

**The Compliance Cost of the Personal  
Income Tax in India, 2000-01:  
Preliminary Estimates**

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## Contents

### Summary

1.	Introduction and Outline	9
	The Impact of Compliance Costs	9
	Simplification and Compliance Cost	10
	The Magnitude of Individual Compliance Costs	
	In other Countries	11
	Outline	11
2.	Measuring Compliance Costs: Conceptual Issues	12
	Defining Costs of Tax Compliance	12
	Mandatory and Voluntary Compliance Costs	13
	Compliance Cost Components in this Study	13
	Valuing Time and Tax Effects in Measuring	
	Compliance Costs	14
3.	Problems with the Information Base and	
	Benchmarks for Compliance Costs	16
	Sample Size and Universe Coverage	16
	Why the Unreliable Study Findings are	
	Plausible Still worth Reporting	16
4.	Compliance Cost of the Personal Income Tax	
	In India: Survey Findings	18
	Basic Characteristics of Respondents	18
	Use and Cost of Tax Advisors	18
	Monetary Compliance Costs	19
	Time Compliance Costs	20
	Overall Legal Compliance Costs	21
	Cost of Bribes and Harassment	22
	Distribution of Compliance Costs across Gross	
	Income Groups and by Occupation	24
5.	Aggregate Compliance Cost Estimates	25
	The Cost of Deducting Taxes at Source: A Case Study	26
	Costs of Collecting Taxes through the Public	
	Sector Banks	27

	Cost of Appeals, Litigation and Prosecution	27
	Administrative Costs of Collecting Taxes	28
	Aggregate Estimates	29
6.	Qualitative Information on Compliance Costs of Inefficiency and Corruption	30
	Bribes and Inefficiency in Relation to Refunds	30
	Other Comments on Bribes and Harassment	30
	Obtaining Permanent Account Numbers (PAN)	31
7.	Conclusions	32
8.	Reform Suggestions and Assessment of Recommendations of the Direct Tax Task Force	33
	Reforming Administration Institutions and Incentives	34
	Reforming Procedures	35
	Automation	36
	Improving Monitoring, Reporting and Client Feedback	37
	Reforming the Policy Process	38
	Tables	41-55
	Annex	56
	Methodology	56
	Areas Covered in Questionnaires	58
	Sample Versus Population Distributions	58
	Aggregation Methodology	61
	Individual Income Tax, Surcharge and Standard Deduction Rates: 1990-00 and 2000-01	62
	Income Tax Knowledge of Respondents	63
	Distribution of Compliance costs in the Sample	64
	References	67

## **Summary**

*Simplification and Compliance Costs:* Complexity of the tax system possibly has adverse effects on tax administration, compliance and compliance costs. Complexity is caused by complex tax laws or administrative procedures, discretionary provisions, tax concessions and poorly drafted laws. A number of countries have attempted tax simplification to reduce compliance and administrative costs.

*Compliance Costs in Developed Countries:* These vary between 3.91 percent of tax revenue in the UK in 1986-87 to between 7.9 to 10.8 percent in Australia in the 1990s.

*Defining Compliance Costs:* Compliance costs are incurred by taxpayers but also third parties who collect taxes (e.g. tax withholders) or who are required to provide information to the tax administration. Non-filers incur costs of non-compliance. So tax compliance cost elements included, in principle, in this study are all costs incurred by taxpayers, non-filers and third parties to comply with tax obligations. Tax compliance costs can be voluntary or mandatory, though both add to the social cost of the tax. Bribes, being a transfer are part of private costs but not costs to society. Compliance activity also has benefits via better record keeping or cash flow benefits of tax deductors. Costs arising from economic distortions and equity violations are, however, omitted.

*Information base, sample size and response rate:* Besides primary survey data and case studies, relevant secondary data are used. For the survey, from a list of 10,234 names the eventual response rate was a disappointing 2.36 percent amounting to less than one taxpayer per 100,000 income tax payers in 2000-01. Overall, the final sample of 172 taxpayers is biased towards high income respondents and salary earners. Therefore, findings of this study must be taken as very preliminary and subject to a large error margin. Nevertheless, the high compliance costs documented make it clear that a reliable cost assessment is urgently needed.

### *Estimates of Compliance Costs:*

- Estimates of compliance costs are high by international standards even for salary earners and excessive for non-salaried taxpayers equalling, at the median, 130 percent of taxes paid.
- Costs are regressive and, for low income and middle income non-salary earners, can be more than double taxes paid even if bribe costs are neglected.
- Both the incidence of bribe payment and the bribe quantum are high, even among salary earners, but especially so for non-salary earners.
- Harassment of assesseees in various forms, whether related to bribes or not, is a serious problem.
- Overall, despite the personal income tax being limited to only around 20 million taxpayers, costs directly borne by taxpayers are estimated at over 0.8 percent of GDP or 49 percent of personal income tax collections. With third party compliance costs, this rises to 56 percent of taxes collected. If conservatively "guesstimated" non-filer costs are added, costs further increase to 59 percent of tax revenue. The overall social cost of the personal income tax, adding administration costs and subtracting bribes is 60 percent of tax revenue. It is reiterated that the poor information base implies that these estimates are subject to a wide margin of error.

### *Other Findings of Interest:*

- *Advisor's* are used more to deal with tax uncertainty and administrative procedures than to help in reducing tax burdens through tax planning.
- *Third party* costs of deducting tax at source amounted, in a case study, to 11.8 percent of taxes withheld.
- *Commercial bank* costs of receiving and remitting taxes, over and above reimbursement received from the government, were Rs. 363 crore or about 1 percent of tax collections.
- *Long delays in receipt of PAN cards* and numbers are a source of harassment.
- *Appeals*, due to their long duration and the fact that the IT Department has been alleged to lose most appeals, lead to

avoidable cost to both taxpayers and government. One reason for extensive appeals is the fear of not achieving internal targets by assessing officers, leading to unsustainable, “high pitched assessments”.

- *Delayed refunds* are a cause of harassment and associated with forced bribe payments by salary earners.
- *Clearances and permissions* required from tax authorities have, according to tax professionals, similar characteristics.
- While findings are not conclusive on the impact of avoidance activity on compliance costs, results, if anything, suggest no uniform *impact of avoidance on compliance costs*.

*Some reform suggestions:* A six-pronged approach to reducing the operating cost of the personal income tax is first suggested: Tax structure simplification, institutional reform, procedural reform, automation, monitoring and client feedback, and tax policy process reform. If this proves to have an inadequate impact on compliance costs, then drastic tax reform is worth considering seriously.

# The Compliance Cost of the Personal Income Tax in India, 2000-01: Preliminary Estimates\*

*Arindam Das-Gupta\*\**

## Introduction and Outline

### *The Impact of Compliance Costs*

Taxpayer compliance costs are an area of growing concern and, for example, have found their way even into political platforms in countries like Australia and the United Kingdom.<sup>1</sup> Compliance cost have been explicitly addressed in the policies of countries like the USA, Australia, the UK, the Netherlands and New Zealand<sup>2</sup> and, increasingly, in India. In the UK, compliance cost assessments (CCAs) are now mandatory while introducing new tax proposals.<sup>3</sup> In Australia, any change in taxation legislation is supported by Taxation Impact Statements (TIS), which details the impact on taxpayers of the legislation and include an assessment of compliance costs. Formal estimation of the overall compliance burden of the tax system was first attempted by Haig (1935)

If the terminology and interest in compliance costs are of recent origin, the ideas are old. In fact, three out of four of Adam Smith's canons

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\* This paper is excerpted and condensed from a report on company compliance costs, Chattopadhyaya and Das-Gupta (2002), prepared for the Planning Commission at the National Institute of Public Finance and Policy. The report is available at the Planning Commission website <http://www.planingcommission.nic.in/reports>.

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<sup>1</sup> See, Evans and Walpole (1997).

<sup>2</sup> See, Sandford (1995).

<sup>3</sup> See, for example, Sandford (1995). Such CCAs are based on estimated compliance costs of a 'typical' business.

of taxation relate directly or indirectly to tax compliance costs. They are 'Certainty', 'Convenience', and the 'Economy'<sup>4</sup>, the other being 'Equity'. Economic effects of high compliance costs include deadweight resource costs, increased non-compliance, distorted production decisions and reduced investment, higher deficits, reduced tax equity, lower economic growth and adverse price movements. Compliance costs, by increasing the effective marginal tax rate, may also distort and hinder investment decisions, both domestic and foreign.

### *Simplification and Compliance Costs*

Growing complexity of the tax system has adverse effects on tax administration, compliance and compliance costs (Sandford, 1995; Bardsley, 1997). Much discussion of simplification reflects a misunderstanding of what makes a tax system complex. For instance, the very use of the income tax rather than a sales tax increases the complexity of tax laws, increasing compliance costs.<sup>5</sup> Tax simplification is necessary but not sufficient to help reduce taxpayers' costs of compliance (James, Sawyer, and Wallschutzky, 1997). In the US, simplification was one of the main objectives of the tax reform movement of the 1980s that culminated in the tax reform act of 1986. Comparing surveys of compliance cost in 1982 and 1989, Blumenthal and Slemrod (1992) concluded that tax reform did not reverse the growth in compliance costs in the 1980s. In other countries simplification during 1980s has also been found to increase compliance costs except in one study of Sweden (Malmer, 1995).<sup>6</sup>

### *The Magnitude of Individual Compliance Costs in other Countries*

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<sup>4</sup> 'Certainty' implies that tax liabilities should be clear and certain, rather than arbitrary; 'Convenience' of payment of taxes refers to the collection of taxes, which should be done in a manner and at a time convenient to the taxpayer; and 'Economy' in collection means that it should not be expensive to collect taxes and hence discouraging for business.

<sup>5</sup> See, Kaplow (1995).

<sup>6</sup> See, also McClure (1989), Boucher (1991), Pope (1994), Talib (1996), Bardsley (1996) and James, Sawyer and Wallschutzky (1997).



Based on large-scale surveys, Sandford estimates the compliance costs of UK tax system in 1986-87 at 3.91 percent of the tax revenue. In terms of percentage of GDP, "compliance costs emerge as in excess of 1 percent of GDP" (Sandford, 1989). In recent estimates of compliance costs of US individual income tax "the annual compliance costs of the federal and sub-federal individual income taxes is many times higher than the budget of the tax administration agency, being \$ 35 billion compared to the total IRS budget of about \$ 6 billion" (Blumenthal and Slemrod, 1996). In Table 1 an international comparison of compliance costs estimates for developed countries is presented.<sup>7</sup> No information is available on income tax compliance costs in India.<sup>8</sup>

### *Outline*

In section 2, compliance costs are defined and the coverage of compliance costs in this study is described. Section 3 is an important section of the paper and describes the severe weaknesses in the information base of the study. In the section arguments are also presented as to why, nonetheless, the study is important for current policy. In section 4, sample based estimates of compliance costs of the personal income tax in India, which are extraordinarily high by international standards, are presented. Using sample based information as well as secondary data on certain types of compliance costs which cannot be assessed using the sample, aggregate estimates are presented in section 5. In section 6 qualitative information on compliance costs is presented, in an attempt to bring home the human dimension of the statistics presented in the earlier two sections. Section 7 reviews the main conclusions. In section 8, some suggestions for compliance cost lowering reforms of tax administration are made along with an assessment of recommendations on the same or related issues by the recently concluded Direct Tax Task Force (2002).

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<sup>7</sup> Estimates of compliance costs are not strictly comparable due to very different tax systems and serious differences in methods adopted. A full review of earlier compliance cost studies, almost all for developed countries, is in Chattopadhyay and Das-Gupta (2002).

<sup>8</sup> Mrs R. Rajamani of the Indian Revenue Service confirmed that she had carried out such a study in the late 1990s but expressed her inability to share the study. Two earlier studies on Indian tax compliance costs, but not for the income tax, are discussed in Chattopadhyay and Das-Gupta (2002).

## ***II. Measuring Compliance Costs: Conceptual Issues***

### *Defining Costs of Tax Compliance*

The conventional definition of tax compliance costs, for example in Sandford (1995) is:

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

Compliance costs are not only incurred by taxpayers but by all agents involved in facilitating the transfer from the private sector to the government exchequer. For example, employers responsible for tax deduction at source and financial institutions entrusted with collecting taxes also incur compliance costs. Overall costs of a tax system include “welfare costs, opportunity costs, psychic costs, social costs and so on”.<sup>9</sup> To assess the total impact of taxes on society, “the total sacrifice imposed upon the populace – total collection costs, administrative and compliance costs, should be looked into”.<sup>10</sup> Slemrod and Yitzhaki (1996) identify compliance costs as one of the five component costs of taxation. The others are administrative costs, deadweight efficiency loss from taxation, the excess burden of tax evasion and avoidance costs.

