

Tatyana Kuznetsova

Impact of the Cost of Compliance on Business Performance



Summary

The article focuses on the theoretical basis of transaction costs, the main component in the cost of compliance with the law. It delivers two models: the analysis of the components of the cost of compliance and the influence of the compliance cost on a business's earning power of the enterprise.

The problem. Although the legitimacy of transaction costs is recognized by all academic economists, there is no generally accepted answers to the fundamental questions of this economic category, namely:

- What are transaction costs?
- Why are they incurred and in what form?
- How to measure them?
- What impact do they have on company efficiency?

The representatives of the two approaches, i.e. the Neo-classical and the property rights approach, make attempts at answering the first question. There are different interpretations of the nature of transaction costs, but none of them gives a clear definition. I suggest the following definition: transaction costs are costs associated with the establishment, protection and exchange of property rights.

The absence of a generally accepted interpretation for the nature of transaction costs has led to the emergence of various theories that explain the causes and the forms of

TATYANA KUZNETSOVA PhD in Economic Sciences, Associate Professor, Institute for the Personnel Training of the State Employment Services of Ukraine.

their existence. The most widespread are the transaction cost theory, the public choice theory, the theory of agreements, the contract theory of the company and the two-factor model of transaction costs. The authors of these theories focus on extensive forms of transaction costs and attempt at explaining their existence through these forms.

Analysis of studies and publications. Most frequently, the following forms of transaction costs are examined in the economic theory: the costs of information search, the costs of negotiations and agreements, the costs of determining the quality of goods and services, the costs of specification and protection of property rights and the costs of opportunistic behaviour.

The most clear and reasonable classification of transaction costs is based on these forms and was set up by O. Williamson, who divides transaction costs to those that precede and those that follow the transaction. S. Arkhiieriev, on the other hand, develops and complements Williamson's classification with due consideration to the economy of Ukraine and the classification by H. de Soto. In his approach, transaction costs are divided into compliance costs and costs of the illegal economy.

H. de Soto's classification is the most appropriate to determine the impact of transaction costs on the performance of the individual enterprises and to explain the choice of the institutional environment (legal or illegal). Researchers (with the exception of Arkhiieriev) only consider negative transaction costs, and disregard the value of these costs inherent in a particular company and their impact on the efficiency of company operation.

According to de Soto, transaction costs comprise two components: the compliance cost and cost of illegal economy. It is possible to evaluate the impact of "transactional burden" on the efficiency of enterprises by using the compliance cost, which consists of the cost of access to the law and the continuation of acting in compliance with the law. The former include the cost of company (legal entity) registration, obtaining a license, opening a bank account, acquiring a legal address and other formalities. The latter costs are associated with tax payment liabilities, observation of the law in the field of employment (working hours, minimum wages and social security), payment of the court costs of conflict resolution within the legal court system. It is well-known that many enterprises and companies, notwithstanding the frequently changing tax and legal regulations, are shifting to the illegal economy. This is explained by the high transaction costs related to acting within the bounds of the law.

However, the implementation of the contract in illegal sector is also associated with expenses, "illegal cost".

De Soto identifies the following elements in the compliance cost:

1. Costs associated with the avoidance of legal sanctions. They include fees for the services of tax and financial advisors, income lost as a result of "double-entry book-keeping".

2. Costs related to the transfer of income. All economic actors without exception are subject to pay indirect taxes and inflation tax (first of all, it concerns the use of cash only) accompanying illegal exchanges. Though the transfers are one-sided, so that the illegal agents can not apply to the state seeking protection of the property rights.

3. Costs associated with the avoidance of taxes and charges on salaries. They reduce incentives for the substitution of labour by capital and technical upgrading. Cheap labour “deprives” the company. In addition, gains from the non-payment of VAT limit the scope of illegal activity only by extreme links in the production chain – namely, retail sales and the initial stages of processing raw materials.

4. Costs associated with the lack of legally fixed property rights. It is possible to transfer the eligibility of property rights only to a limited number of people who may not necessarily include a buyer willing to pay the highest price. Moreover, this capital cannot be used as a bail, invested, freely sold or sometimes even just passed on as inheritance.

5. Costs associated with the inability to use the contract system. Illegal contracting procedures impede the realization of long-term agreements, in which a large number of economic actors is involved. Since the belief that in any event the rights of investors are protected stands for a real incentive for investment in a long-term project.

6. Costs associated with the two-sided nature of the illegal contracts.

7. Cost associated with access to the illegal procedures in dispute resolution.

Legal judicial system has a number of substitutes like family and mafia conflict resolution mechanisms. The use of these alternatives is attributed to the cost of maintaining friendly relations with numerous relatives, countrymen and other ‘fellow’ people taking time and money to provide signs of attraction and the exchange of services. Request for the services of mafia performing the functions of judicial and law enforcement organizations is explained by the need to pay a particular tax. The economic participants’ selection of the institutional environment for their businesses, whether legal or illegal, is defined by the correlation of the compliance cost and the cost of the illegal economy.

The purpose of the study is to identify the most important components of the compliance cost and assessing its impact on the profitability of enterprises.

