



# BG Consulting

*Linking two worlds*

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## TAX SIMPLICITY AND STABILITY: ATTRACTIVE TO COUNTRIES AND INVESTORS\*

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### Introduction:

In taxes it seems that there is no way to make everybody happy: what is good for countries is bad for investors<sup>1</sup> and vice versa. Countries, through their tax administrations, seek to collect more taxes. Investors seek to pay minimum taxes in order to maximize their financial positions.

Is it possible to find a solution that attracts investors and allows tax administrations to collect a fair amount of taxes? The answer is yes and the formula to achieve this consists of simplicity and stability.

This simplicity and stability formula is based on reducing costs and effort from both, tax administrations and investors. For tax administrations it works to reduce the costs of assessing and collecting taxes so the result of the equation "tax revenue less costs" is positive. For investors, it works to minimize the costs associated with paying taxes. The result of investors' equation "taxes paid plus costs of paying them" is therefore positive too.

### Costs associated with taxes

For tax administrations, operating tax systems involve several types of administrative costs. The most common ones are the resources -staff, infrastructure, and training, among others- devoted to impose, assess, levy, collect and solve claims, petitions and appeals. These costs are called administrative costs.

For the private sector, tax costs include not only the amount of the tax itself, but also the so called tax compliance costs, which arise when starting up a business and then, periodically, through the operative life of the entity.

These costs usually include (a) the salaries of the staff devoted to prepare tax returns and maintaining tax information through the year; (b) cost of regular and extraordinary training of specialized staff and (c) fees paid to or fees of outsourcing experts such as lawyers and accountants for several matters like consulting and filing tax appeals.

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<sup>1</sup> Local and foreign investors.

Both, administrative and compliance costs usually become higher as a consequence of changes in the tax structure. This means that besides the regular costs, additional adjusting costs to changes in the tax structure must be added to the above-mentioned equations for both tax administrations and taxpayers.

### What does simplicity mean?

It means that the key to reduce administrative and compliance costs is simplifying the whole tax structure. Tax simplification may be achieved through the simplification of (a) the tax system, (b) the tax legislation and (c) the application of the tax rules<sup>2</sup>.

Simplification of the tax system or structure means reducing the number of taxes by leaving in place only those easier to pay and collect. Simplification of the tax laws means drafting plain and understandable laws and reducing distortions (i.e. exemptions and exonerations). Simplification of application of tax rules means communicating the tax rules directly and effectively to the appropriate sector<sup>3</sup>. In other words, providing each group of taxpayers with the exact information they need, no more, no less.

A complete book can be written on these topics, but it is possible to analyze them briefly to show what are the meaning and the effects of simplification.

Simplification of the tax system imply a harmonization of taxes at all levels: national or federal and local (i.e. state, county and city taxes). Without a proper harmonization, even if the tax rates are not high, the tax burden on taxpayers may be unbearable.

Double taxation at the regional level is a classic example of lack of harmonization. Municipalities often change their legislation creating many barriers to investors, who are forced to move to other municipalities<sup>4</sup>. It is recommended that the harmonization of taxes, related requirements and procedures is drafted at national or federal level and is compulsory for regional governments too.

Simplification of tax legislation can be achieved through (a) making laws shorter and understandable; (b) broadening the tax basis, which also implies eliminating distortions and (c) reducing deductions and tax rates.

Making laws easier to understand imply using a simpler language, avoiding the use of terms and concepts with meanings different than the common meaning of words. It is also important that provisions contained on each tax law are in harmony to avoid differences in meaning and scope. Experts suggest organizing all tax laws in a single code as a way of simplification<sup>5</sup>.

Simplification of the tax laws will reduce the effort of taxpayers and therefore, the associated burden of complying with them. From the tax administration point of view, it also reduces the burden of (i) preparing complicated guidelines to make the laws understandable and (ii) issuing rulings in response to petitions of taxpayers about the interpretation of the law.

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<sup>2</sup> See Jenkins, Glenn and Forlemu, Edwin: "Enhancing Voluntary Compliance by Reducing Compliance Costs" in *Revista de Administracion Tributaria*, No. 12, March 1993.

<sup>3</sup> Id.

<sup>4</sup> See "Costo Venezuela", by FIAS and Conapri. Caracas, Venezuela, 2001. [www.conapri.org](http://www.conapri.org).

<sup>5</sup> Victor, Thuronyi: "Tax Law Design and Drafting". International Monetary Fund, 1996, p. 80.

According to experts, taxpayers fail to comply “because (1) they do not know how to, (2) it takes too much effort to do so, or (3) it is too expensive to do so”<sup>6</sup>. It is said that “a law that is easy to comply with may also be relatively difficult not to comply with”<sup>7</sup>.

The reduction of distortions in the application of tax laws is key to their simplicity. Among the distortive elements of a tax law are the special exemptions, reliefs, and in general, all exceptions to the application of general rule that impose the tax as with the intention of benefit or incentive some taxpayers or activities. Some experts include some deductions in the list of distortive elements.

Distortive elements usually increase administrative costs, consequently increasing the financial effort of the tax administrations. This is because they imply much more complexity in assessing taxes. This is translated into more staff, resources, and time invested in reviewing tax returns, verifying information and auditing taxpayers. Besides, complex tax systems always leave open many ways for tax avoidance and evasion.

In general terms, for tax administrations it makes more sense to lower tax rates while broadening the tax bases than the high cost of providing incentives to few taxpayers through exonerations and other benefits. The reason: simpler taxes and lower rates reduce the tax evasion as well as administrative costs<sup>8</sup>.

