



The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-96

A Report by the Centre for
Fiscal Studies University of Bath
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Insurance in 1995-96

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The present volume draws heavily on the detailed research material contained in the following appendices, published as **Volume 2** of the report.

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Volume 1 of *The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-6* is available on the internet: www.inlandrevenue.gov.uk

Volume 2 of *The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-6* is available, price £60 (postage included) from:
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Glossary of terms

AVCS	additional voluntary contributions
BIK	benefits-in-kind
Bn	billion
Book 480	Employers' Guide to Benefits
CA	Contributions Agency
COP number	Computer-on-line serial number (IR employer data base)
Croner's	Croner's Tax Guides
CSA	Child Support Agency
Cum	cumulative
DSS	Department of Social Security
EMP	employees
Eversheds	Evershed's Maternity Wheel
FD	financial director
FTE	full time equivalent
FPCS	fixed profit car scheme
FT	full time
GDP	Gross Domestic Product
Gee's	Gee's Pay Monthly
Gross cost	cost before cash-flow adjustment
ICAEW	Institute of Chartered Accountants in England and Wales
IR	Inland Revenue
IT	income tax or information technology
K code	code showing an amount to be added to pay in respect of benefits
LEL	lower earnings limit
LV	luncheon voucher
M	million
MATB1	maternity benefit application form
N	number
NI/NICs	National Insurance/National Insurance Contributions
OSP	Occupational Sick Pay
P6	code notification from tax office
P7 booklet	Employers' Further Guide to PAYE
P8 cards	Information cards for employers
P9 (T)	code notification from tax office for use in next tax year
P9X	authority for employers to amend certain codes at the beginning of the year
P11	deductions working sheet
P11D	end-of-year return of an employee's expenses and benefits during the tax year.
P14	individual end of year summary of pay, tax, NIC and SSP/SMP
P35	employer's annual return
P38S	form for use by students employed during holidays
P45	form filled in when an employee leaves a job and when an employee starts a job.

P46	form filled in for employees with no P45.
P60	certificate of employee's pay and tax deducted.
PAYE	Pay As You Earn
PC	personal computer
PRP	profit related pay
PT	part time
PTS	percentage threshold scheme
SA	self assessment
SSALE	social security advice line.
SMP	Statutory Maternity Pay
SSP	Statutory Sick Pay
Tolley's	Tolley's Practical Tax

Glossary of statistical terms

ANOVA	analysis of variance: splitting the total variance into its component parts
Correlation coefficient	degree to which 2 variables are correlated
d.f.	degrees of freedom: number of parameters minus number of variables
F statistic	ratio of explained to unexplained variance
F test	significance of the F statistic
Gini coefficient	measure of inequality from zero to unity
Log-likelihood	logarithm of likelihood, or probability
Multi-collinearity	explanatory variables highly linearly correlated
Multiple correlation coefficient	degree to which variables are correlated
Power value	weight attached to variance of source variable
R-squared	square of the correlation coefficient
OLS	ordinary least squares
Signif	statistical significance: inside acceptable limits
Source variable	variable used for weighting observations
Std dev	standard deviation (mean square deviation)
t-statistic	test of statistical significance of a variable
Variance	square of standard deviation

Variables used in chapter 4 regressions

dumadvis	dummy variable re professional adviser
dumbur	dummy variable re use of bureau
dummain	dummy variable re use of mainframe
dumpart	dummy variable re partnership
dumsole	dummy variable re sole proprietor
ncasuals	no. of casual employees
ndir	no. of directors
newemp	no. of employees
nftjoin	no. of full time joiners
nmatemp	no. of employees taking maternity leave

nmonthpay	no. of monthly paid employees
npts	no. of part time staff
nsick	no. of sick employees
nsickmat	nmatemp plus nsickemp
nweekpay	no. of weekly paid employees
sq	square of relevant variable

Executive Summary

Introduction

- This study was carried out by the Centre for Fiscal Studies, University of Bath.
- It was commissioned by the Board of Inland Revenue and the Department of Social Security, including the Contributions Agency. (1.1)
- Its main purpose was to measure and to analyse the tax “compliance costs” to employers of operating Pay-As-You-Earn, Expenses and Benefits-in-Kind, National Insurance, Statutory Sick Pay and Statutory Maternity Pay in 1995-6 and to make recommendations as to how such costs might be reduced. (1.5)
- Compliance costs (in this context) are those costs incurred by employers in carrying out their responsibilities for the above. (1.2)
- The research was organised in three sequential stages: an initial scoping study (60 employers) in October-December 1995, a large scale postal survey (approximately 1300 responses) in August-December 1996 and 310 in-depth interviews from June 1996 to June 1997. (1.6)

Total compliance costs

- It was found that the total relevant compliance cost for 1995-6 was of the order of £1.32bn. (3.1)
- This amounted to 1.3% of relevant tax receipts or 0.2% of GDP. (3.1)
- Comparing 1981-2 and 1995-6, compliance costs increased by 42% in real terms, much the same as the increase in GDP over the period so their share of GDP was approximately the same. (3.2)

Regressivity of compliance costs

- The pattern of compliance costs is highly regressive against smaller employers in that the “bottom” 30% (by PAYE and NI collected) pay 75% of the compliance costs. (3.3.1)
- Compliance costs per employee were £288 per annum for employers in the 1-4 employee size band but only a little over £5 per annum for those in the 5000+ band. (3.3.2)
- Real gross compliance costs per employee have hardly changed over the 1981-2 to 1995-6 period for the 10-49 size band but have almost doubled for the smallest employers and have fallen by nearly a quarter for employers with over 100 employees. (3.3.8)
- Compliance costs are found to be very high in the 1-9 size band across all sectors but are particularly high in financial and professional services. (3.5)

Cash-flow benefits

- Employers receive “cash-flow” benefits from PAYE and NICs in the interval between collection and payment. At 1995-6 tax and interest rates these benefits amounted to about £10 per annum per employee for small employers and more than offset gross payroll costs for employers with more than 1000 employees. (3.6)

The composition of compliance costs

- Labour costs account for approximately one half of compliance costs. (4.2.2)
- About 80% of labour costs are attributable to routine PAYE and NI operations and end of year work. (4.2.2)
- SSP/SMP, P11D work and audits each account for about 5% of labour costs. (4.2.2)
- The proportion of total compliance costs attributable to SSP/SMP is between 5.4% and 8.4%. The proportion rises to approximately 20% for the largest employers. (4.2.1)

Payroll technology

- The “least cost” method technology for operating a payroll depends mainly on size. At the time of the study manual methods were still cheapest for the very smallest employers, PCs for the broad middle band of employers and mainframes or bureaux for the largest employers. (4.6)
- At the time of the study , PC-based systems probably became cheaper than manual ones at about 25 employees and bureaux (or mainframes) cheaper than PCs at a little over 100 employees. (4.6)
- Savings per employee per annum from using a mainframe or bureau were approximately £10. (4.8)
- There were potentially large gains to be had from using substitute documents or electronic submission for all payroll types. (4.8)

Average marginal compliance costs (1995-6)

The marginal costs reported here are those derived from a multiple regression analysis of the stage 2 data so are “average” marginal costs.

- Over a broad range of employers the average marginal compliance cost of an employee was of the order of £14 per annum but it was much higher for very small employers and much lower for very large employers. (4.9)
- The average marginal cost of each full-time joiner was of the order of £73 with significant economies of scale. (4.9)
- The average marginal cost of a weekly paid employee was of the order of £18 per annum (4.9)
- The average marginal cost of a casual employee was of the order of £21 per annum. (4.9)
- The average marginal compliance cost of a composite SSP/SMP case was tentatively estimated at £47. (4.5)

Comments from respondents and interviewees (5)

A significant minority of postal questionnaire respondents offered comments as did many interviewees. These comments differed as between small and large employers but the following concerns were common to most categories. There were requests for:

- straightforward and simple literature
- delivery of forms in appropriate quantities and at appropriate times
- better informed and more readily available helplines
- more “educational” visits and seminars

There were complaints about

- the non-integration of PAYE and NI
- the high costs of dealing with casuals and joiners

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- the high costs of dealing with benefits-in-kind
 - SSP, particularly the Percentage Threshold Scheme
 - the complexity of SMP. (5.9)

Recommendations to Employers (6.2)

- All employers should consider whether they are using the appropriate technology for their payroll operations. (For least-cost technologies in 1995-6 see 6.2.1).
- Similarly, for reasons of speed, accuracy and cost, employers should consider using approved substitute documents or electronic submission.
- Small employers should review the extent to which routine payroll work is done by their accountants.
- Payroll bureaux are not normally interested in payrolls with less than about 50 employees. But there may well be a market niche for bureaux in setting up payroll systems for small organisations with a subsequent "helpline" facility. Employers and providers might find this worth exploring.
- Since the compliance costs of weekly-paid employees are significantly higher than those of monthly-paid employees, employers should consider whether the trend toward monthly payment should be accelerated.
- Many medium-sized and large employers complained of the costs associated with remuneration in the form of benefits-in-kind (chapter 5). As benefits come to be taxed as cash equivalents, employers must increasingly consider whether such costs are worth incurring.
- Employers should give serious consideration to amalgamating payroll operations when there is no cost advantage in keeping them separate. If they wish to continue with separate payrolls for reasons of confidentiality they should consider whether this justifies any extra cost involved.

Recommendations to the Government (6.3)

Collaboration.

Closer collaboration between the IR and the CA is one of the main themes arising from discussions with employers. Indeed this report was jointly sponsored by them and they already have a Joint Working Programme. The Team therefore welcomes the Budget announcement (March 17 1998) that the IR is to take responsibility for the work of the CA. On the assumption that the whole of the work relating to PAYE, NI, SSP and SMP will now come under the same umbrella this should greatly facilitate the carrying out of some of the recommendations that follow.

- Given that PAYE and NI are not to be amalgamated into a single system, the IR/CA should go as far as it possibly can in achieving consistency and uniformity across PAYE and NIC operations, so as to minimise compliance costs to employers.

Literature (6.3.2, 6.3.5, 6.3.10)

- The existing programme of rewriting and simplifying the PAYE, NI, SSP and SMP literature is to be welcomed, particularly for smaller employers, and should be continued. The team notes that a joint guide was issued by the CA and IR in 1997.
- The team notes and welcomes the recent improvements in the despatch of literature and forms and recommends that the new system be monitored.

-
- Resources should be devoted to preparing a “stripped down” (i.e., shorter and simplified) Employers’ Guide for a manual PAYE, NICs and SSP/SMP system which should be piloted with small employers.
 - A well-written booklet explaining the system for employees on their *first* employment should be available for distribution by employers (and educational institutions), with a view to improving employee education on tax and related matters.
 - Attractive, simple leaflets should be produced about specific aspects of the system and offered to employers for distribution to employees. Although this in itself would be a burden, it might save time in dealing with subsequent enquiries.

Assistance and response (6.3.4 to 6.3.7)

- There should not be unreasonable delays in responding to calls and helplines should be open during the hours in which employers have to contact them. The team notes that an Employers’ Helpline has been set up since the study period and that it is now open to 5 pm.
- Staff should be trained to pass specialised enquiries to competent experts speedily and to ring back if necessary.
- Requests for duplicate information should be reduced to an absolute minimum and when made should include pre-paid reply envelopes.
- “Named” contact staff assigned to particular payrolls should receive training up to the appropriate level of expertise.
- New employers should be given a named IR/CA contact at the outset and offered an “educational” visit so as to get them “up and running”. A CA/IR pilot experiment on this in Leicester is currently being evaluated and an extension to nationwide coverage was announced in the March 1998 Budget.
- More informal one-to-one or “educational” visits, having a preparatory or educational function, should be offered to employers. In view of their expense these would have to be carefully geared to needs.

Dispensations and benefits-in-kind (6.3.8)

- The availability of dispensations should be more widely publicised.
- The coverage of particular dispensations (e.g., locations covered by car dispensations) should be interpreted more liberally
- Consideration should be given to widening the benefits covered by dispensations.
- IR dispensations should be accepted by the CA (the team notes that this is now done)
- The valuation of company cars for tax purposes should be reviewed.
- The treatment of benefits should be common across PAYE and NI class1A contributions.

Technology (6.3.9, 6.3.11)

- The IR/CA should consider evaluating and “kitemarking” commercially produced software.
- More “hands-on” guidance should be given in choosing and running software. Possibly this could be done by organising local software “fairs” with demonstrations by the leading suppliers.
- Information for employers should be made available electronically so as to reduce the amount of paperwork (a CD-ROM is now offered).
- It should be made as easy as possible for employers to submit returns electronically if they wish to do so. The team notes the current IR initiative on electronic submission.

SSP/SMP**(6.3.12, 6.3.13)**

- The system of qualifying days, linking periods and so on, for SSP, which is widely regarded by employers as arcane, should be revised, simplified and made more comprehensible.
- The treatment of waiting days etc. for part-time employees under SSP should be made clearer as employers (and even CA offices) seem to find this difficult.
- The Percentage Threshold Scheme under SSP should be reconsidered and possibly revert to a pre-PTS type of scheme for small employers only.
- The periods for maternity pay and maternity leave should be the same (the team notes that the White Paper "Fairness at Work", May 1998 has proposed that 14 weeks maternity leave should be increased to 18 weeks to match the period over which SMP can be paid).
- The relation between SMP and employment law should be clarified to employers (employers are, perhaps, not generally aware of the booklet "Maternity Rights", DTI, 1992).
- The DSS should explore ways of allowing employers more flexibility within the SMP scheme to deal with issues such as premature or still births and predicting confinement dates.

Additional recommendations**(6.5.4, 6.5.5)**

Additionally two recommendations are made which could involve rather more radical change. They arise from two of the main problems highlighted in the research, the high costs of dealing with joiners and leavers and the relatively high costs falling on small employers.

- In view of the high compliance costs associated with establishing the right tax-codes, serious consideration should be given to the costs, benefits and feasibility of a tax allowances "smart card". If such a card is thought to be viable it should, of course, be piloted.
- The Government should, in the longer term, consider the costs and benefits of alternatives to collecting employees' tax and national insurance contributions from "small" employers. Any such alternative will, of course, have its own disadvantages (see 6.5.5 below).

New compliance costs**(6.6)**

Finally, some recent policy changes are likely to generate extra compliance costs for employers. It is recommended that:

- In all these cases, the relevant policies should be effected with the minimum possible compliance costs for all parties, especially for small employers
- Using the present estimates of compliance costs as a benchmark, a further study should be carried out as soon as the new changes have bedded down.

Chapter 1

Introduction, Objectives and Research Strategy

- 1.1 The research presented in this Report was carried out for the Board of Inland Revenue and the Department of Social Security, including the Contributions Agency. It was commissioned in October 1995 and was completed in June 1998.
- 1.2 **Compliance costs** have been described as the 'hidden costs of taxation'. For the purposes of this research they are **those costs which are associated with complying with the requirements of a tax system, over and above the actual payment of tax and over and above any distortion costs inherent in the tax** (see chapter 2). They do not include the administrative costs of taxation: these are the costs which are borne by the tax authorities. Compliance costs may be incurred directly by a taxpayer or indirectly through a third party, such as a tax agent. This project is specifically concerned with those compliance costs which are incurred by employers in discharging their statutory obligations in respect of Pay-As-You-Earn (PAYE), National Insurance Contributions (NICs), Statutory Sick Pay (SSP) and Statutory Maternity Pay (SMP).
- 1.3 Modern work on the measurement of compliance costs in the United Kingdom dates from Professor Sandford's pioneering study (Sandford 1973). Subsequent work on the UK system has been described by Godwin in Sandford (1995) which also contains excellent accounts of world- wide research on compliance costs covering a wide range of taxes.
- 1.4 It is now generally accepted that compliance costs are an important component of the total costs of taxation to society. It is therefore in the public interest to have up-to-date and reliable measures of their total size and of their distribution.
- 1.5 The **objectives** of this research project were:
- (a) to measure the overall compliance burden on business of PAYE and NICs, including benefits and expenses, with specific consideration being given to SSP and SMP;
 - (b) to establish the distribution of these costs by size and type of business and by other factors (e.g. type of payroll operation - bureau, in-house computer, manual, use of substitute documents, etc.);
 - (c) to disaggregate the main activities which employers undertake for PAYE and NICs and associated activities, to define and identify sub-operations and measure the disaggregated compliance costs of these sub-operations;

(d) from (c), to identify as clearly as possible which sub-operations are the most/least costly and/or difficult for employers and why;

(e) to recommend options for simplification of PAYE and NIC procedures which could reduce compliance costs; and

(f) to investigate the issues relating to the incidence of multiple payrolls, the reasons why these existed, and their effect on the measurement of compliance costs.

1.6. The **research strategy** adopted may be briefly summarised as follows.

Stage 1. In an initial scoping exercise sixty in-depth interviews were carried out from October 1995 to December 1995 with employers across size bands using various record-keeping systems, professional advisers and bureaux. These provided a foundation for the next two stages.

Stage 2. Approximately five thousand postal questionnaires (see **chapter 2 and appendix A1**) were sent out to employers in the summer of 1996. The response rate was approximately 30% and the data set was subjected to computer analysis. This analysis generated the main quantitative conclusions of the present report.

Stage 3. 156 structured interviews were carried out in 1996-7 in respect of PAYE and NICs (103 plus 53 joint interviews, see table 5.2 below), 95 in respect of Benefits and Expenses and 112 in respect of SSP/SMP. These provided further detailed qualitative information about compliance costs and about so-called "hot-spots". Hot-spots are those aspects of tax compliance which give rise to particularly high costs or special difficulty. A description of the contents, samples and methodologies used in these three stages is to be found in chapter 2.

1.7 **Multiple Payrolls.**

A separate study was mounted of "multiple payrolls" (where a single employer operates more than one payroll). This is presented in **Appendix D** and its implications for the measurement of compliance costs are considered in **chapter 2**.

Bibliography

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Chapter 2

The Measurement of Compliance Costs: Methodology

Definition and nature of compliance costs.

2.1 There are three sorts of cost associated with taxation, over and above the actual tax paid.

- Taxes are said to “**distort**” choice, for example an income tax may lead some people to accept less work than they would otherwise have done. This effect is sometimes called the “**excess burden**” of a tax.
- Taxes have to be **administered**: for example, during the period of the present study, PAYE was administered by the Inland Revenue and National Insurance contributions by the Contributions Agency of the DSS.
- Tax laws have to be **complied with**: for example, employers are obliged to implement PAYE.

Strictly speaking all three types of cost should be considered together but this report is concerned only with the last of these, the compliance costs of taxation. Further, it restricts itself to those compliance costs falling on employers in respect of implementing PAYE and NICs, including SSP and SMP.

2..2 Sandford defines compliance costs as “the costs incurred by taxpayers in meeting the requirements laid upon them by the tax law and the revenue authorities”. They include both objective costs like wages paid to book-keepers or fees paid to accountants and psychic costs like anxiety and worry. “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; costs which would disappear if the tax was abolished” (Sandford 1995, p 1). It is useful to distinguish between **gross** compliance costs (the actual real resource costs incurred) and **net** compliance costs which adjust gross costs to take account of cash flow benefits. Strictly, tax deductibility should also be allowed for but it raises wider issues and is not treated in the present study. **Cash flow benefits** arise because the employer has the use of tax deducted between the date on which wages or salaries are paid and the date on which tax payments are made to the Collector of Taxes. Chapter 3 provides estimates of gross compliance costs and attempts a comparison with Sandford’s estimates for 1981-2. It also provides estimates of cash flow benefits and therefore of net compliance costs.

Compliance costs in practice.

2.3. The estimates produced are of **actual** compliance costs. Compliance costs might be more than they need be in that:

- the payroll operation might be conducted inefficiently and the employer might not be using the least-cost method . (chapter 4)
- the employer might be incurring higher costs than are strictly necessary by setting up more than one payroll, e.g., a separate confidential payroll for directors and other highly paid employees (Appendix D)
- the employer might incur expenses in elaborate “tax planning” (in the treatment of benefits, for example) which, strictly speaking, have nothing to do with compliance.
- employers frequently incur costs in giving tax advice to employees. (Appendix A1).

Some of these costs are, in a sense, voluntary. On the other hand compliance costs might be less than they should be in that:

- tax and national insurance contributions might regularly be paid late
- taxable benefits might be given to the employee but not reported
- tax and national insurance contributions might not be deducted where they should be.

The relevance of these considerations to the present study is that compliance itself may be affected by compliance costs: in particular there may be undercompliance with respect to activities which generate very high compliance costs at the margin or are particularly troublesome. Such “hot spots” are reported in **chapter 5** and in **appendices A1, B and C**.

Compliance cost measurement.

2.4. The quantitative information on compliance costs presented in chapter 3 is largely derived from responses to a large scale postal questionnaire (stage 2), supplemented by more detailed qualitative responses derived from face-to-face interviews with employers (stage 3). Other methods of measuring compliance costs are available, e.g., direct work-study and fee scales from accountants and bureaux. These methods are used only to a very limited extent in this study to supplement the information derived from the postal questionnaire and interviews.

The postal questionnaire (stage 2): procedure and methodology.

