The Cost of Complexity

How Britain's tax system strangles the economy and reduces British competitiveness

Nicholas Boys Smith, David Martin and Lawrence Kay
Edited by Natalie Evans

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Executive Summary

The problem of tax complexity

The credit crunch is clearly the most serious and urgent of our current economic problems. However, once stability returns, the Government must make the UK tax system fundamentally simpler. To be economically competitive, Britain needs to reduce the burden of tax complexity on businesses and individuals.

The tax complexity burden is getting out of control. At 8,300 pages, the UK has the second-highest amount of primary tax legislation among the world's top economies.[1] The average length of the annual Finance Act has increased from under 200 pages in the 1970s to over 500 in the past few years. The constant addition of one rule on top of another now means that the economy bears a yearly tax administrative cost of £5.1 billion.[2] People who pay an adviser to help them with their self-assessment forms pay out an estimated £1.25 billion every year.[3]

If the Government does not start to simplify the tax regime, Britain will become ever less competitive as other countries make their tax systems easier to use and thus attract businesses from around the world, including the UK. In March 2008, Belgium advertised itself in *The Economist* as having "an intelligent tax system with notional deduction and advanced ruling for investors"[4] – in sum, simplicity and stability. In 2008 alone, six high profile companies have decided to relocate outside the UK: Shire Pharmaceuticals, the UK's third biggest pharmaceutical company; United Business Media, a publisher; Regus, an office services firm; Charter, an engineering business; Henderson, an asset management firm; and WPP, one of the world's biggest communications companies.[5] All cited the UK's tax system as the reason for their relocation. Many others, such as Google, have simply never moved here but have set up their European headquarters elsewhere.

By designing an evaluative framework with nine tests that assess the absolute and relative levels of tax complexity in the British system, we have been able to start focusing on the issues that cause these problems, particularly the factors of cost, distortion, and bias against smaller enterprises, in a way that allows reasonable historical and international comparison. The results of many of these tests show that the problem of complexity has been getting worse.

The shift towards a tax system that is more comprehensible and easier to deal with must also include a comprehensive assessment of the exemptions in the tax system. There is an unknown number of minor exemptions that have been introduced for one purpose or another over the years, whose impact on revenue the Government itself has admitted is "not known". HMRC lists over 200 of these but there are certainly more.[6]

These exemptions are often regressive. The difficulty of complying with a complex tax system, shown by empirical research collected here for the first time, means that people and firms that cannot afford expert advice lose out because they are often unaware of the benefits available to them. Only 11 per cent of businesses take advantage of R&D tax credits, for example.[7] It would be better if these reliefs and exemptions were abolished in favour of lower tax rates or targeted benefits for those who really need it.

Many exemptions are also contradictory. Some of them, for example, are pro-car (there is an exemption for car parking at or near a workplace), others are anti-car (there are exemptions for free meals on cycle to work days, cyclists' safety

1. World Bank and PricewaterhouseCoopers, *Paying Taxes: The Global Picture*, World Bank Group and PricewaterhouseCoopers, pp 16, 2006

2. KPMG, *Administrative Burdens – HMRC Measurement Project*, 2006

3. Authors' own calculations, see page 30

4. *The Economist* (UK edition), pp 101, 15th – 20th March 2008

5. Houlder V and Brown JB, "Darling under pressure to ease jitters over tax," *Financial Times*, August 30 2008; Houlder V, "Tax factor beats patriotism in WPP relocation," *Financial Times*, October 6 2008

6. See the following page on the HMRC's website: http://www.hmrc.gov.uk/stats/tax_expenditures/00ap_b2.htm

7. PricewaterhouseCoopers, *Enterprise in the UK: Impact of the UK Tax Regime for Private Companies*, PricewaterhouseCoopers, 2006

equipment and relief for a work's bus). Some favour well-off workers (presumably people in the City benefit most from the late night taxi relief), while others favour poorer ones (some trades union investments are exempt from Income Tax).

The solution to the tax complexity problem

To prevent the problem of complexity in the tax system getting worse, the way that tax legislation is made needs to be considered. During Budget time, the Chancellor is always under pressure to "do something", and faces a plethora of suggestions from the Treasury, HMRC, professional bodies and the media about what should be done. An Office of Tax Simplification, proposed by the Conservatives, could help to make this legislative process more concerned with unnecessary complexity, and could start to address problems in existing law, but the system would still be predisposed towards the next big change rather than proper contemplation of the tax system.

