

Heleno Taveira Tôres

Professor de Direito Tributário da Faculdade de Direito
da Universidade de São Paulo - USP
Vice-Presidente da International Fiscal Association - IFA
Advogado

Direito Tributário Internacional Aplicado

Volume VI

Editora Quartier Latin do Brasil

Tel/fax: (55 11) 3101-5780

Rua Santo Amaro - 316 - Loja - Bela Vista

CEP 01315-000 - São Paulo - Brasil

Empresa brasileira, fundada em 20 de novembro de 2001.

TODOS OS DIREITOS RESERVADOS. Proibida a reprodução total ou parcial, por qualquer meio ou processo, especialmente por sistemas gráficos, microfílmicos, fotográficos, reprográficos, fonográficos, videográficos. Vedada a memorização ou a recuperação total ou parcial, bem como a inclusão de qualquer parte desta obra em qualquer sistema de processamento de dados. Essas proibições aplicam-se também às características gráficas da obra e à sua editoração. A violação dos direitos autorais é punível como crime (art. 184 e parágrafos do Código Penal), com pena de prisão e multa, busca e apreensão e indenizações diversas (arts. 101 a 110 da Lei 9.610, de 19.02.1998; Lei dos Direitos Autorais).

Editora Quartier Latin do Brasil
São Paulo, verão de 2012
quartierlatin@quartierlatin.art.br

Vito Tanzi

Complexity in Taxation: Origin and Consequences*

Former Director of Fiscal Affairs Department at the IMF

* Paper to be presented to a Conference at the Law School of Getulio Vargas Foundation, December 13, 2010, Sao Paulo, Brazil. Earlier versions of this paper were presented at the "2009 International Conference on Public Economics and Management", November 28-29, 2009, Xiamen, China, and at the Meeting of the Societa' Italiana di Economia Pubblica (SIEP), Pavia (Italy), September 20, 2010.

I. Introduction

In a paper written a few years ago, I argued that complexity was becoming a predominant characteristic in many walks of modern life. See Tanzi, 2007. I argued that it could have significantly negative consequences for market economies, as it had had for centrally planned economies before those economies largely disappeared. That paper presented various examples (from the world of technology, the financial market, budgetary and tax policy, and other areas) in which complexity had caused problems and, in some cases, had led to disasters. The paper had been written in 2006, well before the 2008 financial crisis. To some extent it anticipated it.

In this paper I will focus more specifically on complexity in taxation, a topic that has attracted some, but not much, attention. The paper will provide what may be the first comprehensive discussion of that topic. It will identify factors that make the tax systems more complex and less transparent than they could be so that the systems' full impact on the countries' economies becomes more difficult to assess. The paper will argue that there is a cumulative process at work. Once created, almost inexorably, tax systems tend to become more complex with the passing of time.

The paper is structured as follows: Section II discusses factors that contribute to tax complexity. Section III is a digression on "agents of complexity". Section IV focuses on the consequences of complexity. Section V presents some indirect, quantitative measurements of complexity. Section VI is a concluding section.

II. Factors that Promote Tax Complexity

Economists earn their reputation, and even Nobel Prizes, by writing elegant and rigorous theoretical papers on various areas of economics. Those who focus on taxation write papers on whether taxes should be optimal, linear, flat-rated, progressive, dual, neutral, equitable, efficient, and so on. In some essential, basic way, economists can be considered the architects of the tax systems. Like architects, through their theories, they suggest the basic lines or principles of tax systems, but leave the detailed work to others. They generally do not write the countries' tax laws and do not get involved with the administration of the taxes.

In the case of architects, once they have drawn the basic design of a new construction, they delegate the responsibility of working out the finishing touches to others. The experts called upon are: the structural engineers, the

plumbers, the electricians, the stonemasons, the tilers, the painters, and so on. When the architects do not retain the daily control over the operations of these experts, the final constructions risk to have different features from the ones desired by the architects. However, once a new building is completed, it generally remains unchanged in future years, except for maintenance work.

Something similar happens to tax economists, but with some significant differences, because they are much less involved in the process than the architects. Real tax systems are generally not the work of economists. Economists rarely find themselves in the position of architects during major tax reforms, or when tax systems are first created. The tax systems of countries are often designed by government bureaucrats (civil servants) and are reviewed by the policymakers in the executive branch of government. The legislative branch then approves the tax laws.

The bureaucrats are often professional lawyers, accountants, general policy experts, political scientists, public administrators, and, occasionally, even economists. It is, thus, not surprising that major tax theories, developed by economists, seem to have little impact on the proposed legislations and even less on the specific tax laws that are approved by the legislatures. This has been the faith, for example, of Kaldor's expenditure tax, or of Mirrlees's optimal taxation theory, or of cash-flow taxes. However, more practical theories, such as those connected with "flat-rate taxes" or "dual income taxes", seem to have had more of an impact.

