers Association, Adelaide, 2004).

⁶² Sandford, Godwin and Hardwick, above n 5.

⁶³ Pope, Fayle and Chen, [The compliance costs of employment related taxation in Australia], above n 56.

⁶⁴ Compliance costs of company tax for UK companies in 1989 expressed as a percentage of annual turnover ranged from 0.77 per cent for small companies (TO < £50,000) to 0.01 per cent for large companies (TO > £10m): Sandford, Godwin and Hardwick, above n 5, 142. The mean compliance costs for all Australian companies in 1994 represented 1.4 per cent of annual turnover. However, the mean compliance costs for small companies (TO < \$500,000) was found to be equivalent to 4 per cent of annual turnover: Pope, Fayle and Chen, [The compliance costs of companies income tax above n 56, 62-3.

⁶⁵ Sandford, *Improving the Methodologies*, above n 3, 404.

⁶⁶ Telephone interview with C Evans, 27 September 2005.

⁶⁷ For studies using turnover, see Sandford, Godwin and Hardwick, above n 5; Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4. For studies using number of employees, see Sandford and Hasseldine, above n 4. For studies using amount of tax paid, see Pope, Fayle and Chen, [The compliance costs of employment related taxation], above n 56. For studies using asset size, see J Slemrod and V Venkatesh, J. Slemrod and V. Venkatesh, 'The Income tax compliance cost of large and Mid-size businesses' (University of Michigan Business School, 2002).

⁶⁸ Sandford and Hasseldine, above n 4.

the level of turnover, however studies carried out in the US suggest that firms with more assets incur greater compliance costs⁶⁹.

An analysis by entity type has also been carried out in Australia. Noting the clear correlation between entity type and the size of the business,⁷⁰ the size variable should be neutralised before measuring the influence of the legal form factor. A breakdown of the average social compliance costs after tax deductions by legal form for firms in the 'small' category revealed that trusts had the highest compliance costs (\$55.34 per \$1000 of turnover) while sole traders had the lowest (\$21.10 per \$1000 of turnover).⁷¹ The same study also considered business industry type as a variable. There is also evidence of a correlation between size and industry type which makes any interpretation of the outcomes very difficult.⁷²

Following their study of medium and large businesses in the US, Slemrod and Venkatesh presented useful two-dimensional analyses of their results.⁷³ A breakdown by asset size and type of form filed shows that in the US\$5 million to US\$10 million (A\$6.8 million to A\$13.5 million) asset size category, corporations and partnerships had almost the same level of compliance costs.⁷⁴ For all asset size categories over US\$10 million, corporations had higher compliance costs than partnerships. The analysis by industry shows that firms in the 'communications, technology and media' sector have the highest compliance costs in the US\$5 million to US\$10 million band, but in the next band — US\$10 million to US\$50 million (A\$13.5 million to A\$67.5 million) — the 'retail, food and healthcare' sector had the highest compliance costs.⁷⁵

While most tax compliance cost research is primarily descriptive, a few studies have attempted to build causal models of tax compliance costs. Beale and Lin, for instance, proposed a classification of the tax compliance costs of small businesses into three categories: costs that can be considered as fixed independently of business size (eg, learning about tax requirements), costs that do vary proportionately with size (eg, organising data and records for tax preparation) and costs that will not be avoided where they are too small to justify the expense of preventing these costs (eg, contesting erroneous assessment).⁷⁶ Beale and Lin claimed that the tax compliance burden does not vary smoothly with size but drops once some thresholds such as computerisation and access to specialised tax expertise are passed.⁷⁷

More recently, in the UK, Hasseldine and Hansford surveyed a large sample consisting of businesses of different sizes and from different industry sectors.⁷⁸ They used regression analysis to test the influence of eight determinants on the cost of compliance of VAT. They concluded that size (expressed as turnover), industry sector, use of computerised system, use of external

⁶⁹ See Slemrod and Venkatesh, above n 67.

⁷⁰ According to the study, 80.3 per cent of sole traders were small businesses (turnover < \$100,000), while 40.1 per cent of companies and 59.5 per cent of trusts belonged to that category: see Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4, 136.

⁷¹ Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 80.

⁷² For instance 58.6 per cent of construction businesses were small and 28.8 per cent of wholesale trade businesses were small: see Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4, 166.

⁷³ Slemrod and Venkatesh, above n 67.

⁷⁴ The average compliance costs were US\$24 864 for entities lodging a 1120 Form (corporations) and US\$25 467 for entities lodging a 1065 Form (partnership). Corporations qualifying for the special 'pass-through' tax treatment (Form 1120S) had much higher compliance costs of US\$48 750: see *ibid*, 42.

⁷⁵ See Slemrod and Venkatesh, above n 67, 43. The author notes that the number of observations in each cell for the 'less than US\$5 million' band, and in the bands US\$50 million and upwards, were too small to be considered statistically significant.

⁷⁶ H. Beale and K Lin, 'Impacts of federal regulations, paperwork and tax requirements on small business' (Office of the Advocacy of the US Small Business Administration, 1998).

⁷⁷ *Ibid* 282.

⁷⁸ J Hasseldine and A Hansford, 'The compliance burden of the VAT : further evidence from the UK' (2002) 17(4) *Australian Tax Forum* 369.

advisers, level of complexity, and psychological stress were statistically significant determinants of compliance costs.⁷⁹

In summary, the extant research generally supports the perception that the costs of complying with tax are high and regressive, and determined according to size. The costs of compliance were particularly high when associated to transaction based taxes such as GST. The literature also identified a range of factors which besides size could influence the tax compliance costs incurred by business taxpayers. These include legal form, industry, complexity of legislation, computer use and use of an external accountant.

IV THE BENEFITS OF COMPLYING WITH TAX FOR SMALL BUSINESSES

Several types of tax compliance benefits have been identified earlier in this paper. They are tax deductibility benefits, cash flow benefits and managerial benefits. Most authors include tax deductibility benefits and cash flow benefits to arrive at net compliance costs. As shown in Table 1 earlier in the paper, the average tax deductibility benefit (\$358) and cash flow benefit (\$113) for small Australian businesses in 1994–95 were not inconsiderable. However, it is argued in this paper that many small businesses could be deriving potentially higher ‘managerial benefits’ as a result of engaging in tax compliance activities. As managerial benefits are potentially significant, but have generally been omitted from most studies, the emphasis here will be on this type of benefit.

