

## Administration and Compliance

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## EXECUTIVE SUMMARY

Assessing how much tax people owe and ensuring it is paid is a costly activity for both taxpayers and the government. Yet modern 'optimal tax theory' has for the most part ignored these costs and has focused on those created by distorting people's behaviour (distortion costs). But it is possible to adapt the standard framework to reflect administration and compliance costs, and include real-world features of tax administration such as penalties for tax evasion, enquiry rates, and obligations to report information to the tax authority.

Part I of this chapter presents a simplified model of this type. The optimal policy is to use a mix of tax instruments determined so that the cost to society of raising an extra pound of revenue is the same for each instrument used. This would give tax instruments that raise revenue relatively efficiently a more prominent place in the tax system than those which raise revenue in a more costly way.

This model generates several valuable insights.

- First, the optimal mix of tax instruments cannot be determined by looking at only a subset of the costs of taxation. A tax instrument that looks attractive when considering only distortion costs may have little role to play because it imposes high administrative or compliance costs.
- Second, it is marginal costs that matter when making incremental policy adjustments. Most publicly available data relate to average or total costs.
- Third, while enforcement activity by the tax authority is a true resource cost to society, any additional revenue such activity brings in is not a resource gain, but a transfer from private citizens. As a result, the superficially appealing rule that the tax authority should maximize tax revenue net of administrative costs is not optimal because it involves too high a level of enforcement.

An important question is what determines each of the costs of taxation. Increases in the probability of punishment or the size of the penalty should reduce evasion, though the latter has not been convincingly established empirically. If citizens are dutiful, evasion can also depend on the context and factors such as tax morale and dissatisfaction with the tax system. This implies that the tax authority should be careful not to alienate taxpayers when carrying out enforcement activity.

Administrative and compliance costs depend on a wide range of factors, including the complexity of the tax, characteristics of the tax base, structure of tax rates, frequency of reform, and organization and efficiency of the tax authority. Taxes should therefore be kept as simple and stable as

possible. In other areas, there is a trade-off between administrative and compliance costs: for example, whether it is the tax authority or taxpayers who have responsibility for calculating tax liability. Providing help and guidance increases administration costs, but reduces compliance costs.

In order to achieve a high level of compliance at modest cost, modern tax systems rely heavily on taxing market transactions, and involve extensive withholding and information reporting requirements. As a result, businesses (as opposed to individuals) play a central role in tax collection.

Part II of the chapter addresses some current UK policy issues.

HM Revenue and Customs has a number of public performance objectives, including targets for reduced non-compliance and for improved accuracy and customer satisfaction. The difficulty with these targets is that they do not give a good sense of the ultimate goal, nor of the trade-offs and priorities involved. The government's work on cutting the burden of regulation gets closer to measuring marginal costs than most previous attempts, but excludes some things normally considered part of compliance costs and focuses on businesses rather than all taxpayers.

HMRC is already taking steps to improve the operation of PAYE, but the time is perhaps right for a more fundamental rethink of how income tax is collected in the UK. The need for paper communication could be much reduced by an online coding system, something that deserves further investigation. Other changes could help reduce the frequency with which PAYE withholds the wrong amount of tax, but at the cost of more burdensome information reporting requirements. A more radical alternative would be to move to a system of universal self assessment. This would allow PAYE to be simplified substantially, reduce employer compliance costs, and cut the number of errors that lie unnoticed for several years. Such a move is likely to be unpopular because of the additional burden placed on individual taxpayers. In part, this could be mitigated if HMRC pre-populated tax returns. And, were it possible to integrate tax credit claims into the tax return, some of the poorest taxpayers may benefit from such a change.

Another issue that has received much recent attention is tax avoidance. The perception remains that tax avoidance is a continuing source of considerable revenue leakage, complexity, and cost. Ultimately, tackling avoidance is part of the process of defining the tax base. This is easier where the tax base reflects a clear economic principle and avoids artificial and ambiguous boundaries. Governments are likely to have to continue to deploy a variety of measures to counteract avoidance and monitor the borders of the tax system where clear boundaries do not exist.

The overriding conclusion is that the UK's tax system is not doing too badly. But, as commercial life continues to change rapidly, there is increasing

pressure for the tax system to adapt. The question is whether it can adapt quickly enough. If not, it runs the risk of imposing unnecessary burdens while simultaneously allowing revenues to escape taxation so that the tax burden is shared in a more capricious and inequitable fashion.

## I. TAX SYSTEMS AND IMPLEMENTATION

### 12.1. INTRODUCTION

How taxes are administered and enforced matters—witness the debacle surrounding the introduction of tax credits in 2003. Most of modern tax theory, however, completely ignores administration and enforcement. The policy formation process is not much better, too often addressing implementation only after reform has been determined, rather than as an integral part of the decision-making process.

In this chapter, we step outside the usual framework for tax analysis to consider the administration and enforcement of the tax system. In essence, our primary focus is not what determines tax liability, but how that liability reaches the government's pocket. Our conclusions are of central relevance to the Mirrlees Review itself, since a number of the reforms being considered will require changes to the way in which taxes are administered and enforced.

The remainder of Part I introduces a simple theoretical framework that clarifies the key issues and trade-offs that exist. Part II applies this framework to current policy issues in the UK and offers some recommendations. Part III concludes. Although we range broadly over these issues, some we touch on only peripherally. We also assume that the net revenue required is fixed—the policy issue is how best to raise this given amount. Box 12.1 defines some key terms.

#### Box 12.1. Definition of key terms

We use the term **remit** to mean transmit funds to the tax authority (by writing a cheque, for example).<sup>1</sup> The agent ultimately liable for a tax—the **statutory bearer**—need not be the agent with responsibility for remittance. **Withholding**  
(*cont.*)

<sup>1</sup> Our use of the term should be distinguished from the UK tax system offering the 'remittance basis' for the non-domiciled that allows an individual—usually someone resident in the UK but not domiciled in the UK—to be taxed on non-UK income only if it is brought into the UK.

**Box 12.1.** (*cont.*)

refers to the situation where some or all of tax liability must be remitted by someone other than the statutory bearer (the most obvious example of this is employers remitting on behalf of employees).

We say that an individual **bears the burden** of a tax to the extent it makes him or her worse off (causes a loss of utility). The loss of utility can occur either because a tax reduces the return an individual receives on his labour or capital, or because a tax increases the prices of the good and services a taxpayer wishes to purchase with his income (or both). To the extent that taxes reduce the rate of return to investing in or running a corporate business, this burden must be traced beyond the impact on the profitability of a legal entity to its impact on the utility of the owners or suppliers of capital to the business.

Who ultimately bears the burden of a tax is generally different from both the agent who remits the tax and the statutory bearer of the tax. This is because a tax system causes changes in pre-tax prices, thereby shifting the burden away from the statutory bearer. For example, a tax on labour earnings will in general increase the pre-tax wage, so that the after-tax wage does not fall by as much as the tax rate. Thus the burden of the tax is shared between the employer, who faces a higher cost of labour than otherwise, and the employee, who receives a lower after-tax wage rate than in the absence of the tax.<sup>2</sup> The response of prices and wages to taxation may not happen in the short run, especially in the presence of inflexible prices (due, for example, to long-term contracts). However, because prices are ultimately set by the interaction of supply and demand, the tax system will, in the long run, affect prices and these effects will determine ultimate incidence.

In the long run, what matters for the impact of a tax system is what actions trigger tax liability, who must remit that liability, and the expected penalties for the failure to remit. Aside from framing issues, what a tax is *called* is not relevant; for example, other things equal, whether a tax is labelled an employer tax or an employee tax will not matter.

We employ the traditional distinction between evasion and avoidance: that of legality. **Evasion** is the use of illegal means to reduce tax liability—false statements on a tax return, for example—whereas **avoidance** is the reduction of liability through legal channels—such as setting up a company so that self-employment income (subject to income tax) can be relabelled as dividends (subject to corporation tax). If uncovered, evasion can be punished through fines or imprisonment, whereas avoidance cannot. In reality, however, the dividing line is not always clear; where this is the case we will clarify as necessary.

<sup>2</sup> In the case of a tax on labour income, exactly how this burden is shared depends critically on the relative elasticity of the demand for and supply of labour: the less elastic is labour demand and the more elastic labour supply, the greater the proportion of the burden borne by employees.

## 12.2. ANALYSIS OF TAX SYSTEM DESIGN

In this section, we show how standard tax theory can be extended to incorporate tax implementation concerns. We begin with a description of the costs of taxation, followed by the extended theoretical framework itself and an outline of its policy implications, and concluding with a discussion of caveats and broader issues that the model does not fully address.

### 12.2.1. The costs of taxation

Taxes impose costs. From an individual taxpayer's point of view, the most obvious of these is the tax revenue itself, which serves to reduce the taxpayer's purchasing power relative to what it would have been without the tax. Of course, from society's point of view, the lost purchasing power is not a cost—it is a transfer from individuals to the government, which can be used to provide public goods or redistribute towards individuals deemed worthy of support.

But taxes have other costs—costs that are true losses to society. We can distinguish three of these: distortion costs, administrative costs, and compliance costs.

**Distortion costs** arise because taxpayers' decisions, including but not limited to how much to work and what to buy, are distorted by taxes. As a simple example, an employee might be unwilling to do an hour of overtime given a post-tax wage of £12, but would willingly work late for his pre-tax wage of £20. If so, the tax has *distorted* the employee's choice over how many hours to work. It is a cost because, had the tax authority agreed not to tax the hour of overtime, the employee would have done the extra hour and been better off as a result (otherwise he wouldn't have been willing to stay late) while tax revenue is unchanged. The change in behaviour occurs because taxes change the relative price of activities so that they do not represent the relative social costs, and is sometimes referred to as the real substitution response. This is to be contrasted with evasion and avoidance, which are efforts to reduce tax liability *without* changing work and consumption decisions (illegally in the former case, legally in the latter).

A different type of distortion cost is the risk exposure cost of tax evasion. An individual who evades part of his liability exposes himself to risk because he doesn't know whether he will be caught and penalized. Assuming he is risk-averse, this is costly: the individual would prefer to remit with certainty an amount equal to his expected tax liability. If the government is effectively

risk-neutral, the social cost of the risk exposure is equal to the amount the individual would be willing to pay in order to eliminate the exposure.

**Administrative costs** are costs incurred by the tax authority in establishing and operating systems to manage all aspects of taxation. **Compliance costs**, in contrast, are incurred directly by taxpayers in complying with their tax-related obligations, and by third parties involved in the tax remittance process (such as employers who are required to remit tax on behalf of their employees).

Why administrative and compliance costs exist may be obvious, but it is worth making explicit. Even if all taxpayers were scrupulously honest, an administrative system would still be required to provide information about tax liabilities and to record and check payments, and taxpayers would still need to spend time and money finding their way through the increasingly complex maze of tax laws. But, of course, not all taxpayers are honest; nor are taxpayers obliged to arrange their affairs in a way that suits the tax authority. As a result, some taxpayers go to considerable lengths (avoidance or evasion) to reduce the size of their tax bill; this expense also constitutes compliance costs.<sup>3</sup> In response to avoidance and evasion, all tax authorities judge it worthwhile to expend resources to limit their deleterious consequences.

### 12.2.2. Optimal taxation

The costs of taxation having been described, the crucial next step is to realize that not all tax policy instruments impose the same costs per pound of revenue raised. All costs (apart from the loss of purchasing power, of course) can vary depending on the characteristics of the tax and its implementation, as can the distribution of costs across individuals. This explains why economists have spent, and continue to spend, so much time trying to find the ‘best’ tax system (the one that minimizes total costs, subject to distributional concerns).

In its search for the best tax system, modern optimal tax theory—begun by Mirrlees (1971) and Diamond and Mirrlees (1971)—has, for the most part, focused on distortion costs, ignoring both administrative and compliance costs as well as evasion. However, as a description of reality, the assumption that tax liability can be ascertained and collected costlessly is patently untrue.

<sup>3</sup> It might be argued that one should distinguish between unavoidable compliance costs (that arise in complying with tax obligations), and voluntary compliance costs (that result from attempts by the taxpayer to reduce his tax liability). In practice, it is very hard to separate the two (it depends on the intentions of the taxpayer). Moreover, both are an equally wasteful use of resources from society’s point of view.

Accounting for evasion and for administrative and compliance costs in normative models is, therefore, important. It turns out that the standard optimal tax framework can be extended straightforwardly to incorporate the other costs of taxation, and to address details of tax system implementation, such as penalties for tax evasion, enquiry rates, and obligations to report information to the tax authority, and so on. We will outline a simplified model of this type below. But before doing this, we spend a few paragraphs describing the normative framework that forms the basis for the model we present—a basis common to most optimal tax models.

### 12.2.3. Normative framework

The standard normative framework for evaluating tax policy assumes that the best tax system is the one that is best for citizens' well-being (or welfare), as they judge it. This means that the *process* that generates welfare levels is irrelevant except insofar as it affects those welfare levels. Whether a tax system is 'fair' depends on its effect on the distribution of welfare across individuals, not on the process that generates this distribution. This assumption may seem unreasonable given the possibility that the welfare of some individuals has been achieved illegally (through evasion). This is something we discuss in more detail later.

Individuals are assumed to make decisions based on what will maximize their level of well-being, as they judge it, given prices and their resources. We recognize that there are situations in which behaviour appears to violate this assumption. We address the issues this raises where appropriate.

To determine how society makes trade-offs across individuals, a social welfare function is used. A social welfare function (implicitly) assigns a weight to each individual's welfare describing how important that welfare is from society's point of view. These weights may differ according to the level of welfare: the higher the weight on low-welfare individuals relative to high-welfare individuals, the more egalitarian is the social welfare function, and the more the society is willing to sacrifice aggregate welfare in favour of a more equal distribution of welfare across individuals. We will presume that the degree of egalitarianism is determined by the political system.

### 12.2.4. Raising revenue efficiently

As mentioned above, optimal tax theory can be straightforwardly extended beyond the traditional focus of enquiry—the choice of rates and bases—to



address the policy instruments related to tax system implementation. In describing this extended framework, it is helpful to ignore distributional issues initially, and introduce them later, allowing us to focus first on how to raise revenue most efficiently (i.e. at minimum cost to society).

Assume the tax authority has to raise a fixed amount of revenue in order to fund public spending. Revenue is raised using a combination of tax instruments; the task of the tax authority is to choose which tax instruments to use (and how much to use each of them) in order to raise the required revenue at minimum cost to society. This choice will depend on the **efficiency cost** of each tax instrument, which describes how costly it is to raise revenue using that instrument. Efficiency cost incorporates all of the costs of taxation identified above—administrative and compliance costs, distortion costs including the risk bearing cost of tax evasion, plus the loss of purchasing power (it is convenient for this exercise to treat lost purchasing power like all the other costs).

What does the optimal policy look like in this model? It turns out that an optimal policy will equalize the Marginal Efficiency Cost of Funds (*MECF*) of any and all tax instruments that are employed.<sup>4</sup> The *MECF* of a particular tax instrument is defined as the marginal (additional) cost to society of raising an extra pound of tax revenue using that tax instrument. The higher is a tax instrument's *MECF*, the less efficient is the tax instrument at collecting revenue. The equalize-*MECF* principle holds because, if it is violated, the same revenue could be raised at lower social cost by reducing reliance on high-*MECF* tax instruments and increasing reliance on low-*MECF* instruments.<sup>5</sup> As shown in Slemrod and Yitzhaki (1996), the *MECF* of a given tax instrument,  $i$ , is equal to:

$$MECF_i = \frac{1 + x_i + c_i}{1 - a_i}$$

where  $a_i$  and  $c_i$  are marginal administrative and compliance costs per pound of revenue raised, and  $x_i$  is the distortion cost per pound raised (including risk exposure costs). The numerator is the social cost of the tax change per pound raised; the denominator is how much of that pound is left once administrative costs have been accounted for. Because  $c_i$  is added in the numerator and  $a_i$  is subtracted in the denominator, the key conceptual

<sup>4</sup> The *MECF* analysis applies to incremental policy changes, but the intuition applies to non-incremental policy changes, as well.

<sup>5</sup> In the more general model where the level of public spending is chosen optimally, it will also be true that the common value of the *MECF* for all tax instruments is equal to the social marginal benefit of public spending. This suggests that the level of public spending should depend, in part, on the efficiency of the tax instruments available to collect the revenue.

difference between compliance costs and administrative costs is explicit: only the latter uses revenue raised from taxpayers.

Three important implications of the model derive immediately from the form of the *MECF*. First, what matters for the evaluation of potential incremental policy changes are marginal costs, not total or average costs. This stands in contrast to much of the empirical evidence on administrative and compliance costs (discussed later), which concerns total costs. Second, since the *MECF* depends on all costs of taxation, policy reforms cannot be evaluated with reference to only a subset of the costs. A reform that looks attractive when considering only distortion costs may be very unattractive when administrative and compliance costs are taken into consideration. Third, to the extent that a trade-off exists between administrative and compliance costs, administrative costs should receive a slightly higher weight because administrative costs must themselves be met through taxation, which entails further administration, compliance, and distortion costs.

Since the optimal policy rule requires that the *MECF* be equalized for all tax instruments employed, it should be clear that tax instruments with a high *MECF* will, all else equal, have a less prominent place in the tax system than those with a low *MECF*. Some high-*MECF* tax instruments should not be used at all.

In this context, it is worth noting that the *MECF* of one tax instrument may depend on the setting of other tax instruments. This implies that the optimal setting of one tax instrument cannot be determined without reference to the settings of other tax instruments. For example, the optimal progressivity of the tax system given a sub-optimal level of enforcement may be below the overall optimal level of progressivity.

Another implication of the equalize-*MECF* rule relates to the appropriate amount of resources to devote to increasing the probability that evasion is detected. One superficially intuitive rule—to increase the probability of detection until the increase in revenue thus generated equals the marginal administrative cost (so that  $a_i = 1$ )—is incorrect.<sup>6</sup> This is clear from the *MECF* formula: if  $a_i = 1$ , then the *MECF* of increasing administrative resources is infinite, which can never characterize an optimal policy. The problem with the intuitive rule is that, although the cost of hiring more auditors is a true resource cost, the revenue brought in does not represent a net gain to the economy, but rather is a transfer from private (non-compliant) citizens. The correct rule will involve a lower probability of detection than the one implied by the superficially intuitive rule.

<sup>6</sup> This is formally demonstrated in Slemrod and Yitzhaki (1987).

This reasoning also makes clear that in general it is not optimal to expend resources to eradicate tax evasion, just as it is generally not optimal to station a police officer on every corner in an attempt to eliminate street crime. This is relevant for our later discussion of ‘tax gap’ measures, because the actual tax gap may be greater than or less than the optimal tax gap.

Finally, from one country’s perspective, expending resources to crack down on cross-border income shifting is particularly attractive, because any revenue collected does not come with an offsetting utility loss to the taxpayer, as the taxpayer would have paid some tax to another tax authority. By ignoring the fiscal spillovers, this policy is very attractive from one country’s point of view, but not necessarily from a global welfare perspective.

### 12.2.5. Distributional concerns

Implementation is not only a question of how to raise funds with minimal resource cost—the distributional consequences of how a tax system is implemented are also relevant. If distributional concerns are allowed for, the optimal policy now involves equating the marginal cost of funds,  $MCF_i$ , of each tax instrument.<sup>7</sup> The  $MCF$  is just the  $MECF$  (described above) re-weighted to reflect distributional consequences:

$$MCF_i = DC_i \times MECF_i$$

where  $DC_i$  is Feldstein’s (1972) distributional characteristic of the tax instrument that describes *who* bears the utility changes caused by a change in the tax instrument. A higher value of  $DC$  indicates that utility changes are concentrated among individuals with a higher marginal social welfare weight (generally lower-income individuals), reflecting the additional social cost of using a tax instrument with adverse distributional consequences (assuming a preference for equality, all else equal). Since the optimal policy now involves equating the  $MCF$  of each tax instrument rather than the  $MECF$ , it will—not surprisingly—involve lower reliance on tax instruments whose burden is concentrated among the poor, and more on those whose burden is concentrated among the rich.

As we will see later, evasion and compliance costs vary across the income distribution. At this stage, it is worth noting that systematic variation between individuals at *different points* in the distribution can be approximately offset by changing the structure of tax rates (making income tax more progressive, for example). In contrast, variation in evasion and compliance costs between

<sup>7</sup> This is shown in Mayshar and Yitzhaki (1995).

individuals at the *same* point in the distribution cannot be offset by changes in tax rates; this issue of horizontal equity is discussed below. Administrative costs have no distributional implications as, in effect, they can be spread across the whole population as desired.

#### 12.2.6. Caveats and broader issues

Like every economic model, the *MECF* framework is highly stylized. Inevitably, there will be some issues that the *MECF* framework does not capture adequately. We discuss a number of these in this section.

##### *Private costs and social costs*

A central assumption of the model just presented is that the private costs of taxation are equivalent to the social costs. In some cases, however, the private cost is clearly not identical to the social cost. One example of this is when the behaviour of taxpayers directly affects people other than the taxpayer concerned and the tax authority (an ‘externality’). Another example is fines for tax evasion. A fine is viewed as a cost by the individual, but from society’s point of view fines collected serve to reduce the amount of revenue that would otherwise have to be collected. This benefit is ignored by the individual—hence the divergence between private and social cost. Note that an increase in fines can look like an attractive policy option indeed: unlike employing additional inspectors, the increase in tax collections due to increased deterrence is achieved with no resource cost. As discussed later, there are reasons unrelated to efficiency cost minimization that make it undesirable to increase fines for tax evasion without limit.

##### *Welfare discounts for tax evaders*

One notable aspect of the standard normative approach, raised by Cowell (1990, p. 136), is that it does not allow for the possibility that there should be a specific social welfare discount applied to the utility of those who are found to be guilty of tax evasion and thus ‘are known to be anti-social’, as opposed to the welfare weight applied to the innocent or uninvestigated (who may or may not be anti-social). If no such discount is applied, non-compliant taxpayers do not per se receive a lower welfare weight than compliant taxpayers. Resolving this issue is a matter of political philosophy rather than economics, and here we can only note that accepting this alternative

perspective of discounting the welfare of non-compliers would suggest higher penalties for detected evaders and more resources spent on detecting evasion. It does not, though, in itself restore the logic behind expanding resources until the marginal revenue raised is equal to the marginal resource cost of raising that revenue.

### *Horizontal equity*

The possibility of tax evasion raises the more general issue of horizontal equity—the extent to which a tax system results in the same tax burden among individuals at the same level of well-being. It is often invoked as a desirable criterion for judging tax policy that cannot be captured by the standard framework. Indeed, not only does our optimal policy fail to eliminate horizontal inequity caused by evasion (doing so would require ‘excessive’ anti-avoidance spending), it commonly involves creating *additional* horizontal inequity through the use of random audits and by making tax liability depend upon ‘tags’ (relatively immutable characteristics of individuals that are correlated with well-being).<sup>8</sup>

The problem with accepting horizontal equity as an explicit criterion is, as Kaplow (1989, 1995) demonstrates, that it means abandoning the Pareto principle (that any reasonable rule should accept a policy that makes some people better off and no one worse off). This doesn’t seem to be a very desirable move. Even if one is willing to make this sacrifice, it is not clear how horizontal equity should be traded off against other objectives.