The policymakers in the executive, and the legislators in the legislative branch, are politicians who come from all walks of life. In many countries, people with law degrees seem to predominate in government positions.¹ Thus, the influence of economists on the initial, basic design of a tax system is generally less direct than that of architects, and it is far less significant than economists would like to believe. This means that the tax systems rarely start with the clean and clear designs proposed by the economists. There is no theoretical filter through which must pass the tax systems being created. There may be, however, other filters, such as revenue neutrality, low costs of administrative, or fairness that may play a role. Because of this, the systems may be complex from the very beginning. Generally tax systems remain in existence for decades during which time they are subjected to frequent, but generally small, modifications. Like cardiovascular systems, over the years tax systems tend to accumulate cholesterol.

¹ There are very few economists in these positions.

Often, the modifications made to them are small, in fact so small that they pass under the radar of public scrutiny. I shall call these small modifications "honey bee" changes. Like the actions of "honey bees", they are too small to attract much attention or reactions. The public finds out about their existence mainly when the government, for whatever reason, decides to remove them. Then, it faces usually strong reactions from those who, in the first place, had pushed for them and had benefited from their existence. The benefits to those who had pushed for them, and the revenue loss to the government, due to their existence, may then turn out to have been significant.

As with the production of honey by the actions of "honey bees", with the passing of time the modifications made to the original tax system accumulate to slowly change the systems that, on the surface, may appear unchanged. The changes are generally not apparent from the data that attract the attention of tax economists, such as the statistical structure of the tax system. As with icebergs, the action over the years may be mostly below the visible surface. However, many small changes can, over the years, significantly modify the tax systems with respect to their allocative efficiency, their contributions to public revenue, their equity and tax incidence, and their administrative and compliance costs. They may occasionally force the governments to make up for revenue losses by increasing their reliance on less efficient taxes, thus setting in motion a process that has been described as "tax degradation", a kind of Gresham's Law of taxation where bad taxes progressively replace good taxes.

If the only objective of taxation were that of raising public revenue, and if the revenue needs of a country were small, perhaps simple taxes could have been used initially. If this had happened, the cumulative process toward increasing complexity could have been prevented, or, at least, contained. For example, a poll tax, collected in equal amount from each citizen, could have been used and could have remained a simple tax. Also a sales tax, collected at the same rate from all final sales, would, also, have been, and have remained, a simple tax. Another possibility would have been a property tax based on the fairly assessed, or market, value of properties, provided that the value could have been determined objectively. However, such simple taxes would conflict with some important objectives of taxation. Also, they would not have generated enough revenue.

As the need for more tax revenue has risen over recent decades (because of expanding public sector activity), and as the number of objectives that tax systems are expected to satisfy in modern societies has increased, the tax systems have become less simple and less transparent. The increasing number of objectives that modern tax systems are expected to satisfy provide

excuses for particular pressure groups, or lobbies, to ask for special treatment for their activities. It is no surprise that, with the passage of time, the numbers of "tax expenditures", "tax incentives", "tax breaks" and other kinds of (transparent and less transparent) "tax preferences" introduced in the tax systems of many countries have made the systems progressively more complex. As mentioned earlier, complexity is a cumulative process just like the work of termites. It is destined to increase with time, unless governments take specific actions at some point to reverse that process. As a general rule, *the longer a tax system has been in existence, the more complex it has become.*

A question that could be raised is whether complexity, like "fiscal illusion" in Puviani's theory, (See Puviani 1901), is the result of intentional governmental action?² Although it is difficult to answer this question definitively, it does not appear that this is the case. It seems more logical to assume that complexity arises almost automatically out of a democratic process that allows various vested interests, lobbies, and other organized groups to push their own objectives in the political arena, with each group arguing that its objectives or activities are meritorious and consistent with those of society at large.

These groups will be helped, in their requests, by the proliferation of social objectives that characterize modern societies, by the fact that each requested change may be seen as too small and too insignificant to attract or elicit strong general reactions, and by the existence of asymmetry in information, between the lobbies, that promote the changes and that often have the full information, and the general public, or those who represent the general public, that have much less information and much less of an incentive to invest the time and the effort to get it.

The lobbies push for "tax breaks" that will help the specific group they represent but will not be noticed, or will be seen as insignificant, by the majority. At times the changes requested may be some reinterpretation of an existing rule by the tax authorities, so that action by the legislature may not be required.³ At other times the changes may be inserted in some proposed legislation that has little, or nothing, to do with taxation. Those who request, or push for, the changes are likely to have far more information

2 On the relationship between tax complexity and fiscal illusion see Heyndels and Smolders, 1995.

3 For an interesting account of how a U.S. \$2.7 billion tax break was obtained see Dommayr, 2009.

on the relevant matter than those who will have to approve them. As the tax system becomes progressively more complex, the asymmetry in the availability of information, between those who request the tax breaks and those who make the decisions, increases and becomes an important weapon for the lobbies and the vested interests.

Tax simplicity is a special kind of "pure public good". As with genuine public goods, it does not have a clear and strong constituency interested in promoting it. The governments that should promote it often find it too costly, politically, to do it. Even tax systems or tax reforms that may have started with the greatest possible characteristics of simplicity, such as the 1986 US so-called "fundamental tax reform", become complex over the long run, because of the increasing number of "honey bees" that attack and exploit them. The "honey bees" will masquerade themselves as worthwhile "tax expenditures", "tax incentives", requests for special treatments for "obviously" meritorious categories of taxpayers, and so on.