A The Concept of Managerial Benefit

Sandford contended that the effect of complying with tax may not always be detrimental, as individuals who complete their tax return and file the necessary information to do so, may at the same time be encouraged to engage in more efficient management of their financial affairs. These managerial benefits are likely to be more significant in the case of businesses as compliance with the tax system will force the business owner to introduce a more efficient financial information system.⁸⁰ Managerial benefits had been previously identified and estimated by Sandford in his 1981 study of the compliance costs of VAT in the UK.⁸¹ In the same publication, Sandford described managerial benefits as follows:

It is clear that there are continuing and not inconsiderable cash benefits from the better record keeping which is necessary to comply with VAT requirements. It is not possible to put a realistic value on these benefits but they are an important offset to the compliance costs of some of the smaller businesses.⁸²

Tran-Nam offered a broader definition a few years later, suggesting that ‘[m]anagerial benefits come in the form of improved decision-making brought about by the need to have more stringent record keeping in order to comply with the requirements of tax law.’⁸³

Key elements in these two definitions should be noted. First, managerial benefits theoretically arise because the better quality of the financial information will be the basis for improved decision-making. Second, managerial benefits are likely to be significant, particularly in the case of small businesses. Third, managerial benefits are difficult to value. In these definitions, better record keeping is identified as the main source of managerial benefits. Yet, record keeping is a

⁷⁹ Ibid 380–2.

⁸⁰ Sandford, Godwin and Hardwick, above n 5, 13.

⁸¹ Sandford et al, above n 6.

⁸² Ibid 118.

⁸³ Tran-Nam, above n 9.

broad concept which encompasses a number of varied and multifaceted activities from which businesses may be able to derive specific forms of managerial benefits. These are now examined.

B *Different Forms of Managerial Benefits*

The different forms of managerial benefits identified by Sandford can be classified into three main categories: benefits generated from improvements to the information system, benefits arising from improvements to controls, and benefits derived from savings on other costs. This section considers each of these categories.

1 *Improved Information System*

The improved information system comes with the necessity to have a complete accounting system where all transactions are recorded. Compliance with VAT or GST, for instance, requires taxpayers to keep a record of their sales and purchases. In the UK, it was found that 32 per cent of respondents thought they had better kept purchase records and 26 per cent had better kept sales record since the introduction of VAT.⁸⁴ The per centages for smaller firms with a turnover under £100 000 per annum (A\$238 000) were 42 per cent and 34 per cent respectively, indicating a clearer perception of improvement among SME owners. In Australia, 73 per cent of small businesses owners expressed the view that compliance obligations acted as an incentive to keep up-to-date records and that the financial report produced from the record keeping system helped them manage the business.⁸⁵ Another survey of Australian small business taxpayers carried out in 2004 revealed generally good record keeping practices.⁸⁶ The primary reason given for maintaining these good quality records was for tax purposes.⁸⁷

In recent years, increasing tax compliance obligations have also been a major driver of the acquisition of computerised information systems ('CIS') by SMEs. Significant computer costs were typically incurred by small firms when a new tax was introduced or when substantial amendments were brought to an existing tax.⁸⁸ In Australia, small business owners interviewed prior to the introduction of GST in 2000,⁸⁹ stated that the new tax was the main reason for acquiring a computer. This acquisition of information technology was actively encouraged by the federal government through the provision of a grant and the possibility of immediate tax deduction.⁹⁰ Computer costs induced by changes in the tax legislation included the acquisition and updating of hardware and software, the modification of accounting and business systems and training of personnel.⁹¹ Small businesses in Western Australia spent an average \$3141 on new equipment and \$2536 on equipment upgrade to comply with the new GST.⁹²

However, computer related expenditures were by no means limited to tax changes. Many small businesses acquired a computer simply because they had to keep financial records for the tax

⁸⁴ Sandford et al, above n 6, 90.

⁸⁵ CPA Australia, 'Small Business Survey Program : Compliance burden' (CPA Australia, 2003).

⁸⁶ C Evans , S Carlon and D Massey, 'Record keeping: Its effect on tax compliance' (CPA Australia, 2005).

⁸⁷ Ibid 8.

⁸⁸ G Bannock and H Albach, *The compliance costs of VAT for smaller firms in Britain and Germany* (1987); CFSUB, 'The tax compliance costs for employers of PAYE and National Insurance in 1995-96' (1998); J Pope, 'Research Methodology for estimating the compliance costs of GST' in A Lymer and D Salter (eds), *Contemporary issues in taxation research* (2003).

⁸⁹ Pope, above n 88, 75-6.

⁹⁰ Ibid.

⁹¹ Tran-Nam and Glover, above n 60; Evans, Carlon and Massey, above n 86.

⁹² N Rametse and J Pope, 'Start-up compliance costs of the GST : empirical evidence from Western Australian small businesses' (2002) 17(4) *Australian Tax Forum* 407.

authorities.⁹³ For example, it was reported that in 1994–95, a period with few significant tax changes in Australia, small business taxpayers spent an average \$458 in modifying tax software, while the average cost for medium sized businesses was \$1670.⁹⁴

These technological changes were likely to generate benefits for the business managers in the form of up-to-date, easily available financial information.⁹⁵ Researchers, who carried out a case study of Australian businesses over three financial years (2000–2003) after the introduction of GST, report numerous instances of business taxpayers deriving managerial benefits from the use of computerised record keeping.⁹⁶ For instance, participants declared that the use of computers gave them instant information about their income and expenses, allowed for analysing, testing and using ‘what if’ scenarios and made application for finance easier as they could provide the bank with adequate financial information.⁹⁷

2 *Improved Controls*

Better control mechanisms will often be associated with the adoption of more sophisticated accounting systems. These improved controls will assist small businesses in three main areas of financial management: cash flow monitoring, stock control and credit management.