While the legislative aspect of the problem is significant, there are things that the Government can start doing without even making any changes to the policy-making process. To begin reversing the problem of tax complexity and thus lessen the economic burden of it, we recommend the following immediate changes:

- *Accounting and tax profits*: the Government should adopt the principle that the taxable profits of a business (whether operated by an individual or a company) should normally equal its accounting profits.
- *Employed and self-employed taxation*: policy-makers should look at the differences in tax treatment and abolish any unjustified distinctions.
- *Capital and income*: the distinction between the two is not justified in many instances. Where it is, the Government needs to make sure that it is sufficiently clear.
- *Reviewing reliefs*: policy-makers should cut unnecessary reliefs and develop a way to make sure that new ones are not adopted when not needed.

Instead of taking a knee-jerk approach, the reform process should first establish, following adequate consultation and careful evaluation, the tax principles that should apply to the area targeted for reform. A strategy can then be announced, with consideration on the problems outlined above, and a careful schedule for implementation worked out. This is the best way to build a tax system which is simpler and more transparent, with fewer distortions and lower compliance costs.

> "However difficult change may be, the benefits of having a simple system that is fairer and encourages firms to locate in the UK means that the effort would be worthwhile"

In an attempt to address some of these problems, the Government has recently announced several changes intended to simplify the system. However, these moves have lacked direction or strategy. They have not faced up to the structural problems and have not been built upon clear underlying principles. Sadly, we do not believe they will have any substantial impact on tax complexity.

But reducing complexity in the tax system will be difficult. Because any changes to the current structure will affect the ways that different groups benefit from certain exemptions, any politician will need to deal with the creation of lots of winners and losers. There are several areas, for example, that need addressing but only

after careful consideration, such as simplification of the distinctions made on the supplies of goods and services for VAT purposes; the amalgamation of Income Tax and National Insurance Contributions; whether it would be sensible to distinguish between business and non-business profits for tax purposes (as commonly occurs overseas); if savings can be encouraged through rationalisation of the rules governing investment vehicles; how stamp duty, stamp duty land tax and stamp duty reserve tax might be aligned; whether tax credits can be amalgamated into the tax system; and how distortion and complexity can be removed from the imputation system of taxing dividends. But however difficult change may be, the benefits of having a simple system that is fairer and encourages firms to locate in the UK means that the effort would be worthwhile.

Radical steps were first taken over twenty years ago to eliminate the worst excesses of high tax rates. Top rates of Income Tax were reduced from 98 per cent to 40 per cent. The full rate of corporation tax is now 28 per cent instead of 52 per cent. Comparably fundamental reform is now required to simplify and stabilise the British tax system.

The problem of tax complexity in numbers

- Tax complexity costs the economy £5.1 billion per year.[8]
- The average length of the Finance Act has increased from under 200 pages in the 1970s to over 500 in the last five years.
- World Bank data shows that countries with clear tax laws or tax codes that align perfectly with accounting rules collect 6 per cent and 10 per cent more revenue respectively (as a proportion of GDP) than countries that do not have clear tax laws.[9]
- The personal cost of tax complexity is around £1.25 billion per year, i.e. the amount spent on tax advisors by self-assessment people who need advice.[10]
- To help complete the basic individual tax return, HMRC provide a 28-page set of guidance notes. If the taxpayer is unfortunate enough to need to complete the additional supplementary pages there is a further 32-page set of notes that explains how to do it. There are also more notes for the schedules.
- 22 million employed taxpayers take on trust that their PAYE and NICs have been accurately computed. They are not always wise to do so. HMRC estimate that inaccurate processing led to 2.8 million errors on PAYE in 2006-07.[11]

8. KPMG, *Administrative Burdens – HMRC Measurement Project*, 2006

9. World Bank and PricewaterhouseCoopers, *Paying Taxes 2008: The Global Picture,* World Bank Group and PricewaterhouseCoopers, pp 24, 2008

10. Authors' own calculations, see page 30

11. National Audit Office, *HM Revenue and Customs: Accuracy in processing Income Tax*, National Audit Office, 2007

Part 1

Why complexity matters

The problem with tax complexity

The burden of high tax: from theory to practice

In 2006-07 only five countries increased their corporate tax rates, Bangladesh, the Dominican Republic, Hungary, Venezuela and Zimbabwe. In contrast 27 countries reduced profit taxes, 12 reduced labour taxes and six eliminated a tax altogether.[12] There is now near-global political subscription to the argument that lower taxation is good for economic growth. Robert Mugabe and Hugo Chávez may disagree, but every rule has its exceptions.

The theoretical rationale behind this political hegemony is well established. Taxation is necessary and desirable to pay for public services, but as well as transferring resources from individuals and corporations to the government, it exerts a "deadweight cost" on the economy. For example, where VAT is added to the price of goods or services, sales may fall because consumers have to pay higher prices. Tax can also depress the real return on a proposed investment to the extent that it is not worth making it. As a result, fewer producers will find fewer purchasers, and overall economic output will be lower than it could be.