Some requests will come from ministers who represent specific sectors or regions. Some will come from members of the legislature. Some will simply be presented as reinterpretations by the tax administration, or even, by outside accounting firms. These reinterpretations may not be challenged by the tax authorities; or may be challenged only after they have been in existence for some time. The more complex the system becomes, the greater will be the efforts of taxpayers, or those who prepare their tax returns, to reinterpret some of the laws in the taxpayers' favor, thus increasing tax avoidance or tax evasion. As a consequence, the tax systems become progressively more opaque and complex with the passing of time. As the systems become more complex, they make it easier for other groups to push for more changes, especially if the changes benefit greatly small groups but do not appear to be too expensive or too unsettling to the majority.

Gary Becker, the Nobel Prize winner in economics, summarized the problem in a blog:

"Complications in the tax code are an excellent example of the conflict that sometimes arises between what is rational at the individual level, and what is rational to society as a whole. Each interest group lobbies to promote the interest of its members, although their interests advance usually at the expense of the interest of others. When many groups succeed in promoting their interests, losers vastly outweigh winners since each group gains from what they do, but loses from what is done to them by hundreds of other powerful interest groups". The Becker-Posner Blog, April 16, 2006.

This point is, of course, similar to the one made by the late Mancur Olson. In democratic societies, where citizens can organize themselves in small groups, each group will push the group's interest, often at the cost of society as a whole. See Olson, 1965 and 1982. I shall refrain from expressing an opinion as to whether less democratic societies are less exposed to this danger, so that their tax systems might suffer less from this process of increasing complexity with the passing of time. Also the literature on the political economy of fiscal policy might have some insights on which form of democratic governments (presidential, parliamentarian, etc.) might reduce the problem.

Because many economists are not likely to be familiar with what I call the "agents of tax complexity", it may be worthwhile to make a short digression, in the next section, on tax lobbies and on the organization of such lobbies, putting emphasis on the United States where this industry is particularly active and where there is more information on the activities of these lobbies. But other countries are likely to have similar agents.

III. A Digression on Lobbies as Agents of Tax Complexity

In democratic countries, individuals are free to organize themselves in groups to protect their positions and to promote the objectives of the groups. The groups may represent industries, sectors within industries, regions, citizens that share common characteristics (senior citizens, retirees, invalids, members of minorities, etc.), or common interests on social issues (such as weapons possession, rights to abortion, gay rights, etc.).⁴ These groups create associations that represent them and that promote their objectives, vis a vis the government and society at large, with their activities, their publications, their research, and their lobbying efforts. These organizations or associations often hire professional lobbyists to do their bidding. The lobbyists are professionals who, like professionals in other activities, can be hired by the interested groups to promote their objectives and to influence the decisions of policymakers, legislators, regulators, or bureaucrats.

Google lists thousands of such lobbies and reports the names of top lobbyists in the United States and in some other countries, as well as the

4 The lobbies can also be single families. For example the Walton Family that owns a large share of Wal-Mart Inc., spent millions of dollars in lobbying efforts aimed at abolishing the estate tax.

names of lobbies that operate vis à vis organizations or political institutions, such as the European Commission, in Brussels, the OECD, in Paris, the WTO in Geneva, and the United Nations in New York. Groups with greater resources, such as corporations and banks, can finance permanent, powerful lobbies and hire the most influential lobbyists. As a U.S. senator [Senator Durbin] is reported to have said: “the banks... are... the most powerful lobby on Capitol Hill... [T]hey frankly own the place”. Their power and influence was in evidence during the discussion of the bill to reform the US financial market in 2010 during which the banks were reported to have spent hundreds of millions of US dollars in lobbying members of Congress.

There is some disagreement on the origin of the terms “lobbyist” (that refers to individuals) and “lobby” (that refers to institutions). The terms seem to have been already in use in the United States as far back as the 1820s. See Byrd, 1991. However, while in the past this must have been an activity for few people, the number of individuals engaged in lobbying activities has grown enormously over the years, especially in some countries. This is definitely a growth industry. The lobbyists have gained much more power than in the past because the areas that can be influenced by their activities (taxation, regulatory decisions, public spending, etc.) have grown in line with the growth in the role of the state, and because of the quality and background of the individuals that now go into lobbying.

Increasingly, those who engage in the lobbying activities, on behalf of clients with deep pockets (corporations, banks, labor unions, foreign governments, including sovereign wealth funds, and so on) are individuals who have held high government positions in the recent past, especially in sensitive areas. These individuals may have been powerful members of parliaments (or congress), individuals who had worked for powerful legislators, former ministers, former high level civil servants (especially in regulatory agencies or in defense ministries), former high level tax administrators, and former central bankers. The professional lobbyists in the United States even include some former presidential candidates. The fact that some of these individuals are able to go in and out of government positions facilitates their lobbying efforts.