2.5.1 A stratified random sample of 5,195 employers' payrolls was originally selected for the research team by the Inland Revenue, using the **payroll** as the sampling unit. Special samples were also drawn to cover government, armed forces and pensioner payrolls. Stratification was based on the number of taxpayer records in each band. Consequently payroll size was the main dimension used both in “grossing up” and in the analysis of compliance cost distribution. (Grossing up is using the sample data to estimate the costs for all payrolls). Because there are so many more small employers than large, the proportions sampled varied from 0.002 for the smallest payrolls to 1.00 for the largest so as to obtain broadly similar numbers across size bands. The

sector classification used was the Inland Revenue's Summary Trade Classification based on the Standard Industrial Classification (C& B for National Statistics, 1992): the division was into 16 groups.

- 2.5.2 A high degree of duplication between the sample frames used for stages 2 and 3 became apparent during the piloting of stage 2. This created practical difficulties for the team in that the same organisation often appeared more than once, either within one sample or between different samples (or both). The most appropriate approach point then had to be identified within an organisation, with care being taken that the same firms were not approached unintentionally for both Stages 2 and 3. Duplication also had implications for approaching organisations with more than one payroll (multiple payrolls) and interpreting their compliance cost data. For a further discussion of this point see paragraphs 2.8.3 to 2.8.4 below.
- 2.5.3 The mailing of the final version of the Stage 2 postal questionnaire was preceded by three pilot studies. The first of these elicited a poor response rate of only 7.5%. Telephone discussions with recipients indicated that the questionnaire was too long, that it asked for inaccessible information and that the existence of multiple payrolls within organisations made it confusing. Two further parallel pilot studies were therefore conducted, with 40 employers in each study. The team compared the responses to these questionnaires which were 4 pages and 8 pages in length, both being substantially shorter than the questionnaire in the first pilot. Since there was no significant difference between responses to the long and short questionnaires (28.2% and 33.3% respectively), it was decided to proceed with the longer version, as the shorter version omitted many useful questions.
- 2.5.4 To ensure that the questionnaire was received by the appropriate person an initial telephone contact was made with each of the original sample of 5,195 employers for Stage 2. The main survey was mailed in August-September 1996, and the majority of questionnaires were returned by the end of that year. The overall response rate was 30.2% which was encouraging and in line with earlier surveys of business compliance costs. Response rates by size bands are shown in table 2.1 below (please see appendix A, table 2.2a, for more detail and for response rates by sector). The unexpectedly poor response rate from the largest employers is consistent with the prevalence of multiple payrolls in that band (see 2.9.3 and 2.9.4 below and **appendix D**) and perhaps results from the difficulty of designing a questionnaire suitable for all sizes of payroll. Note that the responses from the smallest employers were sub-divided into 1-4 and 5-9 employees for subsequent analysis.

Table 2.2 gives adjusted net response rates taking into account that some 10% of firms would have gone out of business since the sample was drawn and that some of the responses were unusable. The net response rate was calculated after the exclusion of duplicated employers; of questionnaires transferred to the multiple payrolls study (2.9.4), of those returned marked "ceased trading" etc., and of those who were found to have gone out of business when followed up by telephone.

Table 2.1 Net response rates

size band	% net response rate
1-9	24.3
10-49	35.8
50-99	39.4
100-499	29.3
500-999	24.5
1000-4999	29.3
5000+	15.3

Table 2.2 Adjusted percentage responses

	net sample % (4632)	net sample after attrition % (4168)
responses (1398)	30.18	33.54
usable responses (1338)	28.90	32.10

The returned questionnaires were coded and the coding was checked on a sample basis. The data were mainly analysed using SPSS (Statistical Package for the Social Sciences); the LIMDEP (Limited Dependent Variables) package was also used at a later stage in the analysis (see **Appendix E**).

- 2.5.5. A separate simple postcard was also completed by 630 respondents who had not replied to the main questionnaire. This was used to assess bias in responses (see 2.9.2 below).
- 2.5.6 A small-scale parallel survey was undertaken of payrolls for pensioners in the expectation that this might reflect compliance costs for the simplest possible type of payroll. Though the numbers were rather too small to draw definite conclusions costs per payroll member tended to be lower than in ordinary payrolls and consistent with the costs of large payrolls. For a full report see **Appendix A3**.

Face-to-face interviews (stage 3): procedure and methodology.

- 2.6.1 In order to supplement the quantitative data obtained in Stage 2 and to obtain richer in-depth information about compliance some 310 "face-to-face" interviews were carried out between August 1996 and December 1997. These interviews have also enabled the team to identify "hot spots" within the system (2.3 above).
- 2.6.2 The 310 interviews were divided as shown in the following table. For a breakdown by size please see **figure 5.2**. Three separate sets of questionnaires were used:
- (A) general interviews concentrating mainly on PAYE and NICs;
 - (B) interviews concerned mainly with SSP or SMP;
 - (C) interviews dealing with benefits and expenses.

Each of these sets of questionnaires had a substantial common introductory section, allowing the team to obtain background information on PAYE/NICs procedures in general.

Table 2.3 Number of stage 3 interviews

Type	Description	Number
A	PAYE and NICs	103
B	SSP/SMP	95 of which 25 joint with PAYE
C	Benefits	112 of which 25 joint with PAYE

- 2.6.3 The joint interviews enabled substantially extra information to be gathered from more than one visit to the same firm, especially in those cases where different aspects of the payroll operation were dealt with by different personnel.
- 2.6.4 As noted above, there were duplication problems with all three samples. As a consequence, the research team had to screen all of the organisations approached very carefully, to ensure that they did not duplicate any visits. There were further complications relating to the structure of payroll functions within each organisation, and also difficulties in identifying the most appropriate contact for each payroll sampled.
- 2.6.5 The organisations approached in respect of type A interviews were mainly drawn from a second Inland Revenue sample, using the same specifications as the Stage 2 sample (see 2.5.1 above). Names and addresses for most of the SSP and SMP samples were initially obtained from Contribution Agency records and supplemented, for technical reasons, from a sample matching the Inland Revenue sample described in 2.5.1 above.
The Stage 3 benefits sample was chosen from a separate exercise that the Inland Revenue had undertaken in 1993-4. In this, they identified individuals with P11Ds. The sample received included tables which showed which benefits were paid to the employees who had been included in that exercise. Employers for stage 3 were matched to individuals for the sample. Unfortunately, this was of limited use to the research, due to subsequent changes which had taken place within the organisations in question.
- 2.6.6 The analysis of the stage 3 material is to be found as follows:

Type A interviews	Appendix B
Type B interviews	Appendix C

All three types are drawn upon in chapter 5 on “hot spots” and in formulating the team’s recommendations. Only data from the type A interviews was comparable with that from stage 2 in that the interviews were drawn from the same sample. Further, interviewers had to allow more or less time for particular sections of the questionnaire depending on the respondent’s specialist knowledge. This was

particularly true in the case of the benefits interviews. Much of the evidence from stage 3 is therefore qualitative in nature.

The measurement of “additive” compliance costs.

2.7.1 The team’s estimates of compliance costs are based on stage 2 data. It was decided to adopt a “bottom up” approach to the measurement of compliance costs: that is to say, rather than asking respondents for a global figure they were asked to build up their costs from actual time taken to complete the main operations. The starting point for the measurement of compliance costs was therefore the number of hours spent each month and at the end of the tax year in dealing with PAYE, NICs, SSP and SMP etc. for the relevant payroll scheme. This includes activities undertaken by directors, partners, managerial and other staff.

This basic data on hours is probably the most reliable of all the data gathered. But the valuation of these hours is by no means a simple matter (see Sandford *op. cit.* p 398). The general approach adopted was to value working time at the respondents’ own valuations. It is acknowledged that this could very well be misleading, particularly in relation to sole proprietors and directors and in relation to non-profit making organisations where professional inputs were sometimes made free of charge. Nevertheless, where hourly earnings were provided they were used to obtain total annual labour costs.

In “grossing up” from the sample to the population as a whole, however, some use was made of New Earnings Survey (NES) figures, partly as a credibility check. Alternative calculations were carried out in which (a) NES figures replaced *all* respondents’ figures for hourly earnings and (b) NES figures were used where earnings figures were not provided by respondents (see tables G5 and G6 in Appendix A2 on grossing up). Over and above these labour costs, adjustments were made to include costs such as fees paid to book-keepers, accountants and bureaux, various direct costs including computer software and hardware and shares of overhead costs where they could be attributed. Appendix A1 grosses up all of these component costs by size band.

2.7.2 Because the primary compliance costs measure is derived by adding up these various elements it is useful to refer to it as **additive costs** which are calculated as in the box below. The check-list of associated costs was provided because it is easy for respondents to overlook items such as telephone calls or postage. On the other hand, it was very important that irrelevant costs should not be included, particularly where there are shared facilities. Respondents were therefore requested to “try to exclude, as far as possible, the costs of payroll activities *not associated* with PAYE, NI, SSP, and SMP administration”. It is recognised, however, that it was not always easy for them to do this.

Additive Costs = (Hours x Hourly Earnings) + Associated Costs

where:

hours is the sum of hours spent by
directors, partners or proprietors;
other managerial staff; and
other staff, on
work in a typical month;
work at the end of the tax year

in relation to "PAYE, NI, SSP and SMP for your payroll scheme";

hourly earnings is the respondent's estimate for each of the three staffing categories and

associated costs is the sum of expenditure on
computer software;
tax adviser's fee (e.g. paid to an accountant);
payroll bureau charges;
other current costs (e.g. telephone, postage, stationery);
additional equipment, computer hardware etc.; plus
additional office space, heating, lighting etc.,
"specifically associated with PAYE, NICs, SSP and SSP".

- 2.7.3 Since one of the objectives of the research was to obtain an estimate of **aggregate compliance costs** the sample estimates were grossed up across all payrolls. Given the means and standard deviations within each size band the means and confidence limits for aggregate compliance costs are estimated using standard methods. The results are recorded in chapter 3 and the procedure itself is explained in annex A2 which presents nine grossing up exercises (G1 to G9) by employment band.

A cross check on whether the grossing up exercise gives sensible results was carried out by using the same method to predict aggregates whose total was known, i.e., total PAYE and NI paid and total employment, both by size band. This proved to be satisfactory.

Additive costs and reported costs

- 2.8 Reference has already been made to a second measure of compliance costs, **reported costs**. Towards the end of the questionnaire, respondents were asked (Q29a):

"what, in your view, would be a fair estimate of the total administrative cost of your payroll scheme for PAYE, NICs, SSP, SMP and benefits/expenses (P11D) work in 1995/6?"

Although additive costs were the primary measure of compliance costs in this study, replies to Q29a have proved to be useful. *A priori*, additive costs are likely to be more reliable than reported costs in that they require the respondent to build up a picture of compliance costs "bottom up". But additive costs are also problematic. There are fewer responses as their construction depends on the

answers to 15 sub-questions; respondents will often be unable, item by item, to separate compliance costs from other costs particularly if facilities are shared by other departments; there is little evidence from stage 3 that employers are able to isolate the tax components within the fees they pay to accountants and bureaux. Reported costs at least have the merit of being a single figure and, for that reason, are readily obtainable; they probably include an element of psychic costs; they are the only source for some of the sub-divisions of compliance costs; they are the only cost data available from some of the respondents in the multiple payroll study. It is reasonable to conclude therefore that they may be used, though cautiously, when no other cost measure is available.

Sample bias

2.9.1 It is important to be reasonably sure that the estimate of gross compliance costs (reported in chapter 3) does not incorporate substantial sample bias. Special steps were taken to investigate two potentially important sources of bias:

- relative over- or under-reporting of compliance costs by respondents
- non response by organisations with multiple payrolls.

2.9.2 **Relative over or under reporting.** A separate postcard was sent out to all non-respondents. This card, already referred to above, contained two questions only, each of which was identical to a question in the postal questionnaire. These questions (adapted from an idea by Maartin Allers, see *Sandford 1995*) were:

“in your view, how do your costs of administering PAYE and NI compare with other payroll schemes of a similar size and type? and the “reported costs” question described in 2.8 above.

It was hoped to use the postcard responses as a way of comparing the compliance costs of respondents and “marginal” non-respondents to the main questionnaire. There is, indeed, evidence that postcard respondents claimed to have substantially higher costs than mainstream respondents. However an analysis of variance failed to find a significant relationship once an adjustment had been allowed for employment. On balance the postcard question does not support the view that has been expressed (e.g., Tait, 1988) that respondents are those with particularly high compliance costs because they are the ones who feel most strongly about them.

2.9.3 **Multiple payrolls and non-response.** Another potentially important source of bias was the existence of “multiple payrolls”. In designing the postal questionnaire, care was taken to establish whether or not the payroll was divided for internal purposes. It was found that some of the respondents with such multiple payrolls were unable to give complete information about all of them. However, the resulting downward bias is likely to be very low, perhaps as low as one-third of one-per-cent. More importantly it could be that the existence of complex multiple payrolls actually discouraged some employers from responding to the survey: i.e., the sample could be biased in that those with complex or costly payrolls were less likely to respond. It was felt that some insight might be gained into the relationship between

multiple payrolls and costs by examining the relationship between “yes” responses to the question “*is more than one payroll operated?*” and additive and reported costs by size band. It was possible for 733 cases to examine whether or not the existence of several payrolls was associated with higher compliance costs. There was a positive and significant correlation between both additive and reported costs and a “yes” answer to the “several payrolls” question. An analysis of variance shows that when corrected for size, the compliance cost effect of multiple payrolls is insignificant but that size and multiple payrolls are *jointly* significant (i.e., payrolls that are both large and multiple have high costs but the two effects are difficult to separate out).

2.9.4 Clearly, the effect of multiple payrolls on compliance costs is a complex one and a special study, **the multiple payrolls study**, was therefore undertaken, the results of which are reported in Appendix D. Data gathered for that study show that, on the whole, both additive and reported costs tend to be higher for employers with multiple payrolls than they are for employers with single or internally divided payrolls. For example, table 2.4 gives the comparative figures for the case of “reported” costs (**for more detail see appendix D**). The differences for “additive” costs are even higher. The multiple payrolls study also suggests that the proportion of multiple payrolls among non-respondents may be high (perhaps 20% for small employers and 80% for large employers). Additionally, evidence obtained from telephone calls to non-respondents in stage 2 suggests that the presence of multiple payrolls is indeed a factor in non-response. Taking all

Table 2.4 Compliance costs and multiple payrolls. £s 1995-6.

size of payroll (number of employees)	mean cost from stage 2 respondents with single payrolls	mean cost from stage 2 respondents with multiple payrolls	mean cost from multiple payroll investigations
1-9	725	677	1056
10-49	1799	2640	2987
50-99	4281	5308	5436
100-499	9538	11018	11262
500-999	24172	28391	28745
1000-4999	23744	33829	43133
5000 +	48656	92227	108577

these factors into account it seems likely that the operation of several payrolls increases compliance costs.

Without further evidence about the distribution of multiple payrolls across size bands, however, it is difficult to make confident estimates of the degree of under-estimation.

Reliability of employers' estimates.

2.10. One major advantage of the questionnaire method used above is that the respondents (often payroll managers) are very close to day-to-day compliance cost operations and are therefore able to give reliable estimates. There are, on the other hand, potential pitfalls which the team did its best to avoid:

- Unconsidered responses: in order to avoid these, respondents were asked to build up a careful picture of costs, starting with the hours spent by staff in dealing with familiar procedures, for example, annual returns, audits etc.
- Neglect of or overstatement of joint costs: respondents' attention was drawn to facilities, such as computer hardware, office space, heating and lighting etc., which may be shared with other parts of the organisation. The precise allocation of such "associated costs" is always somewhat arbitrary however, so that estimates of them are likely to be less reliable than estimates of labour costs, particularly where the costs are incurred by a third party such as a bureau.
- Neglect of "psychic" costs: these highly subjective costs of compliance concerning stress, worry and anxiety do not easily lend themselves to monetary measurement but are nevertheless real. To the extent that psychic costs are omitted, this study underestimates compliance costs though it could be that such costs were sometimes included in **reported costs**.
- Biased respondents: overall sample bias was discussed above. It may also be that some respondents were unrepresentative in that they were aggrieved or hoped to influence policy, or were untypically helpful or wished to impress the interviewer with their competence. Hopefully individual idiosyncrasies will have been ironed out over the sample as a whole.
- Confusion with respect to payroll. A major difficulty of this study is that the unit of analysis was the payroll, rather than the organisation. Steps taken to minimise consequent confusion of respondents included careful design of the front page of the questionnaire (see **appendix F**) and extensive initial telephone contact.

Summary of possible bias in the compliance cost estimate

2.11. The team has been well aware of the possible biases, especially sample bias, in the estimation of compliance costs based on a study of this kind and has taken precautions to minimise them. The principal remaining sources of **upward** bias are likely to be due to:

- overvaluation of the value of time (but see next point)
- inclusion of non tax-related items in fees paid to accountants, advisers and bureaux
- inclusion of non tax-related items in associated costs.
- inclusion of "voluntary compliance" elements in compliance costs (see **2.3 above**)

The principal remaining sources of **downward** bias are likely to be :

- underestimation of the value of sole proprietors' and directors' time by small employers
- the zero value recorded for time put in by charities etc.
- higher incidence of multiple payrolls among non-respondents (more important among larger employers)
- omission of costs associated with directors and higher paid staff where payrolls are internally divided.

Though it would be desirable to make accurate allowances for all these factors the team did not have compelling evidence for a confident upward or downward adjustment of the central compliance cost measurements to be provided in the next chapter.

2.12. Summary of chapter 2

- the quantitative results of this study are primarily based on a large scale postal questionnaire relating to 1995-6
- the original sample was a stratified random sample of employers' payrolls and the net response rate was just over 30%.
- the main mailing was preceded by three pilot mailings as a result of which the questionnaire was simplified and improved.
- the sample for the 103 PAYE and NICs face-to-face interviews was a second IR sample drawn on the same basis as stage 2.
- the sample for the 95 SSP/SMP face-to-face interviews was partly a pre-sifted sample selected by the DSS and partly the second IR sample
- the sample for the 100 Benefits interviews was drawn by the IR on the basis of benefits to individuals.
- the primary method used to measure compliance costs was the "additive" measure, built up component by component.
- as a minor supplement to additive costs an alternative measure, "reported" costs, was used based on the respondent's over-all impression
- various sources of bias were considered (including the presence of multiple payrolls, see **appendix D**) but no net adjustment to the central estimate (see chapter 3) was considered to be appropriate.

References

Alan A Tait, *Value Added Tax, International Practice and Problems*, IMF, Washington DC, 1988, page 352.

C T Sandford et al, *Administrative and Compliance Costs of Taxation*, Fiscal Publications, Bath, 1989, pages 197-200.

Chapter 3

The measurement of compliance costs: estimates of overall size and incidence

Total compliance costs

3.1.1 The total compliance costs reported here are mainly derived using the **additive costs** measure described in chapter 2. Time spent on compliance cost work was valued together with other costs associated with compliance in respect of each payroll in the sample. These costs were then “grossed up” by size band to form an estimate of compliance costs for payrolls in the aggregate. The grossed up figure varies depending on the assumptions made (see tables G1 to G9 in appendix A2) but six out of the nine methods give a grossed-up valuation in the region of £1.3b.

Table 3.1. Estimates of aggregate compliance costs 1995-6

Method (app A2)	Central estimate £b	Description
G1	1.60	original IR sample size bands
G2	1.32	respondent's reported size band
G3, G4	1.29	separate estimate for government sector
G5	1.34	imputation of missing pay rates
G6	1.41	imputation of all pay rates
G7	1.34	estimate based on “reported” cost
G8	1.26	estimate using “comparable” cases only
G9	1.42	estimate based on costs per employee

3.1.2 The Team's preferred method is G2 which most closely corresponds to the methodology envisaged when drawing up the postal questionnaire. Here the “special” samples relating to the armed forces, government and pensions are grossed up separately and the respondents' own employment estimates are used. This method gives a total of **£1.32b** with lower and upper confidence limits of £1.14b and £1.50b respectively. That is to say, one can be 95% sure that compliance costs lie within these limits. The upper and lower confidence limits for each of the methods are given in the appendix A2. To put this figure of £1.32b in perspective, it represents approximately 1.3% of PAYE and NI paid (classes 1 and 1A) or 0.2% of Gross Domestic Product.

3.1.3 A useful alternative gauge of the over-all impact of compliance costs is the sum of the person-hours involved. This is only a partial measure since hours alone are unweighted by earnings, and non-labour costs (which amount to approximately 50% of the total) are ignored. The best estimate of total annual hours worked (on PAYE, NICs and SSP/SMP compliance related activities) is **80.7m**. (See appendix A2, tables 2.1 to 2.4 for a breakdown by sample band and by staff grades). This is equivalent to about 3.5 hours per employee per annum which, again, is about 0.2% of total hours worked.

Table 3.2 Grossed up compliance costs (£000s) 1995-6.