Sandford *et. al.* (1989) have emphasised the need to include *psychic costs* of complying with taxes, in particular for the poorer pensioners, widows and single women. So far, practical methods for measuring these costs have proved elusive.<sup>11</sup>

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<sup>9</sup> See, Evans and Walpole (1997).

<sup>10</sup> See, Mikesell (1986).

<sup>11</sup> Chattopadhyay and Das-Gupta (2002 and 2002a) discuss attempts made by them to measure the psychic costs of tax policy uncertainty and tax law ambiguity and complexity by using contingent valuation methods. Though responses of those who

## *Mandatory and Voluntary Compliance Costs*

Compliance costs can be classified as mandatory and voluntary, with the latter being closely related to the Slemrod-Yitzhaki category of avoidance costs.<sup>12</sup> For policy the two types of costs have different implications. While the government can directly affect the former by simplification, the latter is affected by several social factors, such as fiscal attitudes of the society, and uncertainty, which the government cannot easily influence. In view of different policy prescriptions involved, the distinction between the two needs to be made clearly, to the extent possible.

## *Compliance Cost Components in this Study*

Given the discussion above, it will be clear that definition and classification of compliance costs is not a simple task. In defining the compliance costs of taxation to society as a whole, we include, in this study, *all* costs due to the tax system borne by taxpayers and third parties other than cost arising from economic distortions and equity violations. *We include, therefore, costs of both compliance and non-compliance*, combining compliance costs and avoidance costs in the Slemrod-Yitzhaki classification. Components of the social cost of tax collection, including compliance costs, included and excluded in this study are summarised in tabular form at the end of this section. The table makes clear that the study underestimates the compliance costs of the income tax.

## *Valuing Time and Tax Effects in Measuring Compliance Costs*

If labour hours are perfectly flexible, then the standard neoclassical labour-leisure choice model with competitive labour markets requires that compliance time be valued at the after tax wage rate, using

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appeared to understand what was being asked revealed a high correlation between objective and psychic compliance costs, the attempt was not very successful given the low response rate to contingent valuation questions, even relative to other areas in this survey and the large number of zero responses to the questions.

<sup>12</sup> See, Johnston (1961) and Sandford (1965).

the individual's marginal tax rate. Lost work hours should, in contrast, be valued at the gross wage rate with competitive labour markets. In the absence of competition, a shadow wage rate should be used. In the absence of perfect flexibility, the valuation, even by the individual, depends on the extent to which compliance time reduces paid work time, valued at the gross wage, and the extent to which it reduces leisure, to be valued at the post tax wage. This valuation ignores possible psychic costs because, say, individuals prefer working to compliance activity.<sup>13</sup> A third possibility is that compliance time supplants work time, which, due to imperfect supervision, does not reduce the taxpayer's earnings. In this case, the value of time spent is zero to the taxpayer aside from psychic costs, while the value to society is still the gross wage. In the presence of tax evasion and avoidance, effective marginal tax rates should be used. Under the assumption that private and social costs coincide, one way out is to elicit the compensating variation for compliance time directly from the individual. This was attempted unsuccessfully by Slemrod and Nikki Sorum (1984) and also, apparently successfully, by Bhatnagar (1997). In this study, both the average wage and the individual's own time valuation (both either in pre-tax or post-tax terms depending on the individuals alternate use of time) are used in measuring compliance costs, though final estimates reported are deliberately biased downward by taking the minimum of these.

### **Personal Income Compliance Cost Components Included in The Study**

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<sup>13</sup> Slemrod and Sorum (1984).

**A. Tax Compliance Costs**

<b>Category</b>	Individual taxpayers (salaried)	Individual taxpayers (non-salaried)	Non-filers <sup>14</sup>	Third parties (banks, tax withholders, employers)	Third parties (others)
Time spent by individual	Yes	Yes	No	NR	Yes (Time spent helping others comply)
<i>of which on Tax Planning</i>	Yes	Yes	NR	NR	NR
Direct money costs (including fees paid to tax professionals)	Yes		No	Yes*	No
<i>of which on Tax Planning</i>	Yes	Yes	NA	No**	NA
<i>of which employee costs</i>	NR	Yes	No	Yes*	No
Bribes paid	Yes	Yes	No	No	No
Psychic costs	Not reported	Not reported	No	No	No
Benefits from compliance requirements	No	Yes	NR	No	No

**C. Other social costs of the personal income tax – not examined in detail**

Budgetary costs of the income tax department in relation to the personal income tax.

Budgetary costs of the rest of government (courts, police, legislators, CAG, law ministry, etc).

Economic efficiency costs of the personal income tax.

Economic efficiency costs of personal income tax evasion.

**Notes:**

\* Case studies only.

\*\* For example, cost of tax compliance by company accountants on behalf of employees and directors.

NR: Not relevant.

### III. Problems with the Information Base and Benchmarks for Compliance Costs

<sup>14</sup> These costs are examined by Chattopadhyay and Das-Gupta (2002b) and the estimate of these costs from there is included in the aggregate compliance cost estimates presented below.

## *Sample Size and Universe Coverage*

*Sample size:* In brief, 10,234 randomly selected addresses individuals were obtained from a government data base which covered a large percentage of income tax assesseees. The ultimate sample size from mailed and canvassed questionnaires was disappointing, at 122 salaried and 50 non-salaried respondents. Questionnaire design, sample design and response rates, and methodology are described in the Annex.<sup>15</sup>

*Universe Coverage:* According to the report on direct taxes of the CAG (2001), the number of income tax assesseees stood at 1,95,67,937 in 1999-2000. This implies a sample coverage of 0.00089 percent or just under one taxpayer per lakh (1,00,000) of assesseees. Overall, the sample is biased towards high income respondents, salary earners, and possibly, the highly educated. Sample characteristics in comparison to population characteristics are presented in the Annex .

## *Why the Unreliable Study Findings are Plausible Still Worth Reporting*

Given the small study sample, it is best viewed as no more than case studies of 172 individual income tax assesseees. Samples are inadequate for reliable statistical inference due to the very low response rate, often curtailed further by incomplete questionnaires. There is, therefore, no doubt that average results are subject to a wide error margin. Strong reservations have been expressed about the value of aggregate compliance cost estimates compiled on the basis of such shaky data.<sup>16</sup> Furthermore, methods used to value time expended on

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<sup>15</sup> Full discussion is in Chattopadhyay and Das-Gupta (2002) which also has an evaluation of the mailed, anonymous, questionnaire method adopted for this study against the alternative of canvassed surveys as well as suggestions for future studies.

<sup>16</sup> By Professor D.K. Srivastava. While agreeing with him the justification for presenting aggregate estimates is that in their absence no comparison of survey based compliance costs items and other compliance cost items compiled using indirect information could be made.

compliance activities, though standard in the literature, have been questioned in the Indian context.<sup>17</sup>

While accepting the possible validity of these criticisms, the results are still felt to be worth reporting: Even the median salary earner in these "case studies" had a compliance cost in excess of the highest figure in Table 1, while the outrageous compliance costs of almost all non-salaried individuals in the sample clearly calls into question the very rationale of the personal income tax – even if they are all outliers (See Appendix Tables A10 to A12). Indeed, for many "case studies", monetary cost alone exceeds total compliance costs in earlier studies.

In the event that findings of this study cannot be refuted by a more satisfactory study with an adequate sample, then no government in the world has the right to burden its citizens with such a costly source of finance for government expenditure.<sup>18</sup> Compliance costs should either be lowered or high compliance cost groups – which may include the majority of taxpayers – should be exempted from the personal income tax. It is, therefore important that the results from the first publicly available study of personal income tax compliance costs be made available to scholars to examine and, hopefully, refute when superior information becomes available.

#### **IV. Compliance Cost of the Personal Income Tax in India: Survey Findings**

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<sup>17</sup> By Professor Amaresh Bagchi. While the author does not find his arguments persuasive (that the opportunity cost of time spent complying has little to do with hourly wage rates should, nonetheless, be noted.

<sup>18</sup> Professor Richard Bird commented on a draft of Chattopadhyay and Das-Gupta (2002): "First, in substantive terms, this report is perhaps the strongest evidence I have ever seen suggesting that the PIT [Personal Income Tax] in India is a complete waste of time and money. The country (and the government) would, it seems, be significantly better off if the thing were simply abolished."

### *Basic Characteristics of Respondents*

The method of estimating different tax and income variables used in this study is described in detail in Chattopadhyay and Das-Gupta (2002). Information on incomes and tax payments of respondents is in Table 2. The mean sample income is around 79 percent above the estimated mean population income. Correspondingly, income tax payments are more than double the population average. One unexpected finding is the large TDS percentage of non-salary earners, presumably for interest and dividend income.

Information on taxpayers under scrutiny (or tax audit by the Income tax Department) is in Table 3. Given respondents' high income levels, the percentage under scrutiny was larger than the 1 percent to 2 percent of taxpayers scrutinised annually by the Income tax Department in recent years.<sup>19</sup> Furthermore, a remarkable 22 percent of non-salaried taxpayers and 13 percent of all taxpayers had ongoing scrutiny proceedings with attendant expenditure of time or money. The possibility that Income-tax department scrutinies contribute substantially to compliance costs both in terms of the number of taxpayers affected and in terms of compliance costs per taxpayer is confirmed by Chattopadhyay and Das-Gupta (2002) who find, using regression analysis, that the extra compliance cost of scrutinised individuals, controlling for other factors, amounts to 34 percent of tax paid.

### *Use and Cost of Tax Advisors*

Reliance on tax practitioners was much higher among the self-employed, while fully a third of salary earners completed their own tax returns (Table 4).

Correspondingly, more salaried taxpayers helped others with their tax returns (incurring "third party compliance costs") and spent larger amounts of time doing so than the non-salaried (Table 5). Using a conservative value for the opportunity cost of time, discussed below,

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<sup>19</sup> According to the CAG (2001), for both personal income and corporation tax combined, 1.15 % of the 2.74 crore assessments due for disposal in 1999-2000 were subjected to scrutiny.



third party costs of unpaid assistance from friends to help others comply can be valued at Rs. 399 per salaried taxpayer and Rs. 405 per non-salaried taxpayer given the higher value of time of the latter.

Table 6 shows that both use of tax advisors and fees paid to them were higher for the non-salaried. Reported fees paid in Table 6 correspond reasonably well with those from a case study of a firm of Chartered Accountants, which charges salary earners Rs. 500 to Rs. 1000 and non-salary earners Rs. 1000 to Rs. 5000.

Reasons for use of tax advisors appear to differ between salaried and non-salaried respondents, though very few salaried responses were available (Table 7). Tax uncertainty due to frequent changes in tax provisions and, correspondingly, the desire to ensure perfectly prepared tax documents were considered most important by salary earners. Tax planning was the most important reason for use of tax advisors by the non-salaried, though, overall, they did not give great weight to any one reason.

In a focus group meeting with members of the *Bombay Chartered Accountants Society*, a tax professional expressed the opinion that among major reasons that taxpayers used professional advisors was because outsourcing was generally cheaper and, secondly, for representation before tax authorities in the event of scrutiny or other post-assessment proceedings.

### *Monetary Compliance Costs*

Monetary compliance costs of respondents are reported in Table 8. *Even if time compliance costs are totally omitted, average monetary compliance costs as a percentage of tax are large relative to **total** compliance costs of the income tax found internationally* which are reported in Table 1. This is the case even if conservative sample medians figures are used for comparison. Monetary costs for the non-salaried are especially high as a percentage of taxes and income in comparison with compliance costs in other countries.