Because of their background and the past positions that they occupied, the lobbyists have useful information and connections and they have easy access to those who currently hold key governmental positions and, thus, can influence decisions about legislation or about administrative or interpretative decisions in tax matters (and in other matters) that are of interest to the sponsoring groups. This is one way in which the “honey bee”

changes, that lead to tax (and other sectors’) complexity, come about. Large monetary contributions, made by lobbyists to legislators who, increasingly, need large amount of money for their election campaigns, are helpful.

In their previous activities the lobbyists had acquired specific, detailed and insider knowledge about procedures, rules, and laws, as well as personal relationships with individuals who have the most power to influence changes in particular area. In some cases they can get useful and specific knowledge from the (vested interest) groups that hire them. In all cases they have far more knowledge on specific issues than the population at large, or even than the broad groups of policymakers, including the members of the parliament that will vote on the decisions. If the requested changes appear small, their leverage becomes high, because there will be less opposition to them.

The incomes of the lobbyists have been reported to be very high (often in the millions of dollars) so that the lobbying activity has attracted over the years some of the brightest and best-connected individuals. Only few countries regulate lobbying activities. At times lobbyists operate from within powerful law or accounting firms where they can draw on the firms’ specific, detailed knowledge, of tax laws and tax regulations and procedures, that the firms have acquired. In some cases the activities of lobbyists are closely linked with the activities of political parties. Therefore, the individuals may be in and out of sensitive government jobs⁵.

The way lobbies and lobbyists operate can be glimpsed from what happened in the United States when the Obama administration proposed a Fiscal Stimulus Bill, of nearly \$900 billion in January 2009. As a Wall Street Journal article, of January 28, 2009, put it: “The magnitude of the spending bill drew a swarm of lobbyists representing many sectors.” Some of the groups lobbying for “tax breaks” were the “Center for Environmental Innovation in Roofing”, the “Geothermal Heat Pump Industry”, the “U.S. Footwear Makers”, and many others. Each wanted its share of the \$275 billion tax-relief package that the Bill contained. In a bill of thousands of pages long, it would be easy for “honey bees” to find their small place. The article reported that “tax incentives to encourage capital investments by businesses, expand support for renewable energy sources, and help business use current losses to claim tax refunds...” and many other apparently worthwhile tax incentives had made their way in the proposed legislation.

⁵ See for examples the activities of the “K Street project” in Washington.

It is easy to see what these incentives would do to the complexity of the U.S. tax system.

Perhaps it is redundant to ask whether the lobbying efforts are successful. There are of course no formal data that answer directly and objectively that question but various indications, and a lot of anecdotal evidence, suggest that they are often very successful. A first indicator is the large and growing number of very able and often very well-known individuals engaged in this activity. But, of course, this is not necessarily evidence that they succeed. The second indicator is the large amount of

money paid by groups to the lobbyists. There are reports about tenth of millions of dollars paid to particular lobbyists who have succeeded in getting some tax break for a particular group. Third, is the evidence itself of tax complexity that is to a large extent the result of the lobbying activities. The title of a recent cover story, in Time magazine, tells the result of the lobbying activities in the United States. The story was titled "The Best Laws Money Can Buy". See Time, July 12, 2010.

Calls for genuine tax reforms, the aspect that attracts most of the attention of economists, do not get much support. Perhaps, this is "due to the myriad loopholes, shelters, and deductions that are available for corporations [and other groups]..." See Center for American Congress, 2009. In other words, the various business groups prefer the work of the "honey bees" to the theorizing of the economists. This is, of course, exactly in line with Gary Becker and Mancur Olson's view that, in democratic societies, most groups push for policies that help them directly over policies that help everyone.

IV. The Consequences of Complexity

A good place to start in discussing the consequences of complexity is The Wealth of Nations. In his 1776 masterpiece, Adam Smith described four characteristics that make for a good tax and a good tax system. These are certainty, convenience, economy and equity. When any of these characteristics is missing, a tax, or a tax system, cannot be given a good rating. First, because it imposes on taxpayers a cost (an extra burden) that is additional to the payment that the taxpayer makes to the government. This extra burden can become large under particular circumstances and can be damaging to the economy. Second, because it can make it more difficult to ascertain whether a tax satisfies the desired objectives of neutrality and of horizontal and vertical equity. When thousands of loopholes have come to characterize a tax system, how can we determine whether it is satisfying

objectives of neutrality or, say, the objective of horizontal equity? Third, because a complex tax system destroys the assumption of current and future tax certainty. This leaves the taxpayers with the uncomfortable feeling and worry that they may have overpaid or underpaid their tax obligation.

When taxes or tax systems become complex, they are less likely to satisfy Adam Smith's desirable characteristics. Furthermore, because complexity increases with the passing of time, the longer a tax, or a tax system, remains in existence, the more likely it is that it will not satisfy Adam Smith's desirable characteristics. A priori, it seems likely that income taxes (both personal and corporate) may be more fragile to these "complexity attacks" than indirect taxes. However, no tax is completely immune to them as the complexity of the value added tax in Brazil clearly shows.

Apart from the impact that complexity may have on the question of whether or not a tax system is equitable and efficient, a more complex tax system creates higher "compliance costs" for taxpayers and higher "administrative costs" for tax administrations. The taxpayers encounter total costs that are higher than the tax payments they make to and received by the government. Because of higher administrative costs, the government receives less net revenue than it can use to pay for public services. Therefore, complexity inserts "tax wedges" on both the taxpayers' side and the government's side, and these wedges can become large.