### *Privacy and taxpayer rights*

Because the collection and evaluation of information is a critical aspect of implementing all taxes, the question arises of whether the government and other third parties to the tax system can be trusted with this information. Can the government be relied upon to keep it safe, make appropriate use of it in policy, and forego using it inappropriately by, say, selling it or exploiting

<sup>8</sup> Akerlof (1978) is the seminal article on the use of tags in tax, and other, policy. To see the potential efficiency benefits of tagging, imagine that having blue eyes is positively correlated with ability, and therefore well-being. Levying a tax on blue-eyed individuals would achieve a progressive distribution of the tax burden without the distortion costs associated with, say, graduated income tax rates (the possibility of a tax-reducing behavioural response to an eye colour tax is somewhat limited!). It is horizontally inequitable because an individual with brown eyes would have a lower tax burden than a blue-eyed individual at the same level of well-being.

it for political purposes? Concern over access to private information leads to tax data being fiercely protected in most countries.<sup>9</sup>

Much of this boils down to a question of privacy and whether our model adequately captures the value individuals place on it. Following Lessig (1999), it is helpful to distinguish three separate aspects of privacy. In the first, the concern is the burden of intrusion—what he calls the utility conception: a police search of one's home or car is, to be sure, a hassle. This hassle is, in principle, captured as compliance costs and taken into account by the tax authority in policy making. The second aspect is privacy as dignity—even if a search is not bothersome or costly, it is an offence to one's dignity. Again, in principle, the value of offences to citizens' dignity would be captured in a utility-based measure of compliance costs, although practically speaking this is much more difficult to quantify than the hassle of a search. The third aspect of privacy is its potential use as a way to constrain the power of the state by restricting the scope of regulation that is practically possible. We note that studies that attempt to measure compliance costs do not account for taxpayers' dislike of sharing private information.

If the government cannot be relied upon to take privacy adequately into account when devising policy, steps may be needed to limit the information the government can collect and use. One way this may be achieved is by relying on business-based taxes that do not make use of information about individuals, such as a VAT (value added tax). Particular methods of collection can also act to constrain the use of information. The UK Pay As You Earn (PAYE) system used to withhold income tax is an example of this, since it works well only with a fairly simple tax base. Whether PAYE has been a constraint on policy—and if so, whether this has been beneficial—is an issue to which we will return in Part II of this chapter.

The downside of privacy is that it can make achieving other aims more difficult. In particular, the efficiency of the tax system may be harmed if the use of certain types of information is disallowed. Fairness also commonly requires information: tax allowances for pensioners and the disabled, for example, rely on information about age and disability. Ultimately, a balance must be struck between protecting the privacy of citizens and achieving other aims of the tax system.

Tax systems inevitably impose obligations on taxpayers. But is there a balance: do taxpayers have rights against the tax authority? In the case of a

<sup>9</sup> It is important to distinguish the collection of information to implement policy, to monitor and prosecute taxpayers, and for statistical purposes (to inform policy). We note that in many countries data collected for statistical purposes cannot be used to prosecute an individual for tax non-compliance.

dispute, taxpayers can sometimes ask for some form of internal review, where the tax authority undertakes to have someone not connected with the case look at the issues. Of course, this lacks the independence of a real appeal: recourse to the courts is usually how this is achieved.

In exercising their rights, taxpayers face two issues. The first is knowledge of the routes available. To some degree, this could be addressed by a taxpayers' Bill of Rights, setting out the standards of service taxpayers can expect and the courses of action available in case of a dispute, alongside a list of the responsibilities of taxpayers. But even with one of these, taxpayers may still have little idea of their options. The second issue faced by taxpayers is that, even with an understanding of options open, taxpayers often need time and money to take advantage of them. This is particularly the case with court proceedings, which can be both lengthy and expensive.

### *Transparency*

The way a tax system is implemented can have an important effect on transparency, which has value to a polity not captured by the model we have presented, in that it facilitates an open dialogue about the wisdom of the policies in place and possible alternatives. Getting taxpayers involved in the remittance process (by requiring them to fill in tax returns, for example) is usually good for transparency because they gain some understanding of the calculations involved and see the size of the cheque sent to the tax authority. In contrast, complexity is the enemy of transparency: it contributes to the attractiveness of using tax advisers and computer software, leaving individuals with little idea what is going on.

### 12.3. DETERMINANTS OF EVASION, AVOIDANCE, AND ADMINISTRATIVE AND COMPLIANCE COSTS

The previous section described how the modern theory of optimal taxation can be extended to incorporate administrative and compliance costs and the risk-bearing cost of tax evasion, to address tax system implementation. In this setting, we saw that the marginal efficiency cost of funds (*MECF*) of each tax instrument played a central role in determining the best choice of tax instruments (the combination that raises the required revenue at lowest cost). We also derived a formula that showed how the *MECF* incorporates all the costs of taxation: administrative and compliance costs, distortion costs

including the risk bearing cost of tax evasion, plus lost purchasing power. In this section we address what determines the size of each of these costs by focusing on evasion and avoidance as well as administrative and compliance costs and discussing the relationships and trade-offs that exist between each of them.

### 12.3.1. Tax evasion and deterrence

The canonical economic model of tax evasion (the ‘deterrence model’) presumes that the taxpayer’s actions are not motivated by morality or duty, but are restrained only by the possibility of punishment. The seminal formulation is due to Allingham and Sandmo (1972), who, in the context of an income tax, modelled the punishment as a fixed probability that any income understatement would be detected and subjected to a proportional penalty over and above payment of the outstanding tax liability.<sup>10</sup> The risk-averse taxpayer chooses a report in order to maximize expected utility, so that the choice of whether and how much to evade is akin to a choice of whether and how much to gamble. If, and only if, the expected pay-off to this gamble is positive, a risk-averse taxpayer will chance some evasion, with the amount depending on the expected pay-off and the taxpayer’s risk preferences.<sup>11</sup> The key result for policy is that increases in either the probability of punishment or the penalty rate will reduce evasion.<sup>12</sup> Perhaps surprisingly, the relationship between the tax rate and the level of evasion is a priori ambiguous, depending on the taxpayer’s risk preferences and whether the penalty for detected underreported income is tied to the tax liability evaded.<sup>13</sup>

Once an evader has been identified, imposing a financial penalty is (almost) costless from society’s perspective because it is a transfer rather than a resource-using deterrent like hiring more tax inspectors. As a result, a government concerned with maximizing the expected utility of a representative

<sup>10</sup> The penalty may include damage to one’s reputation.

<sup>11</sup> Like all economic models that are highly stylized, it is not meant literally in the sense that each taxpayer sits at his or her desk and solves a constrained maximization problem. It does, however, suggest that individuals weigh the potential gains from evasion with the costs and chances of being caught. The relevance of the model is ultimately an empirical question, resting on whether it can explain observed patterns of behaviour.

<sup>12</sup> Of course, what matters for decisions is the *perceived* probability of detection and attendant penalties rather than objective values.

<sup>13</sup> The relationship between the tax rate and the level of evasion is ambiguous because, when penalties are proportional to the tax understatement, a tax rate increase raises both the reward to the successful evasion of a given amount of taxable income and the penalty for its detection. See Yitzhaki (1974).



citizen will want to set the penalty as high as possible to deter evasion—this has been well known since Becker (1968). But this argument ignores the possibility that the tax administrator might abuse the system, and the fact that individuals (and the tax authority) make honest mistakes. It also flies in the face of the common notion that the level of punishment should in some sense ‘fit’ the crime.

In contrast to penalties, increasing the probability of detection is costly (it requires more tax inspectors, computers, etc.). A large theoretical literature has explored the extent to which the probability of detecting a given act of evasion can be raised above the average audit coverage rate by exploiting the statistical relationship between what is revealed on tax returns and non-compliance. Sophisticated ‘risk-management’ techniques of this sort are used in many countries (including the UK).

Perhaps the most compelling empirical support for the deterrence model in an income tax setting is the clear evidence that the non-compliance rate is lower for those acts of non-compliance with a higher likelihood of being caught. Klepper and Nagin (1989), for example, show that, across line items of the US income tax form, non-compliance rates are related to proxies for the traceability, deniability, and ambiguity of items, which are in turn related to the probability that evasion will be detected and punished. In contrast, the relationship between non-compliance and the penalty has not been convincingly established.

The deterrence model, and most subsequent extensions and empirical analyses, focus on evasion by *individuals*. Understanding non-compliance by *companies*, however, may require a different framework. This is particularly relevant for large firms, where tax reporting decisions are usually delegated to someone other than the firm’s owner or shareholders (creating the potential for misaligned incentives) and where attention focuses not on (illegal) evasion but on (legal) avoidance or the blurry border between the two.

### 12.3.2. Duty, obligation, and tax evasion

The deterrence model of tax evasion presumes that individuals (and firms) are entirely amoral, and remit taxes only when a cost–benefit calculation indicates they should; the fact that evasion happens to be *illegal* is irrelevant aside from the effect penalties have on the cost–benefit comparison. Arguably, though, a non-trivial segment of individuals (and maybe even firms) would remit the taxes they owe due to a sense of obligation or duty even in the absence of any enforcement. Indeed, some have argued that duty and

obligation are central to understanding taxpaying behaviour because evasion seems to be a winning proposition for many more people than actually do evade. From this perspective, the puzzle is not to explain why people evade, but rather why people don't evade more.

For three reasons, this argument for dismissing the deterrence model is not persuasive. Most important, it often relies on assuming that the probability of an act of evasion being detected is equal to the fraction of returns that are audited in a given year. For the bulk of income subject to tax in developed countries, this will be a vast understatement of the true probability because of the efficacy of risk-management techniques (discussed above), information reports, and withholding (discussed below). Second, it does not put a value on reputational damage to the taxpayer, something that may in practice be quite important. Third, to the extent that past years' returns may be audited, the relevant probability is the probability of being caught over a number of years rather than in a single year.

While the usual argument dismissing the deterrence model is not persuasive, there are certainly reasons to doubt that it is the end of the story. Some experimental evidence finds that subjects respond not only to the probability of detection and the stakes in a tax evasion game, but also to the context provided to them (which shouldn't matter according to the deterrence model). There is also evidence that dissatisfaction with the tax system is related to non-compliance (again, it should not be in a deterrence framework).<sup>14</sup>

Frey (1997) argues that punitive enforcement policies may crowd out the 'intrinsic' motivation of such people by making them feel that they pay taxes because they have to, rather than because they want to. Feld and Frey (2002) argue that where the relationship between the individual and the tax authority is seen as involving an implicit contract sustained by trust, individuals will comply due to high 'tax morale'. To sustain citizens' commitment to the contract, the tax authority must act respectfully toward citizens while at the same time protecting the honest from the free rider. It does this by giving taxpayers the benefit of the doubt when it finds a mistake, by sanctioning small violations more mildly, and by sanctioning large and basic violations (e.g. the failure to file a return) more heavily.<sup>15</sup>

<sup>14</sup> Scholz and Lubell (1998) found, after controlling for attitudes about tax fairness, civic duty, political efficacy, tax duty, opportunity for evasion, and being in a high non-compliance occupation, that high scores on two trust measures ('You can generally trust the government to do what is right' and 'Dishonesty in government is pretty rare') significantly decrease the likelihood of non-compliance.

<sup>15</sup> Some survey evidence also provides support for this view, for example Torgler (2003) and Slemrod (2003) show there is a positive relationship across countries between survey-based attitudes

If perceptions matter for tax compliance, a natural question is to what extent tax compliance behaviour can be manipulated by the government to lower the cost of raising resources. Appeals to patriotism to induce citizens to pay their taxes are common in recent times. That such campaigns are successful during ordinary (non-war) times in swaying taxpayers from their otherwise selfishly optimal compliance strategy has not, though, been compellingly demonstrated.<sup>16</sup>

Given that businesses have a central role in tax remittance, an important question is whether arguments about honesty and dutifulness also apply to companies. If the tax director views paying taxes as a civic virtue and can determine policy, corporate evasion or aggressive avoidance may take on an ethical dimension and become responsive to non-deterrence aspects of the tax system.

### 12.3.3. Tax avoidance

Discussion of tax evasion leads naturally into the subject of tax avoidance. The starting point is that avoidance is legal, unlike evasion. Evasion reflects the mechanisms that are used to assess and collect tax and the ease with which those mechanisms can be controlled and monitored. Avoidance, in contrast, reflects the choice of tax base and the ease with which the concepts it involves can be described in legislation in a way that offers the fewest opportunities to taxpayers to reduce or eliminate their tax liabilities by modifying their behaviour—or the tax characterization of behaviour—in some way. In this respect, avoidance activity can provide an indication of the extent of distortion or non-neutralities that a particular tax base may entail. That said, the boundary between avoidance and evasion may not always be clear. In particular, where there is uncertainty about the correct taxation of particular arrangements or activities, the ‘success’ of particular avoidance may depend upon the tax authority not becoming fully aware of what the taxpayer has done so that the correct taxation of the arrangements or activities in question are never challenged and never have to be justified.

Every tax system is likely to generate some avoidance activity because every system involves the creation of boundaries of one sort or another—between what is taxed and what is not, between taxpayers with different tax

toward tax evasion on the one hand and professed trust in government, and Slemrod (2003) finds that the same relationship holds across individuals within the US and Germany.

<sup>16</sup> In a randomized field experiment with Minnesota taxpayers in a peacetime setting, Blumenthal, Christian, and Slemrod (2001) find no evidence that either of two written appeals to taxpayers’ consciences had a significant effect on compliance.

characteristics—that will then lead to tax arbitrage. If a tax system can avoid creating unnecessary and difficult-to-police boundaries it is likely to be more robust against avoidance than one that does involve such boundaries. Any system, however, is likely to involve a variety of instruments to minimize or impede avoidance activity. In Part II we outline the different approaches that have been adopted in the UK and make a number of observations on their relative success.

#### 12.3.4. Administrative and compliance costs

In this section, we discuss the determinants of administrative and compliance costs. It is convenient to take the two together because many issues are common to both. Most work in this area has been empirical, attempting to measure how big administrative and compliance costs are for different taxes, and how they vary by size of taxpayer.<sup>17</sup> Surprisingly little of this empirical work has tried directly to answer the question we are most interested in: what features of a tax or tax system *cause* high costs? Nevertheless, we can list a number of important factors.

Administrative and compliance costs are generally lower for simpler taxes—those with fewer rates, borderlines, and reliefs. Less effort is required to understand how to comply, the mechanics of fulfilling obligations takes less time and there is less for the tax authority to have to record and monitor. If there is overlap between the bases of different taxes, the use of common definitions and procedures across taxes reduces costs by decreasing the number of calculations that have to be made (this has been one of the main motivations behind moves towards alignment of income tax and National Insurance in the UK in recent years). Complexity and lack of clarity in tax law in general will make for higher administrative and compliance costs.<sup>18</sup>

The characteristics of the tax base are particularly important for administrative costs. The important issue is the ease with which the tax base can be disguised, hidden, or relabelled. Two characteristics are likely to be particularly relevant: physical size and mobility (it is harder to tax diamonds than installed windows, for example), and whether there is compulsory registration (as there is for car owners and holders of driving licences).

<sup>17</sup> Evans (2003a) is a helpful introduction to recent work on the administrative and compliance costs of taxation.

<sup>18</sup> See section 1.7 of Evans (2003b) for a discussion of simplicity and complexity.

The structure of tax rates affects administrative and compliance costs for at least two reasons. First, average costs per pound of revenue collected are likely to fall as the tax rate increases because the cost of complying or inspecting a tax base does not depend on the tax rate (except to the extent that people are more inclined to avoid or evade when the tax rate is higher). Second, variations in tax rates can lead to large increases in administrative and compliance costs. To see this, consider two commodity taxes. If the tax rate is the same for both taxes, only total sales of the two commodities need be reported to and monitored by the tax authority. But if the tax rates differ, even fractionally, sales must be reported and monitored separately, implying considerably higher costs.

In recent years, tax systems in developed countries have moved towards giving small taxpayers the option of calculating their liability against a simplified scheme. The idea is to reduce administrative and compliance costs in cases where the risk of losing tax revenue is low. In practice, providing this sort of choice often turns out to be counter-productive, at least for compliance costs: taxpayers end up calculating their liability against all available schemes to make sure they choose the best one.

A major component of compliance costs is the cost of understanding which tax-related obligations apply to the taxpayer, and what needs to be done to comply with them. In this regard, stability is a highly desirable feature of a tax system, since learning what to do is much more costly the first time than on subsequent occasions. As Sandford (1995) points out, stability is helped if governments get legislation right the first time, which in turn underlines the importance of proper consultation beforehand (the zero per cent starting rate of corporation tax is a classic example of where the government got it wrong<sup>19</sup>). This argument also favours large one-off reforms over incremental changes that require new tax obligations to be understood multiple times. On the other hand, incremental reform might be preferable from the point of view of minimizing the chance of serious breakdown in the new procedures.

Whether the tax authority or the remitter is responsible for calculating tax liability obviously affects compliance costs: the greater is the reliance on the remitter to calculate liability, the higher are compliance costs and the lower administrative costs. Of course, administrative costs also depend upon the organization and efficiency of the tax authority.

Responsibility for remittance is important because there are economies of scale in tax administration and compliance: costs tend to be lower when the

<sup>19</sup> See <[www.hmrc.gov.uk/ria/ria-corporation-tax.pdf](http://www.hmrc.gov.uk/ria/ria-corporation-tax.pdf)>.

tax authority has to deal with fewer, larger remitters. The number of taxpayers (those with statutory liability) will also have some bearing on costs (more taxpayers means more calculations), but it is unlikely to be as important as the number involved in remittance. Administration and compliance is likely to be less costly if remitters understand the tax concerned, and have in place systems that are able to provide the necessary information without much additional work. For this reason it is less costly to tax a transaction that involves a large company, which may well need documentation for its own purposes, than to tax a small business, which may not require the same level of documentation.

There is a trade-off between administrative and compliance costs in regard to the provision of help and guidance: comprehensive user-friendly documentation and telephone support is costly to provide but makes it easier for taxpayers to comply.

Note, as mentioned above, administrative costs have no distributional consequences: they are met out of tax revenue so can effectively be spread across the population as desired. In contrast, compliance costs can have quite marked distributional consequences. These will depend on the ultimate incidence of compliance costs, not on where they fall in the first instance (i.e. on remitters). Ultimate (and long-run) incidence depends on the extent to which prices and wages adjust to shift the burden away from the remitter—the logic is similar to that for the incidence of the tax itself. A limited amount of empirical work has been done to try to estimate the incidence of taxes; to our knowledge, none of this has incorporated the effect of compliance costs (although one might imagine incidence to be similar). This is obviously an extremely important question if we are to understand the distributional consequences of compliance costs.

From the above discussion, it should be clear that, although some factors tend to move administrative and compliance costs in the same direction, others (such as who has responsibility for calculating tax liability) will move them in opposite directions. In fact, there is considerable potential for transferring between administrative and compliance costs. In this case, it is important to consider administrative and compliance costs together rather than targeting one separately from the other.

As a final point, so far we haven't drawn a strong distinction between compliance costs that are unavoidable (those incurred in meeting tax-related obligations) and those undertaken voluntarily (planning to reduce tax liability). Both represent social costs, because they use up resources that could otherwise have been put to valuable purposes. From a policy perspective, however, there may be an important difference: while reducing unavoidable

compliance costs should help to reduce the overall costs imposed by the tax system, cutting voluntary compliance costs may facilitate avoidance and evasion and therefore increase the amount of avoidance and evasion that individuals find it beneficial to undertake. As a result, the tax authority may wish to concentrate on reducing unavoidable compliance costs (though distinguishing between the two is likely to be challenging!).

## 12.4. ENFORCEMENT SYSTEMS

The previous section discussed some of the factors that affect non-compliance and administrative and compliance costs. In this section, we consider a number of common strategies used to achieve a high level of compliance at modest administrative and compliance cost. In particular, we discuss: taxing market transactions, information reporting, and withholding. We also discuss the role of business and IT in tax implementation.

### 12.4.1. Taxing market transactions

Basing tax liability on market transactions—those between a willing buyer and an unconnected willing seller—has several advantages. First, in a market transaction information can potentially be obtained from either party, which provides a natural check on its accuracy. A second property is that market transactions tend to be better documented, and the more documented a transaction, the lower is the cost of gathering information on it. Finally, market transactions establish arm's-length prices, which greatly facilitate valuing the transaction. VAT, for example, relies almost entirely on market transactions, while taxing capital gains on a realization basis rather than the theoretically preferable accruals basis takes advantage of the measurement advantage of market transactions.

Where no suitable market transaction exists, implementing a tax can become quite costly. An example of this involves subsidiaries of a multinational corporation that deal with one another and are based in different countries. Without appropriate safeguards, there is considerable scope for taxable income to be shifted to relatively low-tax jurisdictions through the manipulation of prices used for transactions between subsidiaries (transfer prices). To avoid this happening, the tax authority needs to ensure 'arm's-length' prices are used; this can be extremely complicated if the subsidiaries do not deal with outsiders (where prices won't be artificially manipulated).

### **12.4.2. Information reporting**

Information reporting relates to the requirement that certain transactions incurring tax liability be reported to the tax authority by the party that does not have statutory liability for the tax. It provides the tax authority with information that can be compared against the amount of tax actually remitted, allowing suspect returns to be identified and chased up. Evasion now requires coordination between the party providing the information report and the party responsible for remittance, but—and here is the key—their incentives and willingness to falsify the data are unlikely to be the same (incentives can even work in opposite directions).

Thus, a working system of information reporting discourages non-compliance by increasing the risk of detection for a given amount of tax authority resources. It forms a central element of all modern tax systems. In common with all other OECD countries, the UK requires information reporting on wages and salaries. Information reporting is also required for various other areas.

A rather different requirement to report information to the tax authority is the obligation introduced in the UK to disclose tax avoidance schemes shortly after they are first marketed. The aim is essentially to improve the tax authority's ability to combat what is seen as unacceptable planning: the tax authority has the chance to take early legislative action and (importantly, though this aspect receives less emphasis) gets to understand who is promulgating and using such schemes.

### **12.4.3. Withholding**

Withholding refers to the situation where some or all of a tax liability must be remitted by someone other than the statutory bearer. It facilitates administration by allowing the tax authority to take advantage of economies of scale that exist in dealing with a smaller number of larger remitters who, for other reasons, have sophisticated record-keeping and accounting systems. It also acts as a safeguard, ensuring that some tax is remitted even when the statutory bearer fails to file a return or otherwise disregards their tax obligations. Tax systems often contain an indirect incentive for accurate and well-documented withholding. For example, to be sure of being able to deduct wage payments from taxable profits, businesses need to have their payment records in order, otherwise the deduction will be at risk of challenge.



Withholding is usually restricted to businesses and government agencies. Individuals in their capacity as employees and consumers are usually excluded—they are too numerous and not sufficiently capable as a class to be suitable withholding agents. To be able to withhold the appropriate amount of tax, the withholding agent must have an ongoing relationship with the statutory bearer of the tax, or, alternatively, the withholding scheme must be sufficiently simple to avoid the need for such a relationship.

In the first instance, the (compliance) costs associated with withholding fall on the withholding agents themselves, but they generally count as business expenses that can be deducted from taxable income (reducing tax liability), so get partially transferred to the government. Who bears the ultimate burden of compliance costs depends on the same demand and supply forces as determine the incidence of taxes themselves (see earlier discussion). A few countries provide explicit compensation to withholding agents. Most do not, but effectively compensate withholding agents by allowing a time lag between when tax liability is triggered and when remittance is due (interest can be earned on the tax liability in the intervening period), but this will be no more or less effective in relieving the burden than would be a tax rate cut equivalent to the interest gained during the time lag.<sup>20</sup>

Withholding for income tax is widespread among developed countries: it is required for wages and salaries in all but two of the thirty OECD countries, and for interest in twenty-one of the OECD countries. The use of withholding for other sources of income varies across the OECD.