Payroll type or size band	Additive compliance costs
Pensions	3,255
Non-UK	2,724
Government	33,566
Forces	1
1-4	443,579
5-9	163,407
10-49	297,169
50-99	78,428
100-499	129,210
500-999	47,110
1000-4999	83,600
5000+	16,663
Not known	24,342
Total	1,323,054

3.1.4 Table 3.2 shows how total costs are spread across the “special” samples and the size bands. The very large proportion of costs falling on small and medium sized employers is discussed further in 3.3.1 below.

Comparison with 1981-2 Estimates

3.2.1 Have real compliance costs been increasing or decreasing over time? Professor Sandford, taking a broadly similar approach, estimated compliance costs at £449m for 1981-2. This amounted to approximately 0.2% of GDP which is very similar to the 1995-6 proportion. So, in a broad sense, compliance costs have gone up more or less in line with GDP (i.e., they have grown by 42% in real terms). PAYE, NI and SSP/SMP compliance activities therefore take up about the same proportion of real resources as they did in 1981-2. It would be helpful to know how much of the increase was due to:

- the inclusion of SSP/SMP in the 1995-6 survey
- general cost increases
- increases in compliance costs relative to other costs
- increases in compliance activity.

3.2.2. **SSP/SMP adjustment.** The 1995-6 study included costs of SSP/SMP compliance while that of 1981-2 did not. An adjustment therefore has to be made to take this into account. It is based upon responses to two questions.

- Question 25: "Please estimate the percentage of time spent on each of the following payroll activities"; NB one of these was "routine administration of SSP/SMP".
- Question 29a: "Please estimate how this (reported cost) would be divided between costs associated with PAYE, NICs and SSP/SMP".

The percentages were applied to costs on a case by case basis to derive overall percentages and totals. On that basis a range of percentages was derived as in table 3.3.

Table 3.3 SSP/SMP as percentages of compliance costs 1995-6

Basis	Percentage
labour cost only	5.4
additive costs applying Qu 25 %	6.3*
additive cost applying Qu 29b %	7.5*
reported cost applying Qu 29b %	8.4

Where figures are asterisked it is assumed that the labour percentage applies to additive costs as a whole. For more discussion of the grossing up of responses to these two questions please see 4.2.2 below. Taking 7% as a representative percentage, SSP/SMP costs were approximately £93m which has to be subtracted from 1995-6 costs before comparing them with 1981-2.

3.2.3 **Adjustment for general cost and price increases.** Applying the economy wide GDP deflator (1996(i) index =192 where 1982=100) to the 1981-2 figure gives a figure of £862m for 1995-6. This represents what the resources devoted to compliance in 1981-2 would have cost in 1995-6 if their costs had gone up in line with costs and prices generally.

3.2.4 **Adjustment for the relative increase in compliance costs.** Table 3.4 shows what the specific pattern of compliance related activities of 1981-2 would have cost in 1995-6. The adjustments have been made in a similar way to those made by Sandford in up-dating his own estimates to 1986-7. Labour costs have been updated using the most appropriate figures from the New Earnings Survey (NES) and "other costs within the firm" have simply been adjusted using the RPI.

Table 3.4 Employers' PAYE and NI Costs 1981-2 updated to 1995-6

	1981-2 £m	Index for uprating	1995-6 index	1995-6 £m
<i>Regular costs</i>				
Value of time spent by:				
Directors, partners, proprietors	147	NES office managers		367.5
Computer staff	16	NES computer programmers	236	37.7
Other staff	211	NES costing and account clerks	255	538.0
<i>Other costs within the firm</i>	18	RPI	191	34.4
Payments to advisers	54	NES accountants	277	149.6
<i>Non-Regular Costs</i>				
Costs of special problems	3	NES accountants	277	8.3
Totals	449			1135.5

3.2.5 The figure of £1135m (table 3.4) implies an additional cost increase of £273m over and above the £413m baseline increase due to general inflation (see 3.2.3 above and table 3.5). Table 3.5 brings these figures together (the bold figures in each column add to £1230m). The total increase in real resources devoted to compliance was £781m being made up of £413m in baseline costs plus £273m in costs due to a relative price effect and £95m due to increased compliance cost activity.

3.2.6 It is highly likely that this over-estimates the importance of the relative price effect. The adjustment index in table 3.4 is "base weighted" in that it starts from the 1981-2 composition of costs. An alternative would be to use a "current -weighted" index which starts from the 1995-6 composition of costs. For example, since the 1995-6 costs split about 50:50 between labour and non- labour costs, a simple

Table 3.5. A comparison of 1981-2 and 1995-6 compliance costs (£m)

Compliance costs base	cost	extra cost
1981-2 costs at 1981-2 prices	449	(449)
1981-2 costs @ 1995-6 prices, GDP deflator.	862	413
1981-2 costs @ 1995-6 prices, table 3.3 index	1135	273
implied volume increase	95	95
% volume increase (rounded)		8.4%
1995-6 costs excluding SSP/SMP	1230	1230
1995-6 costs including SSP/SMP	1323	1323

average of the GDP deflator (192) and the compliance cost index derived above (253) would give 1995-6 costs at 1981-2 prices as £566m which would imply a volume increase over and above £449m of 26% rather than the 8.4% given in the table. It is convenient to take this as an upper limit.

3.2.7 Over-all one could say that the claim on resources has gone up by 42% over the period and that the increase due to an increased level of compliance activity has gone up by between 8% and 26%. A detailed analysis of how much of the increase is attributable to increases in costs and how much to increases in activity is beyond the scope of this study but the following points may be made:

- the composition of compliance costs changed quite markedly over the period, which included a major extension of computerisation. For example: labour costs were approximately 78% of total costs in 1981-2 but only about 50% in 1995-6; the cost of advisers (mainly accountants) was 12% of total costs in 1981-2 but had risen to over 21% in 1995-6; computer software and hardware hardly featured in 1981-2 but probably accounted for over 10% of costs in 1995-6 (see table H4 Appendix A2).
- greater use of “advisers”, particularly by small employers, will have increased costs.
- the number of income tax payers in Great Britain (most of them PAYE) increased by about 3.6% .
- much of the new employment since 1981-2 has been generated by employers with less than 10 employees (Storey, 1995) whose compliance costs per head tend to be much higher than those of larger employers (see 3.3.2 below)
- the UK PAYE/NI system is arguably more complex than it was in 1981-2, for example, the introduction of a lower rate band. On the other hand, the number of upper bands has been reduced.

The “regressivity” of compliance costs.

3.3.1 Compliance costs are regressive in that they fall more heavily on smaller employers. Chart 3.1 shows cumulative compliance costs against cumulative PAYE and NI paid. If costs had been evenly distributed the curve would simply be a straight line running from the bottom left to the top right of the diagram. The further it is away from that line the more “inequality” there is. Technically, this may be measured by the “Gini coefficient” which would be zero for a completely even distribution of compliance costs and 1 for a completely uneven distribution. In this case the coefficient is 0.67. From Chart 3.1 it is easily seen that the “bottom” 30% of employers incur about 75% of compliance costs or that 50% of compliance costs fall on employers who generate only about 12% of revenue.

3.3.2 An alternative way of looking at regressivity is to examine compliance costs per employee. The first two columns of Table 3.6 give compliance costs per employee for the 740 cases in which respondents answered both the additive cost and reported cost questions. The final column gives compliance costs per employee for the whole sample (1304 cases)

Chart 3.2 displays the information from the first two columns in a format which makes the regressive nature of compliance costs clear regardless of whether additive or reported costs are used.

Table 3.6 Mean additive and reported costs per employee for comparable cases and for whole sample (£s) 1995-6

size band	additive costs (£) comparables	reported costs (£) comparables	additive costs (£) total
1 to 4	315	263	288
5 to 9	149	141	143
10-49	93	87	89
50-99	58	66	58
100-499	41	50	41
500-999	31	36	29
1000 to 4999	30	19	29
5000+	6	8	5

(Rounded figures from Tables 5.5 and 5.8 of appendix A2)

3.3.3 Costs falling on the **smallest** employers are clearly of interest. The smallest band originally sampled for was 1-9. To obtain more information on the smallest payrolls the team split this into a 1-4 band and a 5-9 band. For the 1-4 band mean additive cost is £288 (for confidence limits please see Appendix A2) It is hazardous to be more precise than this within the 1-4 band both because of definitional difficulties and because the variances become very large. However, employers with only one, two or three employees are of special interest. For the very smallest payrolls costs may be extremely high because even the smallest employer has to become familiar with his or her tax obligations, to set up a system (even a rudimentary one), store tax documentation, deal with enquiries and so on. The relevant costs are shown in table 3.7. These figures are consistent with the illustrations from regression analyses in chapter 4.

Chart 3.1 Cumulative % of Additive Costs and Total PAYE and NI Payments

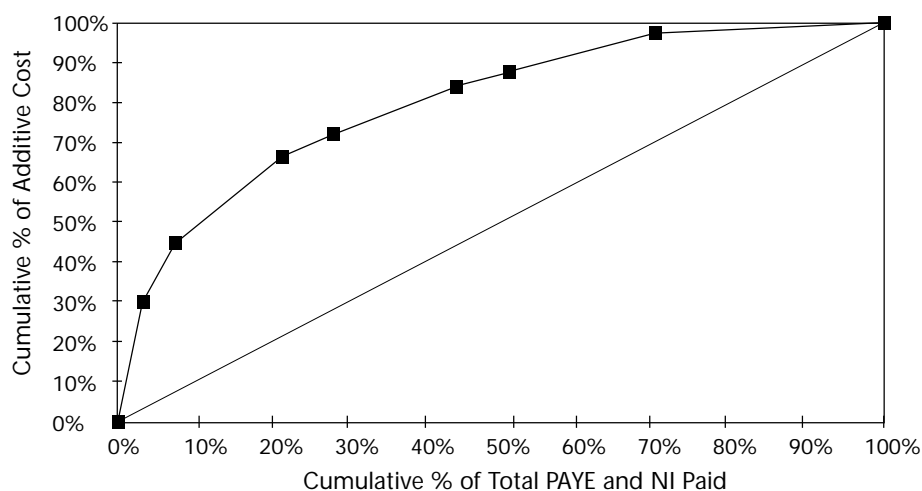


Chart 3.2 Comparison of Additive and Reported Costs per Employee, Size-based Samples

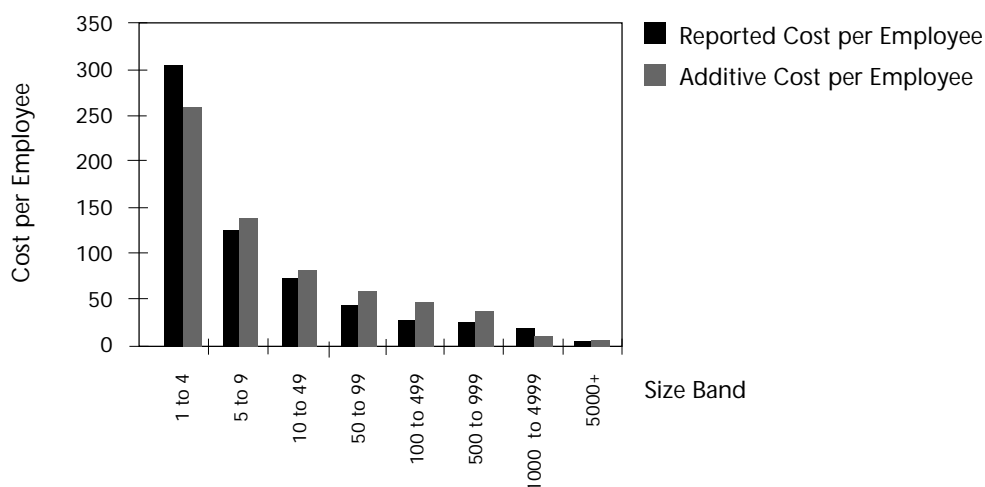


Table 3.7 Compliance costs per employee for very small employers 1995-6 (£)

number of employees	cost per employee	no. of cases
1	£330	29*
2	£315	40
3	£168	38

* excluding one "outlier".

3.3.4 Employers that are both **small and inexperienced** (1 to 4 employees and less than two years experience) were expected to have high compliance costs. This expectation is supported by the data, though only 14 "small, inexperienced" employers provided sufficient information for calculating additive cost. One particular employer (a single director, valuing his time at £35 an hour and recording high adviser's fees) was excluded from this part of the analysis. For the remaining employers the compliance costs per head were as in table 3.8.

Table 3.8 Compliance costs per head for small inexperienced employers. £s 1995-6.

inexperienced employer	404 (13 cases)
experienced employer	281 (91 cases)

For employers outside of the 1-4 range the evidence was much more ambiguous but the evidence for this smallest category suggests that particular attention needs to be paid to their problems.

3.3.5 At the other extreme, for **very large** payrolls, mean annual additive costs per employee are just over £5 per employee: fixed costs, once distributed among all employees are negligible and there are non-trivial scale economies, particularly in respect of joiners (**chapter 4A**). This figure may be taken as a lower bound for businesses with typical payroll structures. There were, indeed, some even lower costs reported but there is reason to believe that these were exceptional cases. (For two

very large employers compliance costs per head were *extremely* low, well below £1. Telephone contact revealed that special factors were at work: in one case there was a very high proportion of employees below the NI lower earnings threshold and in the other there was an extremely high proportion of pensioners still being paid through the main payroll).

3.3.6 Complementary evidence from fees charged by payroll bureaux is also useful here. Though bureau fees were not in general used in this analysis, market data provided by an anonymous large payroll bureau show the expected regressive pattern. Thus, annual costs per employee quoted by the bureau fell from about £68 for 50 employees to about £13 for 5,000 employees. These were annual costs. As always in this sort of analysis it is difficult to be sure that the bureau's fee does not include substantial items not related to tax compliance (and that substantial compliance cost items are not borne by the employer). Bureau costs are therefore used here to reinforce the team's evidence of regressivity rather than to provide further evidence on absolute compliance costs. First year costs per employee were very much higher at £167 and £18 respectively. Very few bureau users will be "new" employers but the figures do draw attention to the high start up costs facing them.

3.3.7 Compliance costs are, then, clearly regressive in that they fall more heavily on small employers. Their full regressive impact may be even more marked when the cumulative effect of all compliance costs, including VAT, corporation tax and income tax, is taken into account (Sandford, 1989). Further, the perceived burden of tax compliance costs may play some part in discouraging potential small employers from taking on staff. The regression analysis of chapter 4 shows that the "fixed" costs of operating the system are substantial and that there are significant economies of scale, not available to the small employer, in dealing with joiners. These considerations put small employers at a clear disadvantage and suggest that particular attention should be paid to them

3.3.8 The computer revolution leads one to expect that compliance costs will have become more regressive since 1981-2, since only about a half of UK businesses actually possess a computer and because manual methods may still be cost effective for the smallest employers. Table 3.9 gives 1981-2 and 1995-6 compliance costs per employee for roughly comparable size bands.

Table 3.9. Change in mean compliance costs per employee 1981-2 to 1995-6

1981-2 size band	1981-2 cost £	1981-2 costs adjusted	1995-6 size band	1995-6 cost £	1995-6 index 1981-2=100
1-5	58	147	1-4	284	193
6-10	39	98	5-9	136	137
11-20	38	96	10-49	84	101*
21-50	29	73	10-49	84	101*
51-100	17	43	50-99	47	109
101-500	18	45	101-500	33	73
500+	11	28	500+	23	82

(The asterisked ratios are aggregated across two categories).

An adjustment has been made to the figures in the fourth column to allow for the exclusion of SSP/SMP from the earlier study, as was done in table 3.5 above. So the 1995-6 figures are a little below those in table 3.6 The final column of table 3.9 expresses 1995-6 costs as an index taking the *updated* 1981-2 costs as 100. (For example, in the 50-99 band the 1981-2 cost was £17. This is equivalent to £43 in 1995-6 and $£47/£43 \times 100 = 109.3$ which appears, rounded, in the final column). Though the pattern is not uniform it is clear that real costs per employee for smaller employers have risen while those for the largest employers have fallen.

Incidence by company type and size

3.4. The highest compliance costs per employee by legal form are those for sole proprietors followed by partners, limited companies and plcs (see table 3.10 in which the highest costs are in italics). But it is nearly always misleading to look at compliance costs in terms of a single factor. An analysis of variance suggests that both legal form and employment are significant in explaining compliance costs per head, as is also their combined effect. Sole proprietors are predominantly found in the 1-49 size range and it is apparently a “cheaper” form for the smallest employers than either partnership or limited company status. Once one moves outside of the smallest range the sole proprietorship becomes very “expensive”. The high compliance costs associated with limited companies for these employers probably reflects the stricter and more formal framework within which they have to operate and the inclusion of directors under Schedule E. The limited company again appears as an “expensive” option (compared to the plc) for large employers in the 1,000-4,999 size band.

The table below makes use of only one variable, employment, apart from legal form. As a great many other factors affect compliance costs, apart from employment the issue is further explored in chapter 4 using multiple regression analysis. It there turns out that variables relating to legal form are statistically significant. If limited company status is taken as the reference case, sole proprietorship and partnership are significant but plc status is not. It may still be the case, however, that legal form is acting as a “proxy” for other factors (see technical appendix E).

Table 3.10 Additive costs per employee by legal form and employment band (£s) 1995-6

	Sole Prop	Partnership	Ltd Co.	PLC	Other	Hosp & Schools	Gov. Bodies
1 to 4	216	249	441	*	40	*	104
5 to 9	87	222	172	*	*	-	30
10 to 49	136	87	90	79	36	107	73
50 to 99	*	34	64	*	51	53	*
100 to 499	-	*	39	41	69	31	35
500 to 999	*	-	32	27	*	30	*
1,000 to 4,999	-	-	55	5	17	10	*
5,000+	-	-	*	*	7	*	*

All figures rounded to whole numbers. * indicates fewer than 5 cases; - indicates no cases.

Incidence by sector and size

3.5. Compliance costs per employee are, as already noted, particularly high for small employers. This is confirmed in the cross tabulations by size and sector given in table 3.11 below in which those sizes and sectors with mean compliance costs per employee above £150 are in italics. The cells with high costs are all in the 1-49 category and are spread across the professional and financial services, construction, and manufacturing sectors. Compliance costs per head are particularly low in the voluntary sector partly because some professional respondents (e.g., hon. treasurers) clearly indicated that they gave their services free, and particularly high in the financial sector. (Not given separately in either table 3.10 or 3.11).

Table 3.11 Mean additive costs per employee by employment and sector £s 1995-6, 7 sector grouping.

	Primary	Manu	Constr	Distrib	Profess /Finance	Misc	Public	All
1 to 4	<i>291</i>	<i>407</i>	<i>370</i>	132	<i>489</i>	162	108	288
5 to 9	<i>178</i>	<i>181</i>	<i>286</i>	133	<i>167</i>	74	59	144
10 to 49	<i>188</i>	84	127	78	90	56	85	89
50 to 99	*	68	82	50	53	*	50	58
100 to 499	*	40	48	43	48	36	31	44
500 to 999	*	35	-	21	29	-	27	29
1000 to 4999	-	69	-	10	15	-	20	30
5000+	-	*	*	7	9	-	2	5

* indicates 10 or fewer cases

Table 3.11 distinguishes seven sectors only as observations were insufficient to give a size/sector breakdown over all 16 sectors. For the same reason table 3.12, although covering 16 sectors gives costs per employee only for each sector as a whole. It also gives mean hourly wage rates making it clear that sectoral differences, such as they are, are not *primarily* determined by differences in pay rates. Multiple regression analysis (**chapter 4 A**) confirms that sector is not statistically significant once other factors are taken into account.

Table 3.12 Additive cost per employee by sector. (£s 1995-6, 16 sector grouping)

sector	mean hourly pay rate for managers (£)	mean compliance cost per employee (£)
primary	9.5	139
manu/utills	11.2	96
construction	8.8	133
wholesale	10.9	72
retail	10.2	114
motor trade	8.7	63
catering	11.7	69
trans & comm	11.5	117
financial	15.0	118
professional	12.9	197
hiring	10.2	65*
medical	9.9	51
recreation etc.	9.2	118
non-UK	12.5	51*
govt	9.3	64
forces	15.8	15*

* indicates 10 or fewer cases, based on table 5.7 appendix A2

Cash flow benefits.

3.6.1 Employers, as tax collectors, hold tax and national insurance payments from the pay date to the 19th of the following month. It may therefore be argued that they enjoy a "cash flow benefit" over that period. The cash flow may be used to reduce an overdraft or other borrowing, to extend trade credit or make short term loans. From the standpoint of the community as a whole this cannot, of course, be a net benefit as it is essentially a transfer from taxpayers in general to employers. But the benefit can, in principle, be very substantial for employers who collect large amounts of tax. Calculation of the value of the cash-flow benefit requires knowledge of:

- tax liability and tax rates
- frequency of wage or salary payments
- the "grace" period
- any slippage in tax payments (assumed to be zero for this exercise).
- the liquidity position
- relevant interest rates.