A priori, there is a presumption that the extra burden (in terms of compliance and administrative costs) created by tax complexity falls disproportionately on the taxpayers rather than on the tax administrations. The reason may be found in an observation by Joseph Stiglitz, 1989, p. 53, that:

"Public bureaucracies seldom place a value on the time of their clients. While the cost of increased personnel to provide better [public] services are apparent, and [are] reflected in the budget, the benefits [to the citizens] are not."

Stiglitz' general observation about the modus operandi of governments is backed by reports that relate to the modus operandi of tax administrations. Chris Evans, 2003, p. 5, has observed that:

"measures taken since the 1980s to reduce administrative costs (as part of policies to reduce public expenditure) may have increased the burden of compliance costs... and... the overall costs to society... A... recent example may lie in the introduction of systems of self-assessment in Australia and the UK in the late 1980s and 1990s."

In recent years there have been complaints from taxpayers about the increasing compliance burdens that tax administrators were passing on the

taxpayers. Some years ago the OECD launched a campaign among its member countries to provide better government services to taxpayers. Some attempts were made by tax administrations to become more taxpayers' friendly and to provide more easily information and forms that taxpayers needed. However, it is not likely that this OECD campaign eliminated the bias towards shifting an increasing (compliance) burden on the taxpayers.

In conclusion, increasing complexity is likely to lead to increasing dissatisfaction with the tax system which may, in turn, lead to increasing tax avoidance and evasion, reduction in the fairness of the system, and reduction in its efficiency and neutrality. Complexity reduces the quality and the legitimacy of the tax system, thus, indirectly, reducing the legitimacy of the economic role of the state.

There is a large literature that has discussed the misallocation of resources created by the existence of tax breaks and tax incentives. This literature is too extensive to cite. See, almost at random, Bird, 2008. As an article put it: "industries which rely more heavily on sunk capital are generally more successful in obtaining tax breaks through lobbying". The article argued that "when politicians give more weight to lobbyists' preferences, taxes fall on average and investment rises. But investment is misallocated among industries, so welfare may fall. Thus, restrictions on business lobbyists may be desirable". See Marceau and Smart, 2003. It is an open question how much, and what kind of restriction a democratic society can put on lobbying activities that some see as genuine expressions of democratic freedom.

V. Evidence of Complexity

In this section we present some evidence of tax complexity. We shall divide the evidence between qualitative and quantitative.

Qualitative Evidence⁶

Concern, if not evidence, about complexity in tax systems can be obtained from statements by tax experts and political figures. In this section we report some of these statements, leaving to the next subsection more quantitative assessments.

Let us start with the United Kingdom. In a book published in 1978 on the British tax system, J.A. Kay and M.A. King wrote that "No one would design such a [tax] system on purposes and nobody did. Only a historical

explanation of how it came about can be offered as justification. That is not a justification, but a demonstration of how seemingly individual rational decisions can have absurd effects in aggregate". This is, of course, the point made by Gary Becker. Interestingly, exactly the same comment has been made about the U.S. financial regulatory system. In a recent article, Harvey Pitt, a former head of the U.S. Security and Exchange

Commission wrote that: "If it were to start from scratch, the U.S. would not invent the kind of financial regulatory system it has today". *Financial Times*, June 12, 2009, p. 3. Thus complexity is not a problem limited to taxation but an almost natural development in many systems. See Tanzi, 2007, for an elaboration of this point.

Writing about complexity in the tax system of Australia, Margaret McKerchar, 2007, stated that "The Australian federal tax system is widely regarded as one of the most complex tax system in the world... in spite of the considerable attention given to tax complexity...". p. 135. She added that in Australia, "personal taxpayers... have limited opportunities to not declare accessible income without detection. [However], there is scope... to inflate their claims for deductions or to exploit the ambiguities created by complex laws and instructional material". p. 192. Furthermore, "[tax] agents [are] overwhelmed by the volume of tax material of which they need to keep abreast... The rate of change [is] an issue as [is] the complexity of the law". p. 193. Statements from other sources support the above view. See for example the International Finance Corporation (I.F.C.) and PricewaterhouseCoopers, 2009, p. 67.

New Zealand, that in the 1970s had been one of the countries that had tried to simplify the whole tax structure and that had introduced several significant elements of simplicity in its system, also seems to have lost its way. According to the *The Economist* (April 16, 2005), a 2001 report to ministers concluded that the New Zealand Tax Code instills "anger, frustration, confusion, alienation".

Italy is reported widely to have major problems connected with tax complexity. Some years ago, Eugenio Scalfaro, then the President of Italy, stated publicly that the income tax declaration that Italian taxpayers were required to fill to comply with their tax obligations was so complex that it could only have been "designed by lunatics". At that time cartoonists had depicted the form as something "between a maze and a monster". It has also been reported that some Italians take advantage of tax amnesties not because they know that they have evaded taxes but because they are never sure that they have complied with all the requirements of the laws.

⁶ This subsection is partly based on Tanzi, 2006 and Tanzi, 2009.