#### 12.4.4. The role of business and IT

The discussion of information reporting and withholding highlights the central role of business in the *implementation* of modern tax systems—in remitting tax revenue and in information reporting. On our calculations, almost 90% of UK tax revenue is remitted by business (Table 12.1). The impetus behind the role of business has been elegantly stated by Richard Bird, who wrote: ‘The key to effective taxation is information, and the key to information in the modern economy is the corporation. The corporation is thus the modern fiscal state’s equivalent of the customs barrier at the border.’<sup>21</sup> Collecting taxes from businesses saves on administrative and compliance costs because of the economies of scale inherent in tax remittance and because

<sup>20</sup> In fact, Sandford et al. (1989) find that this cash-flow benefit can exceed compliance costs for large companies.

<sup>21</sup> Bird (2002).

Table 12.1. Remittance responsibility in the UK tax system: 2006–07

	Receipts (£m)	Remitted by business (£m)	Proportion
<b>HMRC-administered taxes</b>			
<i>Income tax:</i>			
PAYE	124,799	124,799	1.00
Self Assessment, net of repayments	20,306	0	0.00
Other receipts <sup>1</sup>	8,331	4,868	0.58
Tax credits <sup>2,3</sup>	-4,435	-3,992	0.90
Other repayments <sup>2,4</sup>	-5,673	-5,514	0.97
National Insurance <sup>5</sup>	87,273	84,504	0.97
Corporation tax	44,308	44,308	1.00
Petroleum revenue tax	2,155	2,155	1.00
Capital gains tax	3,813	0	0.00
Inheritance tax	3,545	0	0.00
Stamp duties	13,392	13,392	1.00
VAT	77,360	77,360	1.00
Other indirect taxes <sup>6</sup>	48,485	48,485	1.00
<b>Subtotal</b>	<b>423,659</b>	<b>390,366</b>	<b>0.92</b>
<b>Non-HMRC-administered taxes</b>			
VED	5,100	1,020	0.20
Business rates	21,000	21,000	1.00
Council tax	22,200	0	0.00
Other taxes and royalties <sup>7</sup>	13,900	13,900	1.00
<b>Subtotal</b>	<b>62,200</b>	<b>35,920</b>	<b>0.58</b>
<b>Total</b>	<b>485,859</b>	<b>426,286</b>	<b>0.88</b>

Notes (figures in brackets are fractions assumed to be remitted by business):

1. Other receipts category comprises tax deduction scheme for interest (TDSI) (1.00), other tax deducted at source (1.00) and others (0.00).

2. Repayments are classified not according to how repayments were made but according to the tax for which they are repayments.

3. Tax credits comprise the negative tax part of WTC/CTC expenditure (0.90), MIRAS (0.90), LAPRAS (0.90), and other (0.90). The 0.90 for WTC/CTC is based on an estimate of the number of self-employed recipients. The 0.90 figure for all other tax credits is the proportion of gross income tax receipts remitted by business.

4. Other repayments comprise individuals (1.00), personal pension contributions (1.00), pension fund and insurance companies (1.00), charities (0.90), overseas (1.00), PEPs and ISAs (0.90), and other (0.90). Again, 0.90 is the proportion of gross income tax receipts remitted by business.

5. Class 1 National Insurance contributions (1.00), Class 2–4 contributions (0.00).

6. Other indirect taxes comprise (all 1.00): fuel duties, tobacco duties, spirit duty, beer duties, wine duties, cider and perry duties, betting and gaming duties, air passenger duty, insurance premium tax, landfill tax, climate change levy, aggregates levy, and customs duties and levies. A small fraction of customs duties may be attributable to individuals, but it is not easy to assess how much.

7. The main components of other taxes and royalties (all assumed 1.00) are VAT refunds to central government and local authorities, rest of the world taxes on products, national lottery distribution fund, and fossil fuel levy.

Sources: <[http://www.hmrc.gov.uk/stats/tax\\_receipts/table1-2.pdf](http://www.hmrc.gov.uk/stats/tax_receipts/table1-2.pdf)>, <[http://www.hmrc.gov.uk/stats/t\\_receipt/table2-8.pdf](http://www.hmrc.gov.uk/stats/t_receipt/table2-8.pdf)>, <[http://www.hmrc.gov.uk/stats/t\\_receipt/table2-9.pdf](http://www.hmrc.gov.uk/stats/t_receipt/table2-9.pdf)>, Appendix 6 of <[http://www.gad.gov.uk/Documents/Social\\_Security\\_Uprating\\_Order\\_07.pdf](http://www.gad.gov.uk/Documents/Social_Security_Uprating_Order_07.pdf)>, Table C6 of Budget 2008 <[http://www.hmtreasury.gov.uk/media/9/9/bud08\\_completereport.pdf](http://www.hmtreasury.gov.uk/media/9/9/bud08_completereport.pdf)> and authors' calculations.

businesses often already have record-keeping and accounting systems in place that simplify the process of tax remittance and information reporting.

One of the greatest changes in the three decades since the Meade Report (Meade, 1978) is the growth of information technology, now a completely indispensable part of the operation and management of taxes. IT cuts the cost of processing, reduces the risk of errors, helps to expose non-compliance, and may reduce the amount of information that needs to be collected. Its downside is that new IT systems can be extremely difficult and costly to implement and, because taxpayers no longer get involved in tax calculations themselves, lead to growing ignorance about the tax system.

## 12.5. IMPLEMENTATION GUIDELINES

Before turning to some key implementation issues in the UK tax system, it may be helpful to summarize the discussion so far. Getting administration and enforcement right are central to making a tax system work. We have shown how standard optimal tax theory can be extended to address these issues. In such a framework, the characteristics of the optimal policy have a number of important implications. In particular:

- The optimal mix of tax instruments cannot be determined by reference to a subset of the costs of taxation: all costs affect the optimal policy mix, and must therefore be considered together. In particular, this means considering administrative and compliance costs alongside the more traditional distortion costs.
- For incremental policy adjustments, what matters are marginal costs, not total or average costs.
- The optimal policy does not involve eradicating tax evasion. Nor does it involve maximizing revenue net of administrative costs. The correct rule involves lower enforcement spending than either of these alternatives require.

A number of conclusions also follow from our discussions of the determinants of different costs of taxation and of effective enforcement systems:

- Whilst increasing the probability of detecting non-compliance is costly for the tax authority, it does seem to be associated with reduced evasion. In contrast, the effectiveness of higher fines has not been convincingly established.

- When enforcing, authorities should be careful not to alienate taxpayers and thereby reduce the extent to which they comply out of a sense of duty rather than a fear of the consequences of being caught.
- Taxes should be kept as stable and simple as possible to minimize administrative and compliance costs and minimize non-compliance.
- Where possible, it is best to rely on market transactions between arm's-length parties, where information from one side can be easily checked against information from the other.
- Information reporting and withholding are key mechanisms for achieving a high level of compliance at modest administrative and compliance cost. For the same reason, it is generally sensible to maximize reliance on a small number of financially sophisticated entities (i.e. large firms).

## II. ADMINISTRATION AND ENFORCEMENT ISSUES IN THE UK TAX SYSTEM

Having provided an analytical framework for addressing administration and enforcement issues and having discussed what procedures are of practical use in implementing a tax system, we can now assess how the UK tax system measures up. How good is its administration and enforcement and how can it be improved?

The big picture is that the UK tax system makes broad use of the key administration and enforcement mechanisms. It has a wide range of information reporting and withholding requirements, prime among which are the obligations on employers to withhold income tax from employees' wages and inform HMRC of wages and benefits-in-kind and of leavers and joiners. The UK system relies heavily on remittances by businesses, with approximately 88% of all tax revenue being remitted by businesses (Table 12.1).<sup>22</sup>

Table 12.2 details the administrative costs, compliance costs and non-compliance for the main UK taxes. Note that these are average costs rather than the marginal costs as would be required to evaluate an incremental

<sup>22</sup> This is very similar to the proportion found for the US by Christensen, Cline, and Neubig (2001), who calculate that in 1999 businesses 'paid, collected, and remitted' 83.8% of total taxes to all levels of government.

**Table 12.2.** Administrative and compliance costs and non-compliance for major UK taxes (2006–07 unless stated)

Tax <sup>1</sup>	Number of taxpayers <sup>2</sup> (millions)	Revenue raised <sup>3</sup> (billions)	Administrative costs (% of revenue) <sup>4</sup> (%)	Compliance costs (% of revenue)		Non-compliance (% of true liability) <sup>7</sup> (%)
				Sandford/ Inland Revenue <sup>5</sup> (%)	KPMG <sup>6</sup> (%)	
PAYE	36.0	£ 124.8	0.7]			
NICs	28.3	£ 87.3	0.4]	1.3	0.4	1.4
ITSA	9.5	£ 20.3	4.5	N/A	N/A	14.6
CT	0.9	£ 44.3	0.8	2.2	1.5	14.7
VAT	1.9	£ 77.4	0.6	3.7	1.4	14.2

**Notes:**

1. PAYE is Pay As You Earn, NICs National Insurance contributions, ITSA income tax self-assessment, CT corporation tax, and VAT value added tax.

2. Number of taxpayers (source unless stated: <[http://www.hmrc.gov.uk/stats/tax\\_receipts/table1-4.pdf](http://www.hmrc.gov.uk/stats/tax_receipts/table1-4.pdf)>). PAYE: number of individuals under PAYE including individuals who also self-assess. 2005–06. Source: communication from HMRC. NICs: 2005–06. Source: <<http://www.dwp.gov.uk/asd/tabtool.asp>>. ITSA: source: Bourn (2007b). CT: 2005–06. VAT: number of registered traders at 31 March 2007.

3. Revenue raised (source unless stated: <[http://www.hmrc.gov.uk/stats/tax\\_receipts/table1-2.pdf](http://www.hmrc.gov.uk/stats/tax_receipts/table1-2.pdf)>). PAYE: includes revenue raised from self-assessment taxpayers through PAYE. Source: <[http://www.hmrc.gov.uk/stats/t\\_receipt/table2-8.pdf](http://www.hmrc.gov.uk/stats/t_receipt/table2-8.pdf)>. ITSA: excludes revenue raised from self-assessment taxpayers. Source: <[http://www.hmrc.gov.uk/stats/t\\_receipt/table2-8.pdf](http://www.hmrc.gov.uk/stats/t_receipt/table2-8.pdf)>.

4. Administrative costs (source: HMRC autumn report 2007) Includes direct collection costs (staff salary costs and other operating expenditure) and overheads (IT costs, accommodation, other non-cash costs, stock losses, corporate overheads and, where applicable, a share of Valuation Office costs).

5. Sandford/IR compliance costs (source unless stated: Sandford et al. (1989)). Excludes cash-flow benefit. PAYE and NICs: 1995–96. Source: Inland Revenue (1998). CT: 1986–87. VAT: 1986–87.

6. KPMG compliance costs (source: KPMG (2006)) Estimates are for 2005 and cover 'administrative burdens', which exclude tax planning, dealing with change, and understanding which tax obligations are relevant. PAYE and NICs: denominator is 2005–06 PAYE income tax and estimated Class 1 and 1A receipts (£113.9 billion and £82.2 billion respectively). CT: denominator is 2005–06 corporation tax receipts (£608 million). VAT: denominator is 2005–06 VAT receipts (£72.9 billion).

7. Non-compliance (source unless stated: <<http://www.hmrc.gov.uk/pbr2007/mdtl-direct.pdf>>): PAYE and NICs: Includes only small and medium-sized employers (no more than 500 employees). 2003–04. This ignores tax recovered through compliance work and non-payment. If these are taken into account, the figure falls to 1.2%. ITSA: 2001–02. This ignores tax recovered through compliance work and non-payment. If these are taken into account, the figure falls to 12.6%. CT: Includes only small and medium-sized companies (no more than 500 employees). 2003. This ignores tax recovered through compliance work and non-payment. If these are taken into account, the figure falls to 12.5%. VAT: Source: <<http://www.customsandrevenue.eu/pbr2007/mitl.pdf>>.

policy change. With the exception of income tax self-assessment, administrative costs (including overheads) are always less than 1% of revenue.<sup>23</sup> Compliance costs are usually at least as large as administrative costs, but

<sup>23</sup> Two important reasons why administrative costs for self-assessment are much higher than for other taxes are that much of the income tax liability of some self-assessment taxpayers is collected through PAYE, and that individuals who have to self-assess tend to have fairly complicated financial affairs.

much depends on which of the two sets of figures are consulted. The KPMG estimates (Section 12.6.4) are more recent (they relate to 2005) but exclude a number of things normally considered part of compliance costs such as tax planning, dealing with change, and understanding which tax obligations are relevant.

For PAYE/NICs, ITSA, and corporation tax, the column headed 'non-compliance' contains figures from HMRC random enquiry programmes. Note that random enquiries are not able to capture losses to the informal economy and, for PAYE/NICs and corporation tax, include only small and medium-sized companies (no more than 500 employees). The figure for VAT is an estimate of the VAT gap—the difference between the theoretical liability and actual tax revenue—so does include losses to the informal economy. Most striking are the estimates for ITSA, CT and VAT, all of which are above 10% of true liability. In contrast, the figure for PAYE/NICs is only 1.4%. No estimates are available for distortion costs and avoidance.

OECD (2007) gives some sense of how UK administrative costs compare with other countries. The overall UK figure for 2004 of 0.97% of revenue is close to the OECD median, but considerably higher than the US figure of 0.56%. It is important to note, however, that international comparisons of administrative costs are fraught with difficulties because ratios can vary for all sorts of reasons other than efficiency.

Getting estimates of compliance costs that are comparable across countries is even more difficult. Our sense is that overall compliance costs are lower in the UK than in the US, but it is impossible to place this in a comparative OECD context. A PricewaterhouseCoopers–World Bank study (2007) suggests that the UK compares favourably with many other countries. Using a mid-sized case study company, it ranks each of 175 countries according to the 'ease of paying taxes' (a combination of total tax rate, compliance time, and the number of tax payments required). The UK comes 12th, ahead of a number of obvious competitors—the USA at 63rd, Germany at 73rd, and France at 92nd.

Space constrains us from providing an exhaustive discussion of all of the current administration and enforcement issues in the UK tax system. Many are addressed in other chapters in this volume—VAT and missing trader fraud in Chapter 4 (Crawford, Keen, and Smith), tax credit administration in Chapter 2 (Brewer, Saez, and Shephard), international cooperation in Chapter 10 (Griffith, Hines, and Sørensen), and issues relating to small businesses in Chapter 11 (Crawford and Freedman). In the following sections, we concentrate on just three issues: HMRC's objectives and targets, the future of PAYE, and tax avoidance.

## 12.6. HMRC

Tax administration in the UK is undergoing considerable change. The UK was one of very few countries to start the twenty-first century with two tax authorities. In 2005, these were amalgamated to form Her Majesty's Revenue and Customs (HMRC). The resulting department is now undergoing a process of rationalization and modernization to improve its efficiency and ability to meet taxpayers' needs.

HMRC assesses its performance using a wide range of indicators. Along with other government departments, it has committed to a number of targets to improve performance and cut costs. The aim of this section is not to comment on the likelihood that HMRC will meet its targets; rather it is to assess some of the indicators and targets themselves in the light of the principles for tax administration outlined in Part I of this chapter.

### 12.6.1. Performance targets

At the outset, it is worth noting the potential problems with concrete performance targets in government. Unlike in a private business, where the ultimate objective is usually relatively unambiguous, the overall objective for a government department is less tangible. In principle, it should make decisions to enhance the well-being of the citizens, but that is not plausibly measurable. Nevertheless, some subsidiary objectives that are well-defined—for example, minimizing the cost of achieving a well-defined and easily measurable subcategory of output—should be pursued regardless of whether the ultimate objective is profits or social welfare.

What is different for the tax authority compared to most other government departments is the availability of something that has the superficial appearance of a quantitative output measure—revenue collected. Note, though, that in Part I of this chapter we showed that aiming to maximize revenue net of resource expenditures was the wrong objective because it failed to recognize that tax revenue is a transfer rather than a real resource gain.

HMRC has a large set of quantitative performance targets. At the time of writing, HMRC had not released details of their targets for the period 2008–09 to 2010–11 but has indicated that they will be similar in substance to those for the years 2005–06 to 2007–08—so we concentrate on these in this section. For the period 2005–06 to 2007–08, HMRC had three core objectives, the first two of which are directly relevant to the topic of this chapter:

- Improve the extent to which individuals and businesses pay the tax due and receive the credits and payments to which they are entitled.
- Improve customer experience, support business, and reduce the compliance burden.

These two objectives were underpinned by a number of quantitative targets, including targets to:

- Reduce the scale of VAT losses to no more than 11% of the theoretical liability.
- Reduce the illicit market share for cigarettes to no more than 13% and for spirits by at least a half, and hold the illicit market share for oils at no more than 2%.
- Reduce underpayment of direct tax and National Insurance contributions due by at least £3.5 billion a year.
- Increase to at least 90% the proportion of small businesses that find it easy to complete their tax returns, and to at least 85% the proportion of individuals who find their self-assessment statements, PAYE coding notices, and tax credit awards easy to understand.
- Increase the percentage of self-assessment returns filed on time to at least 93%.
- Increase to at least 95% the rate of accuracy achieved in administering SA, PAYE, Tax Credits, and NICs.
- Increase to 35% the percentage of SA tax returns and to 50% the percentage of VAT returns received online.<sup>24</sup>

Alongside these performance targets, HMRC was on course to achieve a substantial monetary saving between 2005–06 and 2007–08 and has agreed to a real terms reduction in its budget of 5% each year over the period 2008–09 to 2010–11, as part of the government's efficiency savings programme.

At first sight, these targets look like a list of 'good' things that HMRC aims to get a bit better at. They do not give a good sense of what is optimal, nor of the priorities and trade-offs involved. For example, why not reallocate resources and aim to reduce VAT losses to 12% (rather than 11%), and direct tax and NI contributions underpayment by £3.75 billion (rather than £3.5 billion)? And do the compliance-cost-reducing initiatives reflect the same trade-offs as the enforcement-increasing policies?

<sup>24</sup> See <<http://www.hmrc.gov.uk/psa/psa2005-2008.htm>>.



A potential pitfall of targets is that they may not be consistent with one another—in particular, can improvements in performance be achieved alongside real-terms cuts in the HMRC budget? HMRC has claimed that operational changes will enable both to be met, but this view does not seem to be shared by the Treasury Committee, who suggested that the failure of HMRC to meet many of their 2007–08 targets may be linked to the need to make efficiency savings (House of Commons Treasury Committee (2008), p. 51).

### 12.6.2. The tax gap

HMRC has published estimates of the size of the tax gap—the difference between the amount of tax collected and the theoretical liability—for VAT and illicit market share for spirits, tobacco, and diesel (HMRC (2007)). For income tax, random enquiry programmes have provided information about tax ‘at risk’ (this is only part of the tax gap—it only covers individuals who file a tax return). Bourn (2003, p. 8) concluded that ‘there are benefits in terms of overall risk management in having an aggregate estimate of the shadow economy if a reliable practical technique can be found’. Although we are sympathetic with the latter view because a tax gap study can inform resource allocation decisions in key ways, it is important to realize that measures of the total tax gap and its components do not *directly* inform policy. This is because policy choices are generally marginal and depend on the relative effectiveness of alternative policies in raising revenue relative to the resource cost of doing so. For example, learning that the non-compliance rate for self-employed individuals is higher than that for multinational corporations does not necessarily imply that it is optimal to beef up enforcement on the self employed at the expense of the multinationals. Rather, an *MECF*-type calculation should, in principle, be relied on.

### 12.6.3. Administrative costs

Each year, HMRC’s annual and autumn reports list the cost of collection per pound collected for each of the main taxes, and overall. For 2006–07, the overall ratio is listed as 1.13 pence per pound (HMRC (2007b), p. 31).<sup>25</sup> For each of several enforcement operations, it also lists the additional tax and penalties collected and estimated cost/yield ratios. These ratios range from

<sup>25</sup> How overhead costs are allocated is critical to this assessment. See notes to Table 12.2 for which overheads are included.

2.0 : 1 to 98 : 1. Critically, they are average, rather than marginal, figures, and it is marginal costs that matter for evaluating policy initiatives.

The text accompanying the yield/cost ratios in the 2004–05 annual report says that they ‘are used as one of a number of factors to help management make considered judgment on the allocation of resources’ (p. 106). The only other factor listed is the need ‘to maintain an effective presence in all areas where there may be non-compliance’. Potential policy reforms cannot be satisfactorily evaluated without considering all costs of taxation—deadweight costs, administrative costs, and compliance costs. The danger of evaluating policies on the basis of their yield/cost ratios is that it ignores any distortion costs and compliance costs induced. If the ratio of distortion and compliance costs to administrative costs varies across policies, then ranking by their administrative cost will lead to misallocation.

Focusing on yield/cost ratios also risks obscuring the fact that additional yield is a transfer from private (albeit non-compliant) citizens while administrative costs are a real resource cost. Even if marginal ratios can be inferred from the averages presented and distortion and compliance costs are negligible, it is not optimal from society’s point of view to expand enforcement up to the point where the ratios are equal to one.

#### **12.6.4. Compliance costs**

The government has embarked on an ambitious programme to quantify and cut the burden of regulation. As part of this, HMRC commissioned KPMG to undertake a large-scale study of the ‘administrative burdens’ of HMRC regulation on business, the results of which are presented in KPMG (2006). Following publication of the KPMG report, the government committed to reductions in various aspects of the burden (dealing with forms and returns and dealing with audits and inspections).

These developments suggest a growing awareness of the importance of compliance costs in the policy-making process, something that has been neglected in the past. Particularly welcome is the fact that the KPMG report attempts to provide a detailed breakdown of costs that can be useful in targeting their reduction. This comes closer to measuring marginal compliance costs than most previous work, which tended only to suggest that total compliance costs were high.

An important note of caution is in order, however. Administrative burdens exclude a number of things normally considered part of compliance costs, such as costs of tax planning, dealing with change, and understanding which

tax obligations are relevant. Moreover, the focus is on business rather than all taxpayers, and only a subset of administrative burdens is currently being targeted. The danger is that compliance costs that do not count as targeted administrative burdens are neglected or—to the extent that burdens from targeted areas can be transferred—are increased (for example by shifting obligations from business to individuals).

It is also not clear how closely tied to the policy-making process the targeting of administrative burdens is. Since 2000, the means by which compliance costs have formally entered policy deliberations is through mandatory impact assessments (IAs). An IA sets out the costs, benefits, and risks of the proposed reform, and compares alternative options with the aim of improving policy-making. But doubts have been expressed over both their quality and the extent to which they have any meaningful impact on legislation.

In the context of compliance costs, the impact assessment that accompanied the new tax credits in 2003 provides a good example of difficulties that have been experienced. The impact assessment suggested that the new tax credits would reduce employer compliance costs by up to £11 million per year. But this estimate excluded what turned out to be the most burdensome part of paying tax credits via employers—amendment notices. The reason for this exclusion was that it could ‘only be estimated once the system is up and running’ (2.17 TC IA). The result was an inaccurate estimate of the overall impact on compliance costs (even allowing for the fact that some of the burden was the result of unforeseen difficulties with the HMRC tax credit computer system).

In summary, efforts to quantify and cut the administrative burden of HMRC regulation and the fact that compliance costs form part of the evaluation of proposed policy changes are both welcome. But desirable reforms cannot be identified accurately without consideration of their incremental impact on *all* compliance costs (as well as administrative and distortion costs), as indicated by the *MECF* framework.

## 12.7. THE FUTURE OF PAYE

How tax is collected is important because it has implications for the costs it imposes and because it affects what tax designs are feasible. In this section, we examine the way income tax is collected in the UK, assess the performance of the primary withholding mechanism (PAYE), and consider some options

for reform. We do not address the issue of whether income tax and National Insurance should be integrated; we refer the interested reader to Adam and Loutzenhiser (2007). A description of how UK income tax works is contained in Chapter 1 (Adam, Browne, and Heady).