3.6.2 The results of these cash-flow calculations are summarised in the following table.

Table 3.13 Cash flow benefit and compliance costs. (£s, 1995-6)

size band	mean additive costs £	mean cash flow benefit £	net mean compliance costs £	net mean cc per head £*
1-4	1041	35	1006	279 (288)
5-9	1189	95	1094	132 (143)
10-49	2146	407	1739	72 (89)
50-99	4490	1478	3012	39 (58)
100-499	9794	3947	5847	2 (41)
500-999	33742	14796	18946	16 (29)
1000-4999	32554	38976	-6422	-6 (29)
5000+	56912	171850	-114938	-11 (5)

* the final column of table 3.6 is inserted in brackets here for comparison.

As cash flow benefits are roughly proportional to tax paid, they increase with payroll size so that net compliance costs become negative for the largest employers.

To illustrate the method used, consider an employer who pays the staff monthly on the 24th and hands tax over to the Collector promptly on the 19th of the following month. In a 30 day month tax is held for 6 days plus 18 days in the following month. So there is a cash flow benefit of $T \times (6/366 + 18/366)$ or $(0.016 + 0.049)T$ or $0.065T$ where T is annual PAYE and NICs collected. The relevant rate of interest will differ across employers. For simplicity the rate is taken to be the average retail banks base rate for 1995-6 of 6.58% (though small firms were typically charged 3.5% above base rate on agreed overdrafts and 29.5% on non-agreed ones). To that extent the present assumption understates benefits to small employers. On the other hand, many small businesses are able to obtain little or no interest on current accounts while many large businesses are able to put out short term money at very advantageous rates. The questionnaire did not include questions about liquidity so estimates of benefits can only be approximate. Nevertheless, on the assumptions made here the value of the cash flow benefit is $(0.065T \times 0.0658)$ or $0.0043T$. Example: if tax is £500,000, pay is monthly and tax is paid monthly, the value of the cash flow benefit is $(£500,000 \times 0.0043)$ or £2,150. The appropriate coefficients for weekly (and fortnightly and four weekly) pay (0.076) were calculated from the 1995-6 calendar, assuming a Friday pay day. Where tax was paid only quarterly an additional cash flow of $0.083T$ was assumed. Example: if tax paid is £4000, pay is made weekly and tax paid quarterly the cash flow benefit is $£4000 \times (0.076 + 0.083) \times 0.0658$ or £42. Table 3.12 sets estimated cash flow benefits by size band against additive compliance costs (excluding the special samples and those where the size band is unknown). For small employers the cash flow benefit is only a small offset to additive compliance

continued on next page

costs but for employers in the 1000+ bands cash flow benefit more than offsets such costs. In this sense the largest employers actually *benefit* from acting as unpaid tax collectors: the cash flow benefits of withholding tax exceed their gross compliance costs. The cash flow benefits calculated here are *underestimates* if employers systematically pay the collector after the 19th of the month.

3.6.3 There are several important reservations to be made about these calculations, however.

(1) As in Sandford (1989) the inclusion of employers' NICs in the total implies that the incidence of employers' contributions falls essentially upon employees (in their absence wage rates would rise). Therefore it was not necessary to ask about the division of NI payments between employers' and employees' contributions. There is a case to be made that employers' contributions give a cash flow benefit over the grace period only and to that extent the above may be overestimates.

(2) It is assumed that cash flow benefits to the organisation essentially go to the employer. If this assumption is relaxed the estimates of cash flow benefits to the employer (though not to the employer and employee together) have to be revised downwards.

(3) A further possibility is that "pay day" itself might be "endogenous" in that it is in some cases earlier than it would have been in the absence of PAYE. Since bringing pay day one day forward is expensive this possibility implies an over-estimation of cash flow benefits using the present method.

(4) Retail banks base rates will be underestimates of the rates that many businesses have to pay for overdrafts or overestimates of what most (though not all) employers can earn on deposits.

(5) To the extent that employers regularly make late payments (i.e., after the 19th of the month) the calculations made above will be underestimates. The calculations assume that all employers pay on the due date. For all the above reasons cash flow benefits have to be interpreted carefully. However, the differential impact on small and large payrolls is clearly present under all assumptions.

Summary of chapter 3.

- employers' compliance costs of implementing PAYE, NICs, SSP and SMP for 1995-6 were of the order of £1.32b or 1.3% of relevant tax receipts or 0.2% of GDP.
- the proportion of person-hours, devoted to compliance work was also 0.2%
- in terms of claims on resources, compliance costs have increased by about 42% between 1981-2 and 1995-6, i.e., at about the same rate as real GDP. It is likely that compliance activity (as distinct from cost) increased by between 8% and 26% over the period.

-
- the pattern of compliance costs is highly regressive against smaller employers in that the “bottom” 30% pay 75% of the compliance costs;
 - compliance costs per employee were £288 per employee per annum for employers in the 1-4 employee band but only about £6 per employee per annum for the 5000+ band.
 - real gross compliance costs per employee have hardly changed over the 1981-2 to 1995-6 period for the 10-49 size band (using a compliance cost index) but have almost doubled for the smallest employers and have fallen by nearly a quarter for employers with over 100 employees.
 - very high compliance costs are to be found in the 1-9 size band for sole proprietors, partners and particularly limited companies;
 - very high compliance costs per employee in the 1-9 size band are found across all sectors but are particularly high in financial and professional services and are low in the voluntary sector;
 - cash flow benefits to employers reduce gross compliance costs per employee by about £10 per annum for small employers and more than offset gross costs for employers with more than 1000 employees. Large employers therefore experience a net benefit from tax compliance.

References

C T Sandford et al., *Administrative and Compliance Costs of Taxation. op. cit.*

D Storey, *Understanding the Small Business Sector*, Routledge 1995.

Chapter 4

The measurement of compliance costs: composition and determination.

Introduction

4.1 Chapter 3 looked at total compliance costs and their incidence. This chapter:

- breaks total compliance costs down into its component parts;
- examines the main factors affecting compliance costs.

The methods used are simple tabulation, analysis of variance and multiple regression analysis. The regression analysis is outlined in this chapter and presented in more detail in chapter 4A .

Splitting up labour costs

4.2.1 Some of the questions in the postal questionnaire specifically asked respondents to attempt to split the total into its component parts. Thus Qu. 25 asked employers to estimate the percentage of time spent on each of the following activities,

- | | |
|--|-------------------------|
| (a) routine PAYE and NI administration | (d) year end activities |
| (b) routine administration of SMP/SSP | (e) PAYE and NI audits |
| (c) work on benefits-in-kind | (f) other |

Table 4.1 indicates that:

- labour costs per employee decrease across size bands in respect of “routine” PAYE and NI operations, end of year operations and audits.
- labour costs per employee in respect of P11Ds and SSP/SMP do not fall with size; on the contrary (except for the very largest employers) they are broadly stable across size bands

Table 4.1 Labour costs per employee by function and employment (N=909) and grossed up costs, (£) 1995-6

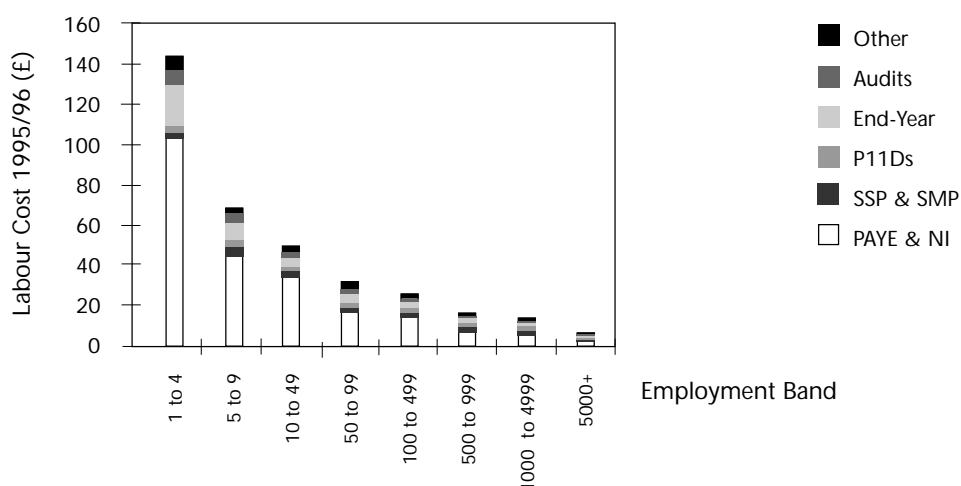
	PAYE & NI	SSP & SMP	P11Ds	End-Year	Audits	Other	Total	N
1 to 4	105.91	1.45	3.40	21.25	6.32	7.13	145.46	138
5 to 9	48.82	1.84	1.50	10.13	5.61	0.51	68.41	98
10 to 49	37.59	1.96	2.54	5.76	2.44	0.74	51.03	247
50 to 99	22.10	1.91	2.32	3.44	1.32	1.27	32.36	127
100 to 499	13.85	1.87	2.11	2.78	0.82	0.46	21.89	131
500 to 999	7.24	1.83	1.32	1.35	0.66	1.72	14.12	65
1,000 to 4,999	6.42	2.25	2.57	1.15	0.24	0.77	13.40	75
5,000+	0.60	0.42	0.11	0.17	0.07	0.37	1.75	28
grossed up £000s	441,393	35,342	36,273	84,051	32,834	29,218	659,113	1168**
grossed up %	67.0	5.4	5.5	12.8	5.0	4.4	100*	

(Note that these costs are based on a larger sample than those for additive costs since more than 100 respondents supplied labour costs but not associated, Qu 26, costs; * the percentages have been rounded; ** this total includes the special samples and those where size was unknown, as well as the regular size bands)

Chart 4.1 displays similar information, this time in terms of shares of cost per employee. Thus:

- the share of routine PAYE and NI, of end of year operations and of audits in labour costs per employee decreases across size bands
- the share of SSP/SMP in labour costs per employee increases with size to over 20% of the total for the largest employers
- the share of benefits-in-kind in labour costs per employee is largest for medium sized employers (500-999).

Chart 4.1 Labour Cost per Employee by Function and Employment



It is likely that the costs of carrying out PAYE and NI, end of year work and audits all have a substantial fixed element in them, together with scale economies, so that the cost per employee falls quite rapidly. The extent of scale economies is explored below. Whether there are scale economies available with respect to SSP/SMP or to P11Ds remains to be established.

4.2.2 As well as labour costs per employee table 4.1 shows, in the two bottom rows, the grossed up costs of carrying out these activities. It can be seen that about 80% of costs are attributable to routine PAYE/NI and end-of-year work and that SSP/SMP, P11D and audits each account for about 5%. Total grossed up labour costs account for about a half of additive compliance costs. The category "other" commonly includes employees' queries, telephone enquires and preparation. It sometimes included Child Support Agency work (which should strictly have been excluded), sometimes revealed misunderstanding (e.g., the inclusion of VAT) and in a few cases (where 100% was allocated to "other") indicated that all the relevant work was done by an accountant or book-keeper. The over-estimation of grossed-up compliance costs due to inappropriate items under "other" is likely to be well below 1%.

Associated costs

4.3 Costs other than labour costs (referred to here as associated costs) account for about half of the total. Qu 26 asked employers to give estimates of the following costs "for activities specifically associated with PAYE, NICs, SSP and SMP":

computer software	tax adviser's fee
payroll bureau charges	other current costs
additional equipment, hardware etc.	additional office space, lighting

Though these estimates are probably less reliable than labour costs, because employers had genuine difficulty in separating out PAYE related costs from others, they highlight an important element in total compliance costs. They are summarised (for 955 cases) in table 4.2 .

- the share of advisers (usually accountants) in total associated costs is dramatically higher for small employers
- the share of software rises up to the 500-999 band, pauses (presumably because of the use of bureaux) and then continues to rise.
- the shares of bureaux, advisers and software between them make up a fairly steady 60-70% of associated costs
- the share of equipment (mainly hardware) rises steadily up to nearly 10% of associated costs for the largest employers

Table 4.2 Percentage components of associated costs 1995-6.

	software	adviser	bureau	current	hardware	overh'd	mean £
non-UK	35.0	15.5	15.9	30.5	2.9	0.0	695
gov	25.0	17.7	6.5	30.5	4.1	16.2	7688
1-4	5.1	64.8	2.7	21.2	1.4	4.8	432
5-9	9.8	54.9	8.2	19.7	1.8	5.5	562
10-49	20.9	36.4	11.0	20.8	3.9	6.9	958
50-99	26.7	15.7	26.3	19.8	4.8	6.8	2061
100-499	28.2	9.3	26.5	22.0	7.9	6.2	4210
500-999	22.2	7.0	17.2	42.6	6.0	5.1	12802
1000-4999	28.8	5.7	32.8	20.1	7.3	5.2	24271
5000+	40.4	1.4	18.6	21.6	9.3	8.7	33424
unknown	0.0	66.7	0.0	11.1	0.0	22.2	130
total %	20.9	29.7	17.3	21.1	4.5	6.6	(100)
mean £	1218	452	1380	624	370	366	4410

Disaggregation of "reported costs"

4.4 Employers in the pilot study had been reluctant to split the hours spent on PAYE and National Insurance as they are largely joint operations. For that reason employers in the main sample were not asked to make that distinction in Q25 (which related to time allocation). They seemed to be willing to do so in the more impressionistic Q 29b which asked for a breakdown of reported costs into PAYE, NI and SSP/SMP (the latter together). The results are reported in table 4.3 and chart 4.2, derived from appendix A1, table 3.26.1. National Insurance costs were reported as approximately two-thirds of PAYE costs for small employers rising to three-quarters for large employers. The *prima facie* evidence of these tables again seems to indicate economies of scale for PAYE and for NI. In the case of SSP/SMP average costs per employee *across all employees* remain relatively constant at around £2 to £5 for all levels of employment. However, whether there are scale economies per SSP/SMP case is discussed in 4.5.2 below.

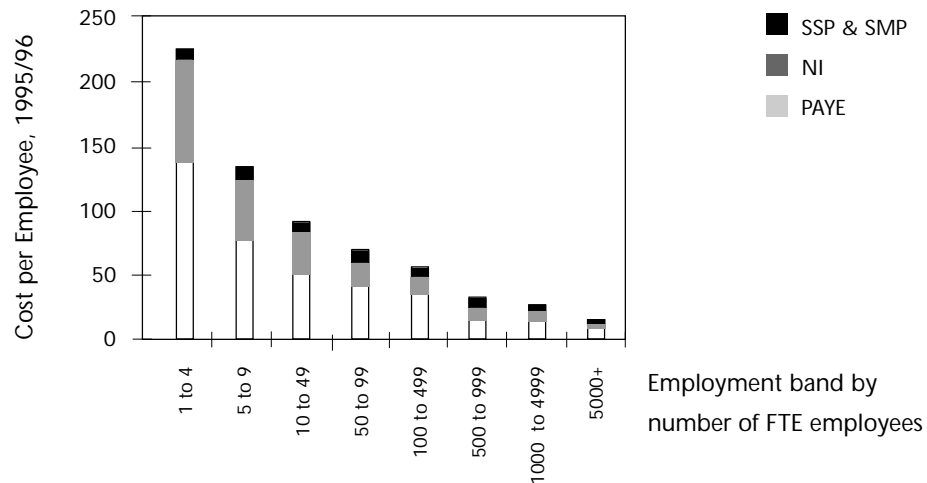
Table 4.3 Mean reported cost per employee by function and employment and grossed up costs (£) 1995-6

Employment band	PAYE	NI	SSP & SMP
1 to 4	132.05	93.91	3.49
5 to 9	76.00	52.71	5.69
10 to 49	51.57	34.70	4.76
50 to 99	35.13	23.61	5.92
100 to 499	27.11	18.42	4.98
500 to 999	13.99	10.76	5.20
1,000 to 4,999	8.22	6.68	3.11
5,000+	2.58	2.01	2.03
grossed up £000s	652,283	461,730	102,001
grossed up %	53.6	38.0	8.4

(The number of cases where reported costs could be disaggregated was 1,007 and the grossing up exercise includes the "special" samples and those where size was unknown).

Table 4.1 lumped PAYE and NI together for reasons already explained. Table 4.3 separates them. The main difference between them, already discussed in chapter 3, is that the “reported” costs split gives a higher figure for SSP/SMP than the additive costs split: 8.4% compared with 5.4% (table3.3). On either basis it is safe to say that activities associated with PAYE and NICs account for well over 90% of the compliance costs measured in this study.

Chart 4.2 Reported Costs (Q29a) per Employee by Function and Employment



Costs per SSP/SMP case

4.5 The discussion in 4.2 and 4.4 above related to cost per employee, not to cost per case. Evidence of the average cost per case from both stages 2 and 3 is summarised in table 4.4. This is drawn from **Appendix C**, tables SSP 4 and 5 and SMP 2 and 3.

Table 4.4 Average cost per SSP/SMP case (£) 1995-6

size band	SSP/SMP stage 2	SSP stage 2	SMP stage 2	SSP stage 3	SMP stage 3
whole sample	45	40*	85*	35*	
1-9	43	39	64	26	
10-49	53	43	171	91	
50-499	54	26	175	19	34
500-4999	30	39	230	20	26
5000+	15		26	11	3
cases	600	177	63	38	23

* population weighted averages.

The stage 2 questionnaire asked only for costs of SSP and SMP together so the stage 2 estimates are based on employers reporting *only* one or the other. The evidence on SSP from across stages 2 and 3 is broadly consistent (see appendix C) except for certain size categories. The evidence on SMP is much less reliable and should be used with care since numbers of cases were low and standard deviations high. In principle the stage 3 evidence should be sounder than that of stage 2 in that it was based on detailed discussion: interviewers’ impressions, however, were

that respondents had great difficulty in cost estimation and, in any case, the number of observations was far smaller than in stage 2. More importantly there was no stage 3 evidence for payrolls with less than 50 employees. Where there were inconsistencies the evidence of stage 2 is therefore preferred, though it is puzzling that some employers reported SMP cases but no SSP cases. A multiple regression analysis of a "composite" SSP/SMP case (as in column 1 of the above table) suggests an average marginal cost of approximately £47 per case. This figure is a gross figure in that it has to include the "knock-on" compliance costs of any replacement. Regression analyses were also carried out separately for SSP and for SMP. For details please see **chapter 4A**, regressions R3(S), R3(M) and R4.

Compliance costs and payroll technology.

4.6.1 Most aspects of an organisation and of its staffing have to be taken as given as far as the payroll operation is concerned. Payroll technology is different in that it is a matter of choice: organisations are, in principle, free to choose manual methods, personal computers, a specialist bureau or a mainframe for their payroll operations and free to choose to submit their returns on standard documents, on substitute documents, on disk or on magnetic tape. The method (or methods) chosen will depend on the size and composition of the payroll. A very small employer with a simple payroll will have to consider whether to use a computer or stick to manual methods. A large employer will have to consider whether to switch to a bureau or to stick to using a PC. One would therefore expect to find organisations in different circumstances using different methods. A simple way of beginning to analyse the choices made is to see how compliance costs per employee vary by size band and employee record type (table 4.5).

Table 4.5 Cost per employee by employment and record type (£) 1995-6

size band	manual	adviser	desktop PC	main frame	bureau	more than one
1 to 4	216.95	309.11	226.08			495.98
5 to 9	118.10	151.63	200.35			165.13
10 to 49	77.49	149.63	81.42	96.09	78.08	110.06
50 to 99	*94.27	*58.63	46.24	62.16	73.88	57.19
100 to 499	*17.88		27.62	31.62	56.32	46.83
500 to 999			26.66	27.74	17.79	32.48
1,000-4,999			26.20	18.31	9.30	42.68
5,000+				*7.72	*9.42	4.34
N	181	27	200	51	69	266

4.6.2. The following observations may be made on the basis of this and related data.

- The regressive pattern of compliance costs is confirmed across all record types (ignoring the asterisked cases where there are 5 or fewer observations).
- The "adviser" cases refer to accountants / tax advisers and are mainly relevant to small employers.

- manual systems still appeared to be the cheapest option for small employers: almost all of the employers using solely manual systems (96%) were small (below 50 employees).
- desktops were the cheapest option for the broad middle band of employers (between 50 and 500 employees): 80% of employers using solely desktops were in this band.
- bureaux began to compete very well for payrolls of over 500: the use of a mainframe also becomes competitive with PCs at this level.

Table 4.5 makes possible a provisional identification of least cost payroll technologies for the various size ranges (table 4.6).

Table 4.6 Provisional designation of least cost payroll technologies

size band	least cost system
1-4	manual
5-8	manual
10-49	manual/pc
50-99	pc
100-499	pc
500-999	bureau
1,000-4,999	bureau
5,000+	mainframe

Manual systems seem still to be the cheapest option for employers with fewer than 10 employees but at somewhere between 10 and 50 employees PCs become cheaper. It would be remarkable, however, if the size bands adopted in this study were to coincide with the bands over which it was efficient to use a particular technology. Estimates of these bands are attempted below.