In Canada, the PricewaterhouseCoopers (PwC) Total Tax Contribution (TTC) Study (released on May 7, 2009) reported that "The complexity and the cost of compliance affect competitiveness, and Canada faces a major challenge on this front. In this year's survey, Canada's mix of federal, provincial and territorial taxes ranks as the second, most complex among the major countries worldwide in which TTC studies were conducted". Similar comments have been made for Brazil.

Finally a few comments on tax complexity in the United States: In this country this is not a new or recent issue. Various reports indicate that tax complexity has been an issue for a long time and has increased significantly over the years. For this country there are several quantitative indicators of this growing complexity. They will be reported in the following sub-section.

The "Tax History Project" of "Taxanalysts", a think tank that specializes on tax issues, has reported that, already in 1926, the U.S. Congress, had created the Joint Committee on Taxation with the objective of simplifying the U.S. tax system. It has also reported that complaints about tax complexity had accompanied the first introduction of the income tax during the American civil war in the 1860s. The tax had been repealed in 1872 and had been reintroduced in 1913. The Tax History Project comments that "tax complexity is a function of democracy" and cites a Treasury official in the Wilson administration that "...modern states prefer equity and complexity to simplicity and inequality". It adds that "people hate complexity, unless it is their complexity". In a Special Report of December 2005, the Tax Foundation, an other American think tank, wrote that "in the last century the cost of tax compliance has grown significantly... because of growing non-economic demands lawmakers place on the tax code".

The U.S. National Taxpayer Advocate's Annual Report to Congress 2005 stated (in its IRS News Release) that:

"Our tax code has grown so complex that it creates opportunities for taxpayers to make inadvertent mistakes as well as to game the system... As taxpayers become confused and make mistakes, or deliberately push the envelope, the IRS understandably responds with increased enforcement actions. The exploitation of "loopholes" leads to calls for new legislation to crack down on abuses, which in turn makes the tax laws more complex... In short complexity begets more complexity."

A report to the President of the United States on tax reform suggested that legislators have lost sight of the fact that the fundamental purpose of the tax system is to finance public spending. Other goals have distracted the

system from its fundamental purpose. The Report concludes that "tax preferences complicate the system, create instability, impose large compliance costs and can lead to inefficient use of resources". See President's Advisory Panel on Federal Tax Reform, November 2005.

Quantitative Evidence

In this sub-section some indirect estimates of complexity are reported. See also, Keating, 2009. Obviously there is no direct measure of tax complexity but there are various, indirect, measures that convey useful impressions about it and about its costs. Only a few are reported here.

The publication *Paying Taxes 2009*, prepared by PricewaterhouseCoopers for the IFC at the World Bank, ranks countries according to the facility with which taxpayers can pay taxes. The five countries where payment is easiest are Maldives, Qatar, Hong Kong (China), United Arab Emirates, and Singapore. That publication also reports estimates of the number of hours per year that it takes to prepare, file and pay (or withhold) the corporation income tax, the value added tax, and social security contributions. The number of hours varies from under 100 hours, for a handful of countries that include Hong Kong (China) and Singapore, to more than 1000 hours in Brazil, Cameroon, Bolivia, and Vietnam. In China it is reported to take 504 hours while in the countries mentioned earlier it takes: 110 in the United Kingdom; 107 in Australia; 70 in New Zealand; 334 in Italy; 119 in Canada; and 187 in the United States. These estimates refer to medium-size companies and are not indicative of large corporations and individuals.

A publication by the European Commission, 2004, provides estimates for various costs, associated with compliance on the part of taxpayers and cost of administration, for several countries. The costs range from as low as 1.3 percent of the amount paid in Sweden to as high as 22.9 percent and 29.6 percent for some cases in Australia and the United States. The estimates come from different sources and are not strictly comparable. They are also difficult to summarize so that the Commission's report should be consulted for details.

A survey study by Chris Evans, 2003, has summarized about two decades of research into "taxation operating costs". These are compliance costs for taxpayers and administrative costs for revenue authorities. Thus, they are not costs that result in government revenue. The paper argues that "tax law design should not take place without clear recognition of the impact of the proposed changes on the operating costs of the tax system", p. 1. The Evans'

paper summarizes the results of more than 60 studies that deal with the operating costs of taxation. He reports that two features appear regularly in the studies: "the regressive nature of compliance [costs] and the potential trade off between administrative and compliance costs". The latter point was stressed earlier. When governments try to save on costs of administration they often do so by shifting the burden on taxpayers, thus increasing compliance costs. The reported studies employed different methodologies that ranged from surveys, to case studies, and to "diary studies" and interviews. Evans stresses that these studies have become more frequent in recent years because of the growing complexity of modern tax systems. The surveys deal with personal income taxes, business taxes, and other taxes. Many of the studies focus on the costs imposed by complex taxes on taxpayers. He warns about the dangers of making cross-country comparisons, because of the different methodologies used and the different response rates to surveys.