Even though business operations are the major sources of cash inflows and outflows, in many jurisdictions the requirements of the taxation system are also likely to have a significant influence on the cash flows of small firms. In Australia, two examples of such influence are provided by the compliance with GST and the compliance with the Pay-As-You-Go (‘PAYG’) system. Compliance with GST forces small firms to keep a record of when they receive GST from their customers, when they pay GST to their suppliers and when they have to disburse the difference to the ATO.⁹⁸ Under the PAYG system, small firms must remit instalment amounts based on their estimated income to the ATO. In most cases, this will require a good element of cash forecasting as for many businesses, profits are taxed when they are earned, not when they are received. No empirical evidence is available to confirm the existence and the magnitude of managerial benefits represented by improved cash flow monitoring. However, a clear majority of Australian Certified Practising Accountants (61 per cent) saw a strong relationship between good quality record keeping and improved cash flow management.⁹⁹

Sandford also expected that more stringent record keeping would lead to improved stock control.¹⁰⁰ This form of managerial benefits does not appear to be commonly perceived by business taxpayers themselves. Only 8 per cent of UK business taxpayers and 12.6 per cent of New Zealand taxpayers agreed that improved stock control was a benefit of complying with VAT or GST.¹⁰¹ However, it is important to point out that these surveys were conducted some time ago, when computerisation was not very widespread among small businesses. Different outcomes may be obtained if a survey was carried out today. It is not unusual for small businesses to acquire integrated accounting systems where the stock management function is linked with the accounting function and sometimes a tax reporting function, such as the preparation of the Business Activity Statement.

⁹³ Scott Holmes and Des Nicholls, ‘Modelling the accounting information requirements of small businesses’ (1989) 19(74) *Accounting and Business Research* 143; R Jarvis, J Kitching and J Curran, *The financial management of small firms: an alternative perspective* (1996).

⁹⁴ Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4, 115.

⁹⁵ Pope, above n 88.

⁹⁶ Tran-Nam, Glover and Wilkin, above n 61.

⁹⁷ *Ibid* 12–3.

⁹⁸ This will be the case for businesses which account for their GST on a cash basis.

⁹⁹ Evans, Carlon and Massey, above n 86, 12.

¹⁰⁰ See Sandford et al, above n 6, 93.

¹⁰¹ *Ibid* 92. Sandford and Hasseldine, above n 4, 77.

In many respects, record keeping associated with tax compliance will be an incentive to develop credit management routines. For example, a comprehensive and up-to-date record of purchases will allow the business to claim discounts more frequently. Likewise, a well kept sales transaction ledger will make it easier to follow customer payments and reduce losses from bad debts.¹⁰² Earlier empirical evidence seemed to indicate that not all SME owner-managers perceived that tax compliance would help them improve their credit management practices.¹⁰³ However, a majority of Australian SMEs surveyed in 2004 had in-house computer-based record keeping systems and in almost all cases, a record of invoices was a feature of that system.¹⁰⁴ Most off-the-shelf accounting packages, such as 'MYOB' and 'Quickbooks' include subsidiary ledgers of debtors and creditors and allow the user to produce an Aged Debtors Trial Balance or an Aged Creditors Trial Balance with minimal effort. These documents may be used by the owner-managers to carry out frequent reviews of the business credit situation.

Notwithstanding the above benefits, it could be argued that some particular aspects of tax accounting may discourage taxpayers from engaging in financial control practices. For instance, the Simplified Tax System ('STS') in Australia encourages business owners to adopt cash accounting and to pool their assets to calculate depreciation. STS also allows taxpayers not to carry out regular stock takes.¹⁰⁵

Overall, although it could be expected that some aspects of tax compliance obligations would be an incentive for small businesses to improve their management controls, there is little evidence that it is actually the case. On the other hand, the acquisition of information technology, driven by increasing tax compliance obligations, seems to be facilitating the implementation of systematic financial control practices.

3 *Savings on Other Costs*

Sandford also suggested that record keeping activities generated by tax compliance may result in savings on external accountant fees and audit fees for the taxpayer.¹⁰⁶ He identified a second potential source of cost savings in the form of a reduction in other compliance costs.¹⁰⁷ Strictly speaking, savings on other costs do not constitute managerial benefits as they do not result in additional information that will lead to better business decisions. However, since the costs associated with hiring an external accountant are essentially related to the acquisition of accounting or managerial information, it can be contended that savings on these costs constitute a managerial benefit. It is arguably more difficult to justify the inclusion of savings on other compliance costs as managerial benefits. One possible justification is that like other types of managerial benefits, savings on other compliance costs are induced by the improved record keeping and better-quality financial information. Savings on accountant fees, then savings on other compliance costs are discussed in this section.

Where tax compliance encourages taxpayers to prepare their accounts internally or to do their own bookkeeping, there will be potential savings on accountant fees and audit fees. They may not require an external accountant, or if they do, they may save at least on accountant time.¹⁰⁸

¹⁰² Sandford et al, above n 6, 92.

¹⁰³ See Sandford and Hasseldine, above n 4. The survey asked small business taxpayers which benefits they were deriving from better record keeping and knowledge of finances forced by the introduction of GST. Almost half of respondents (47.4 per cent) agreed that they derived a benefit because purchase records were better kept. Only 39.6 per cent agreed that they were benefiting from better kept sales records.

¹⁰⁴ Evans, Carlon and Massey, above n 86.

¹⁰⁵ Paul Kenny, 'A 'Simplified Tax System' for small business' (2002) 6(1) *The Tax Specialist* 36.

¹⁰⁶ Sandford et al, above n 6.

¹⁰⁷ *Ibid.*

¹⁰⁸ Sandford et al, above n 6.