As long as they have enough revenue to pay for basic public goods (such as security), economies tend to produce less when they put taxes up than when they pull them down. Taxation is necessary to pay for the goods and services or redistribution that voters want, but the difference between a low tax state and a high tax one is about more than just revenue: the taxpayer's loss from a given amount of taxation exceeds the government's gain.

This theory is now buttressed by empirical economic analysis. A generation ago it was still possible to argue that the relationship between high tax and slow growth was evidentially unproven. It no longer is. An array of international studies, set out in Appendix 1, has supported the link.

One of these studies suggests that "typical estimates of the cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised."[13] This matters. The OECD has concluded that "up to one-third of the growth deceleration in the OECD [over the 1965-95 period] would be explained by higher taxes" and that "the increase in the average tax rate of about 10 percentage points over the last 35 years may have reduced OECD annual growth rates by about 0.5 percentage points."[14]

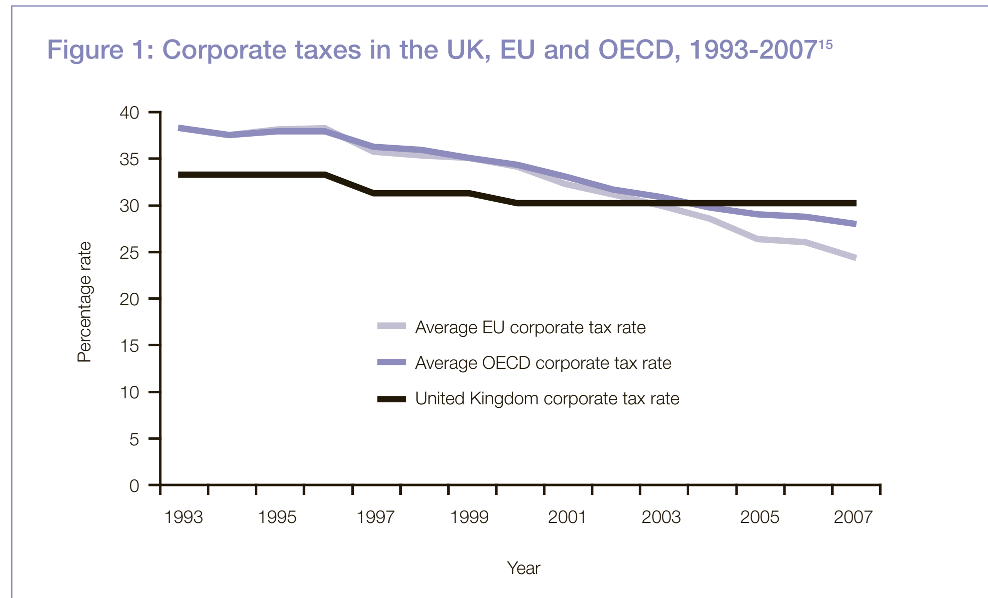
Unfortunately, Britain has started to lose the competitive edge that it once had from having a low tax regime. Champion it or decry it, it remains a fact that across the world developed and developing economies are cutting tax rates in order to encourage investment. There may be no absolutely simple correlation between low taxes and investment (international companies have to base themselves in stable parts of the world with

12. World Bank and PricewaterhouseCoopers, *Paying Taxes 2008: The Global Picture,* World Bank Group and PricewaterhouseCoopers, pp 20-1, 2008

13. Joint Economic Committee, *Economic Benefits of Personal Income Tax Reductions*, Joint Economic Committee, United States Congress, April 2001

14. Liebfritz WJ, Thornton J and Bibbee A, "Taxation and Economic Performance," OECD Economics Department Working Paper 176, 1997

Figure 1: Corporate taxes in the UK, EU and OECD, 1993-2007[15]



predictable laws and access to the necessary workforce), but it still matters.

But what about tax complexity?

Even though the theoretical and empirical arguments over tax *levels* and marginal rates have become well known, the political debate over tax *systems* is still young. Many have asserted that simplicity is a good thing. Speaking in 1980, the Chancellor of the Exchequer, Geoffrey Howe said

> *"I have frequently drawn attention to the extent to which the tax system has woven itself deeply into the fabric of national life. Tax has been piled upon tax, often with little regard for their interaction. The accidental effects of this tax onslaught have often been as damaging as the direct consequences."*[16]

Almost simultaneously, in America in 1981, Robert E. Hall and Alvin Rabushka famously advocated the flat tax. This involved flat income and business taxes, the removal of all other levies and an end to all exemptions, reliefs and credits.[17] The proposal, and its plea for simplicity, has intermittently surfaced in political debate in several countries – most pertinently in Britain in the summer of 2006 when the concept was raised by the Shadow Chancellor of the Exchequer, George Osborne. Although it has not actually been introduced in any Western economy, the flat tax has been promulgated (in one form or another) by many east European ones.[18]

The Chancellor of the Exchequer, Alistair Darling, stated in the 2007 Pre-Budget Report that tax simplification is an important Government objective. To achieve it, he announced several initiatives. Their effect, however, has been disappointing, as we argue in part three of this report.