The basic conclusion from the Evans' survey is that *compliance costs are high*: generally between 2 and 10 percent of tax revenue and up to 2.5 percent of GDP. They tend to be two to six times as high as the administrative costs. Furthermore, compliance costs of personal income taxes, corporate income taxes, and value added taxes tend to be highly regressive. Smaller businesses, in particular, carry a disproportional share of compliance cost. Furthermore, "complexity of legislative provisions, together with the frequency of legislative changes, are identified as prime causes of high compliance costs". Evans, p. 9. See also Green, 1994.

As one would expect, there has been a lot of work on the compliance costs of taxation in countries where the issue has been debated widely, such as Australia, the U.K., Italy, and the U.S.A. In Italy a recent article, in Italian, has summarized much of the studies carried out in that country. The conclusions are similar to those reported by Evans. Specifically "... from the data gathered, it can be stated that compliance costs, that the taxpayers must sustain to satisfy all the expected [legal] requirements in a timely fashion are very high". These costs should be taken into account in any tax reform. See Leccisotti, et al, 2006, my translation. The Italian literature puts also some emphasis on the psychological stress that accompanies the direct costs (in hours and money) connected with the payment of taxes. The stress is connected with the fact that taxpayers are never sure that they have complied with all their tax obligations; therefore, they remain anxious that (many) years later they may be contacted and penalized for intentional or unintentional omission.

There are a lot of studies that provide some information on complexity and compliance costs in the United States. I shall report briefly only on some of them, emphasizing first the complexity of the system and then its impact on compliance costs. The interested reader should consult the studies directly.

An interesting, though indirect, quantitative indication of tax complexity is the number of pages, or of words, needed to describe the tax laws and related regulations and to issue needed instructions to taxpayers. Chris Edwards, of the Cato Institute in Washington, has compiled the information on the number of pages. When the income tax was introduced in the United States, in 1913, the number of pages was 400. It grew to 504 pages, by 1939, and reached 66498 pages by 2006. Between 1995 and 2006 more than 25000 pages had been added. See Edwards, 2006. One must ask whether anyone can possibly know all the content of 66498 pages.

The Tax Foundation, 2005, has measured the growth of the number of words in the Internal Revenue Code; between 1955 and 2005. The words in the Internal Revenue Code and the IRS regulations increased from 718 thousands, in 1955, to 7064 thousands in 2005, for the income taxes only, and from 1396 thousands, in 1955, to 9097 thousands in 2005, for the entire tax code. The Tax Foundation reports also the percentage increase in the number of sections in the Code's subchapters. The increase, between 1954 and 2005, was 615 percent. Much of the increase was caused by questions referring to the tax base.

The Tax Foundation reports that "In 2005 individuals, businesses and non profit (organizations) will spend an estimated six billion hours complying with the Federal income tax Code, with an estimated cost of over \$ 265.1 billion". This is about 22 percent of the income tax collected. Compliance costs are regressive. They amount to 5,9 % of the income of taxpayers with adjusted gross income under US \$20,000 and 0.5% for those with income over US \$ 200,000.

VI. Concluding Remarks

This paper has highlighted an aspect of taxation that has not received the attention that it deserves, especially by economists: the question of tax complexity. The paper has shown that tax complexity is: (a) a major problem in many countries; (b) increases with time; (c) makes the traditional economists' evaluation of tax systems, in terms of efficiency, equity, and certainty, very difficult; and (d) makes a tax system much less certain over time.

The growth of tax complexity arises from the freedom that citizens in democratic societies have to form groups and to promote the interests of legitimate groups against the general public interests. Because of this, the more democratic is a country, and the longer has a tax system been in existence, the more complex the system is likely to have become. The constituencies that exist in countries are likely to promote specific provisions in tax systems, rather than tax simplification. Thus, complexity is the result of attempts at getting various forms of "positional rents" by groups of citizens.

The above conclusion has implications for the work of tax economists. It raises questions about the excessive weight given to theories of taxation, that recommend broad schemes that rarely, if even, result in real-world tax systems, and about the little attention paid to the continuous small changes ("honey bees") that make the tax systems increasingly complex. It concludes that economists should spend more time on the details of tax systems and perhaps less on refining theoretical designs. They should not leave the detailed, practical work entirely to lawyers, accountants and other tax specialists.

Economists should recognize the effect that time has on tax complexity and propose ways to deal with this phenomenon. Perhaps, tax systems, or at least specific provisions in tax systems, could have expiration dates, a concept similar to that proposed by "zero-base budgeting" for public expenditures, so that the tax systems could be reviewed systematically and periodically. Such a review would have the objective of cleaning the tax systems of the "cholesterol" that tends to accumulate over the years. It would amount to a kind of periodic pruning of tax systems, to get rid of weeds accumulated over the years. The discussion in this paper also implies that regardless of how optimal a tax system may be at the time of its creation, it is not likely to remain so over the long run.

Some countries, and especially the Scandinavian countries, have managed to have high tax levels with relatively low "tax complexity". They have done so by the use of "dual income taxes" and of tax systems that rely very little on tax expenditures and tax incentives. Their taxes do not try to reflect the specific circumstances of every taxpayer but are designed to fit broad categories of taxpayers in an equitable way. Other countries have tried to bring tax simplicity through the use of so called "flat rate taxes". These are linear income taxes with a simple general personal exemption, followed by a single, flat tax rate. These taxes have been introduced especially in the former command economies of East Europe, including Russia. These countries had not had personal income taxes in the past so that there had

not been much tax complexity accumulated. They could start with a relatively clean slate.