This proposition assumes that the taxpayer would prepare and keep accounts even if taxes were eliminated. In Australia, only a handful of small proprietary companies are required to prepare external financial reports. It has been noted, for example, that 81.5 per cent of small Australian businesses and 69 per cent of medium businesses use financial statements mainly for tax calculation.¹⁰⁹

The accountant fee saving hypothesis receives little support from existing empirical evidence. Only 25 per cent of respondents to a 1981 survey claimed that they saved money by doing their own accounts as a result of complying with VAT requirements. The percentage was higher (36 per cent) among firms with a turnover under £10 000 (A\$23 800).¹¹⁰ More recently in Australia, Evans, Carlon and Massey used a sample of small Australian SMEs to investigate the relationship between quality of record keeping and fees paid to external accountants.¹¹¹ Contrary to their predictions, they found that businesses with better record keeping practices actually appeared to be paying higher external fees.¹¹² The authors explained this unanticipated result as follows: small firms who invest money and time to support a quality internal information system may also be prepared to incur the costs of engaging quality external professionals.

However, savings on accountant fees may also be realised because small businesses are obtaining services from their external advisers for which they would otherwise have to pay, had they not hired an accountant for tax reasons. Empirical evidence indicates that many accountants or other tax advisers were providing a variety of business services that were incidental to tax related activities. In Australia, accountants often completed compliance tasks other than tax, such as company law obligations, workers compensation and other regulatory requirements.¹¹³ They were also preparing the financial reports required by credit providers or other stakeholders, and were often an important source of advice in the selection and installation of computer software.¹¹⁴ In addition, business clients often received general business advice, or advice regarding their personal tax affairs, superannuation and insurance matters.¹¹⁵

Even where accounting practitioners charged their clients for these additional services, it is reasonable to expect that the fees would have been higher if the services had been provided separately from tax compliance activities. The main reason for this is that the accountant will be able to perform different tasks for the same client with increased productivity. Economies will be achieved because in most cases a common base of information (accounting records) is used to provide different services, and also because the practitioner is familiar with the client's situation.

Sandford also made the suggestion that business taxpayers who keep high quality records will, as a direct or indirect consequence, save on their overall tax compliance costs.¹¹⁶ There will be direct savings because better records will make other tax compliance tasks easier and consequently less costly. Small business taxpayers may also realise indirect savings on their tax compliance costs because firms with better records are less likely to be targeted for a tax audit.¹¹⁷ Furthermore, firms with better records which *are* audited are less likely to receive an amended

¹⁰⁹ Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4, 116.

¹¹⁰ Sandford et al, above n 6, 92.

¹¹¹ Evans, Carlon and Massey, above n 86.

¹¹² Ibid 11.

¹¹³ An example of this is the financial report for businesses in the construction industry required by the Building Services Authority in many Australian states. Another example is the audit of trust accounts required by the legislation governing real estate agents. See CPA Australia, above n 85.

¹¹⁴ Evans Carlon and Massey, above n 86.

¹¹⁵ CPA Australia, above n 85; Matthew Gorton, 'Use of financial management techniques in the U.K.-based small and medium sized enterprises: Empirical research findings' (1999) 12(1) *Journal of Financial Management & Analysis* 56

¹¹⁶ Sandford et al, above n 6.

¹¹⁷ Evans, Carlon and Massey, above n 86, 10.

assessment.¹¹⁸ When these hypotheses were tested, the results could not conclusively establish that improved record keeping would lead to direct or indirect savings on tax compliance costs. The only proposition that received some support was that the preparation of accounting records would reduce the likelihood of taxpayers receiving an amended assessment.¹¹⁹

In conclusion, the empirical evidence on managerial benefits derived as a result of cost savings is rather unconvincing at this stage. There is some indication that many small businesses are obtaining additional value from accounting practitioners in the form of incidental services, however the extent to which this represents a significant cost saving for the client needs to be ascertained by further research. Likewise, additional evidence is required to establish whether business taxpayers with a high quality record keeping system, will as a result derive a benefit in the form of a reduction of exposure to tax audit and adverse audit outcome.

C Evidence of the Importance of Managerial Benefits

So far, only two studies in the UK have attempted to quantify managerial benefits¹²⁰. Both studies relied on the subjective estimates given by owner-managers for the benefits they received. In the 1981 Sandford study, respondents were asked to attribute values to specific managerial benefits, while the 1994 study presented an overall estimation of managerial benefits.

The report from the National Audit Office valued managerial benefits induced by compliance with VAT at £149 million (A\$355 million), representing 9 per cent of gross tax compliance costs (Table 3). The importance of managerial benefits relative to gross tax compliance costs ranged from 28 per cent for businesses with a turnover of £19 000 (A\$45 000) or less to 7.4 per cent for business in the £100 000 to £500 000 (A\$238 000 to A\$1.19 million) category.

The outcome of this survey reveals that managerial benefits derived by small businesses are roughly three times as large as those derived by medium and large firms. This confirms the prediction made by Sandford, Evans and others that managerial benefits will be relatively larger in the case of smaller businesses.¹²¹ While many large firms have to prepare external accounts under the *Corporations Act* (public companies and large proprietary companies in Australia), most SMEs have no reporting obligations and therefore are likely to obtain a benefit from the additional financial information generated by a more rigorous record keeping.

The results from the National Audit Office survey also corroborate earlier findings that the number of benefits from complying with VAT was higher for small business owners.¹²² The earlier 1981 study asked business owners to state the number of benefits which they thought they received as a result of complying with VAT. The data collected was then analysed by firm size category and industry sector. As a correlation exists between size and industry sector, it is necessary to neutralise the size effect by only including responses from small businesses (turnover under £20 000 (A\$47 600)).

¹¹⁸ Ibid.

¹¹⁹ Ibid.

¹²⁰ See Sandford et al, above n 6; National Audit Office, 'HM Customs and Excise : Cost to business of complying with VAT requirements' (Her Majesty Stationery Office, 1994)[The report published by the National Audit Office in 1994 largely relied on the valuation undertaken by Sandford.

¹²¹ See Sandford, Godwin and Hardwick, above n 5; Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4; Tran-Nam, above n 9, 55.

¹²² Sandford et al, above n 6, 94.