But is tax simplification worth the candle? Is there actual evidence that tax complexity is a bad thing? Put another way, can we make the case against complex taxation with anything like the same empirical confidence that we can against high taxation? We can: the evidence suggests that complexity leads to inefficiency, particularly because it adds to distortion.

It has long been argued that simple taxes with a wide base are less likely to produce distortion and inefficiency than complicated ones with many exemptions and reliefs. But, largely unknown to British political debate, a range of economists and social scientists have begun the difficult work of amassing empirical evidence concerning the macro-

15. *KPMG, KPMG's Corporate and Indirect Tax Survey 2007, KPMG, 2007*

16. Hansard, *Parliamentary Debates,* vol 981, p 1478, 1980

17. Hall and Rabushka first published articles on the flat tax in 1981. For further details, see Hall R and Rabushka A, *The Flat Tax (Second Edition),* Hoover Institution Press, 1995

18. Estonia, Lithuania, Latvia, Russia, Serbia, Ukraine, Slovakia, Georgia, Romania and, to a limited extent, Poland, have all implemented a flat tax

economic consequences of complex taxation, and the way it affects decision-making. Specifically, they have examined its affect on optimal individual outcomes as well as overall economic growth and investment. Some of their key findings are outlined below for the first time to a non-specialist audience in this country. Five of them stand out; we deal with each in turn:

1 *Tax complexity makes individuals poorer.*
2 *Tax complexity lowers profits and makes markets less efficient.*
3 *Tax complexity hits small firms hardest.*
4 *Tax complexity lowers tax revenues in the long-term.*
5 *Tax volatility further reduces profits and investment.*

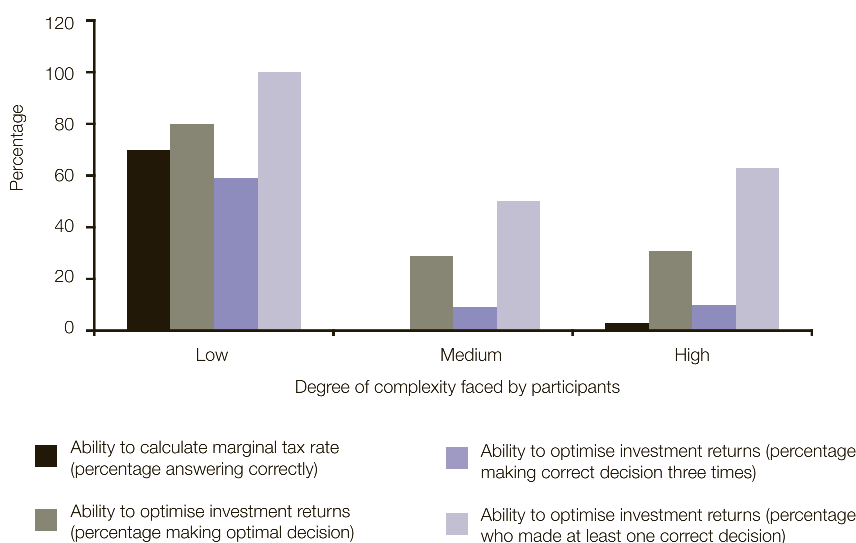
Tax complexity makes individuals poorer

In an experiment, 89 US degree-educated taxpayers were asked to maximise their after-tax income by choosing between a taxable and a non-taxable bond.[19] They were assigned to one of three groups with different levels of tax complexity: a low complexity group which had a marginal tax rate unaffected by lower tax thresholds or rebates; a medium complexity group that had a marginal tax rate affected by a lower tax threshold; and a high complexity group where the marginal tax rate was affected by both a lower tax threshold and a rebate. The taxpayers' ability to maximise their returns was entirely dependent on their skill at accurately estimating their effective marginal tax rate in the three investment decisions they were asked to make.

The low complexity group faced statutory and effective marginal tax rates that were the same: 38.5 per cent. The medium and high complexity groups were given a 35 per cent statutory marginal tax rate, but the effective marginal tax rate, due to the impact of thresholds and rebates, was 38.5 per cent.

