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COMPLEXITY IN TAXATION: ORIGIN AND CONSEQUENCES

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by

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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. 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 had 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 treatment of that topic. It will discuss factors that make the tax systems more complex and less transparent so that the systems' full impact on the economies becomes more difficult to assess. The paper will argue that there is a cumulative process at work. Once created, 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 measures 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, 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' specific tax laws and do not get involved with the administration of the taxes.

In the case of architects, once they have provided 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 tilemen, 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 far less involved in the process than the architects. Real tax systems are generally <u>not</u> 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 then approved by policymakers in the executive branch of government. The legislative branch then approves the tax laws. The bureaucrats are often lawyers, accountants, general policy experts, political scientists, public administrators, and, occasionally, even economists. It is, thus, not surprising that major tax theories seem to have little impact on the proposed legislations and even less on the tax laws that are approved.. This has been the faith, for example, of Kaldor's expenditure tax, Mirrlees's optimal taxation theories and other important theories.

The policymakers in the executive, and the legislators in the legislative branch, are politicians who come from all walks of life but, in many countries, people with law degrees seem to predominate.[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 like to believe. This means that the tax systems rarely start with clean and clear designs proposed by economists. There is no theoretical filter through which the tax systems being created must pass. There may be, however, other filters, such as revenue neutrality, administrative simplicity, and equity. Because of this the systems may be complex from the very beginning. Generally tax systems remain in existence for decades during which they are subjected to frequent, and generally small, modifications. Like cardiovascular systems, over the years they tend to accumulate cholesterol.

Often, the modifications are small, in fact so small that they may pass under the radar of public scrutiny. I shall call these small modifications "honey bee" changes because, like the actions of honey bees, they individually 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

[1] There are very few economists in these positions.

usually strong reactions from those who had pushed for them and had been benefiting 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 can 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 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 <u>from all final sales</u>, would, also, have been and have remained a simple tax. Another possibility would have been a property tax based on the 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 has also increased, the tax systems have become more complex. The increasing number of objectives ave more excuses to 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" and other kinds of (transparent and less transparent) "tax breaks" that have been introduced in the tax systems of many countries have made the systems progressively more complex. As mentioned earlier, complexity is likely to be a cumulative process. It is destined to increase with time, unless governments take specific actions to reverse that process. As a general rule it can be assumed that 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 would seem more logical to assume that complexity arises almost automatically out of a democratic process that allows vested interests, lobbies,

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

and various organized groups to push their own objectives in the political arena, each group arguing that its objectives or activities are meritorious and are consistent with those of society at large. These groups will be helped, in their requests, by the proliferation of social objectives that accompanies 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 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 seen, or will be seen as insignificant, by the majority. At times the changes requested may simply be some reinterpretation of an existing rule by the tax authorities, so that the 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 on the relevant matter than those who will approve them. As the tax system becomes more complex, the asymmetry in information, between those who request 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 and, as such, 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

[3] For an interesting account of how a U.S. $2.7 billion tax break was obtained see Donmayer (2009).

reforms that may have started with the greatest possible characteristics of simplicity, such as the 1986 US "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. Some from parliamentarians. 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 their favor, thus increasing tax avoidance. Therefore, 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, has 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 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.

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 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 in society at large, with their activities, their publications, their research, and their lobbying efforts. These organizations or associations may 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.

Googles reports thousands of such lobbies and also the names of top lobbyists in the United States and some other countries, as well as lobbies that operate vis á vis organizations or political institutions such as the European Union, in Brussels, the OECD, in Paris, 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".

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 in use in the United States already 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 people 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

[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.

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), ministers, high level civil servants (in regulatory agencies or in defense ministries), tax administrators, and central bankers. The professional lobbyists in the United States even include some former presidential candidates.

Because of their background and the past positions that they occupied, the lobbyists have useful connections and easy access to those who currently hold important governmental positions and, thus, can influence decisions about legislation or about administrative or interpretative decisions in tax matters that are of interest to the sponsoring groups. This is one way in which the “honey bee” changes, that lead to tax complexity, come about. Often large money contributions, made by lobbyists to legislators who need increasingly large amount of money for their election campaigns, helps.

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 groups that hire them. In all cases they have far more knowledge than the population at large, or even than the broad groups of policymakers, including the members of the parliament that will make the decisions. If the requested changes appear small, their leverage becomes high because there will be less opposition to them.

The incomes of lobbyists have been reported to be very high (often in the millions of dollars) so that the lobbying activity has attracted some of the brightest and best connected people. 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 jobs.[5]

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

[5] See for examples the activities of the "K Street project" in Washington.

refunds…" and many other apparently worthwhile tax incentives had made their way in the proposed legislation. 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 often 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.

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 economists. This is, of course, exactly in line with Gary Becker's 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. 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 certainty.

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.

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 payments they make to the government. And because of higher administrative costs, the government receives less net revenue that it can use to pay for public services. Therefore, complexity inserts 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 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 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 possibly even 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 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 shall present some evidence of tax complexity. We shall divide the evidence between qualitative and quantitative.

Qualitative Evidence[6]

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 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.

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 adds that in Australia, "personal

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

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.

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 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 vary 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 studies and the potential trade off between administrative and compliance costs”. It will be recalled that the latter point was stressed earlier. When governments try to save on costs of administration they often shift the burden on taxpayers, through higher 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 others. 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 conclusions from the Evans’ survey is that compliance costs are high: generally <u>between 2 and 10 percent of tax revenue and up to 2.5 percent of GDP</u>. 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 <u>tend to be highly regressive</u>. 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 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 and 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 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. The number of pages, when the income tax was introduced in the United States in 1913 , was 400 pages. It had grown to 504 pages by 1939 and had 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 know all the content of 66498 pages.

The Tax Foundation, 2005, has measured the growth of the number of <u>words</u> in the Internal Revenue Code between 1955 and 2005. The words in the Internal Revenue Code and the IRS regulations had increased from 718 thousands, in 1955, to 7064 thousands, for the income taxes only, and from 1396 thousands, in 1955, to 9097 thousands, 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 a 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. This is the question of complexity. The paper has shown that complexity :(a) is a major problem in many countries; (b) it increases with the passage of time; (c) makes the traditional evaluation of tax systems (in terms of efficiency, equity, and certainty) very difficult, and (d) that the fact that it grows with time, makes a tax system much less certain. The growth of complexity arises from the free actions of citizens in democratic societies to form groups and to promote the interests of the 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, the complexity is the result of attempts at various forms of rent seeking 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 that make the tax systems increasingly complex. In conclusion, economists should spend more time on the details of tax systems and not leave this work entirely to lawyers, accountants and others.

Economists should specifically recognize the effect that time has on tax complexity and they should propose ways of dealing with this phenomenon. Perhaps, tax systems could have expiration dates, a concept similar to that of zero-base budgeting, so that the tax systems could be reviewed systematically and periodically. Such a review would have the objective of cleaning the tax systems of all the "cholesterol" that has accumulated over the years. It would amount to a kind of periodic pruning of tax systems to get rid of weeds that accumulate over the years.

Finally, the discussion in this paper indicates that however optimal a tax system may be at the time of its creation, it will not remain so over the long run..

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