Table 3: VAT Traders' Managerial Benefits, UK, 1992–93¹²³

Taxable Turnover (per annum)	Gross Compliance costs (GCC) (£m)	Value of managerial benefits (MB) (£m)	Per centage (MB/ GCC)
0-£19,000	14	4	28 per cent
£19,000-£50,000	149	17	11.5 per cent
£50,000-£100,000	199	21	10.5 per cent
£100,000-£500,000	709	53	7.4 per cent
Over £500,000	518	49	9.4 per cent
Total	1589	144	9 per cent

Table 4 presents the per centage of small businesses by industry sector claiming a particular number of benefits. Overall, 60 per cent of respondents claimed that they received at least one benefit from complying with VAT. The transport and communications sector was the sector where respondents were most likely to perceive at least one benefit, while respondents in finance and business services were the most likely to claim they were receiving no benefit at all. Bearing in mind that these benefits include 'extra cash', it is probable that this cash benefit will be the most easily perceived. For this reason, evidence that managerial benefits are perceived is more likely to be found among those traders claiming a high number of benefits. Approximately 30 per cent of businesses in the primary sector claimed they received three or more benefits, while only 12 per cent of firms in the transport and communication sector had the same claim.

Table 4: Per centage of Small Business Taxpayers* Claiming Particular Number of Benefits (Including Cash Flow Benefits) from Complying with VAT, UK, 1977–78¹²⁴

No of Benefits	Sector of Activity									
	Primary (per cent)	Manufacture and Utilities (per cent)	Construction (per cent)	Transport and Communication (per cent)	Retail (per cent)	Wholesale (per cent)	Finance and Business Services (per cent)	Professional and Scientific Services (per cent)	Miscellaneous Public Services (per cent)	All Sectors (per cent)
0	31	51	33	28	50	50	56	41	29	40
1	16	13	25	28	15	20	21	22	15	20
2	22	18	13	31	13	17	9	17	10	17
3	14	15	13	0	13	12	3	7	8	11
4	11	0	13	3	5	0	6	5	3	7
>4	5	3	3	9	4	0	6	8	2	4
Total	100	100	100	100	10	10	100	100	100	10
					0	0				0

* Small business taxpayers defined as having an annual taxable turnover < £20,000

† Percentages may not add up to 100 per cent because of rounding.

¹²³ National Audit Office, above n 120, 20.

¹²⁴ Ibid 235-9.

Other empirical evidence on the existence of managerial benefits for business taxpayers was collected by researchers in New Zealand and Australia. Business owners surveyed in New Zealand were asked whether they agreed with a number of statements regarding benefits derived as a result of complying with GST obligations. Nearly 50 per cent agreed that their purchase records were better kept, 30.9 per cent said that there was useful cash collected but only 7.4 per cent concurred with the statement that the management of their debtors and creditors would be improved.¹²⁵ In a similar study carried out in Australia, a small majority of business taxpayers agreed that the requirements of the federal tax system would help them to improve their record keeping (see Table 5).¹²⁶

In contrast, few respondents in this study perceived that tax compliance requirements would assist them with internal financial management. This was particularly the case of small business taxpayers.¹²⁷ About one third of respondents in that category agreed that the requirements of the federal tax system would improve their knowledge of cash flow and profitability and only 15 per cent concurred with the statement that it did improve their knowledge of stock control.¹²⁸ More recently, Rametse and Pope, studying the impact of the implementation of GST in Australia, reported that only a minority (34 per cent) of respondents thought they would benefit from keeping records for GST purposes.¹²⁹

Table 5: Perception of Australian Business Taxpayers Regarding Benefits of the Federal Tax System¹³⁰

Requirements of the Federal Tax System:	Per centage of Respondents Who Agree or Strongly Agree with the Statement		
	Small* Businesses	Medium* Businesses	Large* Businesses
Improve Record Keeping	50.3 per cent	53.6 per cent	50 per cent
Improve Knowledge of Cash Flow/ Financial Position	34 per cent	37.5 per cent	42.9 per cent
Improves Knowledge of Profitability	36.8 per cent	38.3 per cent	35.7 per cent
Improve Knowledge of Stock Control	15.4 per cent	20.3 per cent	26 per cent

* The classification used by the authors was the ATO classification based on annual turnover: small: <\$100,000, medium: between \$100,000 and \$9.99 million and large: \$10 million and over.

Other surveys of small business taxpayers undertaken in Australia are in apparent disagreement with the above findings. Research commissioned by CPA Australia which interviewed a sample of 701 SME managers across Australia, found 76 per cent of interviewees who stated that they were using financial information produced from the record keeping system to manage the business.¹³¹ Similarly, Evans, Carlon and Massey had 58 per cent of small business respondents consider general business management to be the most important reason for keeping records (against 23 per cent who thought compliance with tax law was the most important reason).¹³²

¹²⁵ Sandford and Hasseldine, above n 4, 76–7.

¹²⁶ Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4.

¹²⁷ *Ibid.*

¹²⁸ *Ibid.*

¹²⁹ Rametse and Pope, above n 92, 434.

¹³⁰ Evans et al, *A report into the incremental costs of taxpayer compliance* above n 4, Table 7.68 to 7.71.

¹³¹ CPA Australia, above n 85, 17.

¹³² Evans, Carlon and Massey, above n 86, 8.

This apparent discrepancy between research outcomes warrants further explanation. First, we can note the different wording of the questions in each survey. In one survey, respondents were required to state their opinion about specific relationships between tax compliance requirements and improved record keeping and other aspects of financial management. This contrasts with the CPA survey, where the question asked was of a general nature and enquired about respondents' overall perceptions. Similarly, in Evans, Carlon and Massey's survey, respondents were required to rank reasons for keeping records. It can be anticipated that different types of questions will be interpreted differently by respondents,¹³³ and caution needs to be exercised when comparing outcomes.