### 12.7.1. Collection of income tax in the UK

Withholding is an extremely effective way of collecting income tax because it reduces the risk of non-compliance and takes advantage of the economies of scale in tax remittance. But withholding the correct amount of tax is far from straightforward. Individuals often have more than one income source, and income is received at varying frequencies. Since income tax is progressive and liability depends on annual income aggregated across all sources the amount of tax that should be withheld from one income source may depend on how much income there is from other sources. But withholding happens separately for each income source, and withholding agents (e.g. employers) may not know anything about each other.

Two main ways to address this problem have been devised. The first involves giving withholding agents fairly complicated instructions about what to withhold so that the correct liability is collected from the majority of taxpayers; for the remainder, some form of end-of-year reconciliation is necessary. The alternative approach is to rely on a compulsory end-of-year tax return. Since there is then no need for withholding to get the right answer, the withholding process (but not necessarily the tax liability computation process) can be drastically simplified, with any additional inaccuracy introduced being cleaned up by the tax return.

The UK takes the former approach. Income tax due on employment earnings and private and occupational pensions (the most important sources of income for most people) is withheld via a system known as Pay-As-You-Earn (PAYE). PAYE is an extremely important part of income tax collection, accounting for over 80% of income tax revenue. The way PAYE works is discussed in detail below. Tax on interest income is withheld by banks and other financial institutions under the assumption that it is not subject to the higher rate of tax. There is also withholding on royalties, payments, and certain rents. Withholding does not exist for dividends (a form of imputation tax credit is used instead); nor is there any kind of withholding for self-employment profits, state pensions, or taxable benefits (although withholding for government transfers involves a different set of issues).

Small tax liabilities on sources where there is no withholding can be collected via adjustments to PAYE; non-PAYE withholding is *never* adjusted for this purpose. Relying on PAYE to collect tax liabilities incurred elsewhere works because the majority of individuals liable for income tax have substantial amounts of income that come under PAYE.

PAYE and other withholding cannot always collect an individual's full tax liability. In cases where withholding is likely to get the answer wrong, individuals have to complete a self-assessment tax return.<sup>26</sup> Currently, around nine million taxpayers (approximately one third of the total number liable for income tax) are required to self-assess. The majority of these individuals do not come under PAYE at all (the main group is the self-employed). A substantial minority, however, do come under PAYE, but have to self-assess because PAYE and other withholding cannot be guaranteed to get the answer right (this might be the case for individuals with substantial foreign income or income from property).

Tax returns are issued to these taxpayers shortly after the end of the tax year. The filing deadline is 31 October (almost 7 months later) for paper returns and 31 January (almost 10 months later) if the taxpayer files online. Tax liability (beyond that already withheld) is typically remitted in three instalments. The first two (one on 31 January in the year of assessment, one on 31 July following the end of that year) are usually estimated on the basis of the previous year's liability. The balance is due on 31 January after the end of the tax year, coinciding with the deadline for tax returns.

Each year, there are a number of individuals who are not required to self-assess but who end up having had the wrong amount of tax withheld. This might happen as a result of changes in circumstances (becoming unemployed shortly before the end of the tax year, for example). For these individuals, HMRC is responsible for calculating the adjustment that is required, informing the taxpayer and negotiating a payment schedule. Underpayments are often collected via adjustments to future PAYE withholding; overpayments are refunded lump sum.

For PAYE, employers do not automatically have access to all the information they need to calculate how much tax to withhold (they may not know age, disability, or income from other sources, for example). HMRC provides employers with a summary of this information in the form of a tax code, one for each job (or pension) of each individual. A tax code is a combination

<sup>26</sup> Details of who has to file a return can be found at <http://www.hmrc.gov.uk/sa/guidelines.htm>.

of numbers and letters that describes the tax-free entitlement for that job (or pension) and the rate at which income should be taxed. Since HMRC is responsible for calculating tax codes, it must keep track of individuals and their employers during the year.

The amount of tax withheld in any given week or month depends on earnings in the whole tax year to date. In each week or month of the year, tax allowances and tax bands are scaled down according to the proportion of the year that has elapsed ( $\frac{1}{52}$  for week one,  $\frac{1}{26}$  for week two, etc., or  $\frac{1}{12}$  for month one,  $\frac{1}{6}$  for month two, etc.). These rescaled allowances and bands are used to calculate *total* tax liability for the year so far based on *total* earnings so far. The amount of tax remitted in a given week or month is equal to total tax liability for the year so far less the amount of tax already remitted. This type of withholding is known as cumulative withholding. Its advantage is that, when earnings vary across the year, it is much more likely that the correct amount of tax will have been deducted at the end of the tax year than under a non-cumulative system that treats each pay period in isolation. Its disadvantage is that it requires employers to know what happened earlier in the year. If an individual changes jobs, information needs to be passed between employers about total earnings and tax remitted so far this year (achieved under PAYE using P45 forms).

Most employers must remit the tax due once a month (small employers can remit quarterly). This happens roughly three weeks after the end of the month to which the tax relates. Remittances cover National Insurance contributions and student loan deductions as well as income tax, and employers simply remit the total due across all their employees (there is no breakdown by employee and tax). At the end of the tax year, however, employers do provide such a breakdown, allowing all the calculations and remittances to be checked by HMRC.

In 2005–06 there were around 1.7 million active PAYE schemes covering around 36 million individuals.

### 12.7.2. An assessment of PAYE

Over recent decades PAYE has been the object of sustained criticism arguing that it is becoming less able to cope and needs to be reformed. Here we discuss the problems with PAYE and its advantages over alternative systems, addressing accuracy, flexibility, administrative and compliance costs, and non-compliance.

*Accuracy*

In conjunction with other withholding, PAYE is designed to collect the right amount of tax over the tax year for most taxpayers. In around 30% of cases, however, the amount of tax remitted during the year does not tie up with the end-of-year information sent to HMRC by employers (Bourn (2006)). Addressing these occurrences has a high administrative cost for individuals outside self-assessment. There are also cases where the wrong amount of tax has been withheld but the error is not uncovered. Bourn (2007a) suggests this may apply to 0.8 million taxpayers for 2006–07.

Inaccuracy in PAYE can be traced to four main issues:

- Errors made by HMRC.
- Errors made by employers.
- Breakdown in the transmission of information.
- Inertia or lack of understanding from employees.

We discuss these issues in turn. The most common error made by HMRC is failing to calculate tax codes correctly. Bourn (2006) reports that 8% of tax codes were incorrect in the 2005–06 tax year. Many of these errors are the result of HMRC failing to bring together income from different sources—the current PAYE computer system is spread across twelve databases and is based around jobs rather than individuals.<sup>27</sup> The task becomes more difficult when income from other sources is not known for certain when tax codes are calculated. Tax codes then have to be based on estimates, which may turn out to be incorrect. HMRC hopes that modernization already underway will eliminate many of these errors.

Inaccuracies also arise because of errors made by employers. Bourn (2007b) reports that 1.4% of end-of-year returns for 2006–07 had to be sent back to employers for correction. There is also some evidence that employers do not always follow instructions to amend tax codes (Bourn (2006)), but the extent of this is not known.

The third source of inaccuracies is the transmission of information breaking down. PAYE requires information faster and in greater quantities than a non-cumulative withholding system meant to approximate tax liability. But Bourn (2006) reports that around 70% of employees starting a new job do not immediately provide their new employer with a P45 containing their National Insurance number, and more than 70% of employees who are asked

<sup>27</sup> See HMRC 2005–06 annual report p. 27. PAYE modernization plans include moving PAYE onto a unified database.

for information about their earnings history fail to return the necessary form. In such cases, guesses often have to be made, frequently resulting in the wrong amount of tax being withheld.

The final source of inaccuracies is employees. Few check the coding notices HMRC sends them, so errors often lie dormant. They also forget to notify HMRC of relevant changes—or simply don't understand the need so to do. But whether it is fair to blame individuals for failing to deal with errors and exceptions in a system that is designed to do everything for them is a moot point.

These problems are being exacerbated by changes in the economic environment. For example, there are a growing number of individuals with multiple employment or multiple income sources. Internal HMRC estimates suggest that, in 2005–06, approximately 13% of individuals under PAYE had more than one PAYE income source. Job changes have become more frequent, with 20% of jobs lasting less than one year, and 5% less than three months (Bourn (2006)). Approximately 16.5 million income sources terminated during 2005–06. There is also more part-time and temporary work and remuneration has become more complex (particularly the growth of benefits in kind).

### *Flexibility*

Although in some ways PAYE has proved to be adaptable, there have been complaints over a number of decades that it lacks flexibility and therefore constrains tax policy. As long ago as 1972, a Green Paper on tax credits (quoted in Barr, James, and Prest (1977), p. 47) said that PAYE 'has been found to lack flexibility and governments of both political parties have found it difficult to adapt it to accommodate changes that they have felt desirable'.

PAYE is argued to constrain tax policy because end-of-year adjustments and recoding are costly exercises, so any policy change that threatens the ability of PAYE to withhold the correct amount of tax without the need for extensive recoding is likely to be prohibitively expensive. Three examples will suffice: a graduated structure of rates, payment of tax credits by employers, and some form of expenditure tax.

It has often been claimed that PAYE won't work well with a highly graduated structure of tax rates because there needs to be a single wide tax band covering the vast majority of taxpayers. The reason is multiple income sources. If secondary income sources all fall within a wide basic rate band, it is possible to guess with reasonable accuracy the rate at which each income source should be taxed, avoiding large numbers of end-of-year adjustments. But the greater the number of tax rates and the narrower each band, the less



likely it is that all secondary income sources fall within a single band and the more difficult it is to guess what rate each source should be taxed at. So, if withholding needs to collect exactly the right amount of tax from a large number of individuals, there is a constraint on the number of different tax rates there can be for the majority of taxpayers. It is worth noting that a lower rate band (below the basic rate) existed in 1978–79 and 1979–80 and again between 1992–93 and 2007–08, so there is evidently some flexibility in the schedule of rates. But even with the lower rate band in place, the vast majority of taxpayers still had the basic rate as their marginal tax rate.

A second example is the payment of tax credits through the pay packet. Between 2000 and 2006, the vast majority of employees eligible for tax credits received them from their employers rather than directly from the government. HMRC told employers the amount employees were entitled to, and employers were required to add this amount to salary payments. The funds for employers to do so came from the tax they had withheld from their employees. Although the payment of tax credits made use of some of the machinery of PAYE, it never involved adjustments to tax codes. The Regulatory Impact Assessment (RIA) for the 1999 Tax Credits Act said: ‘The option of delivering tax credits through the PAYE coding system was considered, but was rejected on the grounds that PAYE codes could not deliver the necessary accuracy and reliability. Nor would they provide transparency for employees’ (Inland Revenue (1999), p. 5).

Following persistent administrative problems, payment of tax credits via employers was abandoned in 2006. The government’s stated reason for doing so was reducing compliance costs on employers (HMRC (2005)), but the cost incurred by the government was probably also a contributory factor. Payment via employers was primarily symbolic (intended to demonstrate that tax credits were a reward for work), and effectively added an additional link in the payment chain without simplifying administration.

The final example of a constraint imposed by PAYE concerns a progressive expenditure tax of the kind proposed in the Meade Report, in which deposits into savings accounts (and purchases of assets) are deducted from taxable income and withdrawals from such accounts are added to taxable income, similar to the treatment of pension funds now. As with the graduated rate structure, the issue relates primarily to the difficulty of taxing multiple income sources when there is more than one marginal tax rate. Currently, not all higher-rate taxpayers are required to self-assess. For those that are not, income outside PAYE may be taxed at the wrong rate (for example, interest on bank accounts, where withholding is correct for basic-rate taxpayers), but the tax revenue at stake is likely to be fairly small. This is not true of an

expenditure tax, where all deposits must be given tax relief and all withdrawals taxed, not just the interest. Here, the sums involved are presumably too large to ignore.

These arguments suggest that PAYE may have kept the UK tax system simpler than it would otherwise have been. Income tax in the UK is certainly less complex than in the US (which has simple non-cumulative withholding and universal self-assessment) but this need not be due solely to PAYE. And, as discussed below, the government's incentive to keep the rules simple in other respects may be limited because it does not directly bear the major cost of operating PAYE. If the tax system has been kept simpler, it is not clear whether this means the tax system is better: this depends on whether the policy-making process takes full account of complexity created.

While it is impossible to know how binding the constraint imposed by PAYE has been, it seems reasonable to suggest that it has become less binding over time. In part this is because PAYE has become increasingly computerized, reducing the cost of recoding and end-of-year adjustments. But it is also due to a reduced appetite for policies likely to cause problems for PAYE for reasons unrelated to administrative ease. For example, there has been a move away from a highly graduated schedule of rates (for example, in 1976–77 there were ten non-zero tax rates on earned income; in 2008–09 there are only two), partly for political reasons, but also due to concern over the distortionary effects of high marginal rates on top incomes.

#### *Administrative costs*

As Table 12.2 indicates, in 2006–07, the cost to HMRC of administering PAYE (including overheads) was 0.74% of income tax revenue collected through PAYE. Historically, the UK has fared badly in international comparisons of administrative costs. More recent estimates, however, put UK costs on a par with many other OECD countries (see, for example, OECD (2007)). Moreover, there is a growing recognition that such comparisons can be misleading because cost-of-collection ratios depend on all sorts of things other than the efficiency of the tax authority. These include the number of taxpayers, tax rates and structures, the scope of the tax authority, the extent of enforcement activities, broader economic conditions, and differences in measurement methodology.

Because PAYE is a cumulative system that aims to collect the right amount of tax from the majority of taxpayers without an end-of-year adjustment, within-year costs are high and end-of-year costs low relative to a

non-cumulative system of withholding. Whether overall administrative costs would be lower in the UK with an alternative collection mechanism is unclear.

### *Compliance costs*

For most taxpayers under PAYE the correct amount of tax is withheld and remitted by employers without taxpayers having to file an annual return. Consequently, compliance costs of PAYE fall, in the first instance, on employers.<sup>28</sup> The Inland Revenue (1998) investigated the compliance costs of PAYE and National Insurance for 1995–96 (widely known as the ‘Bath study’). Total compliance costs were estimated to be £1.32 billion, or 1.3% of the PAYE and (Class 1 and 1A) NI revenue collected.<sup>29</sup>

The KPMG (2006) study referred to above measured ‘administrative burdens’ on a basis substantially narrower than compliance costs as normally defined. In particular, costs are estimated for a ‘normally efficient business’, and exclude costs associated with tax planning, dealing with change, and understanding which tax obligations are relevant. It is not surprising, therefore, to find that the burden on employers of PAYE and NICs is estimated to be substantially lower than the Bath study found: £759 million in 2005, or 0.4% of PAYE and (Class 1 and 1A) NI revenue.

Both the Bath study and the KPMG report find that compliance costs relative to the size of the employer are much higher for small firms than large ones. For example, the Bath results suggest that average compliance costs for employers with 1–4 employees were £288 per employee in 1995–96, compared with less than £5 for employers with 5,000 or more employees.<sup>30</sup> The Bath study also estimated the ‘cash-flow benefit’ of the PAYE/NIC system, and found it to exceed compliance costs for large employers (those with more than 1,000 employees). This benefit arises because PAYE and NIC remittances

<sup>28</sup> Compliance costs may be shifted to some degree according to the same supply-and-demand logic that applies to the shifting of explicit tax liabilities. Consequently, it cannot be presumed that compliance costs reduce after-tax profits pound for pound relative to what they would have been in the absence of compliance costs.

<sup>29</sup> This £1.32 billion includes £93 million for statutory maternity and sick pay.

<sup>30</sup> Authors’ calculations based on KPMG (2006) and data from the Small Business Service reveal that the KPMG results imply average costs for employers with 1–9 employees of £173 per employee, compared to around £6.50 for employers with 250 or more employees. It wasn’t possible to reproduce the same firm size bandings as the Bath study. The Carter Review of Payroll Services (2001) states that intermediaries can provide a monthly payroll service for employers with up to four employees for £200–£250 per year, and that the marginal cost for additional employees is low.

are due about three weeks after employees are paid, so firms can earn interest on the tax liability in the intervening period.<sup>31</sup>

Tellingly, the Bath study concluded that the high fixed compliance costs in some cases deterred small business owners from taking on their first employee. Sandford concluded that when small firms compete with large firms they are placed under a 'state-created competitive disadvantage' (Sandford (1989), p. 200). Whether this disadvantage for small businesses is socially inefficient, though, is not clear because it might to some extent reflect the higher cost of raising revenue from small businesses.

From the employer's point of view, there is little doubt that the compliance costs of PAYE are higher than those of a simple non-cumulative system. But the size of the difference may be small, particularly given that most employers now run a computerized payroll, either in-house or outsourced. It is worth emphasizing that the P45 forms used to keep track of pay and tax to date when individuals change jobs do not cause a great deal of extra work for employers. Under a non-cumulative system, employers typically still need to give the employee notice of pay and tax deducted (so they can complete their tax return) and send a copy to the tax authority (for information reporting purposes) (Inland Revenue (1979)).

Whiting (2002, p. 44) argues that, because much of the cost of operating PAYE falls in the first instance on employers, the government has little incentive to keep the tax system simple. As a result, the tax system becomes complex with high compliance costs. It is impossible to tell how much this has happened in reality, but, as noted above, the US hasn't managed to avoid a complex tax system despite having universal self-assessment. The fact that taxpayers covered by PAYE incur almost no direct compliance costs mean that most of them are largely unaware of the tax system. Few understand what their tax code means or how their tax liability is determined. This can lead to less disciplined policy-making because individuals are not in a position to criticize bad policy.

### *Non-compliance*

Information from HMRC's employer compliance random enquiry programme indicates that £0.9 billion of income tax and National Insurance was understated on returns from small and medium-sized employers in 2003–04 (HMRC (2007c)). This is equivalent to 1.4% of the total true liability, considerably lower than the figure for self-assessment (see Table 12.2) but very

<sup>31</sup> The cash-flow benefit is not a social cost but instead a transfer from the government to the employer equal to the time value of the money held by the employer.

similar to comparable US data (despite the fact that the US operates non-cumulative withholding). No UK figures are available for non-compliance among large employers.

### 12.7.3. A decade of self-assessment

Self-assessment—under which individuals whose full income tax liability cannot be collected through PAYE and other withholding have to complete a tax return—has been in place for a little over a decade. Before we consider options for reforming PAYE, it is worth spending a few paragraphs analysing how successful self-assessment has been. Self-assessment was introduced from tax year 1996–97, replacing the previous system of assessments made by tax inspectors. It was hailed as ‘the biggest change [in tax administration] since the introduction of PAYE over 50 years earlier’<sup>32</sup> (Inland Revenue (2002a)). While it certainly was a big change, the difference for individuals who file their tax return in time for HMRC to calculate the tax liability is actually not that great. Indeed, under the old system of HMRC assessments, taxpayers were often obliged to provide information about their sources of income on a form not dissimilar to the current tax return.

Perhaps the most fundamental change brought about by self-assessment is the increased responsibility taxpayers are expected to take for their own tax affairs (Green (1996)). HMRC no longer issues estimated assessments; instead, the onus is on taxpayers to file and remit on time. HMRC also has much more extensive enquiry powers, including the ability to conduct audits randomly (previously there needed to be grounds for suspicion), and taxpayers are statutorily required to keep business records for a period of six years.

Eliminating old-style assessments and appeals, combined with transferring to the taxpayer some responsibilities that previously lay with HMRC, was projected to provide an administrative saving of £500 million by 2007–08. In 2006–07, the cost to HMRC of administering self-assessment (including overheads) was 4.46% of revenue collected directly through self-assessment.<sup>33</sup>

While many taxpayers and tax advisers acknowledged that self-assessment was a necessary modernization, there was a widespread feeling that not

<sup>32</sup> Paragraph 4 of IR memorandum submitted to the Treasury Sub-committee in 2002. <<http://www.publications.parliament.uk/pa/cm200102/cmselect/cmtreasy/681/2030601.htm>>.

<sup>33</sup> This is considerably higher than the figure for PAYE, but comparing the two figures is misleading. This is both because individuals under self-assessment tend to have more complicated tax affairs than those who are outside self-assessment and because some self-assessment taxpayers have most of their liability collected through PAYE.

enough effort had been put into making the process as simple as possible for taxpayers. As far as we are aware, no comprehensive study of self-assessment's implications for compliance costs has been undertaken.<sup>34</sup>

The self-assessment return is long (often up to twenty pages) and complex, though a shorter four-page return for those with simple tax affairs was eventually rolled out starting with the 2004–05 tax year. Other improvements over time have included better taxpayer statements and some removal of those with very simple affairs from the system altogether. Around 90% of tax returns are filed on time under the current system—much better than the 50% under the old system (Inland Revenue (2002b))—though many arrive very close to the 31 January deadline. The time between the end of the tax year and the final due date for tax payment is, at 10 months, the longest of any OECD country bar Finland.<sup>35</sup>

On the basis of data from the 2001–02 random enquiry programme (the latest year for which there is information), HMRC estimates that 33% of returns under-declare tax liability and that £2.8 billion of tax is not disclosed, equivalent to 14.6% of the £19.2 billion net receipts from self-assessment in 2001–02 (HMRC (2007c)). Around three-quarters of this is accounted for by 5% of returns; errors contained in many of the other returns may have been unintentional. As the self-assessment random enquiry programme only covers registered taxpayers, it does not provide any estimate of unpaid tax on income from the informal economy or other undisclosed income. It is unclear how these figures compare with the previous system, because there was no random enquiry programme that could provide statistically reliable estimates of unpaid tax. In 2006–07, HMRC accurately calculated the tax due for 96.5% of self-assessment returns.<sup>36</sup>

Overall, self-assessment was indeed a necessary modification to the tax system. Perhaps too much was expected of it too soon, with insufficient

<sup>34</sup> KPMG (2006) includes estimates of the burden of self-assessment for businesses, but excludes groups such as employees and pensioners who have to self-assess. Some idea of the amount of time involved in completing tax returns can be gained from the BMRB evaluation of the 2002–03 short tax return pilot (Inland Revenue (2004)). It found that median total compliance time was reduced from 162 minutes (for the main return) to 120 minutes (for the short return). Obviously, these results cannot be generalized across all self-assessment taxpayers because those eligible for the short return are likely to have simpler affairs than those who aren't. Also, the results do not include the cost of advisors.

<sup>35</sup> Proposals to shorten this period in the Carter Review (2006) were widely attacked, not least because there was no parallel attempt to simplify or streamline the reporting system which might justify a shorter timescale. The only change that got implemented involved moving forward the filing date for paper returns to 31 October for 2007–08 returns onwards.

<sup>36</sup> The annual reconciliation process that forms part of self-assessment uncovers a large number of other errors before they are able to have an impact on final tax remitted.

expectation of the need for continuous improvement. Now that more effort is being put into that improvement process, it is delivering more.

#### 12.7.4. Policy options

In this section we consider ways in which some of the problems described above could be addressed. The first set of reforms attempt to improve the ability of withholding arrangements to collect the right amount of tax. The second set is a radical alternative: drastic simplification of PAYE combined with universal self-assessment. Throughout, we assume that there is no change to the way income tax is assessed.