Regarding different components (Table 9), record keeping costs and advisor's fees form the bulk of costs of non-salaried individuals while advisors fees and tax planning costs dominate for salary earners. The importance of these costs parallels findings for other countries as

reported, for example, by Walpole, *et. al.* (1999). *However, even for the average salaried taxpayer average monetary costs exceed average total compliance costs found in compliance cost studies conducted in other countries.*

### *Time Compliance Costs*

On average, non-salaried taxpayers spent 88 hours per year complying with tax obligations of which the bulk of time was spent keeping records (Table 10). In contrast salary earners spent 28 hours complying with tax obligations. *These averages are high relative to what is seen internationally.* However, sample medians at 11 hours and 30 minutes for the salaried and 17 hours for the non-salaried (Table A10 in the Annex) are comparable to figures reported internationally raising the possibility that the averages do not reflect the experience of the representative taxpayer. For comparison, 11 hours and 27 hours respectively were spent per taxpayer in New Zealand and the United States (Hite and Sawyer, 1997), and 11.2 hours were spent per household per year in Germany (Tiebel, 1984 as reported by Fischer, 1989).

Turning to components, salary earners spent nearly 30 percent of the time or around 9 hours in tax planning, the rest being spent on mandatory compliance activities. Because of greater reliance on tax advisors, self-employed taxpayers spent less time (6-7 hours) on tax planning.

In putting a monetary value to these time compliance costs, four potential values of the opportunity cost of time were computed:

- The self-assessed value per hour of the respondent if respondent stated that (s)he would spend an hour saved from time compliance activities to earn more.
- The respondent's self-assessed value per hour multiplied by (1 minus the respondents marginal tax rate) if the respondent stated that (s)he would spend an hour saved from time compliance activities on leisure activities.
- The average pre- or post-tax hourly earnings of the respondent assuming 1920 working hours per year.

The least of these values (which obviously excluded the pre-tax wage) was then taken, to get the "conservative value of time per hour".<sup>20</sup> A summary of these figures is in Table 11. This procedure obviously biases estimates downward.<sup>21</sup> Nevertheless, even at conservative values, time compliance costs are extremely high on average (Table 12). These costs are estimated at Rs. 27,000 per annum for non-salaried taxpayers and Rs. 2,100 for salaried taxpayers. However, median values, though high are much more conservative at below Rs 1,500 and 900 respectively, though as a percentage of tax even these are high by international standards. That median figures in hours are reasonable internationally but those in rupees are not, is partly a reflection of the high income bias in the sample, which gets further accentuated by the 55 individuals whose compliance costs are more than 25 percent above the median (see Table A11). Of different components, record-keeping by non-salary earners appears to be most burdensome (Table 13).<sup>22</sup>

### *Overall Legal Compliance Costs*

These are reported in Table 14 and, for the tax planning cost component, in Table 15. The picture emerging from the table is of a high compliance cost tax system, with costs largely being associated with compliance activities considered mandatory by taxpayers which yield no offsetting tax benefits. This is particularly true for the non-salaried, whose costs are, on average 10 times higher than salaried taxpayers. Nevertheless, even *median costs* as a percentage of taxes paid by salary earners are high by international standards. Since the data base of the study is small and far from ideal, it is worth reiterating that the results should be treated with caution. Nevertheless, subject to further study, the desirability of a high cost tax such as the personal income tax in India is clearly called into question.

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<sup>20</sup> The correlation between the average wage and the self assessed value is 0.678 while the correlation between the average wage and the conservative value is 0.868. A regression of the average wage on self assessed value has the equation: average wage = 0.0605 + 0.118 (self assessed value), with an R-squared of 0.46.

<sup>21</sup> For example, the ratio of time costs to monetary costs is below that in many international studies. See, for example, Sandford, Godwin and Hardwick (1989).

<sup>22</sup> In the literature, a known possible source of bias in figures for record-keeping as in Table 11 is if the self-employed include ALL record-keeping time in their estimates and not just time for tax purposes. However, in the canvassed pre-survey where this problem was guarded against, reports by some pre-survey respondents are higher than in the final survey, though means are not significantly different, statistically.

A view sometimes expressed is that tax concessions are provided for socially desirable activities or uses of income that are substitutes for direct government expenditure. If this is accepted, only a part of compliance costs are for raising revenue, the rest being the cost of getting benefits from transfers or tax expenditures. So a modified measure is required to assess the compliance cost of raising revenue. This is the ratio of compliance costs to gross taxes. This ratio, along with taxes saved as a percentage of gross taxes is therefore presented in Table 16. As can be seen, compliance costs are substantial even by this yardstick, in excess of 100 percent for the non-salaried. Of interest is the remarkably close figures for tax saving as a percentage of gross taxes for both salaried and non-salaried (43 percent to 45 percent) and the low coefficient of variation. Nevertheless, medians differ widely, with the median non-salaried respondent having no tax saving implying skewed tax saving behaviour by them. Overall, the conclusion appears warranted (subject to caveats regarding the data) that generous concessions raise compliance costs of tax payers while ending up narrowing the tax base and reducing tax buoyancy.

A final way of viewing the impact of compliance costs is to add compliance costs as a percentage of gross income to the effective income tax rate. This is done in Table 17. As can be seen, the increase in the tax burden of non-salaried respondents is more than two-thirds, while that of salaried taxpayers is around 26 percent.

However, for the non-salaried taxpayer there are offsetting benefits, chiefly in terms of preparing income statements (6 respondents) and also from better asset and inventory management (3 respondents each) Unfortunately only 8 qualitative responses on benefits are available.

### *Cost of Bribes and Harassment*

Of survey respondents, 23 percent of salary earners and 42 percent of non-salaried respondents in the final survey "admitted" to paying bribes, keeping in view that respondents were asked if similar

persons paid bribes rather than if they themselves paid bribes.<sup>23</sup> Since "no comment" and omitted responses are also from *potential* bribe payers, the number of *potential* bribe payers rises to 59 percent for salary earners and 79 percent for non-salaried respondents.

To ascertain the quantum of bribes respondents were offered the choice of stating bribe amounts in rupees, as a percentage of taxes paid or as a percentage of taxes saved (Table 18). If the bribe was reported as a percentage of tax saved, it is assumed that the rupee value of the bribe was equal to the percentage difference between our estimate of tax and tax reported by the respondent, if the former exceeded the latter. Otherwise, the information was treated as missing. Eight salary earners who responded to this question, reported bribes at between 5 percent and 20 percent of tax saved, with a median value of 10 percent<sup>24</sup> The four non-salary respondents to this question reported that bribes were 50 percent, 20 percent and 10 percent of taxes saved, respectively. A fourth reported bribes at 100 percent of taxes paid.<sup>25</sup> If per taxpayer bribe payments are realistic, which may be a big if, the table shows that *bribe costs are substantial even for salaried respondents*. For non-salaried respondents, bribe costs of those paying bribes exceeded average legal compliance costs.

Though Table 19 presents survey information from questions regarding harassment, these should not be added to bribe costs, to avoid possible double counting. The important point made by the table is that harassment by income tax officials is not uncommon, especially for salaried taxpayers. While no attempt has been made to go beyond the quantification of harassment costs by the respondents themselves, clearly, *harassment adds substantially to compliance costs of the individual income tax in India* if sample responses are found to be capable of replication.

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<sup>23</sup> The maximum bribe paid figure of Rs 1,47,557 was from a pre-test canvassed questionnaire, where the respondent was asked directly about his bribe payments.

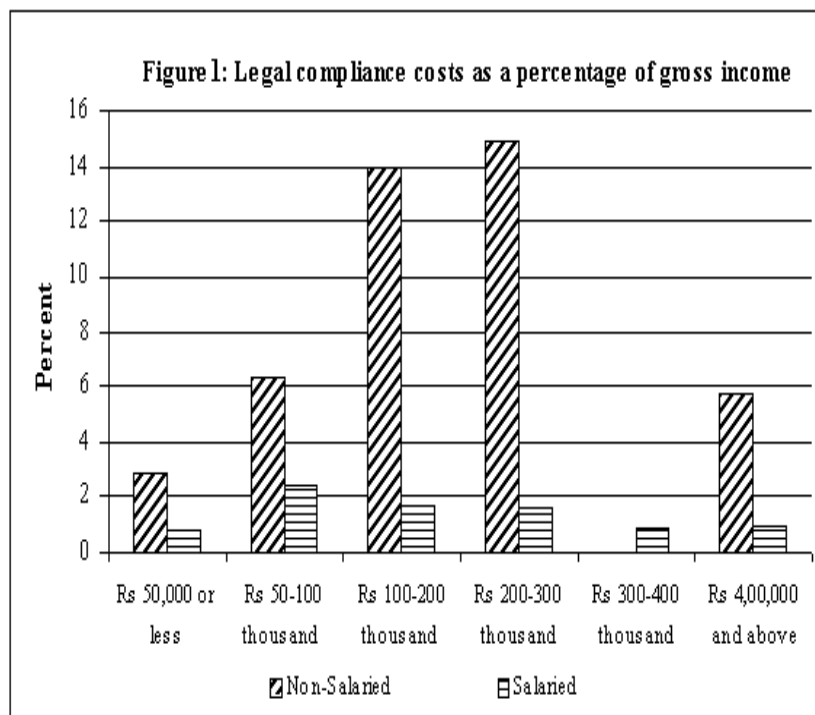
<sup>24</sup> As discussed later, several qualitative responses by salary earners indicated that bribe payments were to obtain refunds, often through advisors. The going rate for such bribes was reported at 10% of the refund due.

<sup>25</sup> This was a book-shop owner with a reported income of Rs 27 lakh who claimed that all book-shop owners had to annually pay large bribes under the threat of revaluation of old stocks and consequent loss

Bearing in mind the indirect nature of questions to elicit information on bribe payment behaviour, it is still of interest to examine aggregate compliance costs, including bribes. *Under the assumption that those not responding to bribe questions in the survey did not pay bribes*, Table 20, when compared to Table 18 suggests that the average bribe cost for salaried taxpayers is around Rs. 200, while that of the non-salaried is around Rs. 4,000. The corresponding figures at the median are much lower, at Rs 2 and Rs 500.

### *Distribution of Compliance Costs across Gross Income Groups and by Occupation*

Tables 22 and 23 along with Figure 1, provide information on variation of compliance costs with income. Overall, compliance costs as a percentage of income have an inverted U-shaped pattern of incidence, first rising then falling with increasing income, for both salaried and non-salaried taxpayers. This pattern is opposite to that reported in Slemrod and Blumenthal (1989) for US taxpayers. Therefore, while increasing the progressivity of the income tax below Rs. 200,000, they add a regressive bias above this. Note that compliance costs, in some cases, even for legal compliance costs of salary earners, exceed tax paid.



Despite data limitations, an examination of indices of the progressivity of compliance costs is reported in Table 23. The table shows that, overall, compliance costs are *regressive* increasing the inequality of income, especially if bribe costs are taken into account.

## V. Aggregate Compliance Cost Estimates

The justification for the aggregate estimates given here, it is recalled, is solely to provide a basis for comparison with compliance cost components, such as third party costs, which are not measured via the survey. To do so, however, sample data by income range must be reweighted so that the average cost is for the population distribution of taxpayers rather than the sample distribution. That these figures are

subject to a wide error margin should be obvious. Before presenting aggregates based on sample based figures, estimates of some missing compliance cost elements in the survey are first presented. These pertain to litigation costs, third party costs of tax withholders and banks, and costs of non-filers. An estimate of the cost of administering the income tax is also made, so that the total cost of collecting the income tax (excluding efficiency and equity costs) can be examined. Of these costs, compliance cost of non-filers are "guesstimated" by Chattopadhyay and Das-Gupta (2002b) to be around Rs. 1089 crore or 3.4 percent of personal income tax collections for the year.

### *The Cost of Deducting Taxes at Source: A Case Study*

The cost of deducting income taxes at source (TDS) is an important part of third party compliance costs. Collections through TDS constituted 53 percent of total collection of income taxes and 60 percent of non-company income taxes in 1999-2000 (CAG 2001). An important reason for the low compliance costs of salaried individuals is because their employers bear the costs of assessing their tax liabilities and preparation tax deduction statements (Form 16A) for employees. The following case study is indicative.