Second, there was a difference in the methods that were used to conduct the surveys. In the earlier study, mailed questionnaires were used, whereas in the latter CPA study, respondents were interviewed by telephone. When comparing large scale mail surveys and interview surveys, Sandford argued that while the quality of information was expected to be higher with an interview survey,¹³⁴ the condition of the interview had a significant impact on the response. In the case of the CPA survey, the number of questions was rather high (23 in total). Moreover, Question Seven had eight different statements about which respondents had to express their agreement or disagreement. It can be anticipated that in these conditions, respondents may be tempted to state their opinion about each statement without taking the time to think it through.

In conclusion, even though the evidence on managerial evidence is extremely patchy, there is some indication that they are recognised by a significant proportion of business owners. Also, there is a perception that the benefits come in the form of improved financial information (notably through the use of a CIS) rather than in the form of improved internal controls, and as mentioned earlier, there is little existing evidence that benefits may come from savings on other costs. Finally, it is worth noting that to this date, there has been no systematic study of managerial benefits from compliance with taxes other than GST/VAT.

V THEORETICAL ISSUES ARISING FROM THE STUDY OF TAX COMPLIANCE COSTS AND BENEFITS

Several researchers have commented on the lack of theoretical coherence of tax compliance costs research. In particular, they have criticized the fact that current research in the area consists mostly of empirical surveys that collect data without any attempt to integrate with other fields of research. James, for example, argues that the findings that tax compliance costs are high and regressive, should be discussed with reference to broader tax policy issues.¹³⁵ He also suggests that more research should address the reasons why compliance costs are so high. Another common criticism concerns the variety of approaches used by researchers to estimate the time spent on compliance activities.¹³⁶

Conceptual issues regarding gross and net compliance costs, avoidable and non-avoidable costs were briefly addressed in the definitions and concepts section. The other theoretical issues which have been discussed in the literature include the measurement of taxpayer's time¹³⁷, the valuation

¹³³ See S Payne (1951) as cited in J J Gill and P Johnson, *Research methods for managers* (3rd ed, 2002).

¹³⁴ Sandford, above n 3, 382–3.

¹³⁵ Simon James, 'Book Reviews : Taxation compliance costs :A Festschrift for Cedric Sandford' [2003] *British Tax Review* 69.

¹³⁶ Rimmer and Wilson, above n 48; J John Turner, Malcolm Smith and J Gurd, 'Recognizing the pitfalls in tax compliance costs research' (1998) 8 *Revenue Law Journal* 62.

¹³⁷ For a full discussion of the valuation of taxpayer compliance time issues, see J Pope, 'The Compliance Costs of Major Taxes in Australia' in C Sandford (ed), *Tax Compliance Costs Measurement and Policy* (1995) 101, 114–9; see also Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 9–12.

of cash flow benefits¹³⁸, the treatment of overhead and the accounting/taxation overlap. Given the focus of this paper on managerial benefits, this section will only consider questions which are directly or indirectly relevant to this particular issue. Such questions include the disentangling of tax and accounting overlap, the question of cost allocation and the problem posed by the measurement of managerial benefits.

A Disentangling Accounting and Tax Related Activities

The problem of how to distinguish between accounting and tax compliance activities and their associated costs translates directly into how to distinguish between accounting-induced and tax-induced managerial benefits.¹³⁹ There are two aspects to the problem of disentanglement.

The first aspect is represented by the fact that many functions or activities conducted within the business, or which have been outsourced to external parties, are performed for several joint purposes. A good example is the presence of payroll records which are maintained for PAYG compliance but are also required by the industrial relation legislation and may be used for costing purposes.¹⁴⁰ Another example is a lease/buy decision where options would be considered from both tax planning and financial management perspectives. One survey of Australian business taxpayers, asked business taxpayers respondents to identify time spent on a list of core accounting activities and time spent on additional record keeping necessary due to tax requirements. On the basis of the results obtained, the researchers considered that they had been able to separate accounting costs from tax compliance costs with some degree of accuracy although they admitted that there were inconsistencies between the response to the question on core accounting activities and subsequent questions.¹⁴¹

The second aspect of the disentanglement problem relates to taxpayer perception of compliance costs. At one extreme, a taxpayer may regard all the costs involved in keeping records and preparing accounts as tax compliance costs because taxation is the only reason he or she recognises for performing these activities. In this situation, any use of the information for a purpose other than tax compliance should be regarded as an offset to compliance costs in the form of a managerial benefit. At the other extreme, tax may be described as no more than a by-product of an ordinary accounting function.¹⁴²

Sandford also argued that the definition of tax compliance costs is a matter of perception and may differ between persons. He illustrates his line of reasoning with the following example:

Consider two university professors A and B, who undertake consultancy work in addition to their main employment. If there were no income tax requirement, A, who wishes to maintain a close check on his financial situation, would keep detailed accounts; B, with no such inclinations, would keep nothing recognisable as accounts, but only records to ensure he was paid for work done. If, then tax is introduced, the tax compliance costs of A would be modest and incremental. Those of B would be the whole of the accounting system he has been obliged to introduce to satisfy the income tax authorities.¹⁴³

This example can be expanded to incorporate the concept of managerial benefits. One might continue Sandford's argument by adding that B, having set up an accounting system, may realise that he has now at his disposal useful information which enables him to keep a close check on his financial situation. While B would be deriving a managerial benefit as a result of being obliged

¹³⁸ For a discussion on the valuation of cash flow benefits, see Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 12–14.

¹³⁹ Tran-Nam, above n 9, 55.

¹⁴⁰ Turner, Smith and Gurd, above n 136, 66.

¹⁴¹ Evans et al, above n 4, 15, 92.

¹⁴² Tran-Nam, above n 9, 57.

¹⁴³ Sandford, above n 3, 394.

to comply with the tax requirements, A on the other hand, would gain no benefit from complying with tax since he was already obtaining the same information before the tax was introduced.

B *The Allocation of Common Costs*

Another problem that emerges as a consequence of the tax/accounting overlap is the allocation of costs which are incurred jointly to perform tax compliance activities and accounting or other business functions. These common costs may come in the form of overhead costs or in the form of the depreciation costs of assets used for a mixed purpose.