Presentation of the basic material. With the help of experimental evaluations and statistical calculations, the cost of access to law incurred by Ukrainian enterprises has been defined. Ninety enterprises were surveyed in Kyiv, Dnipropetrovsk and Zaporizhzhia. Studies show that the expenses associated with registering a limited liability company amount to USD 240 (and take 7 to 30 days, the cost of registration via intermediary companies is between USD 350 and 600, and take 4–15 days). The registration of private joint stock companies cost USD 1500 to 1900 (and take between 35 days and 3 months), and USD 3,000 to 5,000 through intermediary companies (requiring 18 to 30 days).

According to a research by the World Bank, the average cost of access to law for Ukrainian entrepreneurs in 2015 was USD 97.3 (including USD 33 privately paid funds), and part of the cost of continuing operation within the law, considered as financial losses through inspection activities, required an average of USD 1,177.8. Considering that payments to the budget amount to 40% of the income (and it also constitutes costs associated with continued operation within the law), it is clear that, firstly, the compliance cost is rather high and, and secondly, the lion’s share of the “burden

of transaction” is due to the tax component. My survey shows that the essential component of the compliance cost in Ukraine belongs to tax compliance. Thus, taxes on income range between 21 and 35%. This explains the low level of application of the law to ensure the daily functioning of the companies. Almost all the authors examine the impact of one or more taxes on the company’s efficiency or its profitability. That is to say, it is reasonable to study the total effects of tax pressure on businesses, because in this case it is possible to explore the synergistic effect of joint influence of taxes.

Methodological guidelines have been developed to assess the impact of the compliance cost.

In the first stage the company’s efficiency is evaluated, and the compliance cost and its components are determined. The purpose of this stage is to obtain the information required for building econometric models and creating statistical database for further analysis.

The second stage aims at estimating the significance of the constituents of compliance cost. The purpose of this stage is to build an econometric model for the compliance cost and to determine its essential components.

In the third stage the impact of the main components of the compliance cost on business profitability is assessed. The purpose of this stage is to build an econometric model to determine the impact of the compliance cost.

The methodological guidelines were approved for road construction enterprises. The financial conditions of these businesses were analysed on the basis of their status, profitability, efficiency, solvency and business activity.

The efficiency estimate has shown that during the survey, all companies were operating in an unsustainable manner.

An econometric model (1) has been set up with compliance cost as a dependent factor, and value added tax, income tax, social contributions and administrative costs as independent factors.

$$TYAGAR = 1,015409277 ADM^{0,4326557487} * VAT^{0,4821704674} * SOC^{0,3058248766} * PROT^{0,02457605771}, (1)$$

where TYAGAR is the compliance cost, thousand UAH; PROT is the income tax, thousand UAH; SOC stands for social contributions, thousand UAH; VAT stands for the value added tax, thousand UAH; ADM stands for administrative costs (exclusive of costs which are not transactional), thousand UAH; C stands for the constant, which determines the degree of influence of factors not included into the model.

The adequacy of the model was evaluated by multiple determination coefficients R^2 , F -statistics and standard deviation. The high value of coefficients R^2 ($R^2 = 0.9994$, $R^2 = 0.992$), F -statistics (5438,93) and the low value of the standard deviation (0,23) confirm the adequacy of the model.

The statistical significance of the components included in the model was also confirmed by the tests (standard deviation of the regression coefficient, t -statistics P). This model (1) enabled the assessment of the impact of the compliance cost component and revealed that:

- 1% increase in administrative costs increases the compliance cost by 0.43%;
- 1% increase in VAT increases the compliance cost by 0.48%;
- 1% increase in social contributions increases the compliance cost by 0.31%;
- 1% increase in the income tax increases the compliance cost by 0.025%.

The cumulative impact of these factors on the compliance cost revealed that 3% and 5% decrease in the value added tax and in the income tax, respectively, combined with 1% increase in the administrative costs and in social contributions, increase the compliance cost by 0.8%. The results of the econometric analysis acknowledge that the administrative costs are the most important component in the compliance cost, along with the tax component, which includes value added tax, income tax and other taxes and fees. Therefore, an econometric model was built in the third stage for the purpose of assessing the influence of the most important compliance costs constituents on the profitability of the enterprises.

Model (2) is as follows:

$$\text{NPROF} = 3.64326 * \text{TAXE}^{-1.068571} * \text{ADM}^{-0.754974}, \quad (2)$$

where NPROF stands for the net profit, thousand UAH; TAXE stands for the tax component of subordinate to law cost, thousand UAH; ADM stands for administrative costs, thousand UAH. High coefficients R^2 (0.873648), R^2 (0.82344) and F -statistics (13.41714), and the low value of the standard deviation (0.31) prove the model adequacy.

The evaluation of the tests of the model parameters proves their statistical significance.

This model (2) suggests that 1% tax increase causes 1.07% decline in the net profit, and if the administrative costs increase by 1%, the net profit decreases respectively by 0.75%. The combined effect of the alteration in both factors will reduce the profit by 1.82%.

Conclusions. The developed models can be used by management experts at various levels to assess the impact of changes in tax legislation and other regulatory measures on the profitability of enterprises and businesses, and for forecasting their profits by changing the underlying tax rates and the value of administrative costs.

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