Three types of compliance costs of TDS were identified: (A) external costs including fees paid to an external Chartered Accountant, (B) staff costs and (C) overhead administrative expenses. Staff costs are accounts department costs of to completing and submitting TDS returns, depositing TDS and time spent by them to complete and submit Form 16A for employees. Overhead expenses include computer costs for TDS returns and form 16A, photocopying, postal and fax expenses, travel and conveyance, prorated office space at the market rental value, general supplies, stationery and consumables, maintenance and purchase of tax publications and journals. These are listed in Table 24.<sup>26</sup>

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<sup>26</sup> The organisation paid Rs. 3000 to a tax advisor. The accounts department has a staff of 6 with combined daily salary amounting to Rs. 583, assuming 20 working days per month. Given 70 income tax assesseees in the organisation, the total time spent was 2.1875 days a month implying staff costs of Rs. 1,276 per annum. Total computer costs of the accounts department was Rs. 80,056 per annum of which TDS related usage was estimated at 30 days of 240 working days in a year. Rs. 120,000 or one percent of the estimated annual rental value of office space of the organisation (Rs. 12,000,000) was conservatively taken as the share of the Accounts Department of which Rs. 10,000 is



For the year 2000-01, total income taxes deducted amounted to Rs. 8,92,768. In the table, total costs of compliance are estimated at 11.81 percent of taxes deducted at source

The aggregate estimate is based on this case study. It will be biased downward, if the average number of income tax paying employees per organisation is below 70 and if the dispersion of organisations by number of tax paying employees is large. Secondly, the cost of tax deduction at source for interest and dividend income is likely to lower per taxpayer than it is for salary income. Since 60 percent of taxes are collected through TDS, assuming that 80 percent of TDS is for employment income and that the cost of TDS for other income is 0.5 percent of taxes collected, the estimate of TDS compliance costs is  $(0.6)(0.8)(11.81) + (0.6)(0.2)(0.05)$  or 5.68 percent of tax collections.

### *Costs of Collecting Taxes through the Public Sector Banks*

Public sector banks are authorised to collect taxes and deposit them in the government treasury account at the Reserve Bank of India, Nagpur. Banks are compensated at the rate Rs. 11.80 per thousand rupees collected. This straightaway gives us the cost of collecting taxes by the Government at 1.18 percent of taxes collected. Therefore, banks were paid around Rs. 334 crore (1.18 percent of total income tax collection of Rs. 31,674 crore) for 2000-01. A major public sector bank in Mumbai estimated the cost actually incurred by banks to collect taxes and remit them to the government at around Rs. 22-23 per thousand, which is double the rate of reimbursement. If a rate of Rs. 22 is taken as the actual bank collection and remittance cost, then the additional third party cost of banks implied by this is Rs 10.20 per thousand or Rs. 363 crore for 2000-01.

### *Cost of Appeals, Litigation and Prosecution*

In the absence of survey respondents with pending tax appeals or litigation or facing prosecution, a secondary data based estimate of representation costs of these proceedings is made from the report of the CAG (CAG, 2001 and earlier years) and from the fee estimates for such

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assumed to be the share of TDS. The TDS share of costs of general supplies, stationery and consumables and maintenance was Rs. 62,308 per annum.

cases made by the single CA firm responding to the survey. Table 25 presents fees reported for different proceedings by the firm of Chartered Accountants examined *via* a case study.

Information in reports of the CAG includes data on appeals pending before Commissioners (appeals) broken up by ranges of amounts in dispute. Data are also available for court cases and appeals before the ITAT (Income Tax Appellate Tribunal). After discussion with department officers, it is assumed, conservatively, that 40 percent of high demand appeals, 70 percent of low demand appeals, 40 percent of ITAT appeals and 0 percent of court references and writs are for non-company cases. Again conservatively, the incidence of appeals by salaried taxpayers is assumed at 5 percent of total appeals of each kind. With these assumptions and the fee rates in Table 25, estimates of litigation costs are in Table 26. It should be noted that additional time and money (and psychic) costs of taxpayers themselves are not included in these estimates.

### *Administrative Costs of Collecting Taxes*

To complete the picture, administrative costs of collecting taxes should be added. Cost are directly or indirectly incurred by other departments and ministries besides the income tax administration itself, including by:

- The Department of Revenue including the Central Board of Direct Taxes.
- The Finance, Law (Income Tax Appellate Tribunal or ITAT) and Home ministries (Police).
- The Central Public Works Department.
- The Comptroller and Auditor General (for audit of the Income-tax department).
- The Public Accounts Committees of Parliament.

Of these costs, budgetary figures were obtained for the ITAT (Rs. 17.16 crore, revised estimate for 2000-01) and for the Settlement Commission for the year 1999-2000 (Rs. 4.12 crore).<sup>27</sup> An additional amount of Rs. 5 crore is conservatively taken as the expenditure of other

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<sup>27</sup> Government of India, Budget 2000-01, *Notes on Demand for Grants*.

government departments on account of the individual income tax. The figure obtained from the Ministry of Finance for the revenue expenditure of the income-tax department is Rs. 870 crore for 2000-01. Following the apportionment of costs between taxes by the CAG for 1999-2000 (including prorating of the head "Direction and administration"), 87.3 percent is taken to be the share of cost attributable to the non-corporate income tax. This gives a cost of collection of the income tax of Rs. 759 crore for the year 2000-01.<sup>28</sup>

### *Aggregate Estimates*

For sample based costs, the aggregation methodology is described in the Annex. Briefly, aggregate compliance costs as a percentage of total taxes paid and GDP, are inflated using total income taxes collection in 2000-01 from Government of India budget documents, and GDP at factor cost for the year 2000-01 (provisional estimate) from the *Economic Survey*. For taxpayer and gross income distributions, on which compliance cost distributions are based, CAG and Income-tax department estimates were used as explained further in the Annex and in Chattopadhyay and Das-Gupta (2002). However, where sample observations are missing for any cell (i.e. cost component for an income group), the minimum sample figure for the component over all groups is assumed, regardless of progressive or regressive trends. While this biases estimates downward, they are high enough as it is.

For the alternate, median based estimates (a) the proportion of salaried and non-salaried taxpayers (17.91 percent and 82.09 percent) is applied to deflated sample medians.<sup>29</sup> (b) Given the high income bias in the sample, the ratio of the estimated median gross income of all taxpayers (Rs 99,465) to median sample income (Rs 155,699) is used to deflate sample medians. The high median money and bribe compliance costs of the non-salaried in the sample leads to these estimates being higher than the downward biased average based

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<sup>28</sup> In keeping with our conservative approach, Ministry of Finance information on costs was used because these figures were recent and lower than the 1999-2000 cost of collection figure of 3.07% of personal income taxes in CAG (2001). Capital costs and the *market value* of government land and buildings is not accounted for anywhere, though it represents the true opportunity cost of premises occupied.

<sup>29</sup> As a further measure of conservatism, since median time + median monetary costs are below median legal compliance costs the former are reported.

estimates. However, legal compliance costs are lower, due to low median time costs.

Estimates are in Table 27.

Adding case study based estimates of TDS, bank costs, appeals and non-filer costs to survey based estimates, gives total private compliance costs of around 59.5 percent (Table 28). Addition of administrative costs to this gives "the gross operating cost" of the personal income tax. Bribe payments, being transfers between individuals, need to be deducted from this to arrive at the social cost, which amounts to just under 60 percent of tax revenue. It is worth reiterating that these estimates, while alarming, rest on shaky foundations.

## **VI. Qualitative Information on Compliance Costs of Inefficiency and Corruption**

Qualitative information on the cost of bribes, harassment and poor administration, from open ended questions in the survey and focus group meetings, is now summarised.

### *Bribes and Inefficiency in Relation to Refunds*

At least four respondents claimed that they had to pay bribes in order to obtain tax refunds, and that these bribes were paid on the advice of their tax advisor. The going rate of bribes, mentioned in 3 cases, was 10 percent of the refund due. In open ended questions several respondents highlighted procedural difficulties in getting refunds or non-receipt of refunds from past years.

### *Other Comments on Bribes and Harassment*

Other comments made by respondents and during focus group meetings during the study on bribes and harassment included.

"Personnel in the IT dept should be prompt and honest in discharging their duties and bring more revenue to the government rather than to themselves to make the department cost effective. They should stop harassing gullible and prompt taxpayers. Strict laws shouldn't be a tool to harass assesseees."

"Bribes are 25 percent of tax paid for all booksellers under threat of revaluation of stock - even though actual stock is reported."

"Non-official expenses with income and sales tax is very high."

"Laws are complex and officials are corrupt"

"Tax laws are complicated, lots of hassles in submitting the form, and there is generally corruption and inefficiency in the system."

The following additional comments were made by members of the Bombay Chartered Accountants Society at a focus group meeting.

- To get *clearances* (e.g. under section 230A for transfer of immovable properties) bribes had invariably to be paid to income tax officials.
- To avoid harassment, the opportunity cost of which was (e.g.) Rs. 20,000 a bribe of Rs. 5,000 was typically paid.
- Lengthy time delays in *appeals* were exacerbated by an inadequate number of benches though additional benches had recently been sanctioned.
- Lack of integrity of Income tax officials and *assessing officer's fear of targets* lead to significant compliance costs to taxpayers.
- A large proportion of advisors fees were to cover the cost of "idle time" waiting for appointments, meetings and hearings, often on benches outside the rooms of concerned ITD officials.

### *Obtaining Permanent Account Numbers (PAN)*

With computerisation of the IT Department, new PAN numbers and photo identity cards were instituted by the Department in 1995. Delays in issuing PAN numbers are an almost pure representation of inefficiency as bribe opportunities are bound to be low. Eight respondents complained about difficulties in obtaining a PAN. Of this, six respondents reported the following time durations to get a PAN: (a) 3 months; (b) 6 months (c) 6-8 months (d) "Applied for on 26-6-99, but still waiting to get it"; (e) "PAN pending for 2 years"; (f) "PAN awaited for 3 years".

## VII. Conclusions

The major conclusions of this study of compliance costs of the personal income tax in India are now summarised.

- The estimates of compliance costs of the personal income tax in India thrown up by this study are extraordinarily high, even though a strategy of deliberate underestimation was followed.
- Costs are high for salary earners, but at around 7-10 times the costs of salary earners, are excessive for non-salaried taxpayers.
- Costs are regressive and, for low income and middle income non-salary earners, can be more than double the taxes paid even if bribe costs are neglected.
- Both the incidence of bribe payment and the bribe quantum are high, even among salary earners, but especially for non-salary earners.
- Harassment of assesseees in various forms, whether related to bribes or not, is a serious problem adding to tax compliance costs.
- Costs borne by taxpayers amount to 6.8 percent of the gross income of taxpayers or 49 percent of personal income tax collections. If third party compliance costs are added, this rises to 56 percent of taxes collected. If estimated non-filer costs are added this rises to 59 percent of tax revenue.
- The estimates above do not include psychic costs.

Our other conclusions, which have implications for policy are as follows.

- Advisors are used more to deal with tax uncertainty and administrative procedures than to help in reducing tax burdens through tax planning – though the latter is not unimportant.
- Third party costs of deducting tax at source amounted, in a case study, to 11.8 percent of taxes withheld.
- Commercial bank costs of receiving and remitting taxes, over and above reimbursement received from the government, amounted to an estimated Rs. 363 crore or about 1 percent of tax collections.
- Delayed refunds are a cause of much harassment and, according to several salaried respondents, associated with forced bribe payments by salary earners.

- Long delays in receipt of PAN cards and numbers are a source of harassment.
- Appeals, due to their long duration and the fact that the IT Department has been alleged to lose most appeals, lead to avoidable cost to both taxpayers and government. The falling trend during the past 3 years in filed and pending appeals is a welcome beginning.

## **VIII. Reform Suggestions and Assessment of Recommendations of the Direct Tax Task Force**

Given the high compliance costs this survey has found, the personal income tax has emerged as indeed an exceptionally high cost source of funds, certainly by international standards but also possibly in relation to other competing sources of funds in the Indian context. This is partly, but only partly, due to the widespread corruption in the Department that the study finds. The high compliance costs have much more to do with cumbersome procedures and, to a lesser extent, substantive tax provisions. A six-pronged approach to reducing the operating cost of the personal income tax is therefore suggested: Tax structure simplification, institutional reform, procedural reform, automation, monitoring and client feedback and tax policy process reform. If this proves to have an inadequate impact on compliance costs in, say, around 3 years, then drastic tax reform is possibly worth considering seriously to reduce the cost to society of raising government revenue is required.

Of these, tax structure simplification has been extensively discussed by the Direct Tax Task Force (Government of India, Ministry of Finance, 2002). Though some suggestions have been found debatable in public discussion, simplification is not examined here as their recommendations will, broadly, reduce the complexity of the income tax.