Most tax compliance studies have ignored incidental overhead costs because of the difficulty in tracing them to tax compliance tasks.¹⁴⁴ Johnston, who considered such costs, observed that the costs of shared facilities such as office space and lighting are minimal and that, in any case, they should only be taken into account if the elimination of a tax would cause a reduction of these costs.¹⁴⁵

The most common situation where business assets are used for a mixed purpose is where computing equipment is acquired to be used jointly for management and tax compliance purposes.¹⁴⁶ Should the acquisition costs (or depreciation costs) be allocated between tax compliance and financial management on the basis of usage or should 100 per cent be assigned to tax compliance on the ground that the equipment was purchased for the primary reason of tax compliance?

Johnston advocated an 'incremental' approach to solve the problem of common costs. According to this approach, costs that would not have been incurred but for the existence of a tax should be included as tax compliance costs.¹⁴⁷ Following the incremental logic, if computer equipment is acquired for the specific purpose of complying with a new tax, then 100 per cent of its costs should be allocated to tax compliance, even though the equipment is used jointly for management and tax purposes.

The choice of a method for allocating joint costs has important consequences for the valuation of managerial benefits. Under the incremental approach, if the whole cost of acquisition of the computer is allocated as a cost of tax compliance, then a managerial benefit should be recognised to account for any usage other than tax compliance work. On the other hand, if the initial cost of the computer is allocated between tax and accounting, then no managerial benefit need to be recognised to offset the cost of tax compliance.

C *The Measurement of Managerial Benefits*

As noted earlier, the only attempts to quantify managerial benefits were based on subjective evaluations by taxpayers. The controversy surrounding the valuation of taxpayer compliance time costs indicate that relying exclusively on subjective evaluations does not provide a satisfactory measure.¹⁴⁸ In the case of managerial benefits, the valuation appears to be even more

¹⁴⁴ Tran-Nam et al, above n 16, 236.

¹⁴⁵ Johnston, above n 10, 9. An alternative treatment of overhead costs was proposed by Yocum. Yocum argued that for most business organisations, compliance work would increase operating costs and therefore tax compliance costs should include a proportion of overhead costs: J James Yocum, *Retailers' costs of sales tax collection in Ohio* (1961) Sandford's own position on the matter seemed to be very close to Johnston's. He maintained that, where overhead expenditure is independent from taxation; that is, the cost would have been incurred even in the absence of taxation, the overhead compliance costs is zero: Sandford, Godwin and Hardwick, above n 5, 16.

¹⁴⁶ J Pope, 'Factors affecting the compliance cost of the goods and services tax in Australia' in C Evans, J Pope and J Hasseldine (eds), *Tax compliance costs: A festschrift for Cedric Sandford* (2001) 139.

¹⁴⁷ Johnston, above n 10, 8.

¹⁴⁸ For a discussion on the issue of valuation of taxpayers' compliance time, see Pope, 'The Compliance Costs of Major Taxes in Australia', above n 132, 101.

problematic. In the 1981 VAT survey conducted in the UK, only 7.5 per cent among respondents who recognised that they were deriving managerial benefits, gave a positive value to those benefits.¹⁴⁹ This result suggests that whereas business taxpayers would generally be aware that they are receiving managerial benefits from tax compliance, they would not be able to accurately quantify them in dollar terms.

The problem of the measurement of managerial benefits can be expressed in terminology borrowed from the utility theory in economics. Using that theoretical framework, it can be argued that the value of managerial benefits is represented by the marginal utility that can be obtained from using the additional information available to the taxpayer.¹⁵⁰ Transposing the key assumption of diminishing marginal utility,¹⁵¹ it can also be argued that this marginal utility is likely to be diminishing as the amount of accounting information increases. In theory, this means that a firm where there is no pre-existing accounting information system is likely to derive more benefit from the record keeping system imposed by tax compliance than a firm where one is already in place. However, in practice the very existence of managerial benefits and their magnitude may also depend on how accounting information is valued by the firm owner. In the extreme, if the owner-manager does not see any value in using the information derived from the record keeping system, either because the information is irrelevant to decision-making or because it is *perceived* to be irrelevant, then the subjective value of the managerial benefits will be zero.

It may also be argued that managerial benefits have an objective value, regardless of the manager's appreciation of that value. Managerial benefits can be conceived as being represented by the economic gains obtained through the increased business performance, which is brought about by improved decision-making. Yet, it can be further argued that the realisation of these gains is in fact dependent on how effectively, accounting information is used by the owner-manager. Where the owner-manager does not perceive the potential benefit to be derived from using accounting information, that information will be ignored and the managerial benefit corresponding to increased business performance will not materialise. Moreover, even where better performance is achieved the resulting gains may not be attributable to usage of accounting information.

Empirical evidence suggests that at least a segment of the business taxpayer population recognised some value in using the financial information generated by the record keeping system. However, there is also some indication that SME owner-managers generally valued financial information less than large firms.¹⁵² Only 37.5 per cent of small business taxpayers used financial statements for internal management, against 82.8 per cent of large businesses.¹⁵³ Some authors have pointed out that one of the main reason why SME taxpayers do not perceive managerial benefits, is that they may be too busy with tax compliance to monitor their cash flow and scrutinize their financial situation.¹⁵⁴

The apparent inconsistency between the existence of managerial benefits in theory, and the reality of their perception by business taxpayers is at the core of the problem posed by the valuation of this type of compliance benefit. Theoretically, an objective value of managerial

¹⁴⁹ Sandford et al, above n 6, 91.

¹⁵⁰ R Lipsey and K Chrystal, *An introduction to positive economics* (8th ed, 1995).

¹⁵¹ This basic assumption, sometimes called the law of diminishing marginal utility asserts that '[t]he utility that any consumer derives from successive units of a particular product diminishes as total consumption of the product increases while the consumption of all other products remains constant': *ibid*.

¹⁵² Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4.

¹⁵³ *Ibid* 116.

¹⁵⁴ C Evans and Michael Walpole, 'The hidden costs of a GST: An international perspective' (1998) 12(4) *Policy* 3.

benefits could be based either on the valuation of the benefits actually obtained by the business or on the costs of the resources which would produce the same benefits.