As Figure 2 shows, the greater degree of complexity had a stark impact on the taxpayers' ability to understand these effective marginal tax rates. 70 per cent of the low complexity group (19 out of 27) were able to accurately estimate their effective marginal rate. However, *none* of the medium complexity group could and only one (out

Figure 2: Taxpayers' ability to calculate marginal tax rates (MTRs) and optimise investment returns under low, medium and high levels of tax complexity[20]



19. Rupert T, Single L, Wright A, "The Impact of Floors and Phase-Outs on Taxpayers' Decisions and Understanding of Marginal Tax Rates", *Journal of the American Taxation Association,* vol 25, pp 72-86. Full detail on (high) levels of statistical significance and experimental controls are described in the paper. In this, and similar experiments described below, participants were rewarded for success to ensure optimal efforts

20. Rupert T, Single L, Wright A, "The Impact of Floors and Phase-Outs on Taxpayers' Decisions and Understanding of Marginal Tax Rates", *Journal of the American Taxation Association,* vol 25, pp 72-86

of 30) in the high complexity group managed it. On average, those in the medium complexity group got their tax rate wrong by 2.98 per cent. Those in the high complexity group were even less accurate with an average error of 6.47 per cent.

These errors in understanding led to mistakes in decision-making. On average, taxpayers in the low complexity group made the optimal decision 80 per cent of the time. Taxpayers in the medium and high complexity groups made the optimal decision only 29 and 31 per cent of the time respectively. No taxpayers in the low complexity group made the wrong decision in each of the three experiments; 48 per cent of medium and high complexity taxpayers did. 59 per cent of participants in the low complexity group made the optimum decision three times running; only 10 per cent of medium and high complexity taxpayers were able to achieve the same feat.

In short, all else being equal (they were for the purposes of this experiment), taxpayers understand their tax liabilities more acutely and make better financial decisions under a simpler tax system than a complex one. Tax complexity *does* make individuals poorer.[21]

Tax complexity lowers profits and makes markets less efficient

The logical extension of poor decision-making in situations of high tax complexity should be that highly complex tax systems have less efficient markets and lower returns. Does the academic evidence support this? It does.

In a similar (though more complex) experiment, 42 taxpayers were split into six groups of four buyers and three sellers. After training, each group took part in a series of five "double-auction" markets in which sellers could make offers and bids and all participants were financially incentivised to maximise their personal returns.[22]

However, half of the participants faced a transparent tax environment and half a far more opaque one. Under low complexity, three of the groups faced a simple tax environment with only a flat, 40 per cent tax on trading profits. Under high complexity conditions, the other three groups faced an environment with a 15 per cent base tax and two adjustments based on the level of trading profit. These adjustments, which could be positive or negative, were provided in a table and were structured so that they *always resulted in a tax rate of 40 per cent of trading profits*.

The actual economics of both sets of markets were thus identical. All that differed were the levels of tax complexity and transparency between the three low complexity and the three high complexity markets. But this was enough to create sharp differences. The high complexity markets had higher average prices, inefficiently high trading volumes and lower levels of overall profitability (measured by market efficiency which is a measure of profit made by market participants as a percentage of total profit which could have been made in a perfect market). These differences are set out in Table 1. The key finding is again stark: the simpler tax markets were over ten per cent more efficient than the higher tax ones.

Table 1: Impact of tax complexity on market efficiency, pricing and volume[23]

Tax complexity	Average units traded	Average Price, $	Market efficiency, per cent
Low	4.4	645.0	98
High	5.9	658.0	85

21. This is not the only analysis with these findings. See also Rupert T, Wright A, "The Use of Marginal Tax Rates in Decision Making: The Impact of Tax Rate Visibility", *Journal of the American Taxation Association*, vol 20, pp 83-99

22. Boylan S, Frischmann P, "Experimental Evidence on the Role of Tax Complexity in Investment Decisions", presented to The American Taxation Association, February 24 2006