##### *Improvements to current withholding arrangements*

HMRC has already begun to modernize PAYE in ways that should considerably improve its accuracy. But these changes are unlikely to remove the need for large quantities of paper communication, such as HMRC sending tax codes to employers, and employees taking P45s from their old employer to their new one. In principle, it would be possible to develop an online computer coding system that would allow much of this to be done electronically. Withholding agents could be required to register any employee they take on and, in so doing, would be provided with a tax code to use based on information about all income sources of the individual. Without pay-period information reporting, employers would still need to provide information about pay and tax to date when an employee changes jobs, but this could be done through the computer system without the need for employees to carry the information manually between employers. This sort of arrangement has the potential to reduce the cost of communication considerably, but the extent to which it improves the accuracy of PAYE depends on how often employees are to blame for the P45 failing to turn up. For any such computer system to be possible, security issues would need to be addressed: if employers are able to find out information about employees by registering them, there is obviously potential for personal data to be compromised. This is particularly pertinent given the controversy over lost Child Benefit records in 2007, but with careful consideration, it should be possible to address this issue satisfactorily.

A second possible change is to make other withholding non-flat-rate. Currently, withholding is designed to get the answer right for basic-rate taxpayers. Non-PAYE withholding (such as that on interest income) happens at the basic



rate—so the right amount of tax is withheld if this income falls in the basic rate band, but the wrong amount is withheld if it does not. For individuals outside self-assessment, adjustments are often made to the PAYE code to resolve the difference. Potentially, the need for such adjustments could be reduced if withholding on other sources of income was not done at a flat rate. But this could only be achieved at the cost of requiring banks and other withholding agents to tailor withholding to individual circumstances. Information would need to be passed between HMRC and these other withholding agents each year. Were this combined with some sort of online computer system as envisaged above, it may not be too burdensome, though it is certainly administratively more complicated. Any decision would need to weigh any administrative savings against the additional compliance costs imposed.

A final possibility would be to move to monthly information reporting. Currently, information reporting happens annually as part of the end-of-year employer return. During the year, employers just remit the total tax, National Insurance and student loan repayments they owe (based on their own calculations) without any breakdown of what the money covers. This reduces within-year compliance costs for employers, but means that tax codes are not updated to reflect changes in circumstances, so often the wrong tax is withheld. If employers had to report information each time they remit tax liability (usually monthly), this information could be used to modify tax codes and reduce the number of cases where the wrong amount has been withheld at the end of the year. Although the majority of OECD countries have annual information reporting for employers, a substantial minority have monthly reporting, including Finland, Japan, and New Zealand. In the US it is quarterly (OECD (2007)).

Given HMRC is already moving towards requiring electronic transactions from employers, monthly information reporting may not be much of an additional burden assuming it takes the same form as information that has to be provided at the end of the year in any event. Currently, medium and large employers (50+ employees) must file end-of-year returns electronically, and from April 2011, this will apply to all employers. Although there are no published plans to make electronic remittance compulsory, it would not be surprising if this happened at some point. Nevertheless, the burden may be greater on small employers because their computer systems may not be so easily adapted to cope.

It is important to realize, however, that if PAYE is to withhold more accurately on the basis of monthly information reporting, it will require more frequent coding instructions to employers. Individuals whose circumstances change frequently may end up with different tax codes every month. Again,



the extent to which this is a burden depends on how computerized the system is. In principle, it need not make that much difference if payroll software can be automatically linked up to the coding instructions provided by the online coding system. The extent to which such a change would reduce the number of cases where the wrong amount of tax is withheld over the course of the year depends on how common it is for circumstances to change once tax codes have been calculated.

Of these three reforms, an online coding system seems the most clearly beneficial, and we recommend it should be investigated further. Any move in this direction must, however, be tempered by the knowledge that the history of large-scale government IT projects is far from glorious. Both of the other reforms are more marginal and a proper assessment of their value would require detailed operational information. Nevertheless, it seems unlikely that either would be viable in the absence of an improved computer system.

#### *Universal self-assessment and simple non-cumulative withholding*

A radical alternative would be to extend self-assessment across the whole population. For this to result in any administrative savings it would need to be combined with a drastically simplified system of withholding. In the words of a 1979 Inland Revenue review of PAYE (1979, p. 24): ‘Grafting self-assessment on to the present PAYE system would be pointless; it would secure the worst of both worlds—no savings on in-year work, but much more end-of-year effort—and call for many more staff, not less.’ It would need a non-cumulative system of withholding in which the tax authority is not responsible for calculating tax codes (so it need not keep track of employees and employers during the tax year). This is the system operated in the US.

Whether it would result in much of a reduction in employer compliance costs is debatable. The KPMG (2006) burdens report suggests that the majority of the cost to employers of operating PAYE was remitting tax liability and filing end-of-year returns, both of which would be largely unchanged under a non-cumulative system. Calculation of liability—one of the main things simplified by non-cumulation—did not form a large part of the total.

Self-assessment should improve the accuracy of tax calculations for some individuals and remove any constraints on policy imposed by PAYE. It may encourage individuals to take a greater interest in the country’s tax system, but to a degree this will be mitigated if individuals rely on advisers and software to complete their returns. It may also create greater impetus to simplify the tax system (since a universal self-assessment return would have

to be simpler than the current form), though this has not really happened in the US.

The main objection to universal self-assessment is the implications for compliance costs of compulsory tax returns. If PAYE works reasonably well for the majority of taxpayers, why force them to file a return because of the minority for whom PAYE does not work well?

One response to this is that, with the introduction of tax credits, many families effectively have to complete a tax return each year anyway. Around 6 million families receive tax credits, of which approximately 4 million also interact with PAYE. Were it possible to combine tax credit claims into a system of universal self-assessment (as happens in the US), the implications of self-assessment for tax credit recipients would not be that great. But achieving this would be difficult because, unlike the US, the UK has individual assessment for income tax but joint assessment for tax credits. And it still leaves perhaps 25 million individuals under PAYE who do not self-assess and do not receive tax credits, for whom universal self-assessment would be a considerable change.

A second response is pre-population. Over the last couple of decades, a number of Nordic countries have started sending out tax return forms that have been 'pre-populated' with information already held by the tax authority.<sup>37</sup> Typically this information comes from third-party information reports, such as salary information from employers. Taxpayers then need only check the pre-populated information and complete the parts of the tax return that are blank.

Pre-population has a number of obvious advantages (OECD (2007)). In particular, it offers the potential for substantial compliance costs savings because taxpayers have to spend less time completing their tax returns. It is also likely to lead to more accurate tax returns because taxpayer errors are avoided in pre-populated sections. This will reduce the administrative resources required to deal with incorrect returns. One disadvantage of pre-population is that it reveals what information the tax authority holds. Individuals may be less likely to report income missed by a pre-populated return because, if the tax authority doesn't know about it, they infer that their chances of being caught are small. It is unclear how important this is in practice. Successful pre-population is also very demanding. The information held by the tax authority must be accurate, and the tax authority must be able

<sup>37</sup> The US state of California piloted a pre-populated state income tax return in 2004 and 2005, and in 2008 two of the major Democratic presidential candidates proposed such a system for the federal income tax.

to link together all information relating to a given taxpayer soon after the end of the tax year. Historically, HMRC has not found this straightforward.

Given current policies, the value of universal self-assessment depends both on the feasibility of pre-population and on the extent to which withholding can successfully be made to collect the right amount of tax from more taxpayers with less need for manual intervention. Were the policy context to change—particularly were it to move in favour of some form of expenditure tax—the balance may swing in favour of universal self-assessment. But, in either case, the long-term benefits of such a change would need to be substantial to outweigh the considerable disruption caused by switching.

## 12.8. TAX AVOIDANCE

### 12.8.1. Some causes of avoidance

As we have previously noted, the origins of avoidance lie in the difficulty of defining what is sought to be taxed—the tax base. In defining the tax base, tax systems create boundaries, some inevitable and others as matters of the political or other choices that are made in designing the system. Avoidance and the difficulty of constructing adequate countermeasures reflect the ease or difficulty of finding objective and verifiable criteria to determine those boundaries in order to prevent taxpayers seeking to eliminate or reduce their tax liabilities by changing their behaviour in particular ways. Significant avoidance activity is often clustered around the least satisfactory areas of a tax system. Complexity and avoidance can go hand in hand and it may also be the case that avoidance is on occasion difficult to distinguish from illegal evasion. In particular, the harder the tax base is to identify and locate within a particular taxing jurisdiction, the more difficult it is likely to become to tax and, as a corollary to that, the greater the scope for taxpayers to avoid tax on the tax base of a particular taxing jurisdiction. At the same time the inability of revenue authorities to monitor and control satisfactorily taxpayer behaviour in such a situation means that there may be considerable scope for evasion by less scrupulous taxpayers.

Much of the UK government's anti-avoidance agenda has been focused on corporate taxpayers. Companies will, in general, seek to minimize their taxes (both on profits and on employee remuneration) plus the cost of this minimization. There is an acknowledged tension between their understandable perception of taxes as a cost to be minimized, and the tax authorities

seeing companies as needing to act responsibly and constrain their planning actions carefully. It is unsurprising that tax avoidance has attracted considerable attention in areas such as the taxation of international companies, where several tax systems must interact and the scope for tax arbitrage, playing the rules of one system off against another, is considerable.<sup>38</sup> Another area is the taxation of financial companies, where financial innovation (such as the use of derivative instruments) has allowed transactions to be constructed in ways that attract a more favourable tax treatment, while having essentially the same economic effect as simpler transactions that would be taxed less favourably.

At the same time a key challenge facing tax authorities is how to evolve to address the changing methods of commerce. The UK's tax system has struggled to keep up technically with such issues as financial instruments and the general way business financing is carried out.<sup>39</sup> At the other end of the spectrum, the growth of e-business—exemplified by eBay—brings particular challenges to the tax collector. In principle there is nothing new in tax terms: it is still an issue of whether a taxable trade is being carried out or disposals subject to CGT are made. In days gone by the taxman tried to control cash sales at market stalls; more recently activities moved to car boot sales; now the business takes place in cyberspace. This presents greater challenges, however, as to how HMRC can police this effectively.

Another dimension is the position of intellectual capital, which is increasingly replacing physical assets as the basis of wealth creation. If a company owns a trademark or patent that can in principle be 'located' anywhere, leading to profits being diverted abroad, HMRC must solve the question of how it defines a tax base that it can monitor without leaving open opportunities for uncontrolled avoidance or evasion.

There is no simple answer to these issues. A combination of measures to refine or redefine the tax base and to counter the avoidance opportunities that would otherwise undermine the tax base entirely is needed, without at the same time inhibiting ordinary commercial behaviour. The UK as a member of the European Union is forced to operate within the constraints imposed by the EC Treaty freedoms. Claims that ordinary cross-border anti-avoidance rules breach these freedoms has led to a succession of cases before

<sup>38</sup> As noted in Section 12.1, the welfare consequences of a taxpayer's choice regarding to which jurisdiction to pay a given tax are quite different from the choice of whether to pay tax to a given jurisdiction.

<sup>39</sup> Though in some areas it has been commendably quick to adapt: the way that considerable effort has been put into devising a way of catering for Shari'a compliant financing products in FA 2005 and subsequent Acts is very creditable. The driver has been to make sure London is positioned as a centre of the developing Islamic international finance market.

the European Court of Justice that affect all states, undermining their ability to implement measures designed to protect domestic tax revenues against cross-border activity notwithstanding the ECJ's development of an abuse (of Community law) doctrine. In the international context cooperation between revenue authorities, both in terms of finding solutions and in working out ways of policing tax systems efficiently, is likely to be the only satisfactory way forward. National customs authorities have cooperated over many years because they are outward facing. By contrast, revenue authorities responsible for direct taxation have tended to be inward facing. The establishment of the Joint International Tax Shelter Information Centre (JITSIC) between Australia, the UK, the US, Canada, and Japan is, however, a significant step forward in sharing information between the revenue authorities of those countries in order to identify abusive products or arrangements and those marketing them.

#### **12.8.2. Categorizing avoidance and identifying the tax gap**

Tax avoidance is action ordinarily designed to reduce a taxpayer's tax bill in one way or another by legal means (in contrast to evasion which aims at the same objective by fraud, deceit, or other illegal means). Not all tax reduction is characterized as 'avoidance' but for present purposes we do not seek to differentiate 'avoidance' from other forms of tax mitigation, planning, or reduction. However, certain avoidance has been demonized of late in the UK and various other countries as being 'unacceptable'. This raises difficult questions: if the taxpayer is operating in accordance with the law, disclosing fully and meeting all compliance obligations, what is the problem if the result of actions taken is not to the tax authorities' liking? The rejoinder is usually that the result is not in accordance with the legislative intention. But what does the taxpayer have to go by, if not the language of the legislation? If the law can be overridden at the discretion of the tax authorities, where does that leave fairness and certainty?

In some cases the boundary between 'acceptable' and 'unacceptable' avoidance becomes a matter of proper disclosure, that is, that unacceptable avoidance is often down to incomplete disclosure—possibly bordering on evasion if the success of arrangements depends upon non-disclosure. Some of the controversy can be taken out of the debate if there is full and frank disclosure. In addition, initiatives in countries such as the US and UK to require speedier disclosure of tax planning schemes (see below) seek to ensure a better balance in the system or at least an acknowledgement that current intelligence is

important in dealing with avoidance. Even with full disclosure, however, there remain arrangements that continue to generate controversy, being designed for no purpose other than to eliminate tax liabilities or that operate as a 'raid on the Treasury' by generating tax repayments or double reliefs for particular expenditure.

There is undoubtedly room for the view that the UK's tax system, with its reliance on legal 'form' rather than on economic or financial 'substance', is particularly open to avoidance.<sup>40</sup> At the time of the Meade Report, promoters of tax avoidance schemes were fond of citing the following judicial dictum to justify their schemes:<sup>41</sup>

No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow—and quite rightly—to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue.

Countries that have a doctrine of 'abuse of rights' or have legislated an overarching General Anti-Avoidance Rule ('GAAR') leave less scope for argument or, at least, the grounds for argument are somewhat different. The UK government consulted on an overarching statutory GAAR in 1998 but decided against adopting one. It has therefore been left to the judiciary to develop its approach to construing tax legislation to counter avoidance. Initially, the House of Lords dealt many artificial 1970s schemes a judicial blow when it decided in *W T Ramsay v IRC* (1981) 54 TC 101 that composite pre-planned tax avoidance schemes could be rendered ineffective if the legislation in question justified that approach. Subsequent decisions on the *Ramsay* doctrine, however, have illustrated the limitations of this judicial action against avoidance.<sup>42</sup> Furthermore, judicial sentiment on avoidance can change and few governments can delay counter-action against avoidance once discovered to await a judicial answer as to whether particular schemes are effective or not. Earlier legislative action is usually required to protect tax revenues.

Recent years have seen the UK government step up its efforts to reduce the amount of tax revenue that it perceives to be lost as a result of various forms of tax avoidance. As shown in Table 12.3, measures described as 'protecting tax

<sup>40</sup> The best-known case illustrating this is probably *The Duke of Westminster v CIR* (1935) 19 TC 490.

<sup>41</sup> *Ayrshire Pullman Motor Services and D M Ritchie v The Commissioners of Inland Revenue* (1929) 14 TC 754.

<sup>42</sup> See e.g. *Barclays Mercantile Business Finance Ltd v Mawson* (2002) 76 TC 446.

**Table 12.3.** Treasury estimates of amounts raised through measures announced since Budget 2002 aimed at ‘protecting revenues’ (£ billion 2008–09 terms)

Announcement	Year					
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Budget 2008	N/A	N/A	N/A	N/A	N/A	0.7
Between Budget 2007 and Budget 2008	N/A	N/A	N/A	N/A	0.1	0.2
Budget 2007	N/A	N/A	N/A	N/A	0.2	0.3
Between Budget 2006 and Budget 2007	N/A	N/A	N/A	0.3	1.0	1.0
Budget 2006	N/A	N/A	N/A	0.3	0.8	0.6
Between Budget 2005 and Budget 2006	N/A	N/A	0.2	0.6	0.8	0.8
Budget 2005	N/A	N/A	0.8	1.2	1.1	1.1
Between Budget 2004 and Budget 2005	N/A	0.3	1.2	1.3	1.3	1.3
Budget 2004	N/A	0.4	0.9	1.0	1.0	1.0
Between Budget 2003 and Budget 2004	0.0	0.3	0.5	0.7	0.7	0.7
Budget 2003	0.6	0.6	0.6	0.6	0.6	0.6
Between Budget 2002 and Budget 2003	1.1	0.9	1.1	1.1	1.1	1.1
<b>Total</b>	<b>1.7</b>	<b>2.6</b>	<b>5.3</b>	<b>7.1</b>	<b>8.8</b>	<b>9.4</b>
<i>% of national income</i>	<i>0.1</i>	<i>0.2</i>	<i>0.4</i>	<i>0.5</i>	<i>0.6</i>	<i>0.6</i>

*Sources:* Various Budgets. Only measures scored under ‘protecting revenues’, ‘protecting tax revenues’, or ‘anti-avoidance measures’ included. Nominal figures uprated to 2008–09 terms using the Treasury’s latest estimates of money GDP. Where Treasury estimates are not published, the revenue raised is assumed to remain constant as a share of national income.

revenues’ introduced since Budget 2002 alone are estimated to raise around £9.4 billion in 2008–09. Some revenue-raising anti-avoidance measures are always likely to be required to prevent additional tax leakage as new avoidance schemes are developed. But the government clearly wants to do more than just run to stand still, and hopes to reduce avoidance over time.

### 12.8.3. Legislative anti-avoidance techniques

UK governments have tried most legislative techniques to curb avoidance and in recent years the volume of anti-avoidance legislation has increased, due to the ingenuity of tax planners and a determination by the government and revenue authorities to stamp out what they perceive as avoidance, in turn informed by the disclosure regime (see below). The legislative assault on avoidance has mainly involved specific anti-avoidance measures

in the standard detailed rule-based form. Increasingly, however, legislation has incorporated a general tax avoidance test based on the existence of an avoidance motive or purpose or the derivation of tax benefits; effectively 'mini GAARs' attached to specific parts of the tax code (e.g. VAT option to tax and various share schemes provisions) or so-called 'targeted anti-avoidance provisions' (TAARs—notably on capital losses).

These have met with varying degrees of success.<sup>43</sup> The UK government's latest idea is to introduce, probably starting in 2009, 'principles-based' anti-avoidance legislation designed to achieve a better balance of simplicity and revenue protection. The perception that continues to be conveyed by government and HMRC, however, is that avoidance remains a major issue requiring substantial legislative measures every year.

A less conventional approach has involved the threat of retrospective legislation,<sup>44</sup> in particular targeted at employment schemes that sought to eliminate tax and/or NICs on bonus payments. At the time the threat was made, specific measures were introduced to counter identified avoidance but, in a clear signal that the authorities were no longer prepared to tolerate the situation, the Paymaster General threatened retrospective action against schemes uncovered in the future. There is anecdotal evidence that this threat, coupled with the fact that it has been acted upon (see S92 FA 2006), has been largely successful in stopping the annual bonus scheme round, where each year a series of devices targeted at eliminating tax/NICs on 'city' bonuses appeared.

#### 12.8.4. Tax avoidance disclosure

A major initiative, however, has been the introduction of a Tax Avoidance Disclosure (TAD) regime in 2004. The TAD regime was brought in initially for direct tax (income tax, corporation tax, and CGT) and VAT; it has since extended to SDLT and NICs. The direct tax provisions were recast in 2006 and were extended in 2007 with the grant of greater information powers. The TAD regime has two distinct objectives: to identify new schemes, so that it is possible to take early anti-avoidance action; and to show who is using the schemes so as to help HMRC adjust their risk assessments.

The hub of TAD is the requirement for promoters to notify new schemes within five days of making them available or when implementation has started. Whilst the target might be marketed schemes, bespoke advice can

<sup>43</sup> See TLRC (2008) for a detailed examination of the different approaches.

<sup>44</sup> See the statement by the Paymaster General accompanying the December 2004 Pre-Budget Report.



also be caught and one of the practical problems (on both sides) has been identifying what else has to be disclosed. Various provisions in the successive Finance Acts of 2005, 2006, 2007, and the Finance Bill 2008 can be traced to disclosures made under the TAD (though, curiously, no VAT changes to date). To that extent, the regime is clearly working in allowing HMRC to identify and counteract avoidance more quickly. Statistics of disclosures to the end of September 2007 (867 for direct tax, 702 for stamp duty land tax, and 852 for VAT) suggest that the system is certainly delivering substantial data to HMRC.<sup>45</sup>

At the same time, however, the added stimulus to introduce further anti-avoidance legislation and to tweak incessantly existing anti-avoidance provisions has contributed to the sense that the UK's tax system is too complex and lacks stability in the affected areas. This feeling has led to the government's current simplification reviews, one element of which has been its announcement of principles-based anti-avoidance legislation designed to replace longer and more complex provisions with shorter and simpler anti-avoidance provisions based on clear statements of the principle that they are designed to achieve. While there has been general support for the aims of the review, the consultation initiated in December 2007 generated significant criticism that the proposals would create unacceptable uncertainty and went beyond their intended scope. The essential problem is that avoidance is frequently concentrated on those areas of the tax system where there is no clear principle. Accordingly, finding a satisfactory alternative, simpler, legislative approach is unlikely to be straightforward. In the meantime TAD will continue to generate pressure for further detailed rule-based anti-avoidance measures.

#### 12.8.5. 'Tax in the boardroom'

A further stratagem that the government has deployed against avoidance has been publicity. This has not quite amounted to 'naming and shaming' those involved, but there was clearly a campaign in 2005 to demonize avoidance and portray tax avoiders, both corporate and individual, in a very poor light.<sup>46</sup> Some observers saw a degree of irony in the welter of publicity in that evasion,

<sup>45</sup> <<http://www.hmrc.gov.uk/avoidance/avoidance-disclosure-statistics.htm>>.

<sup>46</sup> For example, in announcing the opening of a second JITSIC office in London in September 2007, the Financial Secretary spoke in terms of the need to stamp out avoidance because 'tax avoidance gives those who seek to cheat the system an unfair advantage over the vast majority of taxpayers who play by the rules.' However much governments and revenue authorities may dislike avoidance, legal avoidance *is* playing by the rules.

which is illegal, seemed to be overlooked almost as if it were regarded as less reprehensible than avoidance.<sup>47</sup>

HMRC also sought to raise awareness among senior management of large companies of the potential risks of being caught on the wrong side of what the authorities consider to be unacceptable tax avoidance. In autumn 2005, HMRC officials wrote directly to the chairmen of the UK's largest 500 companies, seeking to establish a dialogue over the management of tax issues and tax risk. There are certainly positive aspects to greater communication between tax collectors and taxpayers, which should lead to greater understanding of the other side's position. There was a perception in some quarters, however, that HMRC was seeking to exert pressure on companies by raising questions about their tax strategies at boardroom level.

HMRC's increased emphasis on 'tax risk' can also be perceived as an attempt to increase uncertainty among taxpayers about the border between acceptable and unacceptable forms of tax planning, and to foster increased nervousness about the reputational risk of being seen to fall on the wrong side of the divide. Promoting opacity and unpredictability may seem a clever way to raise revenue in the short run, but transparency and certainty have long been seen as hallmarks of a fair and efficient tax system.

### 12.8.6. Conclusion

The disclosure regime has been successful in enabling HMRC to take countervailing measures against avoidance more quickly. This success, however, has come at the cost of an outpouring of specific or 'targeted' tax avoidance rules that, on top of other recent legislative activity in the tax field, threatens to clog the system. Even if anti-avoidance provisions are of 'limited' application—consigning schemes to the history books or ensuring that they never work—they involve a continuing cost to taxpayers, and business in particular, in ensuring that their ordinary commercial and personal arrangements do not fall foul of particular provisions and so avoid unintended effects.