There has been a popular view that what creates complexity is the progressive tax rates. However, this is not necessarily correct, because a tax system could be highly progressive and very simple at the same time. Much of the complications come in defining taxable income and not because of the tax rates. However, it is also true that high marginal tax rates promote more efforts by organized groups to obtain tax preferences that over the longer run bring tax complexity.

References

- Bird, Richard. 2008. "Tax Incentives for Foreign Investment in Latin America and the Caribbean: Do They Need to be Harmonized?" In Tanzi et al. editors, 2008.
- Byrd, Robert C. 1991. "Lobbyists", in The Senate, 1789-1989. Addresses on the History of the United States Senate. Vol. 2 (Washington, D.C.: Government Printing Office).
- Canada. 2009. Total Tax Contribution 2008: Canada's tax regime. Complexity and Competitiveness in difficult times. (prepared by PricewaterhouseCoopers).
- Center for American Progress Action Fund. 2009. "Tax Havens and the Business Lobby". Daily Newsletter posted May 7.
- Dixit, Avinash. 1996. "Special Interest Lobbying and Endogenous Commodity Taxation", *Eastern Economic Journal*, vol. 22(4) pp. 375-388.
- Donmayer, Ryan J. 2009. "Bailout of U.S. Banks Gives British Rum a \$2.7 billion benefit", *Bloomberg News* (26 June).
- Edwards, Chris 2006. "Income Tax Rife with Complexity and Inefficiency", in Tax and Budget, Bulletin of the Cato Institute. No. 3, April (Washington, D.C.).
- Evans, Chris. 2003. "Studying the Studies: An Overview of Recent Research into Taxation Operating Costs", *Journal of Tax Research*, pp. 1-38.
- European Commission, 2004. European Tax Survey, Working Paper No. 3/2004.
- Green, S., 1994. "Compliance Costs and Direct Taxation". The Institute of Chartered Accountants in England and Wales.
- Heyndels, B. and C. Smolders. 1995. "Tax Complexity and Fiscal Illusion", *Public Choice*, 85, 127-141.
- Hitt, Greg and Elizabeth Williamson. 2009. "Stimulus Bill Near \$900 billion". *The Wall Street Journal* (January 28).
- IFC and PricewaterhouseCoopers. 2009. *Paying Taxes 2009*. The Global Picture.
- Key, J.A. and M.A. King. 1978. *The British Tax System* (Oxford University Press).
- Keating, David. 2009. "A Taxing Trend: the Rise in Complexity, Forms, and Paperwork Burdens". National Taxpayers Union, Policy Paper 126 (April 15).
- Leccisotto, Mario, Raffaella Giudice and Pacifico Ribecci, 2006. "Il Costo di Adempimento dei Tributi in Italia". In *Rivista di Diritto Finanziario e Scienza delle Finanze*, LXV, 4, I, 580-637.
- Leccisotto, Mario. 1995. *Il Costo ai Tributi* (Bari: Cacucci).
- Marceau, Nicolas and Michael Smart. 2003. "Corporate Lobbying and Commitment Failure in Capital Taxation". *American Economic Review*, Vol. 93 (1) pp. 241-251.

- McKerchar, Margaret, 2007, "Tax Complexity and its Impact on Tax Compliance and Tax Administration in Australia", The IRS Research Bulletin, Proceedings of the 2007 IRS Research Conference, Publication 1500.
- Olson, Mancur, 1965, *The Logic of Collective Action* (Cambridge Mass: Harvard University Press).
- _____, 1982, *The Rise and Decline of Nations* (New Haven: Yale University Press).
- President's Advisory Panel on Federal Tax Reform, 2005, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (November).
- Puviani, Amilcare, (1901) 1973, *Teoria dell'illusione Finanziaria*, (Milano: ISADE).
- Stiglitz, Joseph, 1989, *The Economic Role of the State* (Oxford: Basil Blackwell Ltd).
- Tax Foundation, 2005, "The Rising Cost of Complying with the Federal Income tax", *Special Report* (December 2005), No. 138.
- Tanzi, Vito, 2006, *Death of an Illusion? Decline and Fall of High Tax Economies* (London: Politeia).
- _____, 2007, "Complexity and Systemic Failure" in *Transition and Beyond*, edited by Saul Estrin, Grzegorz W. Koladko and Milica Uvalic (London: Poligrave).
- _____, 2009, "Tax Systems in OECD: Recent Evolution, Competition and convergence", paper presented at the Conference on "Tax Systems: Whence and Whither", Malaga (Spain), September 9-11, 2009. Forthcoming in a conference book.
- Tanzi Vito, Alberto Barreix and Luiz Villela, editors, 2008, *Taxation and Latin American Integration* (Cambridge Mass and Washington, D.C.: Harvard and IDB).

Victor Uckmar

***Per lo sviluppo del
diritto tributario
comparato***

Professore emerito nell'Università di Genova