Reducing multiple tax rates is also an effective way to simplify tax laws. According to expert policymakers, keeping low tax rates and providing assistance to taxpayers in meeting their tax obligations is considered a better formula to attract investors. In countries like Hong Kong, there has been a very positive result with the formula of simpler tax laws. The Hong Kong administration claims that low corporate and personal tax rates is the main pillar of its economy’s long-standing pro-business environment. A high level of voluntary taxpayers compliance, stimulated by the simple tax system, has enabled the Hong Kong tax administration maximizing revenue collection with low administrative costs<sup>9</sup>.

Another advantage of simplifying tax rules is that it favors the automation of the tax return and payment system, so the taxpayers may file tax returns on line saving time and money, while the tax administration can easily review them and confront relevant information among taxpayers.

Taxpayers education and simplification of the application of the tax rules are an important tool in hands of tax administrations. Both tasks require an effort from the tax administration in providing the right and exact information to taxpayers so they do not have to spend time and money in understanding a law that does not apply to them<sup>10</sup>. It involves the simplification of tax returns and the provision of guidelines. In exchange for such effort tax administrations will save time when receiving tax returns filed correctly, on time payments and for the correct amounts,

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<sup>6</sup> Victor, Thuronyi: “Tax Law Design and Drafting”. International Monetary Fund, 1996, p. 114.

<sup>7</sup> Id. p. 115.

<sup>8</sup> “As a ‘rule of thumb’, fewer taxes and broader bases, with minimal exemptions and reliefs, tend to minimize compliance costs with the opposite holding. A common base, common definitions, common procedures, and common valuations can reduce compliance costs and also administrative costs.” Jeff Pope: “The Compliance Costs of Taxation in Australia and Tax Simplification: The Issues”. Published in the Asia-Pacific Tax Bulletin, Volume 1, Number 1, 1995. p.104.

<sup>9</sup> Samuel Y. S. Chan, Daniel K. C. Cheung, Mohamed Ariff and Alfred L. C. Loh: “Compliance Costs of Corporate Taxation in Hong Kong”. Published in the International Tax Journal (U.S.) 25:42-68, Fall 1999.

<sup>10</sup> See Jenkins, Glenn and Forlemu, Edwin: "Enhancing Voluntary Compliance by Reducing Compliance Costs" in Revista de Administracion Tributaria, No. 12, March 1993.

saving them time and money in solving petitions on the interpretation of the laws as well as in appeals.

### What does stability mean?

It means that after simplifying the tax system it must remain as stable as possible. According to many tax experts, new taxes or significant changes in existing taxes significantly increase tax compliance costs by adding temporary start-ups and learning costs. These costs may be minimized by stability<sup>11</sup>.

For investors stability in the tax systems means a friendly tax environment. Paying a regular amount of taxes is not a big problem for investors but not being able to estimate the taxes plus its associated costs in the medium and long term certainly is. Being able to predict a reasonable amount of taxes and compliance costs works as an incentive.

For tax administrations stability means that (a) the effort and cost invested in educating and informing taxpayers about new tax laws and procedures is minimized; (b) the costs of training staff are reduced as well as the costs of producing new tax forms and (c) the costs of assessing taxes, of defending in tax appeals and of imposing sanctions -generally due to mistakes of taxpayers in understanding the new changes or the new tax law- are also reduced; and (d) finally, by reducing costs, efforts may be focused in detecting and punishing tax evasion and fraud.

Increasing the risks of detection for taxpayers will certainly help in the collection of taxes. If it is cheaper and easier to pay taxes than taking the risk of being punished, the choice is obvious. And if it is cheaper and easier to pay taxes than paying lawyers or accountants to find a way to avoid paying taxes or preparing tax appeals, the choice is also obvious.

### Conclusion

It is not necessary to design a complicated structure to promote investment while protecting the lawful interest of a country to collect taxes. On the contrary, the solutions may be just to simplify the current tax system, making it easier and harmonized.

A necessary simplification of the tax administration must usually follow a reform of the tax system. A reorganization of structure and functions of the tax administration is necessary to make it more productive and efficient. A deeper level of automation is also recommended.

What needs to be done to implement the simplicity and stability formula? The first step is an analysis of tax barriers to local and foreign investors. This analysis implies reviewing (a) tax legislation at national and regional level; (b) tax guidelines, forms and procedures; (c) formal and informal requirements to establish a new business; (d) the tax administration structure at national and regional level. It is recommendable to conduct a survey among local and foreign investors in the main cities and in the suburbs. The result of the tax barriers analysis should clearly show where the bottlenecks are as well as the taxes that generate more administrative and compliance costs. The second step is to assist the government in the process of harmonization, simplification and removal of barriers through the design of a new tax policy and legislation framework. The third step is the implementation of the new framework, including reforms of tax laws, tax administration structure and tax procedures, inter alias. The extent of the second and third step obviously depends on the results of the first step.

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<sup>11</sup> Jeff Pope: "The Compliance Costs of Taxation in Australia and Tax Simplification: The Issues". Published in the Asia-Pacific Tax Bulletin, Volume 1, Number 1, 1995. P.104.

Simplifying the tax system may definitely maximize tax revenue while promoting investments. However, the results will not be seen in the short term. This is why stability of the simplified system is paramount. The results of the initial effort of the tax administration in reforming the system, transforming itself into a more efficient agency, and creating the appropriate climate to attract investors take time.

Investors will go to countries depending on many factors, one of which is tax. Just as attending to a contribution party where the host is the tax administration and the investors are the guests: if the music and the food are good through out the whole night and the cost of the contribution is not too high, why not go every time one is invited?