## *Reforming Administration Institutions and Incentives*

If the personal income tax is persisted with in India, then a key reform strategy is to ensure that the income tax administration genuinely *wants* to reduce taxpayer costs because it is in their interest to do so. *This is the most important reform component for a successfully functioning income tax.*<sup>30</sup>

Current institutional problems are reflected in (a) continued reliance on excessive discretion to low level officers who have limited accountability resulting in procedures and a mind set that is anti-taxpayer; (b) a widespread culture of bribes and unhelpful treatment of taxpayers; and (c) an archaic organisation structure, which is taxpayer based under a single officer system, rather than organised along modern, functional lines.

Important reforms suggested are:

- Organisational reform of top management including stability and security of tenure.<sup>31</sup>
- Functional reorganisation of the Income-tax Department to break the single officer – single taxpayer nexus and simultaneously reap gains from specialisation.<sup>32</sup>
- This should include, importantly, a separate taxpayer services division.
- Introduction, as a necessary precondition, of transparent and non-discretionary performance measurement for all units, each staff

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<sup>30</sup> It should be noted that income tax administration involves government organs besides the income tax department which also require examination and reform in order to lower operating costs of the income tax. Secondly, the viewpoint expressed here, if acceptable, implies a criticism of the Direct Tax Task Force (Government of India, Ministry of Finance, 2002 abbreviated in this chapter as "the Kelkar Task Force") since reforms they suggest fail to adequately address incentives of officials and related institutional reforms.

<sup>31</sup> As suggested by the Kelkar Task Force which draws on earlier reform suggestions.

<sup>32</sup> A partial organizational restructuring along functional lines, which was under consideration by the Income Tax Department in the wake of its recent cadre restructuring has, it is reported, recently been shelved.



member, each taxpayer related activity and also the tax department as a whole.<sup>33</sup>

- Performance measures should not only be linked to revenue collections but also to efficiency and to improvements in taxpayer feedback on tax department services.
- Public performance reporting via annual.<sup>34</sup>
- Organisational and individual incentives – both positive and negative<sup>35</sup> - linked to performance.<sup>36,37</sup>
- Strengthened external monitoring by existing organs such as the CAG, Central Vigilance Commission, and also the Tax Ombudsman proposed by the Kelkar Task Force.
- These reforms, coupled with taxpayer friendly automation, which also increases the deterrent capacity of the department, will help in ending this current pernicious cultural orientation of the department.

### *Reforming Procedures*

Substantial improvement in the efficiency of taxpayer related procedures coupled with much better taxpayer services provided by the Income tax department is needed.

The Kelkar Task Force has suggested several welcome reforms, particularly for refunds, clearances, tax payment and, to a lesser extent,

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<sup>33</sup> This is recommended by a variety of scholars (see, Das-Gupta, 2002) and has also been adopted by the Commercial Tax Department in Andhra Pradesh. See, also Febres *et. al.* (1998).

<sup>34</sup> The report structure recommended by the Kelkar Task Force is, however, inadequate.

<sup>35</sup> Negative incentives should include *effective* penalties for corrupt officials with an appropriately nuanced, partial shifting of the burden of proof on them.

<sup>36</sup> The Kelkar Task Force draws a negative lesson from the negative effects of current rewards for the Investigation wing of the income-tax department. However, the correct lesson from rewards for searches appears incentives work — but piecemeal incentives distort effort. Incentivising the entire administration is, it appears, the correct lesson to draw: Don't abolish rewards – redesign them. For example, a fairly common incentive for the entire tax administration is a rule linking the budget to performance achievement (in terms of revenues and independent taxpayer feedback) relative to targets. For recent evidence on the general efficacy of well designed rewards in in tax administration see the World Bank (1999). See, also Milgrom and Roberts (1992) for private sector evidence.

<sup>37</sup> A serious omission by the Kelkar Task Force is that of budget allocation for tax departments being used as an incentive. They do, however, suggest — but without spelling out details — increased flexibility and discretion for them over resource and manpower deployment.

for scrutiny. They have also suggested improvements in assistance to taxpayers.<sup>38</sup> However, the recommendations fall short of what is needed as no clear performance benchmarks are suggested, nor do they outline an appropriate scheme for performance monitoring of the proposed reforms. These need to be chalked out.

Some additional suggestions can also be made.

- The burden on small taxpayers, particularly those from the non-salaried class, is unacceptably high, notwithstanding the presumption of greater evasion among these taxpayers. Two wrongs, both of which harm society, cannot cancel out. Besides improved services, reintroduction of (redesigned) simplified, presumptive, tax assessments for small taxpayers is suggested.
- This is also true for other non-salaried taxpayers. This suggests that simpler tax rules for unincorporated taxpayers with business or professional income and greater recourse to TDS in the case of selected professionals may reduce their costs as also their scope for tax evasion.
- For salary earners, a possibly radical suggestion is to do away with taxation of central government salaries along with a neutral pay cut. This will result in administration and compliance cost saving, reduced government revenue expenditure offsetting reduced revenue. However, the reduced administration cost implies a lower fiscal deficit.<sup>39</sup>
- For such procedures as scrutinies and appeals, automation will enable the success rates of the tax department to be tracked. Once this is done, benchmark success ratios can be laid down as part of their performance indicators.

### *Automation*

The finding of high compliance costs lends greater force to criticisms being levelled against the Income-tax Department for its slow and dysfunctional progress in automation. While this is recognised by the Kelkar Task Force, their recommendations do not have linked

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<sup>38</sup> The scrutiny suggestions of the committee unfortunately lay almost exclusive emphasis on case selection giving little attention on the actual scrutiny procedure.

<sup>39</sup> However, the devolution share of states will need to be increased to compensate their revenue loss from falling income tax collections.

organisational and human reform components. Without these there is an appreciable risk of failure.<sup>40</sup>

Automation should first focus on the woefully adequate PAN data base and tax collections as recognised by the Kelkar Task Force. Networking for improved enforcement, automation of taxpayer services, and development of a performance indicator based MIS can then be scheduled, with remaining applications being scheduled last.<sup>41</sup>

### *Improving Monitoring, Reporting and Client Feedback*

These have already been outlined in a previous subsection. A point requiring clarification is client or taxpayer feedback: This should be required for every case of a taxpayer dealing directly or through a representative with a tax official. Furthermore, the form should (a) be anonymous but identify the tax official; (b) be sent directly to an independent body (such as the proposed Tax Ombudsman or even to a private agency retained for the purpose) and (c) be reported in the tax departments annual report as is done, for example, by the United Kingdom's Inland Revenue Service. The second point concerns proper annual reporting. A suggested structure is in the accompanying Box.

#### **BOX: Annual Reporting of Performance**

The general goal of a tax administering department should be “to collect taxes legally due by providing taxpayer education, assistance and compliance enforcement at minimum social cost”. This implies a focus on effectiveness and efficiency of tax collection. *Effectiveness* reflects tax collection relative to potential as per law. *Efficiency* reflects the cost to society per rupee of revenue raised. It has 3 measurable components: (i) The resource cost of tax administration –

<sup>40</sup> IT projects have had a high rate of failure even in developed countries due to neglect of human resources and institutional reform. See, for example, Clegg *et. al.* (1997) and Ross and Weill (2002). In tax administrations, a glaring example is the USA's Internal Revenue Service whose efforts over the past 50 years have been unsatisfactory. See, Barbone *et. al.* (1999).

<sup>41</sup> See, Das-Gupta and Mookherjee (1998) and Barbone *et. al.* (1999) for international experience of tax administration automation.

as reflected in budgetary expenditure; (ii) resources expended on tax administration by the rest of government (including of the Finance Department, PWD, Police, Law Department and Tribunals, AG's office, etc), and (iii) the compliance cost of taxpayers and third parties.

Annual reports of tax administrations should focus on achievement relative to the estimated magnitude of the problem (e.g. new registrations relative to estimates of current non-filers), NOT on relatively uninformative achievements or growth rates *per se*.

Reports should provide information on:

- Mission and vision statements
- Staff strength, physical resources and infrastructure, organisation and functions of divisions.
- Recruitment, promotions and transfers.
- Achievements against action plan for the year overall and by major activities.
- Manpower improvement activities (training) and infrastructure upgrading with cost details.
- Targets for the year against revenue collected and administrative expenditure.
- Effectiveness indicators relative to targets **in terms of revenue effects** for each activity and program.
- Workload and efficiency (cost-to-revenue) indicators.
- Results of taxpayer feedback on quality and timeliness of services and corruption encountered, external (CAG) audit, ombudsmen's evaluation, vigilance and parliamentary review.
- Targets for the next year.
- Administrative reforms planned next year and in future with cost estimates and performance benchmarks.
- Multi-year information where possible - for MIS and research purposes.

### *Reforming the Policy Process*

The Kelkar Task Force has suggested cost-benefit analysis of new proposals for revenue expenditures. The government may wish to add to this limited compliance cost and administrative cost assessments

to rationally decide if the extra revenue benefits are worth the attendant compliance costs.

A negative aspect of the tax policy process is the role played by high powered committees which deal with administrative reform. Ideally, reforms should be presented as a package which includes implementation plans, costs, and targeted performance levels. Furthermore, implementation of the (accepted) reforms should ideally be overseen by a member of the committee. This forces a measure of realism and accountability on the committee and raises the chance of success. Furthermore, proper “change management” has been recognised as important for successful institutional reform.

### *Overhauling the Tax System: A Medium Run Option*

The high cost of collecting the income tax suggests that the government should greatly reduce its reliance on the income tax in its current form, if administrative efficiency cannot be greatly improved, and explore alternative revenue sources such as presumptive levies, increased TDS, and also indirect taxation if the move to a full VAT is eventually successful. In fact, that a greater reliance on deficit finance, widely seen as the worst possible revenue raising alternative, will be socially superior to the personal income tax cannot be ruled out without further careful examination. A much simplified tax code relying on automatic, presumptive levies which minimize taxpayer compliance requirements is needed and a preliminary attempt is now made to outline such a system.

In particular reforms worth considering are:

- A “retrograde” return to schedular income taxation consisting of:
  - TDS as a final withholding tax for salary and interest income.
  - House rent income taxed by “piggy-backing” on the local property tax.
  - Similar piggy-backing for capital gains via an additional stamp duty (at a suitably low rate) on asset sales.

- Unincorporated business and professional income taxed presumptively on the basis of a few, observable, indicators as in Israel.<sup>42</sup>
- Periodic increasing of the exemption limit in line with inflation.

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<sup>42</sup> See, Das-Gupta and Mookherjee (1998) and references cited there. Also see, Rajaraman (1997).

**Table 1: Recent Individual Income Tax Compliance Cost  
Estimates for Other Countries  
(percentages of tax revenue)**

Country	Year	Individuals	Employers (PAYE)	Other private costs	Admini- strative costs	Total operating costs
<b>Australia<sup>a</sup></b>	1986-87	7.9 – 10.8	1.26		1.13	10.29
Do <sup>b</sup>	1990-91	9.2	1.6		1.1	11.9
Do <sup>c</sup>	1994-95	7.9 (4.00)				
<b>Canada<sup>a</sup></b>	1986	2.53	3.57	0.03	1.00	7.13
<b>Federal Republic of Germany<sup>n</sup></b>	1984	0.75 <sup>6</sup>			2.35	
<b>Israel<sup>o</sup></b>	1987	1.32				
<b>Netherlands<sup>k</sup></b>	1989	1.4 <sup>5</sup>				
<b>New Zealand<sup>i,k,l</sup></b>	1992	8.1			1.0	9.1
<b>Norway<sup>l,m</sup></b>	c. 1988	2.7			1.7	4.4
<b>Sweden<sup>p</sup></b>	1990-91	0.88	0.11	0.17	0.65	1.81
<b>United Kingdom<sup>a</sup></b>	1986-87	2.21	1.02	0.17	1.53	4.93
Do <sup>d</sup>	1986-87	2.8			1.1	3.9
Do <sup>e</sup>	1983-84	3.6				
<b>U.S.A.<sup>f</sup></b>	1982	5-7				
Do <sup>g,h</sup>	1994	5.8				
Do <sup>g</sup>	1995	9.0				

**Notes and Sources:**

a: Sandford (1994a).

b. Pope (1994).

c. Binh *et al.* (2000). The 4% Social compliance costs (SCC) equals imputed costs of time and resources spent by taxpayers *plus* their expenditure *less* managerial benefits. The 7.9% taxpayer compliance costs equal SCC *less* cash flow and tax deduction benefits.

d. Sandford, Godwin and Hardwick (1989). Estimates are for central government taxes.

e. Binh *et al.* (2000) using information in Hite and Sawyer (1997).

f. Slemrod and Sorum (1984). Includes both federal and state income tax revenue.

g. Binh *et al* (2000) using data from Slemrod (1995).