It is important for the integrity of the tax system that people should contribute their 'fair share' of tax revenues and that there should not be undue scope for particular individuals to reduce their share of those revenues. This is the basis of the Paymaster General's statement on employment liabilities. In this respect the tax system that existed in the UK at the time of Meade, with high nominal rates of tax offset by opportunities for avoidance by those

<sup>47</sup> The social responsibilities of corporations with respect to taxpaying are discussed in Slemrod (2004).

with access to specialist advice, represented a poor combination of disincentives and inequity. While the reduction in nominal tax rates since that time has lowered the benefits of specific avoidance, the essential link between avoidance and the tax base remains so that even at lower nominal tax rates avoidance emerges where the tax base is, for whatever reason, difficult to define. Business taxation is a particular illustration because the tax base—‘profits’—is difficult to state and in today’s conditions is global in nature. It is an inherently difficult tax base both to define and to identify with the UK. In this respect, it is difficult to achieve a coherent policy that, on the one hand, demands that businesses pay their ‘fair share’ of taxation without undue avoidance, and, on the other, aims for a globally competitive tax system. Ongoing targeted anti-avoidance provisions may contribute to the former objective while undermining the latter by clogging of the arteries of what aims to be a competitive tax system.

### III. CONCLUSIONS

Administration and enforcement are often neglected in tax policy, but they are central to making a tax system work. In Part I of the chapter we showed how standard optimal tax theory can be extended to address these issues and described a number of important implications. Here, we highlight just two. First, the optimal mix of tax instruments cannot be determined without reference to all the costs of taxation (distortion costs and administrative and compliance costs). Second, for incremental policy adjustments, what matters are marginal costs, not total or average costs.

In Part II we addressed three main issues relating to the administration and enforcement of the UK tax system: the objectives and targets of HMRC, the future of PAYE, and tax avoidance.

The reorganization that created HMRC promises efficiency savings, and recent initiatives make it clear that HMRC takes both administrative and compliance costs into consideration, as is entirely appropriate. Moreover, HMRC is clearly concerned with both raising revenue as well as raising it equitably and accurately. The focus on setting and attaining a long list of quantitative targets, though, runs the risk of obscuring the trade-offs that are implicit in HMRC resource allocation decisions, and potentially making these decisions internally inconsistent. There is also a danger that different costs are not considered simultaneously, and that incremental policy changes are decided on the basis of average rather than marginal costs.

PAYE functions reasonably well for the majority of taxpayers whose circumstances are straightforward but struggles in more complicated cases, particularly for individuals with multiple income sources and frequent job changes. HMRC has already begun to modernize PAYE in ways that should considerably improve its accuracy, but we recommend that more fundamental changes should be considered. In particular, an online system of coding has the potential to remove the need for much of the paper communication currently required, reducing both the number of errors made and administrative costs. The case for universal self-assessment depends both on the extent to which modernization of PAYE manages to address its current shortcomings and on the feasibility of pre-populating tax returns.

Despite significant legislative and other activity designed to counter tax avoidance, the perception remains that tax avoidance is a continuing problem and a source of considerable tax leakage (as compared with the tax that government believes it should be collecting) as well as complexity and cost. In reality, while there is taxation there will be avoidance and the avoidance will tend to be concentrated on those parts of the tax system where lines are drawn between different activities, products, taxpayers, and taxing jurisdictions. A balance must be found between attempting to eliminate every avoidance opportunity and not inhibiting unnecessarily ordinary commercial and personal activities. And tackling avoidance must not mean that tackling evasion is neglected.

Ultimately, tackling avoidance is part of the process of defining the tax base. This will be easier where the tax base reflects a clear underlying economic principle, that does not attempt to tax close substitutes differently, that draws lines where satisfactory objective and independently verifiable criteria exist to distinguish what is intended to be taxed and what is not, and that avoids drawing unnecessary lines without those characteristics.

Beyond such design issues, governments are likely to have to continue to deploy a variety of measures to counteract avoidance and monitor the borders of the tax system where in reality no very clear boundaries exist. A significant problem in the UK has been the tendency to be reactive to avoidance—to address the symptom by negating the latest device without considering the underlying cause of the problem. As a result, taxpayers have revised their plans to circumvent or exploit the latest set of detailed anti-avoidance rules. The attempt to move away from a detailed rule-based approach and find a principles-based answer may signal a recognition that the process of refinement and complication is not ideal and that better methods may be needed to monitor the borders of the tax system.

The overriding conclusion has to be that the UK's tax system is, all things considered, not doing too badly. But it is undoubtedly creaking and as commercial life continues to change rapidly, there is increasing pressure for it to adapt. The question is whether it can adapt quickly enough. If not, it runs the risk of imposing unnecessary burdens while simultaneously allowing revenues to escape taxation such that the tax burden is shared in a more capricious and inequitable fashion.

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## Commentary by John Hasseldine\*

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### 1. INTRODUCTION

The Shaw, Slemrod, and Whiting chapter is an important milestone in the tax administration and compliance literature. A major contribution of the chapter's authors is the framework they have applied to the wide topic of tax system design and implementation. Through their detailed discussion of an extensive literature, a review is provided on important issues such as revenue raising, equity, privacy, taxpayer rights, and the concept of transparency. To these issues, they add the enforcement systems required to 'manage' non-compliance and the costs of these enforcement systems—to both the tax agency and taxpayers themselves. The authors are to be complimented on the rigour with which they buttress their discussion and their outline of an optimal approach to resource allocation.

The authors make a number of interesting remarks, which may not be entirely novel but certainly need to be stated. First, the difficulties imposed by the hard-to-tax sector (e.g. eBay) and challenges imposed by globalization must be addressed. Second, the authors note the importance of modernization of IT systems which in turn, partly dictates the efficiency of tax regimes such as PAYE and VAT. Then, owing to increasing complexity, the authors

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suggest there is a need for strategic thinking on PAYE/NICs. Radical options such as universal tax returns must be considered because the risk that demographic and economic change will have an adverse impact on the system is increasing.

This commentary briefly discusses two further implementation issues that should be considered by any tax administration in the twenty-first century. The first analyses the current environmental context of tax administration and highlights the necessity for consideration to be given to the nature and implementation of monitoring of tax agencies and the level and nature of their public performance reporting. The second issue is a discussion of the importance of considering the internal management of tax agencies and how they might learn from each other through benchmarking efforts and surveys of best practice.

The chapter's authors observe that business plays a key role in the UK tax system. They calculate (Table 12.1) that 88% of UK tax revenue is remitted by business. This is a huge proportion and clearly emphasizes the importance of maintaining good relationships with advisors and businesses to facilitate compliance (HMRC (2006)). Further discussion of this point and the importance of a consultative approach appears in Section 2 of this commentary. The commentary then offers some brief concluding remarks.

## 2. CONSIDERING THE STAKEHOLDERS OF TAX ADMINISTRATIONS

### 2.1. The current environmental context of tax administration

The environment facing tax agencies has changed considerably in recent times (Tomkins et al. (2001)) with issues such as tax shelters, large-scale fraud, tax code complexity, customer service, e-commerce, and globalization requiring consideration and response. These issues affect not only taxpayers and the tax agency itself, but also other stakeholders such as tax practitioners, those involved in processes of tax policy and tax disputes—thus including industry associations, professional organizations, and ultimately every citizen. In addition, one can speculate that the actual process of tax policy formulation has become more politicized in recent years with the establishment of tax-focused pressure groups and more vocal employer representative groups.

The overriding question is how do environmental characteristics impact on tax compliance, and the behaviour of taxpayers, tax practitioners, and tax administrators? From a compliance view, traditional audits consume agency resources, because compliance enforcement measures and performance indicators need careful specification and monitoring (at aggregate, sector, and individual levels). Of course, these issues are not unique to the UK (Weisbach and Plesko (2007)) and other countries face similar pressures and uncertainty.

One well-publicized example is the strategic focus on responsive regulation adopted in Australia where the introduction of the Australian Tax Office's (ATO) Compliance Model (Braithwaite (2003; 2007)) has led to a culture shift, and arguably, can now be viewed as 'best practice'. Essentially the compliance model is a pyramid that conceptually represents taxpayers' motivational postures ranging from Commitment (at the base) through Capitulation, Resistance, and Disengagement (at the peak). Thus appropriate strategies for tax agencies include non-discretionary Command Regulation (at the peak), discretionary Command Regulation, enforced Self-Regulation to Self-Regulation (at the base, which is the desired state). Thus, the model is consistent with the customary goal of voluntary compliance, and at the base, tax agencies can focus on enabling efforts such as education and service delivery. At middle levels, strategies can include business examinations and record keeping reviews, then moving to the top levels there are audits (with/without penalty) and finally prosecution (Hasseldine and Hite (2007); Hasseldine et al. (2007)).

In the UK, following the merger of Customs and Excise with Inland Revenue, different working practices, powers, and penalties have meant an agenda of modernization of these areas. With the (stated) adoption of broad principles of legitimacy and mutual respect into the compliance environment (Feld and Frey (2007); Picciotto (2007)), a consultative approach has been adopted in the UK (e.g. see the work of the Powers committee at <<http://www.hmrc.gov.uk/about/powers-appeal.htm>>). Hence, consultative committees have become the rule, rather than the exception and this now applies to both the setting of policy and the provision of guidance to 'customers'—especially businesses and their advisers. A further principle is to minimize taxpayer burden, and so the application of risk management techniques in audit selection is being refined especially for large business (NAO (2007)). There is international evidence that tax administrations (e.g. HMRC (2007)) are seeking to understand firms' behaviour rather than simply focusing on technical aspects of the tax code.

## 2.2. Public performance reporting and the use of monitoring agencies

Many tax agencies have, for a variety of reasons, become more transparent in their public performance reporting and/or in the amount of oversight that they are subject to, for example, by internal or external bodies with an audit or accountability role. For example, in the US, there is a taxpayer advocate function within the IRS, as well as the Treasury Inspector General of Tax Administration. In addition the IRS Oversight Board was created as part of the 1998 IRS reforms designed to allow IRS to better serve the public and meet the needs of taxpayers. The IRSOB is a nine-member independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction (<http://www.treas.gov/irsob/>). Of course, there also remains an issue of oversight at the point of enactment of tax legislation (e.g. by US Congress or UK Parliament)—as estimated revenue gains/losses can be very imprecise with ‘revenue neutral’ policy and the resulting legislation complex.

Australia established a Board of Taxation in 2000 to advise the government on the formulation and development of tax policy. Several reviews have been undertaken and its work programme currently includes a scoping study on small business compliance costs and a review of the application of consistent self-assessment principles (<http://www.taxboard.gov.au>). Further, in 2003, an Office of the Inspector General of Taxation was established as an independent statutory office to review systematic tax administration issues and to report to government, in the interests of taxpayers, on recommendations that would improve the fairness, efficiency, and integrity of the tax system (McKerchar (2007)).

A further example in the spirit of responsive regulation of transparent public performance reporting, both generally (such as agency business plans), and in detail, is Canada. The Canada Revenue Agency publishes its internal audit reports on the Internet and discloses to stakeholders its public opinion research where executive summaries are published on the website and full reports are available on request.

The examples given in this section are in addition to any role played through a public sector audit function such as the Government Accountability Office in the US and the National Audit Office in the UK. Given the increasingly political nature of tax policy, and the frequent accusations of selectivity when tax-related statistics are used (e.g. by political parties), one

possibility is the establishment of an independent body responsible for commissioning the collection and publication of certain tax statistics although overlap issues with the Office for National Statistics would need resolving.

In summary, just as large companies increasingly consider tax issues as part of corporate governance (KPMG (2004); PwC (2004); Ernst and Young (2006)), so too must tax administrations consider governance and reporting issues. One of the key reasons for this is if there is to be mutual trust and co-operation on the part of taxpayer, tax agent, and tax official, then tax administrations must act and report in a transparent manner. It is not a one-way street.

### 3. MANAGING TAX AGENCIES AND THE NOTION OF 'BEST PRACTICE'

#### 3.1. Internal management of tax agencies

Gill's (2003) World Bank study sets out a useful framework for the main tasks of revenue administration requiring analysis. These tasks can be classified as: (1) operational areas; including: taxpayer registration; processing of customer information; monitoring of withholders/agents; information collection about taxable transactions—and audit/investigation work; risk analysis; recovery of tax arrears and debt management; legal and judicial matters; external relations and customer focus; and (2) organization and management tasks including: strategy; planning; monitoring; personnel management; IT systems management; internal control and asset management. Far less attention has been devoted in the academic literature to the latter broad category, although this is likely to be of concern to review agencies and oversight boards (such as the Public Accounts Committee in the UK).

As part of an edited volume on the 'crisis' in tax administration, Owens and Hamilton (2004) discuss, provide support for, and observe that:

- just simplifying the law does not work;
- policy simplification needs a stronger voice;
- the complexity of policy and law may need to be reduced;
- small business needs special consideration;
- new compliance approaches are needed;
- a new compact is needed;
- tax administrations are underfunded.

Recognizing the above is obviously a useful first step, but clearly these issues interact and the magnitude of the issues facing tax administrators is clearly huge. That having been said, progress is being made and the next section illustrates some of these efforts.

### **3.2. The notion of ‘best practice’ in tax administration**

Until the Centre of Tax Policy and Administration of the OECD began serious work on the ‘administration’ side there was very little sharing of ‘best practice’ although there have been several surveys of administrative practices. For example, the OECD (2005b) Forum on Tax Administration (FTA) allows tax administrators to share information and experience, and identify effective strategies/measures for various areas of tax administration, for example, the ‘Comparative Information Series’ (OECD (2007a)). This report provides internationally comparative data on various aspects of tax systems and their administration in OECD and selected non-OECD countries in terms of international and organizational arrangements for tax administration; aspects of management approaches and practices; return filing, payment, and assessment regimes for the major taxes; selected administrative powers of revenue bodies; tax revenue collections; operational performance information; administrative practice.

Other reports to date include topics such as: compliance risk management (OECD (2004)); strengthening tax audit capabilities (OECD (2006a; 2006b; 2006c)); surveying trends in taxpayer service delivery using new technologies (OECD (2005a)); the use of pre-populated tax returns (OECD (2006d)); and a study on tax intermediaries (OECD (2008)).

In the future, more in-depth benchmarking and documentation of best practices seems highly likely and the European Organisation of Supreme Audit Institutions (EUROSAI) has already begun to collate and categorize the main indicators that tax administrations use to evaluate their performance. Such work will need to identify how to create new and better practices and will require collaboration between international and regional tax organizations and a willingness to share initiatives and results.

## **4. CONCLUDING REMARKS**

Modern tax administrations are large, complex organizations and there is still only a relatively small scholarly literature in the field of tax administration

per se. There are many knowledge gaps that tax agencies must seek to understand. For example, why do taxpayers comply? Why don't they comply? Why do simplified tax regimes often suffer from poor take-up rates? How can compliance costs be minimized?

In summary, there are a number of fundamental characteristics that are likely to be associated with leading tax administrations of the twenty-first century. These are:

- a professional approach to internal management issues (HR; strategic planning);
- attention to cost efficiency and effectiveness;
- responsive engagement with all stakeholders;
- successful introduction of technology applications;
- understanding what drives taxpayer and tax agent behaviour;
- sophisticated risk profiling and informed responses to taxpayer behaviour, including the areas of enforcement and service provision;
- transparency of governance and detailed performance reporting.

Attention to these, however, is not a panacea, and whatever the end-goal is, it will always be difficult for tax administrations to demonstrate to all stakeholders that they are doing well. Perhaps we should consider whether they are doing well enough and examine whether the glass is half-full or half-empty (McCaffery and Baron (2006))! Certainly, the Shaw, Slemrod, and Whiting chapter clearly spells out the lessons to be learned and areas where progress can be made, not only by HMRC in the UK, but by tax administrations worldwide.

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## Commentary by Richard Highfield\*

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### INTRODUCTION

At the present time, the UK tax system is undergoing an unprecedented level of administrative reform aimed at achieving substantial improvements in overall efficiency and effectiveness. While it is by no means unusual for revenue bodies to be subject to major reform activity, a distinguishing feature of the UK situation is the existence of a comprehensive range of mandated outcome-oriented targets—all time-bound and expressed in quantified terms—for improvements to taxpayers' compliance, service delivery, and overall efficiency, and reduced administrative burdens on business. It is difficult to identify another revenue body in an advanced economy with a more daunting array of challenges!

Given these imperatives, the subject of the Shaw, Slemrod, and Whiting chapter and its timing assume a high degree of topicality and provide an ideal opportunity to explore the directions and rationale for the reform of tax implementation in the UK in a way that may inform a wide variety of interested observers.

\* The comments made are provided in a private capacity and are based on a version of the chapter reviewed in August 2007.

### Structure of the chapter

The chapter is structured in three parts. In Part I, the authors provide a description of the principles of optimal tax system design and implementation aspects. Part II discusses substantive issues in a UK context, with a focus on PAYE and income tax self-assessment and HMRC's administration. Part III provides a set of conclusions and recommendations.

#### I. TAX SYSTEMS AND IMPLEMENTATION

This part constitutes a major portion of the chapter and provides a good foundation for the main subject of the chapter. There are a few comments to be made.

At the end of Part I the authors suggest a number of general rules regarding tax system implementation that should be considered in an evaluation of the UK system. From this commentator's perspective, the rules suggested all sound quite reasonable. However, one can readily identify other important 'rules' or 'guiding principles' of an implementation nature. For example: (1) optimize the use of withholding taxes at source; (2) require the payment of tax as close as possible to the timing of the taxing event, while allowing for compliance cost considerations; and (3) arrange tax administration operations organizationally in a way that helps to minimize both administrative and compliance costs. As explained later, this commentator is of the view that the UK does (1) well, lags well behind international best practice on (2), and has recently taken important steps to address (3).

A theme permeating through much of the chapter is that policy developers and tax administrators should possess and use precise information on the *marginal administrative and compliance costs* of the various taxes administered to inform and guide policy decision-making. This would be great if it were readily achievable in practice but based on this commentator's experience it is invariably not the case, for the following reasons:

- Increasingly, revenue bodies are being organized on a 'functional' and/or 'taxpayer segment' basis, thus making it quite a complex exercise for them accurately to attribute aggregate administrative costs to each of the taxes administered. A further complicating factor is the rapidity of developments in the use of technology, which can quickly change the cost structure and aggregate costs—both administrative and compliance costs—of an individual tax. Very few revenue bodies attempt such cost

attribution exercises across the range of taxes they administer and even fewer have reliable data that they are prepared to publish. The UK's HMRC is one of the few revenue bodies that quantifies administrative cost data for each of its taxes and publishes the results.

- Concerning compliance costs, here also there is a dearth of comprehensive and reliable information and to this day there remains some contention, particularly in academic circles, as to what in fact constitutes a 'tax compliance cost'. In their chapter, the authors note that HMRC's recent measurement work in this area focuses on the administrative burden resulting from tax regulations, a subset of what they consider constitute overall tax compliance costs.

There is also the political dimension to tax policy decision-making that is not acknowledged by the authors. At the end of the day, tax policy changes are decided by government and influenced to a fair degree by its programmes and political ideology. Regrettably, such decisions are sometimes made that give little or no regard to, or even fly in the face of, administrative or compliance cost considerations of the kind rightly emphasized by the authors. This factor, coupled with use of tax systems for a plethora of objectives unrelated to their primary revenue raising role, in part explain why tax systems in advanced economies have become so complex (read 'costly to administer'). While it is true that some advanced economies have introduced procedures requiring mandatory cost-benefit analyses to accompany new legislation, these very often must rely on, for the reasons indicated, 'guesstimates' and broad judgements. A further weakness, as noted by the authors, is that these analyses typically exclude the impacts of legislation on individuals who in many countries bear a fair proportion of the compliance burden.

## II. ADMINISTRATION AND ENFORCEMENT ISSUES IN THE UK TAX SYSTEM

Taking a broad sweep tax system implementation in the UK in 2007 and comparing it with the position, say, in the mid-1990s, one can identify many positive developments. For example:

- The outmoded separate organization and administration of direct and indirect taxes has been dispensed with; in its place, a new revenue body

has been established to deliver the many benefits that integrated and more client-oriented processes and approaches to tax administration can bring.

- Administration of NICs has been integrated with tax system administration to achieve increased efficiencies, a practice increasingly being adopted by many other countries.
- In line with international best practice, a separate Large Business Office has been established to deliver a range of tailored services for the largest UK taxpayers who are responsible for collecting the vast bulk of tax revenue.
- There is a strong administrative focus on improving compliance with tax laws (and, as a result, government revenues) using modern risk management techniques. Estimates of the size and composition of the tax gap have been made for the major taxes using a variety of approaches (although not all of this has been published), targets have been set for compliance improvement, and a range of strategies implemented to address key areas of risk. In line with the trend and impacts of globalization, the international dimension of taxpayers' affairs is, from all accounts, receiving special attention.
- Administrative costs have been reduced substantially—in 'cost of collection' terms, from around £1.70 (1995–96) to £1.13 per £100 collected (2006–07)<sup>1</sup>—and appear to be on a further downwards trend with further efficiencies projected up to 2011.
- Compliance costs—in the current EU jargon, 'administrative burdens'—are acknowledged as a key concern by both the government and the HMRC and are receiving special attention. Measurement exercises have recently been conducted to understand better the size and nature of the administrative burden of the major taxes, targets have been set for burden reduction, and a suite of measures has been identified to address burden concerns.<sup>2</sup>
- Progress has been made, particularly over the last 2–3 years, in the take-up of modern electronic services by taxpayers and their agents.

<sup>1</sup> This improved ratio results, in part, from the inclusion of new revenue lines (i.e. NICs and VAT) in the 'cost of collection' computation, as revenue collection operations have been further integrated. Notably, cost of collection ratios for income tax and NICs show improvements of over 20% since year 2000.

<sup>2</sup> See *Progress Towards a new Relationship: How HMRC is Working to Make Life Easier for Business* published alongside Budget 2006.

- A comprehensive review is well advanced to modernize HMRC's enforcement powers, deterrents, and safeguards and relevant legislation is currently being considered.

The conclusion that one draws from these observations is that tax system implementation in the UK is receiving considerable attention. However, these positive developments should not hide the fact that some critically important issues remain to be addressed. These issues (and a few others) and the ideas raised by the authors are discussed in the following paragraphs, starting with some comments concerning HMRC's administration of the tax system, moving then to consider the PAYE system on which the authors have principally focused, before looking briefly at some issues raised of other taxes, namely NI contributions (NICs), corporation tax, and value added tax.

## HMRC

Section 12.6 of the chapter raises a number of issues and expresses a number of viewpoints on HMRC's administration of the tax system. A few comments are called for.

### *The organization of tax administration*

The authors note the recent merger of the two predecessor revenue bodies into a single revenue and customs agency (HMRC) and the efficiency-related rationale for this reform. There are two aspects worthy of comment.

The merger of the two tax bodies was indeed long overdue and there was a strong case on efficiency grounds for the amalgamation, as acknowledged by the authors. An additional potential benefit from the merger, as highlighted by the O'Donnell Review that led to the government's decision, was that it would allow for substantial re-engineering of the way tax administration is conducted, thereby enabling substantial improvements in overall organizational effectiveness and taxpayers' satisfaction with the standard of administration.

A second issue concerns the inclusion of the customs portfolio within HMRC's responsibilities. The administration of customs laws raises many issues unrelated to mainstream tax collection and in these times of heightened risks from terrorism, illegal immigration, and drug trafficking one can well argue that there is a strong case, in a country with 60 million citizens, for a separate dedicated agency for customs administration. One can equally argue that administration of the tax laws (and the other non-tax roles that

HMRC has been given), with an organization of around 60,000–70,000 staff, is more than enough for a single government agency. While a few other OECD countries administer both tax and customs from within a single organization, the vast majority of countries do not and there is certainly no trend in this direction.<sup>3</sup>

### *Performance indicators*

The authors note the setting of compliance improvement targets for VAT—expressed in terms of achieving a reduction in the estimated tax gap, so as to achieve a gap figure of no more than 11%—and direct taxes and NICs—expressed in terms of additional revenue (some £3.5 billion). On this matter, they question what appears to them as a lack of transparency concerning the reasoning behind these objectives and pose the question whether compliance cost-reducing initiatives reflect the same trade-offs as the enforcement-increasing policies. It is also possible that performance indicators and targets based solely on additional yield might prompt areas of the HMRC to concentrate on enquiries of taxpayers' affairs with firmer prospects of immediate payback at the expense of preventative work which might lead to more significant yield in the longer term.