Least cost payroll techniques

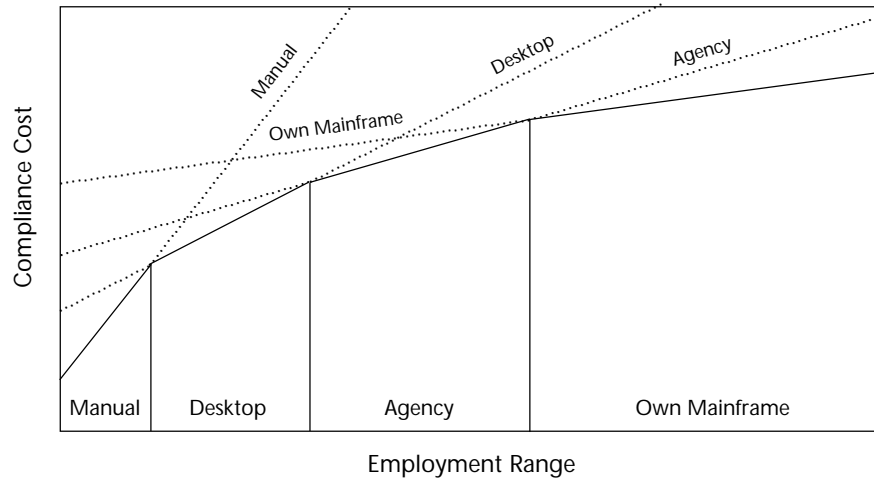
4.6.3 In order to analyse the choice of payroll technology the following simple "model" has been used. Given the degree of complexity of the payroll there will be several techniques available, for example, a manual system, desk top computer, use of a bureau and own mainframe. To illustrate the approach, suppose that only these four methods are available.

In Chart 4.3 each method has a fixed cost and a cost that varies with the number of employees on the payroll: for simplicity the variable cost is shown as a straight line. Manual methods have the lowest fixed cost but the highest variable cost. Use of own mainframe has the highest fixed cost but the lowest variable cost. The other methods lie in between. The least cost curve is an *envelope* of these linear cost curves and traces out the most efficient method for each employment size. This framework has several useful implications.

- The segmented envelope curve indicates that average compliance costs per employee fall as one moves from smaller to larger employers because of spreading overheads and/or because of switching techniques.

- There will be a number of switch points at which one system becomes more cost effective than another.
- The superiority of one system over another cannot be judged independently of size range.

Chart Payroll Technology: an envelope diagram



4.6.4 A rough estimate was made of where these switch points might have been in 1995-6 by using a regression analysis in which compliance costs are “explained” by size of payroll and a constant term. Since only one explanatory variable, employment, was used one would not expect a large proportion of the variation in compliance costs to be explained. This turned out to be the case for manual and mainframe users but the proportions explained for bureaux and PCs were quite high (see final column). The results were slightly unexpected in that bureaux were unambiguously more expensive than mainframes except in the case of employers who had switched over to a bureau.

Table 4.6. Fixed costs and marginal costs under different payroll technologies (£) 1995-6

payroll technology	fixed cost	cost per employee	R squared
manual	178	60.0	0.16
pc	971	26.7	0.42
mainframe	3094	7.5	0.13
new bureau	3718	5.0	0.46
bureau	3803	8.8	0.47

Each payroll technology is represented by a straight line and their intersections give the switch points at which it is cost-effective to “move up” to a higher technology. These intersections are as follows:

Table 4.8 Switch-points (1995-6)

Intersecting pair	employee intersection point
manual/pc	24
pc/mainframe	108
mainframe/new bureau	250

Table 4.8 implies that:

- Users of manual systems with more than 24 employers should, in 1995-6, have considered switching to PCs if they already have them for other activities.
- users of PCs with more than about 100 employees should, in 1995-6, have considered switching to a mainframe or bureau. However, this figure is substantially below the switch point suggested by table 4.5 and is probably an underestimate.
- (with somewhat less confidence) users of mainframes with more than 250 employees should consider switching to a bureau.

4.6.5 There is some additional evidence from regression analysis of the possible cost savings attributable to different payroll technologies (see equation R1 in **chapter 4A**). Taking the use of a PC as the norm, “dummies” were added for employers using only manual methods, only mainframe or only a bureau. The manual dummy was not statistically significant but the use of a mainframe or bureau seemed to reduce compliance costs per employee by about £9-10 per annum. This does not necessarily mean that employers using other methods are failing to choose the least cost technology appropriate to their own circumstances, merely that when these technologies are cost-effective they reduce costs by these amounts. The regression analysis strengthens the impression from table 4.6 above that some employers might be able to achieve significant savings by switching systems. Almost invariably this will be in the direction of a “higher” technology.

Reasons given for switching technology

4.7. The evidence from the postal questionnaire is that about 10% of respondents had changed their systems recently and that the largest type of change was from manual to computer based systems. However, some of the changes proved to be rather unexpected and a small scale telephone investigation was carried out of the reasons for this. As a general rule and in the long run, employers may be expected to choose the least cost technology and are generally well aware of the potential benefits of change. They will, however, also take account of convenience and flexibility and the timing of any change may be very much affected by fortuitous changes in personnel. Some of the reasons given by respondents who seemed to have made unlikely changes illustrate this.

- **bureau to manual (74 employees).** One respondent switched from one bureau to another but experienced delay while waiting for a new permit number (from the Contributions Agency) for submission by magnetic tape. A more expensive manual system was therefore used for one year.

continued on next page

- **bureau to manual (21 employees)**. Falling staff numbers made existing bureau costs of approx. £2500 much too expensive.
- **bureau-to-desktop PC (652 employees)** The employer has two payrolls, one of 50 and one of approx. 1000 over the year. The latter has many joiners and leavers and the bureau introduced too many mistakes.
- **in-house mainframe to desktop PCs (5000+ employees)**. Changed mainly due to the inflexibility of having to deal with the computer department.
- **in-house mainframe to desktop PC (71 employees)**. Major changes in personnel would have meant learning an existing UNIX based mainframe system with non-standard software from scratch.
- **in-house mainframe to desktop PC (68 employees)**. The trigger was the setting up of a company pension scheme with PAYE software provided by the pensions company.
- **in-house mainframe to desktop PC (2000+ employees)**. The mainframe was very inflexible with small changes having to be negotiated through a computer department.
- **desktop PC to bureau (44 employees)**. Payroll work is sensitive and was formerly done by the more highly paid staff.
- **manual to desktop PC (4 employees)**. Their new financial manager is also a financial consultant who runs payrolls for about 200 employees altogether.

Submission arrangements

- 4.8. One would expect there to be a relationship between record type, (manual, PC etc.) and submission arrangement (standard or substitute documents, magnetic tape). This is indeed the case. The information in table 4.9 has been extracted from a larger table (see Appendix A table 3.18) to make it more readily comprehensible. It therefore includes 6 record types and only four submission methods (it omits cases where more than one record type or more than one submission type is used). As is to be expected manual methods (and use of advisers) are associated with standard documents, PCs with substitute documents and mainframes with electronic submission. This is confirmed in table 4.9 and also in the technical appendix. But the pattern is not universal. 45% of employers using PCs submit standard documents and 54% of those using mainframes submit standard or substitute documents. Table 4.10 shows substantial cost savings across all record keeping systems from using non-standard documents

Table 4.9 Number of employers by record type and submission method 1995-6

submission method/ record type	standard docs	substitute docs	magnetic tape
manual	326	6	2
desktop pc	112	122	13
mainframe	14	26	34
in-house software	8	8	5
bureau	18	29	37
adviser	34	6	1

The more sophisticated submission systems are inevitably associated with larger payrolls and some of these savings will be due to size rather than submission method. But table 4.10 suggests that if about a half of the 14.4% PC users were to change over from standard to substitute documents they could achieve cost savings of the order of 37%.

Table 4.10 Compliance Costs per Employee by Record Type and Submission Type (£) 1995-6, number of cases in brackets.

	mean cost	cost with standard docs	cost with substitute docs	cost with tape	cost with other electronic sub
manual system	142	174 (264)	74 (48)	36 (43)	7 (4)
pc system	89	117 (126)	74 (129)	48 (27)	14 (70)
mainframe (bought)	36	65 (12)	36 (13)	28 (38)	(1 case only)
mainframe (own)	59	96 (16)	50 (11)	23 (12)	(1 case only)
bureau	61	75 (27)	73 (37)	47 (53)	17 (3)
adviser	272	297 (79)	170 (15)	49 (15)	N/A

A multiple regression analysis of compliance costs.

4.9.1 The discussion which follows is primarily based upon equations R1, R2 and R3 in **chapter 4A**, which are restricted versions of the rather more general analysis provided in the technical appendix. It is explained in that chapter why it was thought desirable to approach the employment total in three different ways.

- R1 Total employment
- R2 Employment payment frequency
- R3 Employee composition.

Three further equations are used in respect of SSP/SMP.

R3 (S)	SSP
R3 (M)	SMP
R4	SSP+SMP

“Robust” conclusions from across the equations.

4.9.2. The following results held across R1, R2 and R3.

- marginal costs per full-time joiner were high (ranging from £73 to £77 per employee), strongly statistically significant and with large economies of scale. This is a very important result: the number of joiners is far and away the largest single determinant of compliance costs. In all three equations the number of joiners is very highly correlated with the number of leavers so the use of one or the other is sufficient. Alternatively use may be made of the flows in and out of the payroll (joiners plus leavers) which roughly halves the relevant coefficient (see **appendix E**). The impact of part-time joiners and leavers is not statistically significant.
- the impact of legal form was investigated by means of “dummy” variables weighted by employment, taking the limited company as the norm. These were significant for sole proprietorships and for partnerships. The additional costs per employee of sole proprietorship or partnership (ranging from £24 to £50 across the three equations) look rather high but the number of employees in these cases is generally small and the variables may be acting as proxies for size.
- use of an “adviser” pushes up compliance costs per employee (by £50 to £90 across the three equations). To some degree this will be a reflection of “complexity” not picked up elsewhere (see next bullet point).
- an attempt was made to capture “complexity” by using numbers of P11Ds and P9Ds and also the number of directors. Only the number of directors was significant (ranging from £413 to £479 across the three equations). This figure seems rather high but it is very likely that “number of directors” is also here serving as a proxy for other aspects of complexity.
- as described above, the impact of payroll technology was investigated by dummy variables representing each of the main methods with the use of PCs being taken as standard. This produced significant cost reductions from the use of a mainframe or bureau (approximately £10 per employee across all three equations).
- “dummies” for submission method were not statistically significant at the required level.
- among other variables which were put into the equations but were not statistically significant were dummies for seasonal variation, for the government sector and for “experience” of PAYE work.

The equations suggest that scale economies are due primarily to economies in handling joiners, to “dummies” on sole proprietorship and partnership at the lower end and to choice of payroll technology at the upper end. The fixed costs (significant in R1 and R3) and the costs per director are important for smaller organisations but become trivial when expressed per employee for large organisations.

Multiple regression analysis: monthly and weekly paid employees.

4.9.3. The usefulness of the regression method is illustrated here by taking the problem of monthly and weekly paid employees. It is expected that the compliance costs in respect of weekly paid employees will be larger than those in respect of monthly paid employees (other things being equal). But they are hardly likely to be as much as four times as large. Equation R2 (see 4A for details) can be used to estimate the effect of pay frequency. It is found that:

- the marginal compliance cost of weekly paid employees (approximately £18) is higher than that for monthly paid employees (approximately £14), though the ratio is only about 1.3.
- these figures are broadly in line with R1 where the marginal cost per employee is found to be approximately £14 but cannot be directly compared with the technical appendix where no figure is given for monthly paid employees.
- both are subject to significant but small scale economies. The monthly figure for marginal costs falls to £17.65 at 1000 employees and the weekly figure to £12. As in the other equations the really important scale economies are generated by the number of joiners.
- the marginal cost will be much higher for small employers as the dummies for legal form etc., have to be added in and much lower for very large employers as the cost savings from computerisation etc., have to be subtracted.

Summary of chapter 4

The composition of compliance costs

- labour costs account for approximately one half of compliance costs. About 80% of these costs are attributable to routine PAYE and NI operations and end of year work and SSP/SMP, P11D work and audits each account for about 5%.
- the share of routine PAYE and NI, of end of year operations and of audits in labour costs decreases across size bands while those of SSP/SMP and of P11D work do not.
- “associated” costs account for the other half of compliance costs. Between them the costs of bureaux, software and advisers (which are to some degree substitutes) account for 60-70% of these costs across all size bands.
- the compliance costs of PAYE and of NI are reported as splitting in the proportion 59:41.
- the proportion of compliance costs attributable to SSP/SMP is in the range 5.4% to 8.4%. The proportion rises to approximately 20% for the largest employers.

Choice of payroll technology and compliance costs

- the “least cost” method depends mainly on size. Manual methods still seemed to be cheapest (in 1995-6) for some of the smallest employers, PCs for the broad middle band of employers and mainframes or bureaux for the largest employees.
- the “switch points” between these technologies are difficult to calculate using linear regression analysis as there are wide cost variations within each size category. At 1995-6 prices, PC-based systems appeared to become cheaper than manual ones at about 25 employees and bureaux at a little over 100

employees. But the falling costs and increasing power of PCs are pushing these switch points out in both directions.

- the evidence from regression analysis (see chapter 4A) is that the savings per employee per annum from using a mainframe or bureau are approximately £10.
- on the whole employers will tend to use the least cost payroll technology but convenience and flexibility are also important (there is some adverse criticism of mainframes in this respect) and timing may depend very much on personnel.
- There are potentially large gains to be had from using substitute documents or electronic submission for all payroll types. 45% of employers using PCs still submit standard documents and 54% of those using mainframes still submit standard or substitute documents.

Chapter 4A

Regression equations of compliance costs on employment variables.

Introduction

The regression equations referred to in **chapter 4** are presented in more detail in this chapter. A more sophisticated analysis may be found in **appendix E**. It should be noted that there are potential problems associated with multi-collinearity. For example:

- NEWEMP is almost perfectly correlated with the sum of NMTHPAY, NWEKPAY and NOTHPAY (multiple R 0.99)
- NEWEMP is almost perfectly correlated with the sum of NCASUALS, NFTS, NPTS, NPENSION. (multiple R 0.99)
- NFTS is almost perfectly correlated with the sum of NMTHPAY + NWEKPAY *minus* NPT, NCASUALS, NDIR, NPENSION, NOTHER. (multiple R 0.99)

In this situation it is possible that the estimated coefficients may be “unstable”. There is no unique way of coping with the difficulty but the economic logic of the problem suggests that it would be useful to look at institutional and technological variables and their interaction with size (i.e., NEWEMP) as the basic regression (R1) separately from the effects of different payroll compositions (R2 and R3).

The method used was weighted least squares with each variable being divided by a power of the variance of the “source” variable, PAYEPAID which was not included elsewhere in the analysis. Statistically insignificant variables were progressively eliminated, leaving those reported in the tables.

In all cases the coefficients are in £s and relate to 1995-6.

Employment-based equation R1

This equation uses only the total figure for employment and does not attempt to distinguish between monthly and weekly pay, full time and part time employment etc. The number of directors is used instead of dummies for limited companies and plcs. Variables which proved to be insignificant at the 5% level (including number of P11Ds and a government sector dummy) were dropped except for the “adviser” dummy which proved to be significant in equation R3 below.

variable	coefficient	t-statistic	signif of t
newemp	13.91	8.73	.0000
sqnewemp	-.0002	-4.75	.0000
nftjoin	73.25	12.23	.0000
sqftjoin	-.041	-7.42	.0000
ndir	413.05	9.94	.0000
dumpart	43.47	4.92	.0000
dumsole	41.73	2.85	.0045
dumadvis	52.51	1.83	.0683
dumbur	-10.23	-2.98	.0030
dummain	-8.91	-2.80	.0053
constant	219.74	4.06	.0001

Diagnostics.

Multiple R = 0.77. R-squared 0.59.

Degrees of freedom 656+10. F = 94.03. Signif F = .0000.

Source value PAYEPAID. Power value 1.0. Log-likelihood function -6515.

Two illustrations of R1.

4.8.3 The equation is used to generate two illustrative cases

Illustrative case 1. A sole proprietor takes on a single worker.	
Total compliance costs given by the equation are (in £s):	
constant costs	219.74
sole proprietorship	41.73
joiner	73.25
employee	13.91
total	348.63
Illustrative case 2. A plc has 1000 employees, 4 directors and there are 200 joiners. Total compliance costs given by the equation are (in £s):	
employees (net of scale economies)	13,655
joiners@ £74.27 (net of scale economies)	13,018
directors @ £413.85 (no significant scale economies)	1,652
savings from use of bureau	10,225
constant	220
total	18,320
total per employee	18.3

These two illustrations show that this employment based equation “works” reasonably well across employers of different sizes and types.

Employees' payment frequency R2

This equation breaks the employment total down into weekly paid and monthly paid. The other variables are as in R1.

variable	coefficient	t- statistic	signif of t
nweekpay	18.27	7.96	.0000
nmthpay	14.28	6.90	.0000
sqweek	-.0011	-3.35	.0009
sqmonth	-.0003	-6.77	.0000
nftjoin	75.48	13.70	.0000
sqftjoin	-.0364	-7.68	.0000
ndir	439.91	10.82	.0000
dumsole	28.60	2.13	.0901
dumpart	24.86	2.13	.0335
dumadvis	76.59	2.73	.0066
dumbur	-10.19	-3.29	.0011
dummain	-10.08	-2.84	.0047
constant	90.25	1.51	.1307

Diagnostics

Multiple R = 0.82. R squared = 0.68.

Degrees of freedom (558 + 12). F = 96.68. Signif F = .0000.

Source variable PAYEPAID. Power value 1. Log-likelihood function = -5596.

Employee composition R3

This equation breaks employment down into full-time, part-time and casual employees. Otherwise it uses the same variables as R1 and R2 above.

variable	coefficient	t - statistic	signif of t
ncasuals	21.24	3.64	.0003
nfts	13.19	4.60	.0000
sqfts	-.0003	-1.87	.0621
npts	11.05	2.51	.0125
nftjoin	76.88	10.12	.0000
sqftjoin	-.040	-7.31	.0000
ndir	479.30	9.89	.0000
dumpart	43.90	5.47	.0000
dumsole	52.19	4.78	.0000
dumadvis	87.35	3.04	.0025
dumbur	-10.04	-3.00	.0028
dummain	-10.39	-3.24	.0013
constant	130.02	2.36	.0179

Diagnostics.

Multiple R = 0.81 R squared 0.65.

Degrees of freedom (496+12). F= 76.16. Signif F .0000.

Source variable PAYEPAID. Power value =1. Log-likelihood function = -4952.

SSP R3 (S)

This equation removes NCASUAL and NPTS and inserts NSICKEMP instead.

variable	coefficient	t- statistic	signif of t
nfts	11.94	4.35	.0000
nftjoin	75.58	12.79	.0000
sqftjoin	-.035	-6.23	.0000
ndir	372.52	8.76	.0000
nsick	24.55	2.41	.0163
sq sick	-.008	-3.32	.0009
dumadvis	52.71	1.89	.0595
dummain	-6.17	-1.89	.0603
dumbur	-9.27	-2.69	.0074
dumsole	44.50	3.15	.0017
dumpart	47.45	5.51	.0000
constant	223.90	4.24	.0000

Diagnostics.

Multiple R = 0.78. R squared = 0.61.

Degrees of freedom (614 + 11). F = 88.7. Signif F = .0000.

Source variable PAYEPAID. Power value 1. log-likelihood function = -6068

SMP (R3M)

In this equation the variable FTS is removed from equation R3 and NMATEMP inserted. Insignificant terms are then dropped.

variable	coefficient	t- statistic	signif of t
nftjoin	96.04	16.66	.0000
sqnftjoin	-.032	-6.26	.0000
ndir	537.80	13.47	.0000
nmatemp	120.94	3.15	.0004
dumbur	-9.63	-2.55	.0001
dumsole	58.04	3.83	.0001
dumpart	47.73	5.25	.0000
constant	195.99	3.57	.0004

Diagnostics

Multiple R = .77. R squared = .60

Degrees of freedom (588 + 7). F = 124.9. Signif F = .0000

Source variable PAYEPAID. Power value 1. Log-likelihood function -5823

SSP+SMP R4

The above equations are all based on employment measures. R4 omits NEWEMP (and its component parts) and, instead, exploits the power of the NFTJOIN variable. The composite variable NSICKMAT (the sum of SSP and SMP cases) is included.

variable	coefficient	t- statistic	signif of t
nftjoin	81.16	13.31	.0000
sqftjoin	-.026	-5.25	.0000
ndir	449.30	10.72	.0000
nsickmat	46.96	6.79	.0000
sqickmat	-.009	-4.64	.0000
dumbur	-9.28	-2.66	.0080
dumsole	57.73	3.90	.0001
dumpart	48.96	5.47	.0000
constant	223.90	4.24	.0000

Diagnostics.

Multiple R = 0.79. R squared = 0.625

Degrees of freedom (568+8) F = 118.39. Signif F = .0000.