**Table 1: Recent Individual Income Tax Compliance Cost  
Estimates for Other Countries  
(percentages of tax revenue)**

Country	Year	Individuals	Employers (PAYE)	Other private costs	Admini strative costs	Total operating costs
---------	------	-------------	---------------------	---------------------------	-----------------------------	-----------------------------

h. Hite and Sawyer (1997) using data from Slemrod (1995).  
i. Using estimates from Slemrod (1995) for the USA and McCulloch (1992) for New Zealand, Hite and Sawyer (1997) derive comparable estimates of compliance costs for New Zealand and the USA.  
j. Allers (1994).  
k. Hite and Sawyer (1997) using data from McCulloch (1992).  
l. Only for the self-employed individuals.  
m. Nicolaissen (1989).  
n Fischer (1989). The ratios could be underestimated since the base could be total tax revenue.  
o. Friedkes and Gavish (1989).  
p. Malmer (1995). Figures here are computed from his Tables 32 and 33 for income and payroll taxes. VAT and excise duty estimates are excluded. Including all 4 taxes, compliance costs are 1.97% of tax revenue or around 1% of Swedish GDP.

<sup>5</sup> See, Kaplow (1995).

<sup>6</sup> See also McClure (1989), Boucher (1991), Pope (1994), Talib (1996), Bardsley (1996) and James, Sawyer and Wallschutzky (1997).



**Table 2: Gross Income, Taxes, Effective and Marginal Tax Rates: Sample Averages**

	Non salary	Salary	All
<b>Average gross income: AIITS-CAG</b>	<b>N.A.</b>	<b>N.A.</b>	<b>1,19,252</b>
<b>Average tax paid: AIITS-CAG</b>	<b>N.A.</b>	<b>N.A.</b>	<b>16,187</b>
<b>Average tax paid as a % of Average Gross Income: AIITS-CAG</b>	<b>N.A.</b>	<b>N.A.</b>	<b>13.58</b>
<i>Income and Tax Saving</i>			
Estimated gross income (Rs.)	2,86,138	1,91,044	2,13,744
Income tax saving (rebates and deductions in Rs.)	6,835	9,262	8669
<i>Tax payments</i>			
Estimated income tax paid (Rs)	66,001	21,334	32,642
Tax deducted at source (Rs)	23,503	17,955	19,399
Refund due or received (Rs)	0.00	2336	1475
Average marginal tax rate (%)	18.72	20.96	20.45
Average effective tax rate (%) (i.e. $\frac{1}{n} \sum \frac{T_i}{Y_i}$ )*	11.00	7.41	8.21
Average tax paid as a % of average gross income (i.e. $\frac{[\sum T_i]/N}{[\sum Y_j]/M}$ )*	23.07	11.17	15.27
Total responses*	20 to 40	20 to 118	40 to 158

**Notes:** AIITS-CAG: Estimates by Chattopadhyay and Das-Gupta (2002) based on data from various issues of the All India Income Tax Statistics and Reports of the Comptroller and Auditor General.

\*: The number of responses used for different rows varies due to missing observations. So an average tax rates for all observations together is presented in addition to the average effective tax rate over available observations.

**Table 3: Respondents Under Scrutiny**

	Respondents who spent time or money due to scrutiny proceedings (%)			Respondents scrutinised in the current year (%)		
	Non-salary	Salary	All	Non-salary	Salary	All
Mean	21.74	9.57	13.04	6.52	3.48	4.35
Observations	46	115	161			

**Table 4: How Tax Returns Are Completed**

	Number of responses		Percentage of total responses	
	Non-salary	Salary	Non-salary	Salary
By taxpayer	9	37	18.0	32.5
By friend(s)	2	39	4.0	34.2
By advisor	39	38	78.0	33.3
Total responses	50	114	100.0	100.0

**Table 5: Time Spent Helping Others Comply**

	Number of responses		Percentage of total responses	
	Non salary	Salary	Non salary	Salary
Did not help	16	32	51.6	32.3
2 hours or less	1	6	3.2	6.1
3 to 5 hours	8	20	25.8	20.2
6 to 10 hours	3	9	9.7	9.1
10 hours or more	3	32	9.7	32.3
Total responses	31	99		
<b>Average hours</b>	3 hrs 0 mins	5 hrs 28 mins		

**Table 6: Fees paid to (Professional) Tax Advisors**

	Number of responses		Percentage of total responses	
	Non salary	Salary	Non salary	Salary
Rs. 500 or less	2	22	6.3	56.4
Rs. 501 to 2000	14	14	43.8	35.9
Rs. 2001 to 5000	8	3	25.0	7.7
Rs. 5001 to 20000	5	0	15.6	0.0
Rs. 20000 or more	3	0	9.4	0.0
Average (Rs)	5575	459	N.A.	N.A.
Coefficient of variation	1.93	1.67	N.A.	N.A.
Number of observations	32	39		

**Note:** N.A.: not applicable.

**Table 7: Why Tax Advisors Are Engaged (average scores)**

	Non Salary	Salary
Frequent change in tax laws	2.5	4.7
Complex tax affairs	1.7	3.3
Not sure of tax administration procedures	2.4	3.7
Not sure of prompt and courteous guidance from tax administration	1.9	3.6
To reduce tax burden	3.4	4.1
To ensure perfection in tax documents	3.0	4.6
It is cheaper to hire a tax advisor	3.0	3.0
Other reasons	2.0	N.A.
Total questionnaires	23	8

**Note:** 'Very important=5, Quite important=4, Neutral=3, quite unimportant=2, unimportant=1.

**Table 8: Monetary Compliance Costs**

	In Rupees			As a percentage of tax			As a percentage of income		
	Non-salary	Salary	All	Non-salary	Salary	All	Non-salary	Salary	All
Average	15163	921	4683	171.9	30.4	58.7	6.01	0.61	1.67
Median	1485	858	948	52.0	1.6	14.1	3.00	0.13	0.26
Coefficient of variation	2.0	2.1	3.6	2.1	4.3	3.5	1.7	2.4	3.0
Observations	33	115	148	23	92	115	31	113	144

**Table 9: Average Value of Components of Monetary Compliance Costs (in Rs.)**

Activities	Non-salary	Salary	All
Record keeping	6605	95	1620
Tax planning and research	429	189	245
Filing of tax return	960	176	359
Obtaining PAN	60	62	62
Fees paid to the advisor	5575	459	2275
Other monetary costs <sup>1</sup>	1534	60	122
<b>Total monetary cost (excl advisor fees)</b>	<b>9588</b>	<b>581</b>	<b>2408</b>
<b>Total monetary cost</b>	<b>15163</b>	<b>921</b>	<b>4683</b>
<i>% on Tax planning and research</i>	<i>2.83</i>	<i>18.14</i>	<i>5.24</i>

**Note:** 1 Scrutiny, tax refund, in appeal and litigation, and others.

**Table 10: Hours Spent in Complying with Income Tax Laws (Sample Averages)**

Activity	Non-salary	Salary	All
Record keeping	67.8	7.3	20.9
Completing and submitting tax return	5.2	5.2	5.2
Tax planning and research	7.2	8.2	8.0
Obtaining a Permanent Account Number (PAN)	1.3	2.6	2.3
Any other tax related activities*	6.6	4.5	4.8
<b>Total Hours Spent</b>	<b>88.1</b>	<b>27.9</b>	<b>41.3</b>
<i>% on Tax Planning and research</i>	<i>8.20</i>	<i>29.41</i>	<i>19.33</i>

**Note:** \*: Time spent on scrutiny, tax refund, in appeal matters and unspecified activities.

**Table 11: Hourly Value of Time and Average Hourly Earnings (in Rs)**

Time Value	Non-salary	Salary	All
Self assessed value per hour (pre-tax)	761	211	402
Self assessed value per hour (after tax adjustment)	750	199	391
Average pre-tax hourly earnings	149	99	111
Average post-tax hourly earnings	132	83	95
Average conservative value of time per hour	135	77	93

**Note:** The number of observations in reported averages is not uniform, given missing data, explaining the higher conservative value compared to post-tax hourly earnings for the non-salaried.

**Table 12: Time Compliance Costs (at conservative values of time per hour)**

	In rupees			As a percentage of tax			As a percentage of income		
	Non-salary	Salary	All	Non-salary	Salary	All	Non-salary	Salary	All
Average	26880	2086	7614	75.70	31.60	39.96	3.72	1.17	1.71
Median	1485	858	948	17.38	7.14	8.79	0.78	0.49	0.55
Coefficient of variation	4.1	1.7	6.9	1.5	3.2	2.6	2.2	1.9	2.6
Observations	33	115	148	22	94	116	31	115	146

**Table 13: Average Value of Components of Time Compliance Costs (in Rs)**

Activities	Non-salary	Salary	All
Average value of record keeping	25047	590	6118
Completing and submitting tax return	602	409	453
Tax planning and research	505	627	599
Obtaining a Permanent Account Number (PAN)	121	169	143
Other tax related activities*	604	291	301
<b>Total Hours Spent</b>	<b>26880</b>	<b>2086</b>	<b>7614</b>
<i>% on tax planning and research</i>	<i>1.88</i>	<i>30.08</i>	<i>7.87</i>

**Note:** \*: Time spent on scrutiny, tax refund, in appeal matters and unspecified activities.

**Table 14: Legal (Time and Money) Compliance Costs**

	In Rupees			As a percentage of tax			As a percentage of income		
	Non-salary	Salary	All	Non-salary	Salary	All	Non-salary	Salary	All
Average	37168	3049	12074	255.36	61.35	98.15	10.05	1.79	3.52
Median	5251	1296	1784	103.13	12.11	17.33	7.61	0.84	1.05
Coefficient of variation	2.9	1.5	4.7	1.5	3.6	2.8	1.3	1.7	2.1
Observations	41	114	155	22	94	116	30	113	143

**Table 15: Average Value of Legal Tax Planning Costs (as a Percentage of Total Legal Costs)**

	Non-salary	Salary	All
	2.22	26.10	6.87

**Table 16: Compliance Cost and Tax Saved as a Percentage of Gross Tax (Before Rebate and Tax Saved Through Deductions)**

	Legal compliance cost			Tax saved		
	Non-salary	Salary	All	Non-salary	Salary	All
Average	120.91	23.03	39.22	45.33	43.16	43.60
Median	70.88	7.26	8.88	0.00	36.20	24.82
Coefficient of variation	1.20	2.05	2.06	0.61	0.74	0.71
Observations	22	111	133	22	86	108

**Table 17: Effective Tax Rate Plus Legal Compliance Cost as a Percentage of Income**

	Non-salary	Salary	All
Average	18.39	9.36	11.18
Coefficient of variation	1.01	0.76	0.98
Observations	27	107	134
Average effective tax rate	11.00	7.41	8.21

**Table 18: Bribes**

	In Rupees			As a percentage of tax			As a percentage of income		
	Non-salary	Salary	All	Non-salary	Salary	All	Non-salary	Salary	All
Average	47629	1447	12993	48.22	10.93	18.92	6.51	0.78	2.21
Coefficient of variation	1.5	1.5	2.9	0.9	1.2	1.4	1.3	1.4	2.1
Observations	4	12	16	3	11	14	4	12	16

**Table 19: Respondents Claiming Harassment by Income Tax Officials**

	Percentage harassed by IT officer			Harassment cost as a percentage of tax paid		
	Non-salary	Salary	All	Non-salary	Salary	All
Average	14.29	23.08	20.00	2.78	6.43	5.00
Coefficient of variation	N.A.	N.A.	N.A.	3.00	3.74	3.85
Observations	21	39	60	9	14	23

**Table 20: Legal and Bribe Compliance Costs**

	In Rupees			As a percentage of tax			As a percentage of income		
	Non-salary	Salary	All	Non-salary	Salary	All	Non-salary	Salary	All
Average	41815	3201	13415	261.9	62.6	100.4	10.9	1.9	3.8
Median	5751	1298	1840	130.7	12.6	18.4	8.3	0.9	1.1
Coefficient of variation	2.8	1.5	4.6	1.5	3.5	2.7	1.3	1.6	2.0
Observations	41	114	155	22	94	116	30	113	143

**Table 21: Estimates of Compliance Costs Costs as a Percentage of Gross Income by Range of Income: Salaried Respondents**