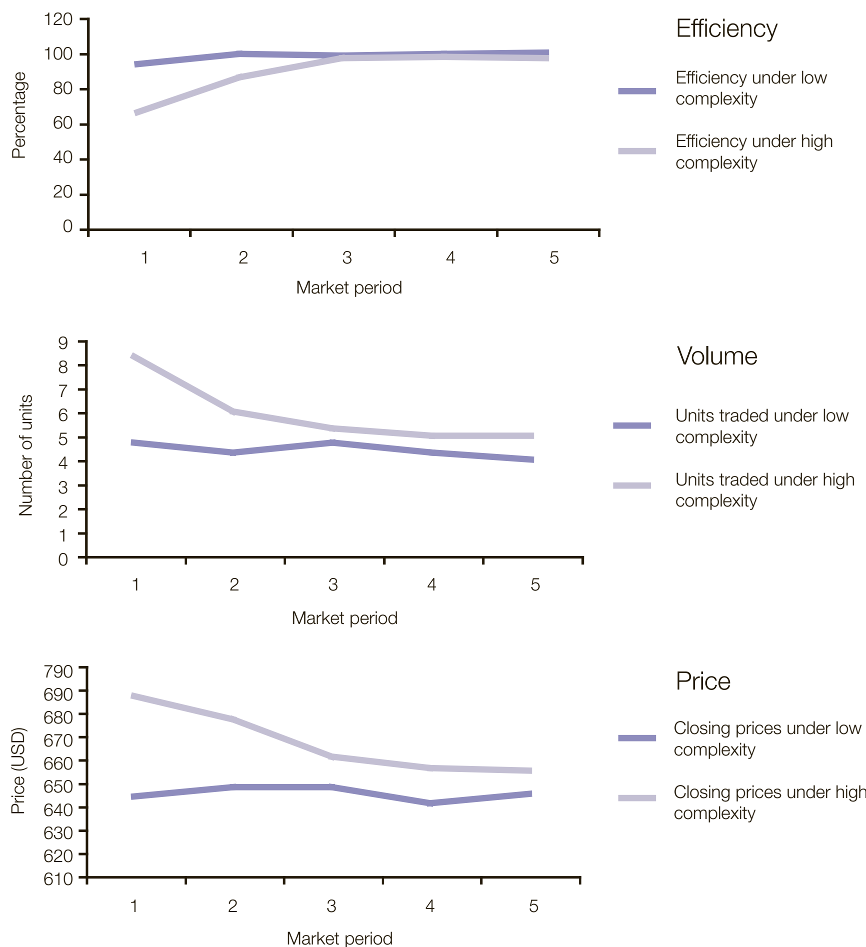
23. Across the five market periods and all six groups. Boylan S, Frischmann P, "Experimental Evidence on the Role of Tax Complexity in Investment Decisions", presented to The American Taxation Association, February 24 2006

In short, by raising the transactional cost of an exchange, a complex tax system *increases* the deadweight cost of taxation. Multiple rates, tapers and adjustments may not be as headline-grabbing or unpopular as raising tax rates, but they can be very nearly as harmful. Complexity may even discourage new investment from happening at all.[24]

Tax volatility reduces profits and investment

The research cited above found that the differences in market efficiency between low tax complexity and high tax complexity markets did erode over time. Volumes and prices both decreased and efficiency increased between the first and fifth market periods (see figures three, four and five for details). As we might expect *a priori*, market participants are good at learning from their own mistakes and mastering initially challenging complexity. However, the differences did not disappear entirely, even though the scope of the tax rules in all the markets in the experiment were very much more limited than the complex rules to be found in the real world. Put differently, under a stable tax regime, where the rules stay constant, markets can begin to compensate for tax complexity. Under an unstable tax regime constant changes to the rules make this much harder. Tax volatility exacerbates the tendencies of a complex tax system to suppress market efficiency and hold back investment, as shown by the graphs below. Tax volatility reduces profits.

Figure 3: Evolution of the impact of tax complexity on market efficiency, volume and price in a competitive market[25]



24. See below, for example, for the success of the Netherlands in attracting new holding companies with its simple tax regime

25. "Market efficiency" means the ratio of actual to possible wealth that could have been created. Boylan S and Frischmann P, "Experimental Evidence on the Role of Tax Complexity in Investment Decisions," unpublished paper, pp 25, 2006

Table 2: Observed international tax volatility (the higher the number, the greater the volatility)[26]

Country	Effective capital tax rate (1970-2001)	Effective consumption tax rate (1970– 2001)	Marginal effective tax rate (1982– 2002)	Average effective tax rate (1982– 2002)	Statutory tax rate (1982– 2002)
Austria	484.6	3.4	20.1	8.9	33.8
Belgium	45.0	6.3	1.7	2.3	2.3
Denmark	124.4	7.1	NA	NA	NA
Finland	1,431.1	11.4	34.9	40.0	46.6
France	119.5	1.8	11.2	36.4	32.3
Greece	23.8	2.7	1.0	1.1	1.2
Ireland	65.2	7.6	6.4	1.3	0.0
Italy	21.1	7.1	153.0	54.2	51.7
Japan	1,244.0	0.8	15.5	1.2	18.1
Luxembourg	715.1	4.0	NA	NA	NA
Netherlands	59.5	2.0	7.2	8.8	9.6
Portugal	21.8	7.0	67.1	15.1	17.2
Spain	8.5	4.0	1.3	0.7	0.9
Sweden	29.3	20.0	22.7	30.1	33.3
UK	203.3	6.2	107.8	2.2	55.5
US	7.2	0.7	0.3	25.2	57.4

Unsurprisingly, high tax volatility is also associated with lower levels of investment.[27] Levels of international tax volatility, derived from data collated by a study of 16 developed countries over many years, are set out in Table 2. Several findings emerge. First, the UK's effective capital and marginal tax rates have been among the most internationally volatile over the last quarter century. Britain's effective capital tax rate has been the fifth most volatile out of the 16 countries. Its effective marginal tax rate has been the second most volatile – second only to Italy. This may in large part be as a result of reductions in penally high tax rates in the 1980s. However, it also reflects more recent substantive changes to capital taxation.