Source variable PAYEPAID. Power value 1. Log-likelihood function = -5615

Summary of chapter 4A

- the average marginal compliance cost of an employee was of the order of £14 per annum in 1995-6.
- the average marginal cost of a full-time joiner was of the order of £73 with significant and large scale economies
- use of an "adviser" was associated with significantly higher compliance costs.
- "dummy" variables for legal form showed high and significant extra compliance costs for sole proprietors and partners
- use of a mainframe or bureau was associated with a reduction of the order of some £10 per annum per employee.
- the compliance cost per director was high and strongly significant at over £400 per director. This figure was probably also proxying for other aspects of complexity.
- on the basis of the regression analysis the compliance costs for a sole proprietor, taking on a single worker, were of the order of £350.
- the marginal compliance cost associated with monthly employees was of the order of £14 per annum and that for weekly paid employees of the order of £18, both subject to statistically significant but small scale economies.
- the marginal compliance costs associated with casual, full-time and part-time staff (less than 16 hours a week) were of the order of £21, £13 and £11 respectively per annum, again with significant but small scale economies for the latter two.
- the marginal compliance cost of a composite SSP/SMP case were of the order of £47
- the marginal compliance cost of an SSP case could have been as low as £24 and that of an SMP case as high as £120. However, these estimates are very tentative and should be treated with caution.

Chapter 5

Identification of Hotspots

Introduction

- 5.1 One of the objectives of the research was to identify aspects of the current PAYE and NI system which are particularly expensive in terms of their compliance costs, and to suggest ways in which these costs might be reduced (see 1.6 (c) and (d)). These are here referred to as 'hotspots'.

Questions included in Stages 2 and 3 of the project

- 5.2.1 Both the Stage 2 postal questionnaire and the Stage 3 face-to-face interview schedules contained questions which were intended to allow interviewees to identify areas associated with relatively high compliance costs. For **Stage 2** these questions were:

Stage 2 Questions 27 and 28:

"Questions about additional costs and problems and your views of PAYE and NICs (including benefits and expenses, SSP and SMP)"

- 27a Are any particular aspects of your PAYE and NI administration of this payroll scheme which REGULARLY give rise to high costs?
- 27b If YES, please specify which aspects give rise to high PAYE and NI administrative costs.
- 28a Have there been any UNUSUAL difficulties with administering PAYE & NI in the 1995/96 tax year?
- 28b If YES, please describe them briefly, and if possible estimate any costs incurred.

- 5.2.2 **Stage 3.** Questions were also included in the specialised sections of each of the three types of Stage 3 interview. In the **type A** interviews, covering questions on PAYE and NICs, there were opportunities for interviewees to comment on 'options for change' and the impact of self-assessment. Similar questions about the impact of changes were included in the **type B** interviews, dealing with SSP/SMP. In the **type C** interviews, which concentrated on benefits and expenses, detailed questions were also included about the £8,500 limit for benefits, the use made of dispensations, hotspots associated with particular benefit calculations and changes brought about by the introduction of self-assessment. Please see **appendix F** where the questionnaires are reproduced in full.
- 5.2.3 Given the scale of the stage 2 postal survey, the total number of comments is rather small (169 respondents made 244 comments and 116 of these are

elaborations or explanations of earlier points, comments on the survey or comments that there were no problems). In table 5.1 the “relevant” comments are highlighted: there are 128 of these, relating to high costs or hotspots. This might be taken to mean that the scale of the problem is small. Such a conclusion would be rash, however, since the relevant question was an optional question at the end of what was already a rather long questionnaire. The questionnaires have, in fact, proved a useful source of information about areas of concern. A classified table of the main types of comments received is set out below.

Table 5.1 Analysis of comments given on final page of postal questionnaire.

Topic of comment	No.
Further explanation of earlier answers	62
Reasons for some questions being hard to answer	24
Reasons for costs being low	22
Benefits/P11Ds comments	19
SSP	14
Criticism of PAYE documentation	12
SMP comments	11
Merge PAYE and NICs	11
Comments about software	10
PAYE and NICs are a burden on employer	10
Simplify the system	9
Critical of Inland Revenue	8
Record keeping and submission	8
NICs comment	5
Comments on the survey	5
Critical of DSS	4
Comment about end-year procedures	3
No problems	3
Difficult to keep up to date	3
Costs are high because of PRP, cars, travel, entertainment	1
Problems with casuals	1
Problems with money purchase scheme	1
Comment on Helpline	1
Comment on self-assessment	1

5.3 The stage 3 interviews were categorised by size bands in terms of numbers of employees as shown in Figure 5.2. Employers’ comments are organised in this chapter by size of payroll since it became clear that the principal concerns of very small and very large employers were different. For example, on benefits-in-kind, “learning the rules” was very time-consuming for small employers whereas dealing with P11Ds was very time-consuming for large employers. And the CA’s compliance activity is mostly geared to the bottom end of the employer size distribution. Employers’ comments are drawn from all three sets of interview schedules. The comments on SSP/SMP are drawn from Appendix C (sections 5 and 9) where they were organised by topic.

Table. 5.2 stage 3 interviews completed

Type of interview	No.	Micro*	Small*	Medium*	Large*	Very Large*
PAYE & NIC (A)	103	11	21	30	27	14
SSP	28	7	6	11	3	1
SMP	39	1	2	16	18	2
Joint SSP/SMP/PAYE	28	4	5	12	5	2
Benefits	87	11	24	26	15	11
Joint Benefits/PAYE	25		4	9	9	3
Overall Total	310	34	62	104	77	33

*as defined in Figure 5.3 below.

Table 5.3 Stage 3 size-bands.

Description	No of employees in payroll scheme
1. Micro	1-9
2. Small	10-49
3. Medium	50-99
	100-499
4. Large	500-999
	1,000-4,999
5. Very large	5,000+

The final sections of the chapter summarise the main ‘hot spots’ identified and the suggestions for change that have been made for reducing their associated compliance costs. Each section is prefaced by a box giving the national totals of payroll for each size category (see **appendix A2**, table 24).

Micro-payrolls (1-9 employees)

<p>1-4 employees Total payrolls: 627,914. Share of total compliance costs: 33% . Average compliance cost per employee: £288 per annum. Share of routine PAYE and NI work in compliance labour costs: 72%</p> <p>5-9 employees Total payrolls: 154,370. Share of total compliance costs: 12%. Average compliance cost per employee: £143 per annum. Share of routine PAYE and NI work in compliance labour costs: 72%. Number of stage 3 interviews carried out in these categories:34 .</p>
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- 5.4.1 In some cases, the payrolls sampled in this category were actually part of a larger organisation, or a group of organisations, with multiple payrolls. In such instances, the views expressed have been treated with some caution as they are not from true ‘micro’ organisations. The micro payrolls that were just one part of a multiple payroll situation often dealt with the PAYE/NIC calculations for directors or higher-paid employees and had been set up separately for confidentiality purposes. For a

fuller discussion of the reasons for and costs of this please see **Appendix D** on multiple payrolls.

5.4.2 Those responsible for 'stand-alone' micro payrolls have very specific problems. In particular, many of these respondents said that they would appreciate more proactive help from the Inland Revenue. This was particularly true in the case of relatively new employers. Very often the payroll was operated by a relatively inexperienced individual. This is consistent with the finding in chapter 3 that inexperienced new employers have very high compliance costs. The average experience of the staff running micro payrolls who were interviewed for Stage 3 was 3.4 years and 48% had been involved in payroll work for less than 2 years. Given that the research samples used had few new (less than 2 years old) organisations in them, this may well be an underestimate of the true level of relative inexperience in terms of those working in micro firms.

5.4.3 As a consequence of this inexperience and the anxieties arising from it, there were genuine 'cries for help' from many of those visited:

"I would welcome some on-site training here in the office and would like frequent audit visits to tell me if I'm going wrong. Our accountant tried to tell me what to do but I ended up completely baffled! I lie awake at night worrying that I might have got things wrong and now the papers are full of how this self assessment thing might make matters worse."

"I have found that, because we are such a small business, there is so much that I need to know and find out for such a few people. This amount of knowledge would probably suffice for a much greater payroll."

"For a small company the tax and NI is very confusing and difficult to calculate."

"I personally find the administration of the payroll an absolute nightmare, especially at the end of the year. I find the whole structure to be so complicated and unfair to an employer that it is one of the few things in life that angers and frustrates me."

These sorts of comment give colour to the view that there are probably significant "psychic" compliance costs which cannot be captured adequately in the measures used in chapters 2-4 above. The second comment picks up the important finding from chapter 4 of high "fixed" compliance costs which must bear heavily on the small employer.

5.4.4 The micro payroll was often run by one of the owners and owners' time was frequently undercosted, being described as 'unpaid work' undertaken outside of normal office hours and at home!

"For me, it is about 20 years or so since I first had anything to do with PAYE and NIC. Since then, all of the difficult bits like SMP and SSP and more than one

reduced rate of tax have been introduced and are very painful indeed - it is the only part of my duties that I find to be a total bind. Ours is a very small residential home for the elderly. I feel that we are quite unsuitable for inclusion in this review since it is entitled 'survey of cost to employers' and we are all voluntary so that there are no costs."

"I do my books weekly at no cost to the business. PAYE is also done outside of business hours so there is no extra cost."

"The administrative cost here is very low because most of the payroll is done voluntarily."

In these cases compliance work was obviously burdensome but was valued as being at or near zero. As explained in chapter 3, a check on the distorting effect of this was carried out using supplementary New Earnings Survey data.

- 5.4.5 Set-up costs of PAYE were often cited as relatively expensive by those responsible for micro payrolls and 68% of the employers in this category reported using a manual payroll system. 52% said that they had not considered using computer software to help them; several respondents commented that they did not know that such software was available. One respondent suggested that,

"Because of the work involved with PAYE and NICs I no longer directly employ any staff ... should circumstances change I feel that the tax office should provide suitable computer software free of charge as most small businesses now use computers."

This represents rather an extreme case but a significant number of employers mentioned the desirability of help (even if not free help) with software.

- 5.4.6 This awareness of costs was illustrated by the responses to questions about whether the NI lower earnings limit threshold influenced the employment decision. In both Stages 2 and 3 of the research this effect was most significant in the case of micro payrolls.
- 5.4.7 Very little help was received from agents in determining how to minimise payroll costs. This was despite the fact that most of the employers interviewed used professional accountants' help to prepare their financial accounts and often paid substantial fees for this work.
- 5.4.8 There were many complaints that the literature received was largely irrelevant to the employer in question and was hard to follow:

"Inland Revenue documents are far too lengthy and numerous for companies of my size to read and understand."

"The amount of 'paper' received annually requires considerable sifting through to retrieve those items relevant to this Council."

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- 5.4.9 Many of the employers in the micro payroll category had part-time and/or casual workers. Respondents stated that this gave them particular problems in dealing with code changes necessitated by multiple employments. Four respondents asked for the simplified employers' pack to be amended so that it made it clear how to handle staff with multiple employments.

"Problems often arise with short term jobs. Casuals are a problem too in terms of obtaining their P45s, true names, addresses, national insurance numbers and their unwillingness to sign P46 forms etc. If the threshold were raised, a lot of these people would fall out of the system and the problem would be solved!"

This comment, and others like it, confirms the importance of casual employees and joiners and leavers in raising compliance costs.

- 5.4.10 Only 34% of the overall number of Stage 3 micro-payrolls that were sampled claimed to be providing Benefits-in Kind. However, there were a number of occasions where interviewers commented that respondents clearly did not understand what benefits were and where details were not being declared, or were wrongly declared. This was particularly so in terms of private telephone bills and mobile phones. Expense payments also went unrecorded on a large number of occasions, although there was little evidence that this was deliberate. The overall picture was of payrolls being operated with insufficient understanding of what was required, causing considerable worry for those involved and a loss of revenue to the tax authorities.

- 5.4.11 These employers have little experience of either SSP or SMP and find it difficult to understand:

"SMP is way too complex for small companies to get their heads around."

"Simplify manuals and documents."

They find it more difficult than PAYE:

"Basic operation of PAYE and NI is very straightforward provided every one of your employees' affairs are not complex. Any deviation from the norm i.e., into SSP etc., then takes time to read all the complex regulations to decide whether SSP recovery applies. Many small employers who tend to do their own payroll end up not trying to recover SSP and SMP or NIC compensation as they feel the time and effort does not justify the return."

They object to the fact that it cannot be reclaimed (except under the PTS about which many of them were poorly informed). Under the Percentage Threshold Scheme employers are able to reclaim the excess of sickness benefit payments over and above 13% of NI contributions in any month.

"Very unfair that SSP cannot be claimed back."

“Did not know about Percentage Threshold Scheme.”

“Percentage Threshold Scheme should be given more publicity.”

Small payrolls (10 to 49 employees)

Total payrolls: 143,471
Share of total compliance costs: 22% .
Average compliance cost per employee: £90 per annum.
Share of routine PAYE and NI work in compliance labour costs: 73%
Number of stage 3 interviews carried out: 62.

5.5.1 Within the small payrolls sampled there was again a significant difference between the views of those interviewed on behalf of ‘stand-alone’ small enterprises and those whose payrolls were just one in a group or other multiple payroll situation. The average experience of those operating the small payrolls and interviewed for Stage 3 was 8 years; this was over double that of those involved with the micro payrolls. In general, these interviewees tended to be much more aware of what was required of them to deal with PAYE and NICs. In 45% of the Stage 3 interviews they were described as the organisation’s bookkeeper or accountant. In no cases (as expected) did they have specialist tax knowledge.

5.5.2 A large number of interviewees responsible for small payrolls ‘complained’ about their compliance costs:

“The government has consistently increased the cost and work load on small business simply because such costs are ‘hidden’ from the voting public and there are few, if any, repercussions. The changes introduced such as small companies having to pay out sick pay without compensation is a situation that even the Mafia would not suggest. The increase in costs and burdens on industry has been difficult enough but the new penalties for failure, either inadvertent or otherwise have been horrendous.”

5.5.3 Respondents with small payrolls still underestimated the value of time where compliance work was done ‘voluntarily’:

“The costs to our company at the present time are relatively low as one of our shareholders provides us with a free service re-payroll calculations...”

“Like many small, family businesses, the burden of bureaucracy and carrying out work on behalf of Government agencies falls on owners and directors. Their time and costs cannot be measured as it is usually dealt with in hours outside normal work...”

5.5.4 Many of the respondents in this size band continued to express an urgent need for more proactive advice from the Inland Revenue. Educational visits were much appreciated and 14 Stage 3 interviewees from the small payroll category

specifically asked for these to be made more regularly. It was also suggested that there might be 'drop-in seminars or advice centres specifically aimed at the needs of small firms.' The individual who made this suggestion presumed that these services would be provided free of charge; 6 other small payroll interviewees commented that their organisations could not afford the fees charged for most of the payroll courses they were notified of (provided by the private sector). It was noticeable that many of these employers were keeping a close eye on costs; 5 small payroll respondents asked for the Inland Revenue to always provide reply-paid envelopes.

- 5.5.5 The literature received (annual pack) was generally acknowledged to be 'getting better', although several respondents in this category still found it 'daunting for the non-specialist'.

"All the guides issued by the Inland Revenue etc. have the disadvantage of being written by professionals who are conversant with the subject matter. They failed to understand that people responsible for implementing the instructions are, in most companies, not professional accountants. Civil Service English can be virtually incomprehensible to the lay person. The wording of guides to PAYE and NI should be much simpler."

In this respect small and micro employers were sharing the same concerns.

- 5.5.6 Six interviewees asked for updates to be made available on disc/CD ROM. Those responsible for the payrolls in this small size category exhibited a marked shift away from using manual systems and towards using desktop computers. Sage was easily the most popular software provider. Four interviewees admitted that they did not pay (or receive) annual updates for their software; in other words, they could have been operating their payrolls using out-of-date bands and rates. In each of these cases they took the view that

"it doesn't matter because the Revenue sorts things out for us at the end of the year".

However, the analysis of stage 2 (see chapter 4) suggested that almost all employers do keep their software up-to-date so the problem is probably not quantitatively significant. Several of the other payrolls using software (12%) stated that they did not pay for continued access to a helpline.

- 5.5.7 Coding issues continued to be cited as causing difficulties and as being expensive to sort out in terms of the time taken. This was particularly so in cases where individuals had multiple employments and for those employees on K codes. On three occasions interviewers commented that they had realised that the most recent coding notices were not being applied for some employees; in two of these cases this was because an employee had queried the change and so it had been 'set aside' while waiting for a response from the Inland Revenue.

5.5.8 Company cars were the most popular BIK provided by small payrolls, with mobile phones and health care coming second and third respectively. Ten respondents cited high compliance costs associated with the determination of car prices. A significant number of those interviewed did not know what dispensations were, but felt that they could benefit significantly from these when this was explained. Many of those who had received dispensations were very grateful and reported significant amounts of time/costs saved as a result.

5.5.9 Several of those dealing with small firm payrolls stated that they would appreciate Inland Revenue visits specifically to ensure that they had adequate record-keeping systems in place in respect of expenses paid. The following comments were typical of those made:

“Dispensations are a godsend; our costs would treble without them. But why are there so many bands for motor mileage?”

“Dispensations save 50% of the time I would otherwise have to spend; I have asked the local Inland Revenue to come and check that all is well.”

“I have only just found out about dispensations; I wish someone had told us sooner.”

Clearly, dispensations are good news and are compliance cost reducing.

5.5.10 The vast majority of small payroll respondents were complimentary about their dealings with Inland Revenue staff. Five stated that they would appreciate one named point of contact in the Revenue; someone they could build up a relationship with who could ‘come out and get to know our business’ in order to provide the maximum amount of help.

5.5.11 Several interviewees dealing with small payrolls objected to the time taken to get replacement stationery and complained that they could still be:

“passed from pillar to post without getting anywhere”

“When PAYE, benefit-in-kind national insurance etc. duplicate books were needed we phoned an advertised number only to be put through to approximately 8 other people at 4 other numbers which was not only time-consuming but did not get the result in terms of obtaining the books required.”

5.5.12 Comments on SSP by small employers again related mainly to complexity and to requests for simplification.

“SSP is a major problem: very complicated, with too many entitlement conditions.”

“Weekend pay. Hard to marry month to month calculations using different months and different tables.”

There were complaints about the literature

“Too much jargon in DSS manuals.”

“Gee’s is in plain English, no jargon” ,

and about telephone help:

“Helpline should answer the phone.”

“Local office treat you like a criminal.”

Again there were complaints about the PTS:

“Very unfair that SSP cannot be claimed back.”

“The Percentage Threshold Scheme is a pain in the neck - would be much easier as a percentage of gross wages.”

There were requests for better information for employees

“Employees don’t understand when company sick pay runs out and they get SSP only.”

“There should also be an employees’ leaflet” .”

There was relatively little experience of SMP.

“SMP is very infrequent but there is a very good DSS booklet.”

“Would like more simple calculations for examples.”

Medium payrolls (50 to 499 employees)

50-99 employees

Total payrolls: 18,656.

Share of total compliance costs: 6% .

Average compliance cost per employee: £59 per annum.

Share of routine PAYE and NI work in compliance labour costs: 69%

100-499 employees

Total payrolls: 15,792.

Share of total compliance costs: 10% .

Average compliance cost per employee: £41 per annum.

Share of routine PAYE and NI work in compliance labour costs: 63%

Number of stage 3 interviews carried out in these two categories: 104.

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- 5.6.1 Within the medium firms that were sampled there was usually a payroll manager employed to deal with PAYE and NICs. The use of such a specialist led to a much better appreciation of the PAYE system in general, both in terms of its advantages and the potential to reduce compliance costs. However, the treatment of benefits-in-kind attracted criticism:

“We are compelled to take on more and more of the tax collector’s work as the years progress ... the expenses rules get tighter each year and more complicated to follow. With declining honesty, people try to beat the system..”

“Schedule a table of allowable benefits i.e. car, fuel, BUPA etc. with any other benefits being treated as cash. Simple - isn’t it!”

- 5.6.2 It was from this size category that there were the most demands for merging tax and national insurance or abolishing the latter:

“The single most important thing that could be done to ease tax administration of PAYE and NIC is the abolition of NIC, with the revenue to be raised by increasing the tax rates - ... however, no one will do this politically. The most annoying problem we face is that there are different rules for benefits for tax and NI. As the whole army of inspectors, collectors and so forth would be made redundant at the DSS, I would expect their huge vested interest to scupper any plans anyway!”

“I feel that having PAYE and NIC is unnecessary. As far as I am concerned there is one ‘pot’. A single deduction would be better in the long run. I realise that this is a political hot potato.”

“The biggest saving in administrative costs would be to consolidate Tax and NIC into one tax.”

“Many people in my line of work believe it is about time income tax and employees NI were combined. I tend to agree with them. It would also provide the impetus to overhaul the welfare system. Benefits could be worked on a ‘work credit’ system. Think of the savings of such a scheme. If NI and PAYE were truly harmonised/merged into one tax not only would our workload be greatly simplified/reduced but the country would save a lot of money in bureaucracy costs etc.”

“Merge HM Customs and Excise, the Inland Revenue and Department of Social Security into one agency.”

Ten of the Stage 3 interviewees in this size category commented that if a fundamental change was not possible then NIC calculations should be made cumulative to bring them more in line with PAYE.

5.6.3 There was a corresponding increase in awareness of the availability of dispensations and of the complexities surrounding the calculations of some benefits. In 50% of the Stage 3 benefit interviews, the Finance Director either helped with or took over the BIK calculations. This was partly for confidentiality purposes and also because of their perceived difficulty.