The measurement of managerial benefits using the basis of 'actual' benefits derived would require the valuation of the economic gains derived from improved business performance. This method presents a number of conceptual and practical problems. Firstly, measuring managerial benefits on the basis of economic gains relies on the premise that the use of accounting information *necessarily* provides an advantage to the firm. At this stage, the relationship between comprehensiveness of accounting information and improved business performance has not been convincingly established.¹⁵⁵ Secondly, valuing the pay-off resulting from the improved accounting information is in itself problematic because it would be difficult to identify and measure the incidence of that particular factor on business performance.¹⁵⁶

Following a valuation approach based on the cost of resources, the value of managerial benefits would be assumed to be equivalent to the cost of obtaining the same information either by acquiring an internal information system, or by seeking the information from an external party. The advantage of this method is that it is consistent with economic utility theory which posits that utility is measured by the largest amount that consumers would be prepared to pay to acquire the good from which they derive utility.¹⁵⁷ However, there are several practical difficulties associated with the cost of resources approach. First, while the cost of obtaining the information from an external party may be readily available, the computation of the cost of generating the information internally may be more problematic, particularly because of the accounting/tax cost overlap mentioned earlier. Second, this method assumes that all business managers will derive the same managerial benefits from particular types of accounting information.

As discussed previously, the magnitude of the benefit derived by the owner-manager as result of using financial information will ultimately depend on the effectiveness of usage of that information for decision-making. The degree of effectiveness will itself be influenced by three main factors: the quality of the information generated by the information system, the degree of appreciation that each manager-owner has of that information and the nature of the decisions that the information will be used for.

A subjective evaluation of managerial benefits is likely to be influenced by the personal characteristics of the information user, alongside other factors such as the type, age, size and profitability of the business.¹⁵⁸ Among the personal characteristics, accounting training was identified by Sandford as a possible determinant of perceived managerial benefits. Overall, individuals who had no accounting training were more likely to perceive benefits than those who had received formal training as bookkeepers or accountants.¹⁵⁹ Other possible factors determining perception and usage of accounting information include the status of the person preparing tax compliance information (business owner, manager or employee), educational background and motivation.¹⁶⁰

¹⁵⁵ Richard McMahon, 'Business growth and performance and the financial reporting practices of Australian manufacturing SMEs' (2001) 39(2) *Journal of Small Business Management* 152.

¹⁵⁶ Richard Due, 'The valuation of information' (1996) 13(1) *Information Systems Management* 68.

¹⁵⁷ Lipsey and Chrystal, above n 150, 129.

¹⁵⁸ In most small businesses, the user of accounting information will be the owner-manager himself or his close family. On this issue see: J Ang, 'On the theory of finance for privately held firms' (1992) 1(3) *The Journal of Small Business Finance* 185; D J Storey, *Understanding the small business sector* (1994); J A Welsh and J F White, 'A small business is not a little big business' (1981) 59(4) *Harvard Business Review* 18.

¹⁵⁹ Sandford et al, above n 6, 95.

¹⁶⁰ Nadine Lybaert, 'The information use in a SME: Its importance and some elements of influence' (1998) 10(2) *Small Business Economics* 171.

While there are limitations to both objective and subjective methods of measuring managerial benefits, it is contended that a combination of the two approaches would offer the best opportunity to resolve the measurement dilemma. Firstly, the concurrent use of two approaches would allow the researcher to offset the weaknesses of one approach with the strengths of the other. Secondly, it will offer the possibility of triangulation, thereby increasing the validity of the findings. Thirdly, the analysis of discrepancies between the results obtained from the objective valuation method and the subjective valuations by business owners will improve our understanding of why some managerial benefits may be realised and not perceived, and others may be perceived and not realised.

VI IDENTIFYING THE RESEARCH GAP ON MANAGERIAL BENEFITS

In light of the above discussion, it appears managerial benefits are an under-researched topic. There is an urgent need for more empirical evidence, more analysis and more theoretical research on this issue. First, there is a need for fresh and comprehensive data on managerial benefits. Only two studies so far have collected detailed data on managerial benefits and attempted to estimate them. Both studies were carried out in the UK in the 1980s and 1990s and both restricted their analysis to VAT. We need more across-the-board evidence about managerial benefits arising from compliance with all taxes including income tax and company tax. Second, more than two decades after Sandford first identified managerial benefits of compliance with VAT, we still do not know how widely these benefits are spread among business taxpayers and whether specific factors determine the level of perceived benefits. Qualitative information collected in New Zealand and in Australia has confirmed that business taxpayers, particularly small business taxpayers, could identify some managerial benefits derived as a result of tax compliance activities. However, there are inconsistencies between findings from different surveys and anecdotal evidence obtained from case studies needs to be confirmed by large scale systematic studies. Further research is also necessary in order to shed light on a number of issues. What is the influence of tax compliance on the acquisition of computerised information systems by small business taxpayers? What are specific benefits derived from using these systems which are perceived by owner-managers? Is the additional information produced by these systems used in a manner that will be beneficial to the organisation? Are there specific factors that affect the way managerial benefits are perceived and actually derived? Third, it has been argued earlier that the valuation of managerial benefits is linked to the resolution of the 'joint costs' problem mentioned by Allers and others. Although a number of papers have discussed the problem of joint costs in theory and have proposed general approaches, there has been no attempt so far to deal with this problem in practical terms. It is suggested that a comparison between businesses who have to comply with the normal requirements of the tax system with similar businesses exposed to minimal tax obligations would allow researchers to quarantine tax-related costs from costs related to core accounting and business functions.

It is essential that all above issues be addressed before the problem of the measurement of managerial benefits can be resolved. Sandford recognised that subjective valuations by taxpayers did not provide a reliable measure of managerial benefits and that further research was required in this area.¹⁶¹ It is expected that a better understanding of the conditions in which managerial benefits arise and an analysis of the factors that leads to their perception will allow researchers to develop a sound methodology for their valuation.

¹⁶¹ Sandford et al, above n 6, 95.