Edmiston found that regression analyses of these findings, compared to a range of economic indicators (interest rates, wages, GDP price index, capital price index, real GDP per worker) finds a very high level of negative correlation (99 per cent confidence), between high levels of capital tax volatility and levels of overall investment. *Increases* in tax volatility are very strongly correlated with *reductions* in investment per worker.

Tax volatility *does*, then, lower investment levels, as common sense would suggest. Permanence in the tax code encourages investment in an economy. Volatility and uncertainty in the tax code discourage it. This is not just an opinion or (very reasonable) assumption. It is an observable fact.[28]

Tax complexity hits small firms hardest

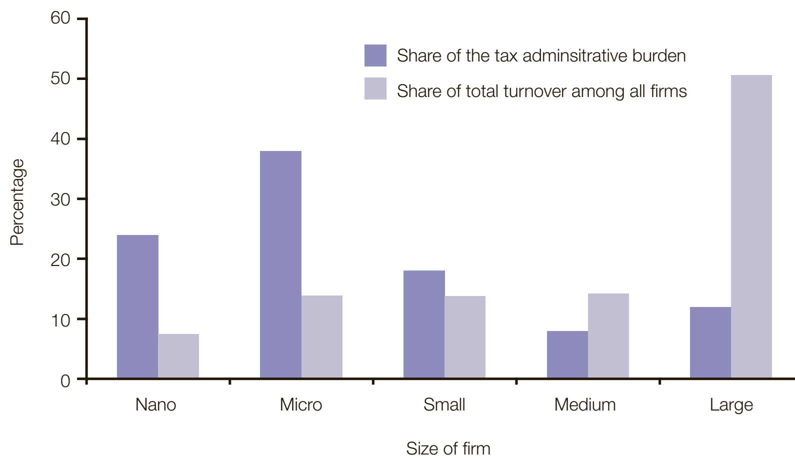
A complex tax system is harder to navigate for small firms than for large ones. They do not have the specialist compliance, legal and accounting departments which the large firms' efficiencies of scale permit them to employ. The cost of external advice falls more heavily on smaller cash-flows.

26. The numbers in the table are the product of a modelling process, where the final size of the figure reflects the degree of volatility. See Edmiston K, "Tax Uncertainty and Investment: A Cross-Country Empirical Examination", *Economic Inquiry*, vol 42, pp 425-440, for details of the method used

27. Edmiston K, "Tax Uncertainty and Investment: A Cross-Country Empirical Examination", *Economic Inquiry*, vol 42, pp 425-440. Edmiston initially analysed 17 countries but Germany was excluded due to insufficient time series data

28. This is not the only study to investigate this issue but it is probably the most comprehensive. Other studies have shown how different taxpayers respond to tax rate uncertainty in directionally different ways. Some risk averse savers may even save *more* under conditions of tax uncertainty. See Watson H, "The Effects of Income Tax Uncertainty in a Dynamic Setting", *Southern Economic Journal*, vol 53, pp 682-689. For a more theoretical approach see Alm J, "Uncertain Tax Policies, Individual Behaviour, and Welfare",*The American Economic Review*, vol 78, pp 237-24

Figure 6: Share of the tax administrative burden by firm size[29]



The CBI's recent report on the UK tax system argued that "the compliance burden of the corporate tax system falls disproportionately on SMEs."[30] Two academics found evidence that strongly suggests as much. They conducted a fully controlled analysis of the time spent by 1,569 British firms on administering Pay As You Earn (PAYE), National Insurance (NI), Statutory Sick Pay (SSP) and Statutory Maternity Pay (SMP) and found that the mean compliance costs of tax administration were sharply negatively correlated with size. As firms get larger their tax administration bill becomes radically easier to manage (see Figure 6 for the latest data).

Tax complexity lowers tax revenues

As complicated tax rules make it harder to run and grow businesses, other factors being equal we would expect government revenues to grow less quickly in countries with higher tax complexity than countries with lower tax complexity. Research is beginning to back this up – though there is more work to do. World Bank data shows that countries with clear tax laws or tax codes that align perfectly with accounting rules collect 6 per cent and 10 per cent more revenue respectively (as a proportion of GDP) than countries that do not have clear tax laws.[31] In short, everyone loses – businesses suffer, but so do the taxpayer and the government in the long-run.