“Mobile phones can be particularly tricky, with lengthy calculations for relatively small amounts of tax...”

“...We never have a year when we don't have to ask for an extension for submitting our P11Ds. I'm pleased that staff have started to take up cash equivalents instead of company cars; our fleet has halved already. Cars are complicated to calculate and the telephone benefits are also tricky; it's difficult to know who's subject to NICs and who isn't.”

“Can't we have a simpler method for cars?”

“The car rules are far too complicated...”

“I do wish we could persuade more employees to opt for cash equivalents rather than company cars.”

“We have problems with estimates of business mileage; many staff are terrible at keeping records. I do wish the PAYE auditor would be more thorough about this.”

“Things are getting harder to deal with. I often phone the Inland Revenue for help, but I've started to feel that I know more than the person on the other end of the phone.”

“Our P11Ds are now very complicated and we are assessing whether to continue with some of the benefits. The FD is particularly annoyed that his visits to the opera are assessed - he hates opera!! We've just paid £450 for our agents to give us an in-house course on BIK and will probably need several more, as it just touched the surface of what we need to understand.”

“Taxation of benefits is now far too complex - quite horrific at times.”

“We are trying to cut benefits due to their complexity.”

“We continue to argue about unresolved benefits issues, especially re- overseas postings.”

5.6.4 In terms of the payroll staff's dealings with the Inland Revenue there was a general acknowledgement that communications had improved over the previous 2 years. Comments such as 'we find the Revenue very helpful', 'customer service is excellent, especially from the Inland Revenue' and 'things are clearly better than

they used to be' were commonplace. However, there were re-enforced calls for a named contact who could make regular on-site visits to a firm and thus get to know the business.

- 5.6.5 There were also many complaints about inappropriate quantities of forms, duplication of literature and loss of forms:

"We always have to ask for more P11Ds, although we don't need much of the information that we receive."

"We often get multiple copies of tables."

"A pack is sent for all 47 companies in the group at the start of the year; what a waste of paper!"

"We have been dealt with by 4 different tax districts within 3 years. The files have got lost and there are always new IR staff to make contact with."

"We have moved tax districts and still get literature from both, despite numerous attempts to tell the IR. The new P45s/P46s are still hard to get hold of."

"They (IR) are improving. But P45s still get lost by the IR far too often and duplicates are requested from the company. We are a group and receive 3 of everything. Also, we are fully computerised so that we don't want details that apply to manual payrolls."

- 5.6.6 There was praise for recent changes in terms of quality and clarity of information, although some still found the content too 'technical'.

"Clarity has improved of late and English is clearer. But there is far too much in the Employer's Pack. A large pile arrived recently, accompanied by blurb saying 'we are cutting down the size of packs.'"

"What arrives is getting better and easier to follow."

"More layman's language please."

- 5.6.7 Respondents in this medium size category were also much more specific in identifying other areas which gave rise to high compliance costs. Establishing employment status and the correct treatment for casual employees were frequently discussed and a large number of the firms that were visited ran a 'sleepers payroll' in this context.

"the paperwork for summer casuals is time-consuming, especially when compared to their payroll costs."

“a disproportionate amount of time is spent accounting for casuals: a sleeper payroll is used.”

“casuals are a nightmare for me; why can't we use a system similar to the one for sub-contractors?”

“we need clearer guidance re casuals and employment status.”

“The IR urgently need to review the administration of status issues.”

5.6.8 Only one interviewee had heard of 'status officers' and that person had not found their existence helpful as different rulings had been given by the designated official at the Inland Revenue and the official's opposite number at the Contributions Agency.

5.6.9 The costs associated with joiners and leavers was felt to be too high by some interviewees in this size category. In particular there were complaints about the delay and cost of getting correct codings for new employees without P45s. There were also a number of comments made about duplicate P45s being requested by the Inland Revenue. The following are typical:

“Things are definitely improving overall. But P45s still get lost by the Inland Revenue far too often and duplicates are then requested from our company.”

“The P45 and P46 are confusing and we still receive far too many queries from the Inland Revenue requesting information that we have already sent in - the Revenue staff need to improve communication between themselves.”

5.6.10. Comments on SSP by medium sized employers related partly to resentment at having to be involved in SSP at all:

“Firms are unpaid book-keepers for the government. They receive no benefit and have all the onus and responsibility of getting it right.”

“All employers' SSP should be dealt with by DSS, not by employers”,

As with smaller payrolls they were concerned about its difficulty and complexity:

“SSP and SMP are the major problems. They occur relatively infrequently hence it is not profitable to get a good understanding. This means reading leaflets etc., each time a query is raised if the software does not deal with it.”

“SSP is very complicated: lots of SSP queries.”

Some respondents complained about helplines:

“Helpline not always there. They seem to work 10 to 4. Problems arise at the end of the day when they have gone away.”

"Very difficult to get through. Helpline should have more lines."

Some of them would welcome more "education":

"DSS should have more workshops, especially to explain qualifying days and weekend rules."

Again, as with smaller employers, there was some dissatisfaction with the DSS literature:

"Croner's gives a much better picture of what to do: clearer and more complete."

The commercial literature was sometimes preferred because of its anonymity:

"Gee's, Croner's consulted because DSS insist on names".

There were problems about the rules:

"What if you are sick Saturday and Sunday? Linked periods: have people been sick on Sunday when they return on Monday?"

"Our pay runs to Sunday, theirs to Saturday: they were very rigid. Their forms do not suit our circumstances. We work a 7-day week with employees covering different hours, so our shops are open 98 hours a week."

As usual there were objections to the PTS:

(On the PTS). "We get nothing back. It is an insult. It is designed to catch only a very small percentage of employers."

Opting out was an issue for more respondents than in the smaller categories:

"We are not considering opting out. New employees may need SSP so you still have to keep SSP records."

"Opting out would save the firm money."

The payment of SSP for each part-time job (though correct) was regarded as an anomaly:

"Person with 2 part-time jobs: both employers had to pay SSP - she earned more money by staying off sick. Kept giving different dates: she was off for months."

More help for employees was asked for:

"Need leaflet for employees too!"

“On the whole employees have a poor grasp of SSP. They query waiting days and qualifying days.”

5.6.11 Comments on SMP related partly to its difficulty:

“ SMP is complicated and troublesome when you have few cases.”

DSS literature on SMP was compared unfavourably with commercial publications:

“Croner’s sections are easier to use for finding things.”

“Evershed’s Maternity Wheel invaluable.”

Respondents found the system difficult to understand and to operate:

“Problems with eligibility criteria, hard to work out payment.”

“Working out qualifying weeks is main problem.”

“Unclear on the treatment of bonuses in calculating average earnings.”

Again there were problems with employee queries:

“Staff are not sure when they get form MAT B1.”

There was far less objection to the rebate system than to the PTS for SSP but employers would, of course, prefer a full rebate:

“SMP should be full 100% or even 102% including handling. Why only 92%?”

Large payrolls (500 to 4,999 employees)

500-999 employees

Total payrolls: 2,170.

Share of total compliance costs: 3.5% .

Average compliance cost per employee: £29 per annum.

Share of routine PAYE and NI work in compliance labour costs: 52%

1000-4999 employees

Total payrolls: 1,852.

Share of total compliance costs: 6% .

Average compliance cost per employee: £29.5 per annum.

Share of routine PAYE and NI work in compliance labour costs: 48%

No of stage 3 interviews with employers in these two size categories: 77

5.7.1 Those interviewed in respect of large payrolls often had extensive knowledge and experience of PAYE. Many were still called payroll managers, but were in charge of payroll departments with several assistants working for them and were engaged in

more pro-active "tax planning" type activities as opposed to just undertaking compliance work. If necessary, they received specific tax advice from outside professionals about individual issues of concern.

- 5.7.2 As far as the Inland Revenue was concerned the needs of these respondents were different from those of smaller employers; they would contact the IR for advice on fewer occasions and, when they did have queries, these tended to be relatively specialised. Because of this, their level of satisfaction with the Inland Revenue was lower:

"The new district set-up has not worked well; we often get put through to someone who does not appear to have sufficient knowledge to deal with our queries."

"The speed of response from the Inland Revenue is still too slow and I get very annoyed when I am referred back to the basic handbooks." (although the respondent acknowledged that the literature had improved over the past two years).

"Why can't we be given new codes in computer-readable form?"

"Why are the IR always losing information?"

- 5.7.3 This discontent was not universal. The staff of six of these senior payroll managers staff expressed satisfaction with IR personnel. These staff could be in routine weekly (or even daily) contact with staff at the appropriate office.

- 5.7.4 Many of the interviewees in this size category had a detailed understanding of the legislation governing benefits and expenses and had spent time producing in-house guides to PAYE and NICs. They would frequently run in-house courses to help employees understand how their pay was calculated and could spend up to a day a week dealing with employees' queries. These would sometimes be about their general tax affairs, rather than just their PAYE and NICs. Three respondents commented that the impact of the lower rate income tax band can be difficult to explain and 4 more said that K codes caused them difficulties.

- 5.7.5 In terms of benefits, the following remarks were typical of the payroll managers interviewed:

"Dealing with expenses claims has become more difficult than benefits; having a dispensation is always a great help."

"A wide-range of dispensations is very useful and time-saving. We are hoping that an impending audit will help us to get the firm to recognise the need to tighten up internal procedures. We are also looking into establishing a 'flexible benefit scheme'."

We often find that we know more than the IR staff when we approach them with a particular query.”

“We would like more help re the verification system that we are trying to put into place for expenses; we had thought that a recent DSS audit would give over more time to this and were disappointed when it didn’t.”

“I now have one FTE employee doing nothing else but recording details of travel for the purposes of our dispensations.”

- 5.7.6 The interviewees from large payrolls were also far more aware of the ramifications of the introduction of self-assessment. The following comment is typical of many that were made:

“I am most concerned about SA and our expenses records, I am in the process of writing a manual for staff and hope that the IR will reinforce the need for them to comply with this. It’s a bit of an uphill struggle at times.”

- 5.7.7 Many of these employers were already calculating the cash equivalent of benefits, so this would not in itself add to their workload. Indeed, the payroll function was often part of an integrated customised IT system, dealing with human resource issues as well as financial matters. For example, some of these systems dealt with absence management and personnel administration. Two interviewees said that their systems had been designed for them by US corporations and that SSP/SMP had caused huge difficulties in this respect. In both cases, manual checks were still being undertaken re these calculations as difficulties had not yet been ironed out. Although the integrated systems were usually supposed to include benefits in kind, most of them did not deal with complex benefit calculations. These were often recorded using simple spreadsheets and in 78% of the stage 3 benefits interviews they were dealt with separately by the payroll manager or finance director.

- 5.7.8 Such integrated systems typically covered a whole group of companies rather than just the payroll samples and this made for difficulties with the apportionment of joint and common costs. This problem was recognised by several of the interviewees, typical comments being as follows:

“Our costing system does not specifically split the cost of maintaining our payroll functions, let alone for single payrolls.”

“The costs given have had to be based on a proportion of our total bill for payroll services and the time spent on administration is that of the main payroll staff involved.”

“There are 13 full-time officers carrying out payroll functions centrally. Also there are at least 30 officers in departments who work full-time on payroll administration. The costs associated with this function cannot be fully identified centrally...”

5.7.9 Comments on SSP partly related to workload:

"There would be a big reduction in work load if we didn't have to keep SSP records."

There were well-informed comments on specific difficulties:

"Main problem is qualifying days with shift workers, night work, which complicates the situation."

"Waiting time causes real difficulties, especially among those who are genuinely ill."

There were the usual difficulties in dealing with employees' queries:

"If employees exceed their entitlement, pay is reduced next month. The fact it is dealt with in arrears disorients people. They get cross, don't understand rulings..."

SSP was commonly less well regarded than OSP schemes:

"Our occupational sick pay scheme is much easier to work out than SSP. Obviously it would be easier if you did just one."

"We could just do SSP for the very few cases where they run out of Occupational Sick Pay. Employees wonder why it is given to them and then taken back. It is pointless now."

"Employees average 7-8 days sickness, but 95% is covered by Occupational Sick Pay. Yet all SSP has to be calculated and recorded."

Again there was a preference for non-official literature.

5.7.10 While these employers are again critical of SMP their comments tend to be more detailed and better informed. Some are concerned about the complexity of SMP, particularly the relationship of SMP to employment law:

"Too many grey areas and conflicts with employment law - SMP is way too complex."

"We reworked the holiday entitlement after EC ruling, Oct 95. Could not find anything re ruling on 14 week maternity rule."

"SMP is a bit more complicated to calculate than PAYE, NI or even SSP. Previous earnings, dates, etc., all have to be taken into account."

However, there is some acknowledgement of improvement:

“They really have made an improvement this year with one PAYE and NI booklet incorporating SMP.”

“The SMP table is particularly useful.”

Some points about the detailed working of SMP were raised:

“21 days notice: problems if babies arrive early or late.”

“Can’t take away benefits when they are on SMP: benefits differ from site to site: LVs, car, mobile phone. Agreement needed on what should be provided. A comparable car or an old car from the pool?”

“Must SMP run from Sunday to Saturday or can it be a floating week?”

“Retrospective salary increases complicate the situation.”

Costs were generated in explaining things to employees:

“Employees did not understand rules, so a company information pack and a new form were prepared by the personnel department. Took 2 full days.”

“Staff are unclear on qualifying period. Most think they are entitled to 18 weeks.”

“The useful manual on maternity leave could be sent to employees.”

“More information directed at employees is needed: especially an ABC guide.”

Very large payrolls (5,000+ employees)

Total payrolls: 314
Share of total compliance costs: 1.3% .
Average compliance cost per employee: £5.4 per annum.
Share of routine PAYE and NI work in compliance labour costs: 34%
Number of interviews with employers in this category: 33

5.8.1 As expected, those interviewed as responsible for very large payrolls were the most highly qualified group of respondents. Most were qualified tax specialists with payroll managers and other staff working for them. Some of them had specialised in employee taxation and were clear experts in their field. They held firm views about the PAYE system and ways in which this might be changed:

“The initial attempts to harmonise PAYE/NIC regulations must be accelerated.”

“The government’s policy is to ‘reduce the burdens on business’. If that is true, the government should simplify the legislation which creates the burden in the first place. In fact, they do the opposite. The recent introduction of self-assessment or the changes in the calculation of average earnings for SMP are examples of them actually increasing the burden on business.” ...

“I would like to see CA/IR staff allocated to us officially, so that they are professionally accountable on an individual basis for working with us in a proactive and helpful manner.”

“I have always had a very good working relationship with most colleagues in the Inland Revenue ... but moving the districts away from the taxpayers geographically was a disastrous idea.”

“The IR needs to gear up to the needs of the larger business. We need multiple copies of some literature, which they don’t seem to appreciate. Then, when we don’t want it, they’ll send us 30 copies of the same thing!”

5.8.2 In the case of these payrolls up to 6 separate staff were interviewed in order to gain a true picture of the range of payroll work undertaken. This was necessary, in order to gain a true picture of the total compliance costs involved, since in no case did the individuals concerned have an in-depth understanding of the costs incurred by their colleagues. In four of the cases where multiple interviews were carried out, the payroll personnel were located at more than one site.

5.8.3 Dispensations were still, at this level, recorded as important in reducing compliance costs, although 3 of those interviewed commented that the costs of recording the information required for these was, in their opinion, excessive. In one case the interviewer was told that two FTE employees were needed just to record travel and subsistence information which was required for the continuation of the dispensation and was not needed for any other reason. In one other case 1 FTE person was paid for the same purpose and in 2 other payrolls this was the job of 1.5 FTEs. Concerns about the problems associated with the implementation of triangular travel arrangements were voiced by 7 of the senior interviewees from the payrolls in this size category.

5.8.4 PAYE settlements agreements were recorded as giving rise to high compliance costs by three of the very large payrolls. They emphasise trivia - the lunchtime staff sandwiches were given as an example in three cases.

5.8.5 Even these employers find SSP difficult to operate, though they are more familiar with it.

“SSP necessitates a weekly return - payroll work has been made more complicated.”

“For the long term sick, the movement from SSP to benefits can cause queries.”

They give serious attention to opting out.

“Our occupational sick pay is slightly different from SSP, so it is not worth opting out. We examined the proposal very closely. We would have to keep SSP records in case a person came close to exhausting a year’s occupational sick pay.”

“Remove all aspects of SSP rules subject to the employee receiving OSP which is at least the minimum SSP.”

As with smaller employers there was dislike of the Percentage Threshold Scheme:

“Our system works on cost per person. The old 80% reclaimable scheme was based on individual records, now it is based on the employer in total, which is difficult. We would prefer an individual basis or cost centre basis.”

Again there was comparison with commercial publications:

“Gee’s, Tolleys Monthly Pay News are easier and quicker. Examples, how to apply, cross-references extremely useful.”

5.8.6 Similarly, these experienced employers nevertheless, have difficulty in operating the SMP system.

“They are messing around with the qualifying periods. I am always revisiting SMP: rules do not mesh with annual leave rules. And what about pension contributions?”

“Early births and other exceptional cases... there are problems when a baby is lost or when a premature birth occurs before the confinement start date.”

“Retrospective pay awards affect calculations of average earnings. Some staff were unhappy about the calculation of average weekly earnings.”

There was favourable mention of private courses and literature:

“Payroll Alliance courses, £235 per person per day, are clearer on Employment Law.”

“More user-friendly, easier to find info in Croner’s and Gee’s. More specific examples, greater detail.”

There were requests for information to be put on-line:

“IR CD-ROM just arrived. Hope it will be easier to search for relevant terms. SMP information should be put on CD-ROM software for on-line reference.”

As with SSP employees find it difficult to understand:

“Staff have little understanding of SMP.”

Summary. This summary picks out the areas about which employers have expressed concern.

5.9.1 Micro-payrolls (1-9 employees):

- employers are relatively inexperienced in terms of their dealings with the PAYE system and find much of the literature that they receive to be irrelevant to their needs.
- they often use manual methods to operate the payroll and fewer than anticipated from the stage 2 responses receive professional help with this task.
- they have particular difficulties with joiners and leavers.
- they sometimes undervalue time ‘outside of office hours at home’ or ‘on a voluntary basis.’
- they would appreciate more help from the Inland Revenue, particularly if this could be provided ‘on-site’.
- they find SSP/SMP complex and difficult to understand.

5.9.2 Small payrolls (10-49 employees):

- employers are more experienced and better informed than employers with micro-payrolls.
- like micro-employers they still sometimes underestimate their time costs.
- they are complimentary about dealing with IR staff, and welcome recent improvements in the literature but still complain about delays in receiving stationery
- they make much more use of PCs than do micro-employers, as one would expect from the evidence of chapter 4.
- like those in all size bands they have difficulty in dealing with coding
- they find compliance costs high in respect of car prices
- they have a fairly poor knowledge of dispensations
- they find SSP to be complex and jargon-loaded and the Percentage Threshold Scheme unhelpful
- they have complaints about the comprehensibility of the literature and about the helpline.
- they have relatively limited experience of SMP which they regard as too complex

5.9.3 Medium-sized payrolls (100-499)

- a full-time payroll manager is often in charge and is relatively well informed
- employers in this size band are enthusiasts for merging PAYE and NI
- payroll managers have a good understanding of benefits and dispensations but find the system difficult and complex
- employers welcome recent improvements in communication and in the clarity of the literature which, however, was still too technical
- joiners and leavers generated high compliance costs and also requests from IR for old information re P45s which they had lost

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- dealing with casuals and establishing employment status also generated high compliance costs
 - these employers understood SSP/SMP but thought it far too complex particularly in relation to waiting days, qualifying days and “linked spells”
 - in particular they had problems under SSP with linking periods and with the Sunday to Saturday week.
 - they tended to object to SSP and particularly to the Percentage Threshold Scheme
 - they were, however, reluctant to opt out.
 - they were complimentary about non-DSS literature on SSP and SMP, such as Croner’s and Gee’s.
 - they thought that better information should be available to employees
 - in relation to SMP they had difficulty with eligibility, with qualifying weeks, treatment of bonuses, etc.

5.9.4 Large payrolls (500-4999)

- the payroll departments are often large and take on taxation planning responsibilities, they are in less frequent, though more specialised contact with the IR and sometimes complain about IR lack of expertise.
- they often produce in-house guides
- they make extensive use of dispensations and many of them already calculate the cash-equivalence of benefits
- they have integrated computerised systems which make it difficult to apportion costs
- however, packages do not usually deal adequately with SSP/SMP
- SSP involves extra record-keeping and both SSP and SMP are difficult to explain to employees.
- they complained of complexity in SSP in similar terms as did smaller employers.
- many of them find “opting out” attractive.
- linked spells, qualifying days, shift work, night work, etc., all caused problems with SSP
- some were concerned about the complexity of SMP, particularly the relationship of SMP and employment law.

5.9.5 Very large payrolls (5000 + employees)

- the respondents were often tax specialists supervising payroll managers
- they tended to be critical of the system as a whole, calling for simplification and harmonisation
- they were concerned at the high costs of recording information for dispensations
- they were critical of the complexities of SSP and of the Percentage Threshold Scheme in particular.
- publications such as Tolley’s and Gee’s were again favourably compared with IR and DSS literature.
- some of these respondents were anxious to have more information on CD-ROM.
- their concerns about SMP were similar to those expressed by smaller organisations.