These viewpoints justify a range of comments, in part drawing on this commentator's working experience with HMRC officials:

- There is a strong case to argue that one of the major goals of a revenue body is to achieve improved overall compliance with tax laws, noting that increased revenues flow from improved compliance in an overall sense. Objectives expressed in terms of increased compliance (even if in revenue terms) are a logical consequence of this primary goal and specific targets would seem to be appropriate as a means of gauging overall progress.
- The targets set are, in many respects, aspirational in nature and form part of a broader set of objectives used by HMRC to gauge progress in achieving improved performance.
- Progress towards the targets is to be made in each of years up to the target year, and is the expected outcome from the full range of HMRC's service,

<sup>3</sup> In line with the views expressed, it was announced on 14 November 2007 that the government had decided to create a new Home Office agency, the UK Border Agency. The new agency will report to both the Chancellor of the Exchequer, on fiscal issues, and the Home Secretary and will combine most of HMRC's Detection Directorate and some of those who support them along with UK Visas and the Border and Immigration Agency. Policy on customs and tax matters and associated processing will remain within HMRC. The UK Border Agency is expected to have around 25,000 staff in total and it will begin to operate on an interim basis from January 2008 while the necessary legislation is put in place (as per HMRC's *Departmental Autumn Performance Report 2007*).

education, and enforcement activities across all segments of taxpayers, not just from inquiries/audits, as implied by the authors. HMRC does not break down the overall targets and attribute them to individual functional areas within its operations and, in this sense, it appears unlikely that the targets per se would lead to the sort of behaviour suggested by the authors. HMRC has been extremely transparent in its work on VAT gap measurement, considerably more so than revenue bodies in other advanced economies, and it provides a report of its ongoing work each December with the government's pre-Budget papers. If one looks at HMRC's most recent report the improvement in compliance required to achieve a VAT gap target of 11% is around £3.0 billion, which is more or less in line with the target for improved compliance of direct taxes and NI contributions (i.e. £3.5 billion). In this sense, there appears to be some consistency from HMRC in the respective targets, although clearly each area of risk will be subject to its own set of strategies.

- HMRC is largely a 'trailblazer' among national revenue bodies with mandated targets of this nature; perhaps some time should be allowed to see if the approach has any validity as a performance enhancing tool for revenue bodies before conclusive judgements are made.
- The authors are most probably correct in questioning whether the same trade-offs have been made concerning compliance cost-reducing initiatives. In fact, it is more than likely that the targets were set quite independently, by different officials and at different points in time, of the process for setting compliance improvement targets.

### *Measuring compliance costs*

The authors note the considerable work carried out by HMRC (with KPMG's assistance) to get a better handle on the incidence and nature of the administrative burden on business resulting from the tax system, and the setting of targets aimed at achieving burden reductions. However, they express concerns that little attention has been given to individuals/citizens in any of the measurement work and a related concern that, as a result of this omission, the opportunity might be taken to transfer some of the costs of business onto individuals as part of the burden reduction programme. Another issue stems from the fact that the burden measurement work undertaken using the Standard Cost Methodology (SCM) may not be statistically representative and therefore questions arise in relation to its accuracy and usefulness. A few comments are called for.

The authors are correct in their conclusion that the focus of the recent burden measurement work has been on business and not individuals. However, given that the measurement work did cover some 3 million unincorporated/self-employed individuals who pay income tax, it can be said that a portion of the individuals' population is covered. This does, of course, leave some 7 million other taxpayers (e.g. employees and investors) who file tax returns and pay taxes and as a result incur an administrative burden.

Concerning the possibility that measures taken to address business's administrative burden may result in some cost transfer to individuals, this does appear to be unfounded. In parallel with the conduct of the measurement studies, HMRC (and the Treasury) undertook a detailed study of measures that might be taken to reduce administrative burdens and achieve the targets set. The results of this study were published alongside Budget 2006.<sup>4</sup> A reading of the study indicates that the measures planned to reduce business's administrative burden should have no impact on citizens.

In relation to the use of the SCM, the published reports do acknowledge that because of the underlying methodological approach the aggregate costs are likely to be 'understated'. That said, the measurement of administrative burdens/compliance costs, regardless of the methodologies used, is generally always associated with various assumptions and elements of guesswork that give rise to some degree of inaccuracy or doubt. The quantification of burdens/costs resulting from tax regulations is by no means a precise science.

On the other hand, application of the SCM does have the clear advantage of providing detailed and precise information on the specific information obligations pertaining to each tax and, as a result, facilitates the identification of the most burdensome areas of regulation. Furthermore, there is currently considerable interest in, and use of, the methodology across Europe, potentially leading to some opportunities for cross-country benchmarking. In February 2007, the EU's ECOFIN Council mandated use of a modified SCM methodology as part of an EU-wide burden reduction effort to achieve savings of 25% by 2012.

### **The future of PAYE**

Section 12.7 of the chapter describes the operation of the PAYE systems and the self-assessment regime applicable to those required to file annual

<sup>4</sup> See *Progress Towards a new Relationship: How HMRC is Working to Make Life Easier for Business*.



tax returns. It concludes with views on policy options to address perceived weaknesses in the PAYE and interest withholding arrangements.

As noted by the authors, substantial reliance is placed on the personal income tax and NI contributions for government revenue purposes.<sup>5</sup> In 2006–07, revenue from these taxes represented a little over 50% of the total receipts collected by the HMRC (or around 45% of all government tax revenue). Central to the efficient and effective collection of both PIT and NICs are the separate withholding arrangements administered by employers and financial institutions in respect of employment and interest income respectively. Applying the authors' data, these withholding mechanisms were responsible for almost 89% of all personal income tax and NICs collected in 2006–07.<sup>6</sup> This high degree of reliance on withholding no doubt contributes to achieving high levels of compliance and is to be applauded. On the other hand, such a heavy reliance on the private sector as 'tax collectors' heightens the need for withholding arrangements that impose the minimum of costs and disruption on business, while at the same time protecting the Revenue.

The UK system of PAYE has long been lauded worldwide for its ability to free the majority of employee taxpayers from the obligation to file an end-year tax return, as is the case in some other advanced economies. This is largely achieved through the operation of the *cumulative* withholding feature of the PAYE arrangements that requires employers to calculate and withhold taxes for each employee on a progressive (i.e. cumulative) basis throughout the year, taking account of all their employment income. In conjunction with a system of withholding tax at the basic rate from interest payments these arrangements enable around two-thirds of all personal taxpayers to be freed from the obligation to file an end-year tax return.

The UK approach to personal tax administration (i.e. complex PAYE withholding arrangements but return-free for most employees) stands in contrast to the practice seen in other Anglo-Saxon economies (e.g. Australia, Canada, and the US) and in some European countries. There, simpler PAYE withholding arrangements (generally involving a *non-cumulative* form of withholding) are used, but all employees are generally required to file an end-year tax return. Tax returns enable the revenue body to view information relevant to determining a taxpayer's full year tax liability and to calculate

<sup>5</sup> The OECD considers NICs as akin to personal income tax and, for comparative purposes, as a 'tax'.

<sup>6</sup> As shown in Table 12.1 of the chapter, employers withheld £124.8 billion PAYE and £84.5 billion NICs. Financial institutions withheld £4.9 billion tax in respect of payments of interest. Netting off £9.5 billion repayments attributed to business gives a total of £204.7 billion, 88.8% of the total of £230.6 billion personal income tax and NICs.

whether any taxes are due after all types of advance payments. As employees typically represent a large proportion of the personal taxpayer population, this universal requirement to file an end-year tax return results in a significant compliance burden. Not surprisingly, proponents of tax reform in many of these countries regularly call for a simpler approach, ideally that involves getting rid of tax returns for most employees.

At first glance, the return-free feature of the UK system appears highly attractive given that it avoids the compliance costs associated with end-year tax returns and the administrative costs of processing them. However, as highlighted by the authors, the PAYE arrangements are becoming increasingly difficult (read ‘costly’) to administer properly for both employers and HMRC and lack the flexibility needed to accommodate effectively some government policy demands. In support of their concerns, the authors note the following points:

- *Inaccuracy*: Reports from the National Audit Office (NAO) note that about 30% of cases require an end-of-year adjustment due to errors in coding and the way PAYE is operated, and roughly 0.8 million taxpayers may end having paid the wrong amount of tax.
- *Lack of flexibility*: There is an inability to easily accommodate new entitlements for taxpayers or new government policy measures, as evidenced by experience with the system of tax credits introduced in 1999. The authors note that initial attempts to pay tax credits via employers failed and new arrangements entailing the direct crediting of tax credits by HMRC to taxpayers’ bank accounts were introduced in 2006. Somewhat perversely, these new procedures require claimants to file something akin to a tax return to support their claim.

A further difficulty raised concerns the operation of the flat rate withholding system on interest income, which for some taxpayers results in too much tax being withheld (and the need for repayment arrangements), while for others (i.e. above basic rate taxpayers) too little is withheld.

Against this background, the authors express doubts (as does this commentator) as to whether the existing arrangements, taken in their entirety, represent a more effective and efficient means of administering the personal tax for employees than arrangements of the kind seen in other countries. An additional consideration is that there have been developments in a number of countries entailing the use of pre-filled tax returns that offer a highly effective way to minimize the compliance costs associated with preparing end-year tax returns (see later comments).

*Policy options for withholding*

To address the issues identified, the authors canvass a set of policy changes to the PAYE and interest withholding arrangements. On the surface, their ideas have both pros and cons and each would need careful appraisal. One reservation, in this commentator's view, is that adoption of a number of the suggestions (e.g. monthly reporting by employers) would increase the compliance burden on business at a time when priority is being given to burden reduction. However, the authors have an alternative suggestion for the longer term to address the issues raised that is discussed in the next part of this commentary.

*Long-term reform options*

To address the many 'rough edges' and limitations of the current withholding mechanisms, and to simplify their administration, the authors raise the possibility of adopting a system of universal self-assessment, ideally supported by a system of pre-filled tax returns. The rationale for this idea is as follows:

1. A move to universal self-assessment would provide a simpler, less costly and more accurate means of establishing each taxpayer's proper end-of-year tax liability and its reconciliation with taxes withheld at source, as well as providing information to validate taxpayers' entitlements to tax credits.
2. To avoid the significant additional compliance costs that a system of universal self-assessment arrangements would otherwise impose, the introduction of a system of pre-filled tax returns, along the lines seen in a growing number of other countries, is suggested as an accompanying feature.

At first glance, this may appear a little unrealistic, given both the magnitude of the changes their adoption would entail and perhaps a general lack of awareness of the concept of pre-filled tax returns. However, this commentator believes that the suggestion has considerable merit and a strong underlying rationale, as explained in the comments that follow, and warrants detailed study.

Around fifteen of the thirty OECD countries generally require all personal taxpayers to file an end-year tax return. In most of these countries, this obligation results in a significant compliance burden for employee taxpayers, given the relatively large number involved and the tendency for complex tax systems. In the late 1980s, taking advantage of newly emerging technology

and a strong desire to ease the compliance burden of personal taxpayers, Danish tax authorities piloted the first version of what is now known as a 'pre-filled tax return'. The system has undergone ongoing refinement since the initial version.

As the name implies, a pre-filled tax return is one prepared in the first instance *by the revenue body for the taxpayer*. Under these arrangements, information reports (e.g. covering wages, fringe benefits, interest, dividends, pensions, sales of assets, taxes withheld and certain deduction items such as child care, mortgage interest, and pension contributions) that must be reported on electronic media and contain a unique taxpayer identifier are captured and validated by the revenue body. This large information processing activity enables the revenue body to generate a (pre-filled) tax return that sets out amounts and sources of known income and deductions and the like, and provides a preliminary calculation of tax liability/refunds and so on. These returns are sent to taxpayers for vetting around 5–10 weeks after the end of the relevant fiscal year, either via the Internet and/or on paper, with taxpayers being normally required to indicate either that the return is complete or to provide further information. In a few countries, taxpayers need not respond if the return is correct. Once taxpayers' responses have been processed by the revenue body, formal notices and refunds, where applicable, are sent to taxpayers.

Compiling and presenting information in the form of a pre-filled tax return removes the need for many taxpayers to undertake the task manually, thus significantly reducing the burden that they would otherwise face to comply with the law. In countries where these systems are well established and based on a comprehensive array of third party reports, substantial benefits are being derived. For example, the Danish revenue body reported that for fiscal year 2006 around 70% of all personal taxpayers received a pre-filled return that was complete in all respects, thereby significantly reducing their compliance burden. Other taxpayers were assisted, but to a lesser degree.

Today, the use of pre-filled returns is well entrenched and operating very effectively in all Nordic region countries. In recent years, similar (but not as sophisticated) pre-filled return systems have been adopted by revenue bodies in Chile, Portugal, Spain, and France. The Australian Taxation Office has operated a limited form of pre-filling as part of its electronic return filing system for a number of years and plans to expand it significantly into a 'full production system' from July 2008. The Dutch revenue body plans to introduce pre-filled personal tax returns for the 2008 fiscal year.

Given the experience in the countries mentioned, and in light of what appears to be an emerging trend in personal tax administration, it is quite conceivable to this commentator that adoption of the authors' suggestions is both realistic and, potentially, the most effective overall solution to address the problems being experienced. However, this solution is one for the longer term. Implementing a system of universal self-assessment incorporating a system of pre-filled tax returns is a substantial undertaking that would take many years to implement fully. In addition to the planning needed, there are three prerequisite features that must be in place to enable such arrangements to operate effectively: (1) an extensive system of third party reporting to the revenue body; (2) the use of a unique high integrity taxpayer identifier by third parties so that reports can be readily and accurately matched with tax records; and (3) optimal use of technology by reporting bodies and the revenue body enabling rapid transmission, capture, and processing of information reports.

### **National Insurance Contributions (NICs)**

The authors note that substantial reform of the NICs has eroded the link between NICs paid and social security benefits received to the point where it appears worth considering whether the case for separate NICs any longer exists. NICs are, after all, analogous to the personal income tax so it might well be asked whether there is a need for two personal income taxes. A related concern is that despite their convergence over time, in practice a number of differences exist between PAYE and NICs that unnecessarily complicate compliance (read 'add costs') for employers who collect the vast majority of NICs. For example, the definition of 'pay' differs for PAYE and NICs purposes, while PAYE operates on a cumulative basis but a different approach applies for NICs. They indicate that because of these sorts of complications businesses are regularly calling for reform as a matter of high priority.

Across the OECD, twenty-eight of the thirty member countries operate separate social security contribution (SSC) schemes; only two countries (i.e. Australia and New Zealand) do not administer separate SSC regimes, instead choosing to pay the various benefits out of general government revenue (and thus avoiding the costs of such schemes!). While there does not appear to be any worldwide trend to rationalize personal income tax and SSC regimes, this appears worthy of study in a UK context given the NICs' evolution and the potentially significant benefits that a unified approach could deliver.

If the idea of unification is put aside, further efforts to harmonize PAYE and NICs would also appear worthy of urgent consideration. Actions along these lines have recently been taken by the Dutch government in its efforts to reduce administrative burdens on business by 25% by 2007. From all accounts, this objective will be met and measures to harmonize SSCs and PAYE have reportedly made a fair contribution to this outcome.<sup>7</sup>

### Corporation tax

Despite the fairly high profile of the corporation tax in the UK, it is a relatively small source of government revenue. In 2006–07, corporation taxes represented less than 10% of government receipts (see Table 12.1). The last published figures for OECD countries show UK corporate tax receipts in 2004 at some 2.8% of GDP, somewhat below the OECD (unweighted) average of 3.4%. Yet, despite the relatively low contribution of corporation tax to revenue its administration receives considerable attention within HMRC, in particular, from its enquiry programme. The revenue yield from these activities is significant and growing, an outcome in line with what is being observed in most other advanced economies.

One issue is the extraordinarily generous return filing and tax payment obligations that are a feature of the current UK corporate tax regime (and to an extent for the income tax). Compared to the position in most OECD countries, the timing of tax payments (including advance payments) for corporate taxpayers is lagged considerably, particularly for companies with profits less than £1.5 million, while companies are given up to twelve months to file their end-year tax return. While these arrangements clearly benefit companies by reducing their compliance burden they are ‘substantially excessive’ when contrasted with the practices applied in other advanced economies and clearly have a number of downsides. Deferring tax payments has a cost to the UK Exchequer (read ‘taxpaying community’) and may contribute to revenue losses as some taxpayers ‘find other uses for their funds’. Furthermore, abnormally long filing periods also impede a revenue body’s capacity to detect and deal with non-compliance behaviour in a timely manner, and must inevitably result in the deferred collection of some revenue arising from enquiry work, or worse, a loss of some revenue resulting from non-payment of belatedly imposed additional liabilities.

<sup>7</sup> See *Focus on Businesses, Dutch Progress Report on Reducing Administrative Burdens*, April 2006.

### Value added tax

The VAT is a significant source of UK government revenue raising £77 billion in 2006–07, around 16% of all government revenue (as per Table 12.1).

While originally conceived as a simple single rate tax on consumption expenditure, VAT systems generally have evolved into a relatively complex (read ‘costly’) method for raising government revenue. The UK’s VAT, with its multiple rate structure and various exempt goods and services, fits squarely into this category, notwithstanding a range of policy measures taken by the UK government to ease the compliance burden of smaller businesses. In these respects, the UK’s VAT mirrors much of what is seen generally across Europe in VAT system design.

On a positive note, the UK’s VAT is characterized by a quite generous (by EU standards) registration threshold and a number of concessions, also subject to generous thresholds, to smaller businesses that enable use of simplified approaches for determining VAT liabilities. These concessions, which include the cash basis of accounting and a flat rate scheme where VAT liabilities can be based on a set proportion of a business’s turnover, are intended to ease their administrative burden. Yet, despite these concessions, the administrative burden of the VAT, as quantified by HMRC’s own measurement research, is the highest of any tax administered in the UK.<sup>8</sup>

An additional challenge for HMRC and the government concerns the relatively high level of revenue leakage from the VAT system resulting from all forms of non-compliance, in particular, ‘missing trader intra-community’ or ‘carousel’ fraud. HMRC’s own research of the VAT tax gap points to a high incidence of revenue leakage—some 14.2% of the theoretical tax base for 2006–07. For what was originally conceived as a self-policing tax, leakage of this magnitude constitutes serious erosion of the tax base and warrants close and sustained attention. To their credit, the HMRC (and the former Customs and Excise Department responsible for VAT administration until April 2005) have been very active and transparent in their administration of VAT over the last seven years and can point to overall progress in reversing a trend of serious and increasing compliance that was evident in the early 2000s.

In circumstances of significant administrative burden and high revenue leakage it is disappointing that the authors have not canvassed any ideas for VAT reform. Is it time, for example, at least to consider the feasibility of a

<sup>8</sup> HMRC’s administrative burden measurement studies conducted in 2005–06 revealed that the VAT was by far the most costly tax for business to administer—some £1,020 million. The figures for other major taxes were £608 million (corporation tax), £759 million (employer taxes—PAYE and NICs), and £857 million business taxes.



major simplification of the VAT system, entailing a substantial broadening of the tax base and a single (but substantially lower) standard rate? (The same comment applies equally to all European VATs.) For example, a VAT system with a tax base modelled along the lines of New Zealand's GST and a basic rate of, say, 12.5%<sup>9</sup> would raise substantially more revenue than the existing VAT system, some of which could be used to compensate those adversely impacted by such a reform. More importantly, however, a VAT designed along these lines would be less relatively costly for business and HMRC to administer (read 'easier to administer') and would provide considerably less incentive for non-compliant behaviour (read 'easier for HMRC to administer'). While this idea would undoubtedly be met with strong political opposition, one can argue that the existing situation of high revenue leakage and compliance costs requires a radical response. Further tinkering is unlikely to get the job done!

### III. CONCLUSIONS

The authors end with some brief conclusions. For his part this commentator would conclude as follows on some of the key issues raised by them.

First, he would strongly support in principle according a high priority to the modernization of HMRC's IT systems. Indeed, he would be surprised if such modernization did not already have the necessary priority within the Department.

Second, he would support the continued process of harmonizing the definitions and rules for PAYE and NICs purposes. The unification of personal tax and NICs is certainly worthy of consideration given the erosion of the contributory principle and the potential benefits flowing from a simpler system. In the longer term this commentator would support moving towards the adoption of universal self-assessment incorporating a system of pre-filled tax returns coupled with a rationalization of the reporting requirements for the tax credits system.

Third, he would suggest that it is simpler to subsidize smaller businesses for their use of payroll agents (such as the scheme that the New Zealand IRD administers) rather than a scheme under which HMRC carry out payroll and other compliance tasks for very small employers.

<sup>9</sup> The commentator acknowledges that existing EU rules do not permit VAT's having a standard rate of less than 15%. A reform along the lines suggested would, accordingly, require enlightenment at the EU level.



Finally, as regards the use of tax shelters with a cross-border dimension, this remains a complex and difficult area for all revenue bodies to tackle. With JITSIC, it is already receiving attention and this commentator would expect that the risks to revenue that it involves are already appreciated and receiving a high degree of priority within HMRC.

## Commentary by Brian Mace\*

Brian Mace is a member of the IFS Tax Law Review Committee. He is a former Policy Director in the Inland Revenue (now HMRC). Between 1984 and 2004 when he retired, he worked primarily on personal taxation, providing policy advice to successive ministers on income tax, employment, inheritance tax, capital gains tax and the tax treatment of pensions, savings, and charitable giving. In 1988–89 he led the Revenue team that implemented independent taxation of husband and wife. Later he had responsibility for teams introducing new policy measures such as ISAs, reforms to capital gains tax, and on-line filing by employers.

### INTRODUCTION

The Shaw, Slemrod, and Whiting chapter focuses primarily on the way the tax system is run and not on the structure, balance, or incidence of UK taxes. Those issues are considered in other chapters. But as the authors acknowledge, the structure of a tax and how it is administered are matters which are closely inter-linked. The structure of a tax may largely determine the way it is administered (or preclude certain administrative options). Conversely existing administration structures may make certain policy options difficult to implement without radical change.

The chapter is in two main parts. Part I looks at the economic theory and other principles which may underpin attempts to optimize how taxes are implemented; Part II looks at specific issues of administration in the UK, concentrating on PAYE, self-assessment of income tax, and measures to curb tax avoidance. This Part also discusses a number of specific ideas for possible change.

\* This commentary sets out the commentator's personal views and opinions and not those of any organization. It is based on a version of the chapter dated 23 May 2007.

The following commentary looks at a number of the issues considered in the chapter, drawing attention to the key conclusions and testing some of the ideas and proposals in a little more depth. It also seeks to identify some subjects and issues which the authors have not mentioned, or mentioned only indirectly, which might be worth further attention. In preparing this commentary I have had the benefit of reading the commentary prepared by my fellow commentator on the chapter, Richard Highfield. I agree with much, though not all, of what he says.<sup>1</sup>

## I: TAX SYSTEMS AND IMPLEMENTATION

This part looks in turn at:

- the theoretical analysis of tax design, drawing on previous work by the authors and the economic literature more generally and taking that work forward in a number of places;
- determinants of evasion, avoidance, and administrative and compliance costs;
- enforcement systems;

and concludes with a section offering some particular implementation guidelines.

