

THE (COMPLIANCE) COST OF TAXING BUSINESS

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My presentation will address four aspects of business compliance costs:

1. Magnitude
2. Nature and Determinants
3. Policy Implications
4. Effect of Tax Reform

The paper contains much, much more detail about #2. It also addresses the likely compliance costs of alternative tax systems, which I will not discuss in great detail today.

1. Magnitude

Estimates of the Compliance Costs of the U.S. Federal Corporation Income Tax (2005 dollars)

Study	Year	Companies Covered	Per Firm Compliance Cost	Total Compliance Cost	% of Revenue
Slemrod and Blumenthal (1993)	1992	~1300 largest U.S. companies	\$1.55 million	\$2.20 billion	2.7
Slemrod (1997)	1996	~1300 largest U.S. companies	\$1.80 million	\$2.34 billion	n.c.
Slemrod and Venkatesh (2002)	2000	Smaller than largest 1300, more than \$5 million of assets	\$104,000 - \$110,000	\$23.0-\$24.4 billion	n.c.

2. The Nature and Determinants of Compliance Costs

- About 60 percent of cost is for internal personnel; the figure is 65 percent for the biggest companies.
- About 17 percent goes to internal non-personnel expenses.
- The share of expenses allocated to outside assistance is higher for medium-sized firms than for the big firms: 25 percent versus 18 percent.
- About 25 percent of the compliance cost of big businesses is due to state tax requirements; the figure is closer to 30 percent for medium-sized businesses.

- Size matters. The ratio of costs to size declines with size. The ratio of cost to assets declines by about 0.5 percent (not percentage points) for each percent increase in assets.
- Sector matters. Being in the mining or oil and gas sector increased costs substantially, while being in the wholesale or retail trade sector implies lower costs than otherwise.
- A larger number of active entities is associated with higher compliance costs.

- Firms subject to the Alternative Minimum Tax have significantly higher compliance costs.
- Having ongoing litigation is associated with higher costs.
- Foreign activity matters. For the biggest companies, almost 40 percent of the total compliance cost of federal taxes was due to foreign-source income, which is high relative to the share of companies' foreign activities.

3. Policy Implications

- With some exceptions, compliance costs represent costs to society.
- Compliance cost estimates do not distinguish between involuntary costs that are must be expended to comply with the law, and discretionary costs that are incurred to avoid taxes.
- To the extent that tax planning lowers tax liability, the costs to society are larger than the net private costs incurred by businesses.

- To assess the ultimate incidence of compliance costs, their burden must be traced to individuals in their role as customers, shareholders, workers and the like.
- The key factor in tracing the burden is what determines compliance costs. To the extent they depend on, for example, size, sector, and multinationality, this generates inefficient incentives, *unless these costs mimic the true cost of enforcing taxes.*

4. Effect of Tax Reform

- Based on their own survey responses, the biggest cost-saving reform would be to conform the tax and financial statement definition of income. Second biggest is establishing complete uniformity among states, and between the states and the federal government.
- Survey respondents expressed considerable skepticism about whether fundamental tax reform, such as a value-added tax or a flat tax, would deliver considerable, or even positive, savings in compliance costs. The most often mentioned concern had to do with the transition period.

- Based on experience in other countries and other analysis, either a VAT or a flat tax could in principle provide substantial reductions in compliance cost, although VATs in practice do not generate noticeably lower costs-to-revenue ratios than the income taxes the same countries levy.
- Other types of consumption taxes, such as a retail sales tax or a personal consumption tax, have daunting administrative and compliance problems.

5. Conclusions

- Compliance costs represent resources that, under other circumstances, could have been used to add to the productive capacity of the country.
- There is often, but not always, a tradeoff that must be made between these other goals and simplicity.
- The simplest tax system is not necessarily the best, but neither is all of the complexity in the current system necessarily serving a useful purpose.

- The U.S. tax system is already largely privatized in one important sense.
- Businesses remit over 80 percent of taxes at all levels, including withholding, and are central to the backbone of the enforcement mechanism, by providing the tax authorities with information reports.
- Compliance costs dwarf administrative costs, by as much as a factor of twenty.
- Tax policy needs to address these costs, even if they do not show up in government budgets.