5.9.6 **Common concerns.** Some of these comments and concerns are common across all or most size bands. Specifically, there were requests for:

- straightforward and simple literature
- delivery of forms in appropriate quantities and at appropriate times
- better informed and more readily available helplines
- more “educational” visits and seminars and complaints about:
 - the non-integration of PAYE and NI
 - the high costs of dealing with casuals and joiners
 - the high costs of dealing with benefits-in-kind
 - the complexity of SSP, particularly the PTS
 - the complexity of SMP.

These concerns, together with the evidence of stage 2 were taken into account in formulating the recommendations in chapter 6.

Chapter 6

Recommendations

Introduction

- 6.1.1 One of the objectives of this study was to identify costly aspects of compliance costs and to make recommendations for the simplification of procedures. The recommendations which follow are based upon the size, composition and distribution of compliance costs, measured in the large-scale postal survey (stage 2) and upon points made to the team during interviews with employers (stage 3).
- 6.1.2 While the reduction of compliance costs for employers must be regarded as an objective of policy, it cannot be considered on its own. One way of reducing compliance costs would be to simplify the whole system. Provided that this could be done with no significant adverse effects upon revenue, the compliance costs falling on all parties would fall. This would be an unambiguous improvement, a “win-win” situation. The recommendations in this report relating to administrative integration probably fall into this category.
- 6.1.3 Another way of reducing compliance costs for employers would be to pass them on to another party. A major increase in the amount of help provided by the IR/CA, for example, in “educating” employers, helping with new technology or improving telephone response to enquirers, would probably reduce compliance costs to employers but increase the costs of tax administration. No doubt it would also reduce the total, particularly in the longer term. In making such recommendations the team recognises that a balance has to be struck. Similarly the compliance costs for employers could be reduced by passing some costs on to employees, for example, by reducing the “free” advice often given to them at present. This would be unfortunate.

Recommendations to employers

- 6.2.1 **Payroll technology.** On the whole employers may be expected to choose the payroll technology that minimises the cost of carrying out their payroll operations, subject to reliability and avoidance of delay. Indeed, one third of them had changed their payroll methods in the previous five years. However, the range of costs across employers of roughly the same size (**appendix A2**), while no doubt reflecting their differing circumstances, provides *prima facie* evidence of scope for further cost reduction. And decisions to change the system are sometimes made fortuitously, for example, following a personnel change (**4.7**). The team therefore recommends that:
- All employers should consider whether they are using the appropriate technology for their payroll operations. For 1995-6 the data suggested that, as a rough rule of thumb, employers with more than 20 employees and using manual methods should have considered switching to PCs and those with more

than 100 employees should have considered using a payroll bureau or possibly a mainframe computer (if one was used in the organisation for other purposes). The falling costs and increasing power of PCs since then have made them an attractive option for all but the very largest and very smallest size-bands.

- Similarly, for reasons of speed, accuracy and cost employers should consider using approved substitute documents or electronic submission.

6.2.2 **Accountants and payroll bureaux.** Small employers make considerable use of accountants, partly for end of year work, audits, directors' payrolls and tax advice. While there are good reasons for using such professional help it is not appropriate for routine payroll work which is usually much more cheaply done in-house or by a part-time book-keeper. Resort to accountants is one reason why compliance costs are so high for small employers.

- Employers should review the extent to which routine payroll work is done by their accountants. Payroll bureaux are not normally interested in payrolls with less than about 50 employees. But there may well be a market niche for bureaux in setting up payroll systems for small organisations with a subsequent "helpline" facility.
- Employers and payroll bureaux should explore the possibility of setting up systems for small employers.

6.2.3 **Monthly and weekly paid employees**

- since the compliance costs of weekly-paid employees are significantly higher than those of monthly-paid employees, employers should consider whether the trend toward monthly payment should be accelerated.

6.2.4 **Payment of benefits-in-kind**

- many medium-sized and large employers complained of the costs associated with remuneration in the form of benefits-in-kind (**chapter 5**). As benefits come to be taxed as cash equivalents, employers must increasingly consider whether such costs are worth incurring.

6.2.5 **Multiple payrolls.** It was reported in **2.9.4 (also Appendix D)** that employers who operate several payrolls tend to incur higher compliance costs. Often there are very good reasons for this, e.g., separate payrolls for weekly paid staff or for off-shore workers. But when 200 employers were asked to give reasons for having multiple payrolls (more than one reason being allowed) 198 said that confidentiality was important (either for the executive payroll or across divisions) and 64 gave "historical" reasons (**table D17**). It is therefore recommended that :

- employers should give serious consideration to amalgamating payroll operations when there is no cost advantage in keeping them separate. If they wish to continue with separate payrolls for reasons of confidentiality they should consider whether this justifies any extra cost involved.

Recommendations to the Government

- 6.3.1. **Collaboration.** Closer collaboration between the IR and the CA is one of the main themes arising from discussions with employers. Indeed this report was jointly sponsored by them and they already have a Joint Working Programme. The Team therefore welcomes the Budget announcement (March 17 1998) that the IR is to take responsibility for the work of the CA. On the assumption that the whole of the work relating to PAYE, NI, SSP and SMP will now come under the same umbrella this should greatly facilitate the carrying out of some of the recommendations that follow.
- 6.3.2. **Simplification of literature.** It was acknowledged that the general standard of literature had improved, but problems remain in terms of the language used being too technical for non-specialists. There were widespread requests, particularly from small and micro employers, that the literature received from the IR and the CA should be simpler and more comprehensible (e.g., 5.5.5). Sometimes that literature has to reflect the inherent complexity of tax legislation. But even complex legislation is capable of being rewritten in more comprehensible form, as the Tax Law Rewrite Project, being currently undertaken by the IR, has demonstrated.
- The existing programme of rewriting and simplifying the PAYE, NI, SSP and SSP literature is to be welcomed, especially for smaller employers, and should be continued. The team notes that a joint guide was issued by the CA and IR in 1997.
- 6.3.3 **Despatch of literature and forms.** Employers reported frustration, and extra costs, in the period covered by the research (1995-6) when literature and forms were sent late or in inappropriate quantities: for example, multiple copies of the Employers' Pack, or an insufficient number of P45s. Either way, compliance costs are increased. Unwanted material has to be stored or disposed of, or telephone calls made (and possibly chased up) to obtain extra or copies of forms. Since the period covered by the research the system has been greatly improved. The Employers' Pack has been reduced in size and employers are able to order forms (e.g., P14s) in the precise quantities that they need. CD-ROM options are also included.
- The team stresses the importance of sending out tax literature and forms to employers at the right time and in the right quantities. It notes and welcomes the recent improvements in the despatch of literature and forms and recommends that the new system be monitored.
- 6.3.4 **Quality of service.** The level of service received from the Inland Revenue and Contributions Agency staff is considered to have improved considerably in recent years; 92% of all those interviewed for stage 3 stated that the IR staff they dealt with were either helpful or very helpful. The corresponding figure for CA staff was 64%. The team understands from the CA that surveys of their customers by independent research organisations have revealed a satisfaction rating of over 80%. Complaints from interviewees about the quality of service differed somewhat

depending on the size of payroll (**chapter 5**). Some small and medium sized employers tended to criticise helplines for the time taken to get through, for the lack of knowledge of staff and for unavailability outside of the hours 10-4. Some larger employers, with tax expertise and complex benefits-in-kind, tend to be more critical of the technical knowledge of their named IR staff. The team recommends that:

- There should not be unreasonable delays in responding to calls and helplines should be open during the hours in which employers have to contact them. The team notes that an Employers' Helpline has been set up since the study period and that it is now open to 5 pm.
- Helpline staff should be trained to pass specialised enquiries to competent experts speedily and to ring back if necessary.
- "Named" contact staff assigned to particular payrolls should be trained up to the appropriate level of expertise.

6.3.5. **Small employers with manual payrolls.** Simplification is especially important for small employers (**3.3.3**) whose very high compliance costs per employee largely arise from the time involved in reading the relevant literature, understanding the system and keeping up-to-date with changes. Notwithstanding the trend to computerisation it also remains the case that a manual payroll is the least cost system for many of these small employers (**4.6.1**). This is likely to be the case for the next few years.

- The team therefore recommends that resources be devoted to preparing a "stripped down" (i.e., shorter and simpler) Employers' Guide for a manual PAYE, NICs and SSP/SMP system which should be piloted with small employers.

6.3.6 **New employers.** Most new employers are also small employers and there is evidence that they have higher compliance costs than existing small employers (**3.3.4**) as they are still "on a learning curve".

- The team recommends that new employers be given a named IR/CA contact at the outset and offered an "educational" visit so as to get them "up and running". A CA/IR pilot experiment on this in Leicester is currently being evaluated and an extension to nationwide coverage was announced in the March 1998 Budget.

6.3.7 **Educational visits.** The more experienced of the interviewers used in stage 3 reported that "educational visits", formerly anticipated with a feeling of dread, are now welcomed by payroll staff and requests were made by all size categories that they should be increased. This is perceived as especially important given the increased burden that self-assessment will impose on employers in maintaining accurate expense records. The visits allow mistakes to be rectified as soon as possible and can prevent future mistakes by improving understanding of the system. How far visits should be educational, rather than simply remedial, is partly a matter of cost. Nevertheless,

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- The team recommends that more informal one-to-one visits, having a preparatory or educational function, should be offered to employers. In view of their expense these would have to be carefully geared to needs.

6.3.8 Benefits-in-kind and dispensations. In principle dispensations reduce the compliance costs of giving benefits-in-kind. Some employers who had only recently “discovered” dispensations were enthusiastic about them and claimed that they had reduced this aspect of their compliance costs by 59% or more (5.5.9). On cars specifically, the system of valuation seems to have become very complex and to have generated significant compliance costs. This is partly because of modifications or “extras” which require an adjustment to the list price. Finally, some employers found it frustrating and costly that treatment of benefits is not consistent across PAYE and NI. The team recommends that:

- The availability of dispensations should be more widely publicised.
- The coverage of particular dispensations (e.g., locations covered by car dispensations) should be interpreted more liberally
- Consideration should be given to widening the benefits covered by dispensations.
- IR dispensations should be accepted by the CA (this is now done)
- The treatment of benefits-in-kind should be common across PAYE and NI class1A contributions.
- The valuation of company cars for tax purposes should be reviewed.

6.3.9 Information retrieval by IR. Some interviewees complained that the IR sometimes seems to find it easier to ask employers for the same information again (e.g., about P45s) than to use its own retrieval systems. This can be annoying and costly , particularly when the reply is not postage-paid. The team recommends that:

- Requests for duplicate information should be reduced to an absolute minimum and when made should include pre-paid reply envelopes. In making this recommendation it is recognised that it will increase the IR’s administrative costs but it should help to reduce a particularly annoying aspect of compliance costs.

6.3.10 Information for employees. Several respondents requested an employees’ leaflet, especially in relation to SSP/SMP (e.g., 5.12). Strictly such leaflets and booklets are widely available through Post Offices and other centres, e.g. the Benefit Agency’s FB series of leaflets and more specialised leaflets such as NI244 *Statutory Sick Pay*. In practice they may not be readily available and employees often find it easier to look to their employers for information. Some employers, even quite small ones, produce explanatory leaflets of their own. The team recommends that:

- A well-written booklet explaining the system for employees on their *first* employment should be available for distribution by employers (and educational institutions), with a view to improving employee education on tax and related matters.

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- Attractive, simple leaflets should be produced about specific aspects of the system and offered to employers for distribution to employees. Although this in itself would be a burden, it might save time in dealing with subsequent enquiries.

6.3.11 **Help with technology.** The least-cost technologies available for different sizes of payroll were discussed in detail in 4.6.1-4.6.4 (dealing with computerisation) and 4.8 (dealing with submission arrangements). On the whole employers are quite capable of making their own decisions in this important area but some smaller employers are bewildered by the number of packages available (**Appendix A 3.22.1**) and not all the packages are reliable. Some of the larger employers would welcome greater use of computer technology by the IR itself. The team doubts that, given the good commercial packages available, the IR should try to produce “official” software of its own but that its role should be to encourage and assist. It is recommended that:

- The IR/CA should evaluate and “kitemark” commercially produced software.
- More “hands-on” guidance should be given in choosing and running software. Possibly this could be done by organising local software “fairs” with demonstrations by the leading suppliers.
- Information for employers should be made available electronically so as to reduce the amount of paperwork (a CD-ROM is now available).
- It should be made as easy as possible for employers to submit electronically if they wish to do so. The team notes the current IR initiative on electronic submission.

6.3.12 **SSP.** Many employers, especially those who operate their own OSP schemes would welcome the scrapping of SSP which they see as a complex and high cost operation from which they derive little or no benefit (e.g., 5.5.12). Since April 1997 employers can choose not to operate SSP for employees provided that they pay employees who are off sick at a rate which is at least equal to SSP. Most of them are aware, however, that “opting out” is not appropriate for all categories of employee. They are particularly critical of the Percentage Threshold Scheme which was an attempt to direct help to those employers particularly badly hit by sickness. The team recommends that:

- The system of qualifying days, linking periods and so on for SSP, which is widely regarded as arcane, should be revised, simplified and made more comprehensible.
- The treatment of waiting days etc. for part-time employees should be reconsidered as employers (and even CA offices) seem to find this difficult.
- The Percentage Threshold Scheme should be reconsidered and possibly revert to a pre-PTS type of scheme for small employers only.

6.3.13 **SMP.** Since small employers encounter SMP only rarely it is important that it should be presented in as comprehensible form as possible (7.2.2 above). Though employers are far less critical of SMP than of SSP (probably because 92% can be reclaimed) they reported confusion over different periods for maternity pay and

maternity leave and difficulties about the treatment of benefits-in-kind, the definition of qualifying weeks, etc. The team recommends that:

- The periods for maternity pay and maternity leave should be the same (the team notes that the white Paper “Fairness at Work”, May 1998 has proposed that 14 weeks maternity leave should be increased to 18 weeks to match the period over which SMP can be paid).
- The relation between SMP and employment law should be clarified to employers (employers are, perhaps, not generally aware of the booklet “Maternity Rights”, DTI, 1994).
- The DSS should explore ways of allowing employers more flexibility within the SMP scheme to deal with issues such as premature or still births and predicting confinement dates.

However, as long as SMP (unlike SSP) is based on normal salary it is difficult to make recommendations which would significantly reduce the compliance cost burden (see 6.4.4 below).

Compliance cost reductions

6.4 It is not easy to estimate the compliance cost savings that might be achieved if the above recommendations were implemented since one would need to know precisely how much time was saved on each of the procedures. The following discussion therefore establishes rough orders of magnitude only, on the assumption that savings of 10% may be achieved.

(a) Simplification or clarification of the literature, better education for new employers, a “manual pack” and so on could be considered as reducing the “constant” element in compliance cost: that is, the time that has to be spent learning the rules and setting up the system. Taking the regression equations of chapter 4A as a starting point, this constant element could be taken to be approximately £200 per annum (the average of the three main regressions plus £50 to cover the other elements in the equations which should probably be included in fixed costs.) Suppose that implementation of these proposals led to a 10% reduction, i.e., £20 per payroll. Over all payrolls the saving would be about £22m per annum. This would represent a reduction of less than 2% in total compliance costs but would be an important cost saving to very small employers.

(b) Reductions in the costs of particular compliance activities will reduce over-all compliance costs by the percentage reduction achieved, multiplied by the share of that activity in the total. For example, P11D-related activities account for approximately 5.5% of grossed up labour costs (**table 4.1**) and labour costs account for about half the total. Hence a 10% reduction in labour costs associated with P11Ds could be expected to reduce over-all compliance costs by $£1.32b \times 5.5\% \times 50\% \times 10\% = £3.6 \text{ m}$ or less than one-third of 1%. Much of this cost saving would accrue to the larger employers.

On the other hand a 10% reduction in routine PAYE/NI labour costs would reduce compliance costs by over £46m or 3.5%.

(c) For joiners it is convenient to start from the high marginal cost figure derived from the regressions of 4A of about £70 per annum. Joiners account for about one-quarter of the payroll total. Again assume a saving of 10%. Across all payrolls this gives a saving of just over £40m which is very similar to the PAYE/NI saving calculated above.

It should be emphasised that these calculations are illustrative rather than being precise estimates.

Wider considerations

- 6.5.1. The above recommendations are rather modest and taken together the reduction achieved in compliance costs is likely to be well below 100m. Indeed much of the gain would be in improving relations and therefore reducing “psychic costs” and stress: there would also be some improvement in “fairness” . In the course of the team’s discussions with employers and others some more radical suggestions were canvassed and it is worth discussing these briefly.
- 6.5.2. **Amalgamation of PAYE and NI.** When invited to comment, employers almost invariably (and sometimes in strong language) argue for an amalgamation of PAYE and NI. This is a matter of policy and outside of the remit of the present report. It was recently considered, and rejected, in the report *Work Incentives. The Modernisation of Britain’s Tax and Benefit System. No. 2* by Martin Taylor. There would almost certainly be compliance cost savings from amalgamating the two, though the extent of these is difficult to measure (see 4.4). Employers have suggested that, short of this, the Lower Earnings Limit should coincide with the (most common) Tax Threshold, etc., and that NI should be cumulative, like PAYE. But “free pay” differs across individuals for various reasons so the potential savings from this would be limited. And the unit of time for NI (except for directors) is the week or the month. Major savings could be made only by abandoning the insurance principle and/or differences in the relevant period. One aspect of additional costs associated with NI has been the necessity of dealing with two separate bodies. This should be eased by the joint operation of IR/CA. It is therefore recommended that:
- Given that PAYE and NI are not to be amalgamated into a single system, the IR/CA should go as far as it possibly can in achieving consistency and uniformity across PAYE and NIC operations, so as to minimise compliance costs to employers.
- 6.5.3 **A uniform rate of maternity pay.** The compliance costs associated with SMP could be greatly reduced by having a uniform rate of maternity pay as is the case with SSP. Roughly, this could reduce the compliance cost per case of SMP to that of SSP. However, it raises major problems both of social policy and of legality which are well beyond the scope of this report and the team has no recommendation to make.

6.5.4 **Proposal for a “smart card”.** This proposal arises from the high compliance costs associated with joiners (leavers) and casuals (see **4A passim** and **chapter 5**). Much of this cost comes from the need to establish the correct coding in order to allow the right amount of “free-pay” for the period concerned. In principle it might be possible to deal with this by issuing a smart-card which embodied information about each individual’s tax allowances. This card would be “swiped” by the employer (much as credit cards are swiped at present) so the correct allowances would be made even for employees who have several jobs or are working only for a short period. To some degree this would shift compliance costs from the employer to the employee (who would have possession of the card) but their combined compliance costs should be lower.

- In view of the high compliance costs associated with establishing the right tax-codes, serious consideration should be given to the costs, benefits and feasibility of a tax allowances “smart card”. If such a card is thought to be viable it should, of course, be piloted.

6.5.5 **The nature of PAYE.** The cumulative PAYE system is an efficient tax-raising machine, reluctantly admired by some payroll managers: the compliance cost to revenue ratio of 1.3% is very low.(3.1.2). But it works best for large, rather “static” payrolls, i.e., payrolls with hardly any staff turnover or casual or part-time employees, that is to say, where there is a one-to-one relationship between taxpayer and employer. For much of society this is still an appropriate model but in an increasingly “flexible” labour market the employer-employee nexus becomes much weaker. It may increasingly come to be the case that it is an inappropriate one for tax purposes and that the individual taxpayer will come to take more responsibility for his or her tax affairs and the employer less. Further, since compliance costs per employee are very high for small payrolls, a reduction in their tax-collecting role might make the distribution of compliance costs among employers less “unfair” . This, however, is to look much further ahead. The disadvantages of such a move would probably include increased compliance costs for employees, increased administration costs for the IR/CA and some reduction in tax revenue. The present recommendation is therefore the cautious one that:

- The Government should, in the longer term, consider the costs and benefits of alternatives to collecting employees’ tax and national insurance contributions from “small” employers. Any such alternative will, of course, have its own disadvantages.

6.6 **New compliance costs.** The amalgamation of CA and IR, if carried through effectively, should be a major factor in reducing compliance costs to employers. On the other hand, since the team embarked upon this research a number of policy and operational changes have taken place or are under consideration which are likely to increase compliance costs. These are:

- (a) **Self-assessment** (though this reduced compliance costs for some of the self-employed).

(b) The Working Families Tax Credit (WFTC).

(c) The Scottish Variable Rate

(d) Student Loan Repayment

(e) Individual Learning Accounts

(f) Stakeholder Pensions.

The team did not feel able to quantify the likely impact of these changes on compliance costs. However, it is recommended that:

- In all these cases, the relevant policies should be effected with the minimum possible compliance costs for all parties, especially for small employers
- Using the present estimates of compliance costs as a benchmark, a further study should be carried out as soon as the new changes have bedded down.

Price £20.00
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