This part of the chapter provides a helpful background to the specific analysis of tax issues in the UK which follows in Part II. A few points, not in any particular order of importance, call for some comment.

- (i) Although the authors acknowledge that the general theory is highly stylized I feel, like my fellow commentator, that the absence of any reference to the role of politicians in shaping tax policy and administrative structures is an important gap in the analysis. Tax administrators and others supporting ministers in charge of tax policy will naturally aim to cover the considerations described by the authors in the advice that they give to government. But politicians often have wider considerations which they wish to bring into the analysis. Not all of these are the product of expediency or ideology. In seeking election a government may have made commitments about the sort of tax measures which

<sup>1</sup> I have not duplicated my fellow commentator's analysis where I agree with what he says (for example, his very clear discussion of performance indicators) but have focused on subjects where I have particular experience or where my perspective on the chapter is different.

it will or will not consider. For example, the government may have pledged not to raise a particular tax rate or not to impose tax on certain sorts of transactions. If, subsequently, there is a need to raise taxes it may therefore be that the optimal measure to do so in economic theory is closed off. In these circumstances it is not unprincipled for the government to look for alternative, if theoretically sub-optimal, means to raise the revenue it needs. It is important to recognize that administrators do not have final control over the decisions which are taken about tax structures.<sup>2</sup>

- (ii) The authors comment on the importance of IT in the administration of the tax system. In the UK the tax administration was relatively late, by international standards, in making full use of IT in a number of areas and has subsequently continued to lag behind. There are political and historical reasons for this. Plans to computerize the largest<sup>3</sup> administrative system, PAYE, on the basis of nine large centralized processing centres, which had begun in the late 1960s, were abandoned in 1971 when the then government decided that it wanted to look at more radical options for a system of tax credits or negative income tax. When those proposals were in turn put on one side following the change of government in 1974 work began on proposals to computerize PAYE using desk-top terminals in local offices. As a result of this rather disrupted development process it was not until the early 1980s that PAYE was fully computerized, though that particular project was completed on time and on budget.
- (iii) Although IT is now fundamental to the operation of the tax system the authors note that there are cautions to be aware of. The chapter mentions two but there are arguably others. For example, although computer systems can be very efficient at handling large numbers of straightforward, similar transactions, they may be less effective where non-standard action is required. There are two aspects to this. First, it may be more difficult, perhaps impossible, for the non-standard action to be handled by the computer even with manual intervention by an operator. This is particularly true for very large administrative computer systems. Adjustments or tweaks which in a manual system can be readily applied to give a more satisfactory outcome in a particular case may not be practicable. Second, there is a mirror to the point made by

<sup>2</sup> And as my fellow commentator notes policy-makers may not have the necessary factual information about marginal costs and other matters to enable them to carry out the analysis which theory would require.

<sup>3</sup> Largest both in terms of the number of persons liable to the tax and in total revenue raised.

the authors that IT may lead to taxpayers being less well informed about the tax system and how it works. This may also apply to the staff in local tax offices who, because the computer does the work and calculation, may have less understanding of what the administrative structure is trying to achieve in principle and therefore be less able to devise ways of dealing with individual problems.

- (iv) Another factor to bear in mind in the design of administrative systems for taxation is that long-standing taxes like income tax are not superimposed on the economic structure of a country. They are the products of a wide range of cultural, historical, economic, social, political, and other factors. The way the tax system works is often deeply embedded both in the economic structure of the country and in the national psyche.<sup>4</sup> Moving to a new system may require not just a change to administrative procedures and computers; it may also depend on changing culture and attitudes too. This may in turn require lengthy programmes of education or re-education before a radically new design can be fully accommodated and assimilated. And those transitional costs need to be factored into the balance of whether the benefits of the change are actually worthwhile. This is partly why international comparisons in taxation need to be treated with very considerable caution. Just because an approach works well in one country and may be technically feasible in another does not necessarily mean that it can in practice be easily translated from one to the other. The approach may be the result of particular cultural or social features in the first country which simply do not apply in the other.
- (v) In Section 12.3.2 the authors comment on the factors that lead people to pay their taxes rather than evade them. I agree with their view that the data here are not sufficient to overturn the theoretical deterrence-based model on evasion which they support. But it is important not to underestimate the role which cultural factors play in affecting compliance. On the whole, UK citizens have been acknowledged to be generally compliant in meeting their tax obligations. This goes hand in hand with a culture in which most people pay their credit card and other bills on time even where the sanctions for not doing so are weak. I suggest this is one, though not the only, reason why the UK does not have relatively strong enforcement powers.

<sup>4</sup> For example, consider how in the UK the number of a tax form, 'P45', has come to represent leaving a job.

II: ADMINISTRATION AND ENFORCEMENT  
ISSUES IN THE UK TAX SYSTEM

GENERAL

Part II focuses on income tax self-assessment and the operation of PAYE. This is undoubtedly an important area given the high proportion of total revenue raised by income tax and through the PAYE system in particular. However, the issues here are in my experience well-trodden ground. That is not to say there are no problems with taxes and charges on individual income but, for reasons which I shall fill out later, I am not sure that this is where the critical pressure points lie in the UK tax system. Other issues include the following:

- Whether there are ways in which the current serious leakage of VAT through ‘carousel fraud’ might be addressed (though admittedly this may not be an issue which the UK can easily tackle on its own because of the EU rules which govern VAT).
- Whether the present administrative structure for tax credits—of which there has been a lot of criticism—could be improved.
- Whether the structure of the more recent ‘environmental’ taxes (landfill tax, air passenger duty, etc.) is appropriate, especially since charges like these seem likely to be a growth area for future taxation.
- The implications of European Court of Justice decisions for the structure of corporation tax.
- Whether the totality of the tasks which HMRC is currently undertaking is manageable, and organizationally sensible.

PAYE

The authors look at a number of aspects of the present PAYE system for deducting tax from employees’ pay.

**Accuracy**

In Section 12.7.2 the authors refer to reports about accuracy in the operation of PAYE. This is undoubtedly a concern and it is right to stress the importance of finding ways to reduce these inaccuracies. In the light of current constraints on HMRC resources I feel this is likely to mean that individuals will have to

take more responsibility for ensuring the correctness of their own tax bills. Nevertheless it is important to keep this issue in perspective. Bourn (2005) cites an internal HMRC report which estimated that around £575 million per annum of tax due had not been pursued by the department and that taxpayers were not being advised of around £295 million per annum of tax potentially repayable.<sup>5</sup> However, the total yield from PAYE in 2005–06 was £113,894 million<sup>6</sup> so the variances identified by HMRC were of the order of  $\pm\frac{1}{2}\%$ .

### Changes in working patterns and demographics

#### *Employees*

In recent years the number of individuals whose circumstances are less easily accommodated within PAYE has undoubtedly increased. Typically problems arise where the individual has a number of jobs either simultaneously or sequentially during a tax year. But in practice the number of such cases remains a relatively small proportion of the total number of employees. For example, figures from the labour force statistics show that in 2000 over 80% of employees had been in their current job for over a year and almost 70% for two years. And while the number of employees with multiple employments has increased substantially since the mid 1980s the number of employees who held more than one job in 2000 was still only 4% of the employed workforce. These figures are now slightly out of date but I do not believe that they will have changed significantly.

I feel the authors underestimate the effectiveness of PAYE. PAYE can and does work very successfully, and with little manual intervention, for an employee who has a single job throughout the tax year or who changes job not too close to the end of the tax year.<sup>7</sup> That still describes the vast majority of the working population in the UK.

#### *Pensioners*

Another group for whom PAYE works less well consists of pensioners who have several pensions from a number of past employments. This is a relatively

<sup>5</sup> Bourn (2005).

<sup>6</sup> <[http://www.hmrc.gov.uk/stats/t\\_receipt/table2-8.pdf](http://www.hmrc.gov.uk/stats/t_receipt/table2-8.pdf)>.

<sup>7</sup> If the change of job happens too close to the end of the tax year the P45 process may not catch up with the employee in their new job before the end of the tax year and cumulation may therefore break down.

recent (but growing) phenomenon as those who took advantage of the extension of pension options in the 1970s and 1980s start to reach retirement age.

In principle PAYE should work well for pensioners.<sup>8</sup> Their pensions come from the same payers each year and apart from any annual uprating the sums paid do not fluctuate between pay-periods. But difficulties occur where the pensioner has more than one pension because manual intervention is necessary to co-ordinate the correct deductions, month by month, from each payment. Getting that right requires personal attention from the pensioner's tax office which is very resource intensive. In practice it may be necessary for pensioners to be proactive themselves in ensuring that the right deductions are made from their income or in completing a tax return at the end of the tax year to ensure that they pay the right amount of tax.

There is an irony in having a system which, having got a person's tax affairs right without tax returns for the whole of their working life, requires the person to start filing a return once they have retired. But there is no easy answer to that problem and unfortunately I believe it is unlikely that resources will be available either in HMRC or elsewhere in government to undertake the complex co-ordination work which would be necessary to get the right results within PAYE. However, one solution which might be worth examining is whether, if an individual has pensions from several sources, one of the pension payers could act in the lead as a sort of clearing house for all the others. If all the pensions due to an individual were channelled to the person through the lead payer that provider could aggregate all the amounts and apply PAYE to the total sum before then paying the correct net amount to the pensioner. Such a system would obviously require the agreement of both the pensioner and pension providers and would undoubtedly mean more work for the pension payer co-ordinating the payments. But the other pension payers could have less work to do and would simply have to pay pension without tax deductions to the lead provider. There might, therefore, not be much increase in the total compliance costs of pension payers overall.

### Flexibility

The authors are concerned that PAYE imposes some inflexibility on the tax system and may prevent certain policies being introduced. As an example they

<sup>8</sup> And in practice more than half of those aged 65 or over are in any case not liable to income tax.



mention that when the present system of personal tax credits was introduced they could not be accommodated within PAYE. However, this seems a rather harsh analysis: after all even a Rolls Royce car cannot fly you to New York! Had the UK had a system of universal self-assessment in place at the time tax credits were introduced, the task of getting substantial numbers of credit recipients to complete returns of income as is now required would have been much simpler if not obviated altogether. But, just like PAYE, universal self-assessment could not have delivered what the government at the time wanted, that is tax credits paid with wages and responding 'in real time' to fluctuations in the employees wages or salary. That would require a much more sophisticated system along the lines of the tax credits or negative income tax envisaged by the then government in 1972. The authors point to the difficulties of asking employers to operate such a system. Indeed, it must be very doubtful whether any such system could ever be made to work in a structure where the tax credits due may depend not only on changes in the individual's own income but on changes in the income of their partner too.

Apart from the example of tax credits, the authors do not indicate which policy options they think might have been precluded because of constraints imposed by PAYE so it is not easy to know what weight to attach to this factor. I do not recall many, if any, occasions over the past thirty years when ministers have said they would have introduced a particular, attractive policy if only the structure of PAYE had not made it impractical.

One kind of policy which under PAYE could be introduced only at considerable administrative cost or by bringing a large number of individuals into self-assessment is a tax relief for a kind of personal expenditure incurred by a significant proportion of the taxpaying population.<sup>9</sup> Child care costs might be an example. But from a tax policy perspective that restriction might well be perceived as an advantage, rather than a disadvantage if the aim generally is to have simpler taxes with broader bases and lower rates. By contrast the tax structure in the US is complicated by a wide range of specific deductions for various sorts of expenditure which can be accommodated in the system with little administrative cost because all taxpayers are obliged to file a return. That is unattractive on wider policy grounds and I think the UK system is better in this respect.

I would not suggest that there is no case for more flexibility in the tax system. One policy which undoubtedly would be precluded by the structure

<sup>9</sup> In the past this problem has been partially overcome by giving the tax relief at source, allowing the individual to deduct the relief from the payment before making it. Tax relief for charitable donations by basic rate taxpayers continues to be given in this way.

of PAYE is a local income tax under which substantial numbers of local authorities were permitted to set their own, separate local income tax rates. The law already envisages that there might be a different basic rate of income tax for individuals living in Scotland if the Scottish Executive decides to introduce such a measure.<sup>10</sup> Even that would be likely to impose significant new burdens on some employers with additional risks of error. But a tax system in which there were, say, ten rates of local income tax would involve impossible burdens for employers and the risk of very large numbers of errors. Any future government that wished to introduce a local income tax would therefore have to find some alternative mechanism to PAYE (probably some form of end-of-year assessment) to collect it. But there is a 'chicken-and-egg' issue to be addressed here: until the tax system is more flexible some policies may be difficult to implement, but until those policies are identified as required options by government there is less incentive to change the administrative structure.

### **Compliance costs**

I do not myself believe that the existence of PAYE has made the tax code itself more complicated. Over the last thirty to forty years many substantial changes have been made (for example, abolition of mortgage interest relief, abolition of child and other tax allowances, reduction in the number of income tax rates) which have simplified both the income tax and the basic operation of PAYE for both employers and employees. The taxation of employment income is certainly more complex than it was. In my view, that is primarily in response to the increasing sophistication in forms of remuneration for some employees, to which the tax code has had to respond. However, I think that overall the employer's task in running payroll has become much more complicated since PAYE was first introduced. Because of the success of employers in operating PAYE, governments have, perhaps understandably, been encouraged to require them to take on more and more tasks: deduction of earnings related NICs, payment of statutory sick pay, maternity pay and paternity pay, recovery of student loans. Moreover, these tasks go alongside the wider burdens which employers have had to shoulder such as health and safety requirements for their employees. In total these requirements are now undoubtedly too heavy, and ought to be reduced.

<sup>10</sup> Section 73 Scotland Act 1998.

## NATIONAL INSURANCE CONTRIBUTIONS (NICs)

I believe it is reasonable to argue that, on its own, and with the use of IT, PAYE for most employers, including small employers, is only a little more complicated than a non-cumulative system of tax withholding from employees' pay. But NICs add an additional level of complexity with a choice from several rates and structures to apply depending on the employee's circumstances. Once the employee's situation has been established most of these otherwise variable factors remain constant from pay-period to pay-period. But the fact that NICs are calculated non-cumulatively and on a pay-period basis (rather than cumulatively and annually as for income tax under PAYE) means that employers have to apply two different charges to, broadly, the same earnings. This undoubtedly imposes an additional compliance burden especially for small employers. Finding a means to lighten that burden, by aligning or assimilating income tax and NICs has been at the top of the wish list for business and employers for some time. Unfortunately, I do not believe that such an approach is going to be fruitful, for two main reasons.

First, significant alignment between income tax and NICs can be achieved only at the price of correspondingly significant changes in the incidence of one or both of these charges, probably mainly NICs. But that means substantial numbers not only of gainers but also losers amongst employees, many of whom could be on low or relatively low incomes. These changes would not be for any reason of improved fairness towards the individuals affected but to produce a reduction in employer compliance costs. However worthy that objective it is hard to see a government finding those consequences easy to accept.

Secondly, NICs are not just a single charge on the employee's wages or salary. There are also (secondary) employer NICs, calculated broadly but not entirely on the same base as the employee charge, but remitted and paid<sup>11</sup> by the employer rather than deducted from the employee's pay. Any initiative to achieve a reduction in employer compliance costs through aligning tax and NICs really has to address both of the NICs charges. Even if the employee NICs charge could be fully aligned with income tax there might be little reduction in employers' compliance costs if the employer NICs charge was left in place. But replacing employer NICs with a new charge in a way

<sup>11</sup> In economic terms the cost of employer NICs is, of course, ultimately borne at least in part by employees since the charge reduces the total remuneration which an employer can afford.

that does not have largely capricious distributional effects is very hard to achieve.

These remarks may no doubt be criticized by some as defeatist. But it would be wrong to believe that 'fundamental studies' of the options in this area have not been undertaken within government over the years.

### Recent studies

The Treasury has now published a study<sup>12</sup> which looks at the option of charging employee NICs on an annual basis and collecting them cumulatively. The study concludes that on balance the benefits of administrative alignment do not outweigh the costs.

The study could no doubt be challenged in a number of respects. For example, the work assumes that the structure of PAYE codes remains broadly as it is now but I think there might be scope for rather more compliance cost savings for employers if the structure of PAYE codes were changed in some respects (by making them offsets against the amounts of income tax and NICs payable rather than against income subject to tax and NICs before those charges are calculated).<sup>13</sup> And the study does not look at the more radical option of merging income tax and NICs. But I do not think either of these changes would affect the overall conclusion that the study reaches against the change. Indeed, the study indicates that the consequences of radical change to employer as well as employee NICs would have further, difficult distributional and compliance consequences.

In my view the only way to achieve radical simplification for employers in the task of operating PAYE and NICs would be gradually to phase out both employer and employee NICs over time (probably a decade or more) by systematically shifting the burden on to income tax, corporation tax, and possibly other new taxes. By that means the very difficult distributional consequences of the change could be managed in such a way that individuals and employers could adjust to them slowly. Such a plan would naturally face its own obstacles since among other things it would require some replacement for the existing contributory principle (though I do not think that issue is insuperable). It would also require some means of dealing with the present arrangement under which employees in company or other pension

<sup>12</sup> HM Treasury (2007).

<sup>13</sup> This further change would involve additional transitional cost for all employers and government which would have to be taken into account.

schemes pay a lower 'contracted out' rate of NICs. Crucially it would need a sustained commitment to the change by government over probably three general elections.

### **Issues for small employers**

If PAYE and NICs are looked at in isolation, most concern about compliance costs is focused on small employers without computer support. The Treasury study just mentioned estimates that about 20% of employers currently rely on manual payroll though HMRC expect this number to fall significantly over the next three to four years.

Because of the complexity of PAYE and NICs combined there are very good reasons for encouraging all employers, however small, to make use of computerized payroll processing. Such processing can in fact be purchased quite cheaply, as the chapter notes (footnote 30). It has been suggested that HMRC might themselves offer a payroll service for small employers but, like my fellow commentator, I think it would be preferable to subsidize small employers to use commercial payroll schemes. It would not necessarily be right for HMRC to set up in competition with commercial payroll firms and employers ought to have agents who are independent of HMRC. There have been subsidies for employers to e-file their end-of-year and other returns for some time which is in itself an encouragement for employers to switch to computerized payroll.

### **CHANGES TO WITHHOLDING**

The chapter suggests three changes to withholding in order to improve the operation of PAYE: an online computer system; varying withholding on non-PAYE income by reference to PAYE income and introducing pay-period information reporting. As my fellow commentator notes these changes would increase the compliance burdens on business when priority is being given to reducing that burden—an initiative which the authors also support. Moreover, I feel these changes may be pointing in the wrong direction. I think it is right to recognize that PAYE withholding cannot get everyone's tax deductions precisely correct during and at the end of the tax year without disproportionate and costly intervention by employers and other intermediaries or staff in local tax offices. I shall return below to what I think is a better strategy, and one with greater potential for the longer term.

#### SELF-ASSESSMENT

I share the authors' perception that while overall the introduction of self-assessment has been good some aspects of it have been less so. And as they point out there is still more that could be done.

One aspect of self-assessment which the authors mention is e-filing. This undoubtedly had its teething troubles when it was first introduced. But for individuals the system now works well and HMRC could do more to publicize its virtues.

The authors welcome the efforts made to remove people with simple tax affairs from self-assessment. However, it is worth asking whether striving too hard to keep people out of self-assessment is actually the right approach. As I noted earlier there is a real dilemma to be addressed here in relation to how best to deal with the tax affairs of the minority of employees and other individuals with which PAYE does not deal effectively. One solution might be to identify groups of taxpayers—such as those who have a series of employments during the year—who should be positively encouraged to take greater charge of their own tax affairs, maintain records of their own, and make use of self-assessment with e-filing at the end of the year to get their tax liability right.

#### THE LONGER TERM

The authors and my fellow commentator feel that the problems which have been identified with PAYE may provide a case for looking at a move over time to some sort of universal self-assessment system. However, I do not find the arguments put forward persuasive. This is partly because I think the circumstances in which PAYE does not work well are less common than is often suggested, as I have mentioned above.

The authors suggest several reasons why a system of universal self-assessment would have advantages. The change would require all employees to file a tax return each year which would mean either additional work for them or incurring the cost of paying an adviser to handle the task. For that price the chapter says that HMRC would save some work, employers' compliance costs might fall a little, some as yet unspecified policy changes—new stealth taxes?—would be facilitated, and taxpayers would understand their tax bills better. That does not sound a very easy proposal for a government to persuade people to accept. For a number of individuals, tax bills

would be made more accurate. That might be sufficient to persuade some that the change was worthwhile, but they might also ask whether there was simpler way of achieving the same result. I believe that taxpayers whose affairs are unlikely to be correctly dealt with under PAYE should be encouraged to take more responsibility for their own tax affairs. But I do not think there is a very strong case for asking all employees to do this.

In putting forward the case for looking at a system of universal self-assessment the authors and my fellow commentator argue that the additional compliance costs of the large numbers of employees filing tax returns for the first time would be significantly reduced if tax returns were pre-populated by HMRC with information about the individuals' income and tax deductions. This approach has clearly worked well in other countries such as Denmark, and is certainly worth further examination in the UK.<sup>14</sup> But as the authors and my fellow commentator note there are a number of features, not yet present in the UK system, which are prerequisites for pre-population to work well. For example, the absence of a unique taxpayer identifier in the UK is a major hurdle to be overcome.

In practice I feel neither PAYE nor universal self-assessment provide an ideal way to collect income tax with low administrative costs, low compliance costs for *both* employers and employees, flexibility to accommodate a wide range of tax policies, and securing the flow of tax revenue to government. Each system has its advantages and disadvantages and I am not convinced that there is an objective basis for preferring one system over the other. However, once one particular system has been adopted by a country and has become embedded in its culture, it is very difficult to change to another.

Against this background I do not believe that a study of universal self-assessment is likely to prove productive at the present time. That is not to say that the existing system does not require change and development. My preferred strategy, as I have already indicated, would be to abandon the task of trying to make PAYE work for individuals for whom the work involves disproportionate costs either for employers or HMRC *but* to ensure the PAYE system is properly maintained for the majority of employees for whom it works satisfactorily. And there are a number of further initiatives such as an examination of whether returns can be pre-populated which are worth pursuing. A combination of these strategies would provide sufficient work for HMRC to handle in the short to medium term and would not close off options for wider change in the future.

<sup>14</sup> However, a policy which is successful in a country of 5½ million people will not necessarily work so well in a country with more than ten times the population.

## HMRC

Good tax administration requires adequate resources and funding. Running the tax system is never going to have the same priority within government as major spending programmes such as education, health, or defence. But it is important that tax administration is not starved of the relatively modest sums which it needs to maintain and renew itself. Efficient administrative systems and willing compliance are not easy to recover, once lost, and without them the funding for public spending generally may be put at risk.

HMRC is currently undergoing a large amount of change and is also trying to achieve a substantial reduction in the numbers of staff in the department—by about 12,500 at present with a further similar reduction to come over the next five years. This has led to concerns about staff morale. Managing change and down-sizing simultaneously is a very difficult combination of measures to handle. Some concern has been expressed in the media that the senior management of HMRC have recently been too focused on managing change and not sufficiently on the basic business of running the tax system.

The authors approve the merger of the Inland Revenue and Customs and Excise to form HMRC which took place in 2005. The merger was recommended in a report by the then Permanent Secretary to the Treasury, Gus O'Donnell,<sup>15</sup> and there was undoubtedly a case for making this change. But such mergers require amongst other things substantial amount of senior management time to carry out successfully. And while the changes may yield savings in the longer term they initially require investment to ensure that the full benefits of merger can be realized. For HMRC, it is not clear whether all the necessary investment has been put in.

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<sup>15</sup> HM Treasury (2004).