Range-wise number of respondents	3	31	60	15	4	5	
<b>Total number of respondents=118</b>	Rs 50000 or less	Rs 50-100 thousand	Rs 100-200 thousand	Rs 200-300 thousand	Rs 300-400 thousand	Rs 4,00,000 and above	
Time spent	0.48	1.56	1.08	1.45	0.54	0.55	
Money spent	0.31	0.86	0.59	0.16	0.31	0.36	
Bribes paid	N.A.	0.02	0.27	0.14	0.00	0.00	
Legal (time plus money) compliance costs	0.79	2.42	1.67	1.61	0.85	0.91	
Legal + bribe compliance costs	N.A.	2.44	1.94	1.75	0.85	0.91	
		<i>Memo Items</i>					
Legal + bribe compliance costs (as a percentage of tax paid)	N.A.	103.54	25.01	13.66	3.66	4.02	
Legal + bribe compliance costs (In Rs)	N.A.	2506	3331	4452	3113	6544	
Value of time spent helping others comply (Rs)	147	510	797	1591	750	1088	
Effective tax rate + total legal CC (% Income)	N.A.	4.82	9.49	13.95	23.50	22.75	
Tax saved as a % of tax paid	9.56	66.66	52.24	22.84	17.21	9.44	

**Note:** N.A: No data available or not applicable



**Table 22: Estimates of Compliance Costs as a Percentage of Gross Income by Range of Income: Non-Salaried Respondents**

Range-wise number of respondents	2	15	11	5	1	3	
<b>Total number of respondents=37</b>	Rs 50,000 or less	Rs 50-100 thousand	Rs 100-200 thousand	Rs 200-300 thousand	Rs 300-400 thousand	Rs 4,00,000 and above	
Time spent	1.64	2.36	9.19	1.14	0.00	1.57	
Money spent	1.23	3.99	4.81	13.79	N.A.	4.19	
Bribes paid	N.A.	0.37	0.00	17.34	N.A.	7.18	
Legal (time plus money) compliance costs	2.87	6.35	14.01	14.93	N.A.	5.76	
Legal + bribe compliance costs	N.A.	6.72	14.01	32.26	N.A.	12.94	
		<i>Memo Items</i>					
Legal + bribe compliance costs (as a percentage of tax paid)	N.A.	337.54	183.66	223.49	N.A.	42.59	
Legal + bribe compliance costs (in Rs)	N.A.	4870	21490	78459	N.A.	265847	
Value of time spent helping others comply (in Rs)	156	109	555	58	226	478	
Effective tax rate + total legal CC(% income)	2.87	7.93	23.11	29.65	N.A.	35.02	
Tax saved as a % of tax paid	N.A.	183.89	63.48	26.02	13.16	0.55	

**Note:** N.A: No data available or not applicable

**Table 23: Indicators of Vertical Equity**

	Gross income	Legal compliance costs	Legal+bribe compliance costs
Gini coefficient	0.147	0.140	0.124
Gini of after compliance cost income	----	0.147	0.148
Kakwani's Index <sup>43</sup>	----	-0.007	-0.024

**Table 24: Costs of Complying With Tax Deducted at Sources (TDS): A Case Study**

(in rupees per annum)

<i>A. Variable costs per employee subject to TDS</i>	
1. Staff costs related to completing and submitting TDS returns	11,666
2. Staff cost to complete and submit Form 16A for employees	1,276
3. Computer costs for completing and submitting TDS returns	10,007
4. Photocopying, postal and fax expenses.	5,000
<i>Total variable costs</i>	<i>27,949</i>
<i>B. Fixed costs</i>	
5. Travel and conveyance	1,200
6. Office space at market rental value, general supplies, stationery	72,308
7. Purchase of tax publications and journals	1,000
8. Cost of tax advisor/CAs	3,000
<i>Total fixed costs</i>	<i>77,508</i>
<b>Total costs of compliance: TDS</b>	<b>1,05,548</b>
<b>Total income tax paid (April'2000-March'2001)</b>	<b>892,768</b>
<b>Compliance costs of TDS as a percentage of Total income tax paid</b>	<b>11.81</b>

<sup>43</sup> Kakwani's index of progressivity is the difference between the Gini index of compliance costs incurred and net-of-compliance-cost-income.

**Table 25: Fees for Representation Charged by a Firm  
of Chartered Accountants**

	Non-business individuals	Individuals carrying on business or profession
Appeals before Commissioner (Appeals)	Rs. 1500	Rs. 3500
Appeals before Income Tax Appellate Tribunal (ITAT)	Rs. 3500	Rs. 5000
References to Courts	Rs. 3500	Rs. 5000

**Table 26: Appeals Representation Costs: Crude Estimates**

	2000- 2001	1999-00	1998-99	1997-98	1996-97
Appeals for disposal by Commissioners (Appeals)	--	2,97,225	2,98,837	2,96,484	3,30,953
Appeals for disposal by the ITAT	--	1,16,639	1,22,247	1,35,246	1,38,952
Representation costs of salaried taxpayers (5% of appeals at each level) (Rs. lakh)	--	217	237	245	265
Representation cost of non-salaried (95% of appeals at each level) (Rs. lakh)	--	8,200	9,028	9,237	10,092
Total representation costs	--	8,417	9,265	9,482	10,357
Appeal costs as a percentage of previous year costs	0.93	0.91	0.98	0.92	--
Projected appeal costs for 2000-2001 (Rs lakh)	7859	--	--	--	--

**Note:** Prior to 1998-99, low demand appeals below Rs. 5 lakh were made to Deputy Commissioners (Appeals)

Source of appeals data: CAG (various years)

**Table 27: Aggregate Compliance Cost Estimates for Components Covered in the Survey**

	As a percentage of tax paid based on sample:		Average as a percentage of gross taxpayer income	Average as a percentage of GDP*
	Averages	63.88% of Medians		
Monetary compliance costs	22.07	27.36	3.07	0.37
<b>Legal compliance cost</b>	<b>44.93</b>	<b>37.29</b>	<b>6.26</b>	<b>0.75</b>
<i>of which voluntary compliance cost</i>	1.72	1.22	0.16	<0.01
Bribe compliance cost	2.40	14.50	0.33	0.04
<b>Legal + Bribe Compliance Cost</b>	<b>47.33</b>	<b>51.79</b>	<b>6.59</b>	<b>0.79</b>
Cost of helping others	1.68	0.26	0.23	0.03
<b>Total compliance cost (including cost of helping others)</b>	<b>49.01</b>	<b>52.05</b>	<b>6.82</b>	<b>0.82</b>
<i>Total Non-corporate income tax collection</i>	<i>100.00</i>	<i>100.00</i>	<i>13.93</i>	<i>1.67</i>

**Notes:** \*: Quick estimate of GDP at factor cost for the year 2000-01. \*\*: Some double counting may be involved with other cost items.

**Table 28: Aggregate Costs of Collecting the Individual Income Tax: Compliance and Administrative Costs (Percentages of Individual Income Tax Collected in 2000-01)**

Item		Estimates with sample averages
Total compliance cost of taxpayers (excluding litigation costs)		49.01
<i>of which legal compliance cost</i>		46.61
Add estimated cost of representation in appeals cases	Rs. 78.59 crore	0.25
Non-filer costs (Chattopadhyay and Das-Gupta, 2002b)	Rs. 1089 crore	3.40
Cost of collecting taxes through banks	Rs. 363 crore	1.15
Cost of tax deduction at source		5.68
<b>Total private compliance costs</b>		<b>59.49</b>
Government cost of collecting taxes – Income-tax department	Rs. 759 crore	2.40
Government cost of collecting taxes – other (ITAT, settlement Commission, etc.)	Rs. 27.28 crore	0.09
<b>Total direct cost of collecting personal income taxes</b>		<b>61.98</b>
<b>Total social cost (deducting bribes)</b>		<b>59.58</b>

## ***Annex***

### ***Methodology***

The pre-test area was largely restricted to South Delhi to persons with whom canvassers had earlier dealings, such as shopkeepers, colleagues and relations though some questionnaires were administered in other areas and to complete strangers. 50 questionnaires for individuals were canvassed in two pre-survey rounds. Canvassers were asked to (a) administer the questionnaire as if for the final study but also (b) ask respondents about their reactions to different questions and the questionnaire. Instead of a pre-survey, for a separate questionnaire for tax professionals, a focus group meeting (with the BCAS and the CITP, Mumbai) was preferred.

A stratified random sample design, with stratification by the only useful criterion, location, was initially planned and names and addresses of individual taxpayers were obtained from a large government data base. Given incomplete or incorrect addresses only 5435 of the 10,234 addresses could ultimately be used for mailing of questionnaires and reminders. Only 132 responses were received (100 from salary earners, 28 from self-employed and 4 unspecified) of which 10 (7 from the salaried) had to be discarded. Since, an examination of questionnaires made it clear that unspecified responses were not from salaried individuals they are included with the non-salaried. To increase the sample, where questions were similar, pre-survey respondents were added to the sample after statistical tests of differences in means or the significance of dummy variables in regression exercises (reported in Chattopadhyay and Das-Gupta, 2002), confirmed no significant difference for most items surveyed between the pre-survey and the mailed final survey. The important exception to this is discussed below. From tax professionals, only 1 response was received to the 120 questionnaires distributed through associations of tax professionals. The ultimate questionnaire distribution and response rates are in Table A1.

**Table A1: Questionnaires sent and responses received**

	Numbers	% of initial sample
<b>Mailing and canvassing details</b>		
Canvassed during two pre-surveys	50	Not Applicable
Addresses received from government data base	10,234	97.80
of which addresses found incomplete	4,700	44.92
Net received	5,534	52.89
Add addresses from other sources	230	2.20
of which questionnaires mailed to addresses obtained from elsewhere	100	0.96
of which responses received	3	
Questionnaires hand delivered after individual contact	130	1.24
of which responses received	Not ascertainable as business reply envelopes were identical to those used in the general mailing.	
Total addresses available	5,764	55.08
Number of questionnaires mailed or hand delivered	5,530	52.85
Number not deliverable by post offices due to incorrect addresses or inability to trace addressees	295	2.82
<i>Memo</i>		
120 tax professional questionnaires mailed to tax professionals	1 response received	
<b>Details of responses</b>		
	Salaried	Self-employed
Responses received	100	32
Responses discarded	7	3
Total sample for questions not asked in pre-surveys	93	29
Gross response rate (%)		2.36
Net response rate (%)		2.17
Add pre-survey canvassed questionnaires	29	21
Total sample for common pre-survey and final survey questions	122	50

The important exception where differences did show up between the canvassed pre survey and the mailed final survey this was questions relating to bribes (Table A2). So if ascertaining bribe costs is important, anonymous mailed surveys may have significant advantages over face-to-face canvassed surveys despite a low response rate, data quality and respondent bias.

**Table A2: Response to Questions on Bribe Payment  
Pretests (Canvassed) Versus  
Final (Mailed) Sample**

	Pre Tests		Final Sample	
	Salary	Non-Salary	Salary	Non-Salary
Percentage admitting to Bribing	4.8	7.7	22.7	42.4
Percentage senying bribing	81.0	69.2	41.2	21.2
Percentage not commenting	14.3	23.1	36.1	36.4
Response rate (%)	100.0	100.0	96.0	46.5
Potential maximum bribe payers (%)	19.0	30.8	58.8	78.8

### *Areas Covered in Questionnaires*

Areas covered in questionnaires included:

- Fiscal knowledge and attitudes: Around 10 questions covering information on how tax returns were completed; reasons for use of advisors,; time spent helping others; self assessed knowledge of the income tax; and assessment of benefits from government services and whether income taxes were high, about right or too low.
- Reported compliance costs: 5 questions dealing with time spent and its valuation; compliance related expenditure and benefits from compliance activities, if any.
- Taxes, income and administration procedures: 10 questions covering tax payments, tax saving, and whether the taxpayer was facing scrutiny or appeals.
- Tax evasion, bribe payment and benefits from bribes: 5 questions in all.
- Background information including education, sex, age, income and occupation.
- Open ended questions on how high respondents felt compliance costs were and if they wished to call attention to any other matters.

### *Sample Versus Population Distributions*

Sampling bias is a serious problem in this study. (a) The most serious is the omission of non-filers. (b) Non-response bias also has partly unknown characteristics. Comparison with Income-tax feapartment data suggests high income taxpayers are over-represented in the sample. However, given inadequate data from the department on



taxpayers classified by (gross) income, the exact nature of this bias cannot be determined. (c) It is likely that there is an over-representation of highly educated taxpayers, though this cannot be verified.

Official statistics on the income distribution of income tax payers provide limited and out-of-date. The latest available data, reported in CAG (2001), consists of (a) taxpayer distributions by range of **taxable** income for 4 broad income groups for 1999-2000 and (b) sample based estimates from the All India Income Tax Statistics (AIITS) of distribution by 10 ranges of taxable income for 1996-97, including information on gross income, taxable income and tax paid for taxpayers. The population distribution was estimated after inflating all income figures and ranges to 2000-01 rupees, using the Consumer Price Index for Urban Non-Manual Employees (1985=100) and then merging the 1999-2000 and 1996-97 distributions. No attempt was made to project taxpayer growth to 2000-01. For sample respondents, pre-survey data was inflated by the price index for one year, since it was conducted in 2000-01. The pre-survey and final survey data were then merged and grouped by ranges of taxable income. Comparing sample and "population", the sample is biased towards high income taxpayers, except for the absence of respondents in the second highest income range. Details are in Table A3.

**Table A3: Cumulative Distribution of Assesseees: Population  
Versus Study Sample**

Income range in 1996-97 Rupees '000	Income range in 2000-01 Rupees '000	"Population" distribution of assesseees in 1999-00			Sample distribution of respondents			Sample minus population		
		All	Salaried	Non- Salaried	All	Salaried	Non- Salaried	All	Salaried	Non- Salaried
0-40	0-52.44	12.73	3.94	14.71	3.23	2.54	5.41	-9.51	-1.40	-9.31
40-50	52.44-65.55	41.97	16.45	47.72	10.32	5.93	24.32	-31.65	-10.52	-23.39
50-100	65.55-131.1	83.90	79.99	84.78	43.23	41.53	48.65	-40.68	-38.46	-36.14
100-200	131.1-262.19	97.43	99.85	96.88	89.03	89.83	86.49	-8.39	-10.02	-10.39
200-300	262.19-393.29	97.76	99.91	97.28	94.84	95.76	91.89	-2.92	-4.15	-5.39
300-400	393.29-524.38	97.92	99.94	97.47	96.13	97.46	91.89	-1.79	-2.48	-5.58
400-500	524.38-655.48	98.56	99.96	98.25	98.06	99.15	94.59	-0.50	-0.81	-3.66
500-1000	655.48-1310.95	99.87	99.98	99.84	98.06	99.15	94.59	-1.80	-0.83	-5.25
1000 & above	1310.95 & above	100.00	100.00	100.00	100.00	100.00	100.00	0.00	0.00	0.00

## Aggregation Methodology

Assuming that proportions of assesseees in each real income group remains unaltered, distributions of salaried and non-salaried taxpayers were derived, ensuring that the total number of assesseees matched the CAG total from the merged taxpayer distribution described above. Where necessary, linear interpolation was used. The computations are summarised in Tables A4 and A5.

**Table A4: Estimating Gross Income from AIITS and CAG Data**

AIITS returned income range in 2000-01 Rupees	Gross income per capita (AIITS, in 2000-01 Rs)	Income returned per capita (AIITS in 2000-01 Rs)	Final assessee estimate to match CAG total	% of salaried taxpayers	Gross income of all assesseees (Rs 10 <sup>6</sup> )	
0	52438	46,961	32,034	25,07,257	5.66	1177444
52438	65548	60,208	57,807	57,57,791	7.82	3466647
65548	131095	99,465	90,841	82,58,311	27.69	8214121
131095	210795	1,97,191	1,73,038	23,10,135	26.84	4555376
210795	262191	1,97,192	1,73,038	3,41,221	0.27	672860
262191	393286	3,68,156	3,16,748	64,327	3.61	236825
393286	524382	5,13,789	4,48,551	30,184	2.58	155081
524382	655477	6,41,545	5,85,363	15,406	5.05	98839
655477	1053977	10,07,756	9,02,789	2,35,603	0.29	2374304
1053977	1310954	10,07,756	9,02,789	20,879	2.12	210409
1310954 and above	59,87,320	52,53,364	52,53,364	26,282	2.90	1573572
<b>Total</b>				<b>1,95,67,396</b>	<b>17.91</b>	<b>227,354,78</b>

5 See, Kaplow (1995)

**Table A5: Estimating the Total Number of Assesseees from AIITS and CAG Data**

AIITS returned income range in 2000-01 Rupees	Number of assesseees: AIITS (1996-97)		AIITS: 1996-97 figures inflated to match CAG		
	Non salary	Salary	Non salary	Salary	
0	52438	1017703	65646	2200566	141946
52438	65548	2279737	208113	4929446	450000
65548	131095	2510850	1057436	5429179	2286480
131095	210795	1355162	286701	2930249	619930
210795	262191	33756	421	72990	910
262191	393286	86100	1073	186174	2321
393286	524382	56579	360	122340	778
524382	655477	28702	360	62062	778

**Table A5: Estimating the Total Number of Assesses from AIITS and CAG Data**

AIITS returned income range in 2000-01 Rupees	Number of assessee: AIITS (1996-97)		AIITS: 1996-97 figures inflated to match CAG		
	Non salary	Salary	Non salary	Salary	
655477	1053977	24392	317	52742	685
1053977	1310954	15729	204	34011	442
	1310954 and above	19705	352	42608	761
	Total	<b>7428415</b>	<b>1620983</b>	<b>16062367</b>	<b>3505031</b>
	Salary plus Non-Salary	<b>9049398</b>		<b>19567397</b>	

Average compliance costs for each income group were then computed. *In case of missing data, cells the minimum value across all the income groups of compliance costs for the particular category was conservatively assumed.* Total legal compliance costs were derived using a two-step procedure. First, by adding time and money compliance costs total legal costs were obtained. Due to missing observations, averages for subcategories over available observations, exceeded totals. So individual averages were scaled down proportionately to add up to totals.

*Individual Income Tax, Surcharge and Standard Deduction Rates: 1999-00 and 2000-01*

Rates of income-tax for the financial year (FY) 2000-2001 (Assessment year 2001-02) are in Table A6. Table A7 gives rates of surcharge on tax payable for FY 2000-2001 and Table A8 gives rates of standard deduction for FY 2000-01.

**Table A6: Rates of Income Tax for Individuals: Assessment year 2000-2001 & 2001-2002**

Net income range	Rates of income-tax
Up to Rs. 50,000	Nil
Rs. 50,000-Rs. 60,000	10 per cent of the amount by which the total income exceeds Rs. 50,000;
Rs. 60,000- Rs.1,50,000	Rs. 1,000 plus 20 per cent of the total income in excess of Rs. 60,000;
Rs. 1,50,000 and above	Rs. 19,000 plus 30 per cent of the total income in excess of Rs. 1,50,000.

**Table A7: Surcharge in Financial Year 2000-2001:  
Assessment year 2001-2002**

Income slab	Surcharge for AY 2000-2001	Surcharge for AY 2001-2002	Marginal relief for AY 2001-2002
Total Income upto 60,000/-	NIL	NIL	NIL
Total Income exceeding Rs 60,000/- but not exceeding Rs 1,50,000/-.	10%	10%	Note 1
Total Income exceeding Rs 1,50,000/-	10%	15%	Note 2

**Note 1:** If net income exceeds Rs. 60,000 total income tax and surcharge payable shall not exceed income tax on net income of Rs.60,000 (i.e. Rs. 1,000) by more than the amount of income that exceeds Rs. 60,000.

**Note 2:** If net income exceeds Rs. 150,000 total income tax and surcharge shall not exceed income tax on net income of Rs. 150,000 (i.e. Rs. 20,900) by more than the amount of income that exceeds Rs. 150,000.

\* Surcharge is payable after calculating rebate u/s 88 and 88.B.

**Table A8: Rates of Standard Deduction from Salary  
Income for Financial Year 2000-2001  
(Assessment year 2001-2002)**

Gross salary income below Rs 100,000	One-third of gross income with a ceiling of Rs 25,000
Gross salary income above Rs 100,000 up to Rs 500,000	Rs 20,000
Gross salary income above Rs 500,000	Nil

### *Income Tax Knowledge of Respondents*

In the limited responses received, salary earners reported better knowledge of the income tax than the non-salaried (Table A9).

**Table A9: Knowledge About the Income Tax**

	Number of responses			Percentage of total responses		
	Non salaried	Salaried	All	Non salaried	Salaried	All
Excellent	0	1	1	0.0	2.9	1.9
Good	0	5	5	0.0	14.3	9.6
Average	8	17	25	47.1	48.6	48.1
Fair	3	7	10	17.6	20.0	19.2
Poor	4	3	7	23.5	8.6	13.5
No knowledge	2	2	4	11.8	5.7	7.7
Total responses	17	35	52	100.0	100.0	100.0
Total questionnaires where question asked	23	41	74	N.A.	N.A.	N.A.

*Distribution of Compliance Costs in the Sample*

**Table A10: Compliance Costs in Hours and Rupees**

Group	Total time spent (hours)	Time compliance costs (Rs)	Money compliance costs (Rs)	Bribes (Rs)	Legal compliance costs (Rs)	Third party time cost of helping others (Rs)
<b>Salaried respondents</b>						
Zero	6	6	24	0	0	28
Low	41	43	44	6	61	9
Medium	18	20	14	0	15	11
High	50	46	35	6	38	47
Median	11.5	858	250	750	1296	200
Maximum	420	24840	14360	7500	28490	7800
Responses	115	115	117	12	114	95
<b>Non-salaried respondents</b>						
Zero	4	4	1	0	0	13
Low	8	9	3	2	7	3
Medium	4	2	4	0	5	2
High	17	18	34	2	29	10
Median	17	1485	3081	21330	5251	57
Maximum	843	632400	143341	147557	666128	4743
Responses	33	33	42	4	41	28
<b>Criteria for classification</b>						
(Low: <0.75 combined median; Medium: 0.75-1.25 combined median; High: >1.25 combined median)						
0.75 combined median	9	711.38	375.00	562.50	1338.00	129.00
1.25 combined median	15	1185.63	625.00	937.50	2230.00	215.00

**Table A11: Compliance Costs and Tax Saving as a Percentage of Tax Paid**

Group	Time compliance costs	Money compliance costs	Bribes	Legal compliance costs	Legal compliance costs+ bribes	Tax saved	Legal compliance costs (% of gross tax)	
<b>Salaried respondents</b>								
Zero		1	16	0	0	0	32	0
Low		44	33	6	49	49	12	53
Medium		8	7	2	13	12	11	17
High		41	36	3	32	33	63	41
Median		7.1	1.6	5.6	12.1	12.6	36.2	7.3
Maximum		897	973	41	1870	1870	100	361
Respondents		94	92	11	94	94	118	111
<b>Non-salaried respondents</b>								
Zero		3	1	0	0	0	24	0
Low		3	0	0	2	2	4	5
Medium		3	2	0	1	1	3	1
High		13	20	3	19	19	9	18
Median		17	52	25	103	131	0.0	71
Maximum		480	1654	100	1717	1717	100	1717
Total		22	23	3	22	22	40	24
<b>Criteria for classification</b>								
(Low: <0.75 combined median; Medium: 0.75-1.25 combined median; High: >1.25 combined median)								
0.75 combined median		6.59	2.34	6.03	12.99	13.80	18.61	6.66
1.25 combined median		10.99	3.91	10.05	21.66	23.00	31.02	11.11

**Table A12: Compliance Costs as a Percentage of Gross Income**

Group	Time compliance costs	Money compliance costs	Bribes	Legal compliance costs	Legal compliance costs + bribes
<b>Salary</b>					
Zero		6	21	0	0
Low		46	41	6	53
Medium		14	14	2	20
High		49	37	4	40
Median		0.49	0.13	0.37	0.84
Maximum		17.0	11.3	3.8	21.3
Respondents		115	113	12	113
<b>Non-Salary</b>					
Zero		4	1	0	0
Low		8	2	1	3
Medium		3	1	0	2
High		16	27	3	25
Median		1	3	3	8
Maximum		44	55	19	57
Respondents		31	31	4	30
<b>Criteria for classification</b> (Low: <0.75 combined median; Medium: 0.75-1.25 combined median; High: >1.25 combined median)					
0.75 combined median		0.41	0.19	0.37	0.78
1.25 combined median		0.68	0.32	0.62	1.31



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