Implications

In part two of this report we outline the complexity of the UK tax system and establish the harm it does to the British economy. However, we hope that this summary of recent behavioural and macroeconomic analysis can give policy-makers confidence. Tax complexity really matters. It increases the deadweight cost of transactions, reduces profits, distorts decision-making, dissuades investment and reduces tax revenues. It undermines the poorest and the smallest firms most of all. Tax volatility just makes matters worse.

Those seeking to optimise the Government's tax policy should therefore be tackling *complex* and *uncertain* taxation just as confidently as they have been making the case against *high* taxation for the last twenty years.[32] Ironically, those wanting to increase the Government's tax take in the long-term should be doing precisely the same things.

29. "Tax administrative burden" means the compliance costs, costs of working with intermediaries and acquisition costs borne by firms when then they comply with UK tax law. "Nano" firms means companies with no employees; "micro" to those with 1-9 employees; "small" to those with 10-49; "medium" to those with 50-249; and "large" to those with more than 250. Sources: KPMG, *Administrative Burdens: HMRC Measurement Project*, KPMG, 2006; BERR Enterprise Directorate Analytical Unit

30. CBI, *UK Business Tax: A Compelling Case for Change,* CBI, pp 39, 2008

31. World Bank and PricewaterhouseCoopers, *Paying Taxes 2008: The Global Picture,* World Bank Group and PricewaterhouseCoopers, pp 24, 2008

32. Even though tax rates have fallen over recent years, the amount of revenue collected has risen, largely because tax allowances have not been increased in line with earnings

The growth in tax competition – simplicity as well as rates

Competition over tax complexity

One academic recently defined tax competition as "the use by governments of low effective tax rates to attract capital and business activity to their country."[33] *Tax rates*, however, are not the only means with which countries are competing with each other. *Simplification* of tax regimes has also become an important part of competition between countries.

Over the last decade many governments have very adeptly simplified their tax regimes, making them more attractive to companies and investors in the process. Developing economies are doing this. But so are developed ones in order to lure corporate headquarters and specific sectors (such as insurance and fund management) away from more established centres, such as London. In March 2008, for instance, the Belgian Government was advertising its country in *The Economist* as having "an intelligent tax system with notional deduction and advanced ruling for investors."[34] It promised simplicity and stability.

In 2006-07 alone at least eight countries simplified the process of paying tax and six made major simplifications to their tax codes. Since 2005, 65 reforming economies have promulgated 90 reforms.[35] The World Bank and PricewaterhouseCoopers have categorised simplifications under three main headings:

- *The Introduction of online filing*. This reduces the cost of paying taxes. It is available to individuals and companies in the UK, as it is in many other countries.
- *The combination of taxes*. To reduce the bureaucratic burden for both the taxpayer and tax administration, over the last five years many countries have melded different taxes together. For instance, Portuguese companies now pay only two taxes, at the same time, on profits. Slovakia has consolidated several social security and related contributions into a single social contribution tax and Bosnia has combined three and Uruguay four labour contributions into one monthly payment. In all, Uruguay has eliminated 15 taxes in recent years.
- *The simplification of tax administration through alignment of tax and accounting systems and the introduction of risk-based tax authority audits*. World Bank data shows that countries with clear tax laws or tax codes that align perfectly with accounting rules collect 6 per cent and 10 per cent more revenue respectively (as a proportion of GDP) than countries that do not have clear tax laws. A wide range of countries have therefore taken simplifying measures in the last three years. They include Azerbaijan, Bulgaria, Colombia, Lesotho, Malaysia, the Netherlands, Tanzania, Turkey and Uzbekistan.

Three internationally-focused countries, New Zealand, Australia and the Netherlands, have all recently made their tax systems simpler and more attractive. This shows that programmes of tax simplification *are* possible.

New Zealand tax simplification[36]

Twenty five years ago, New Zealand's tax system was widely seen as failing. A narrow base, high tax rates and enormous complexity were all failing to generate sufficient revenues. The system was seen by the public as unfair and lacking in integrity. Tax avoidance was rife. High tax rates and uneven rules were thought to be significantly contributing to New Zealand's poor economic performance.

33. Teather R, *The Benefits of Tax Competition,* Institute for Economic Affairs, pp 25, 2005

34. *The Economist* (UK edition), pp 101, 15th – 20th March 2008

35. World Bank and PricewaterhouseCoopers, *Paying Taxes 2008: The Global Picture,* World Bank Group and PricewaterhouseCoopers, pp 21-25, 2008

36. The rest of this chapter is based on analysis conducted for and by the Tax Reform Commission, published as part of that report and written by the authors and Corin Taylor and Jonathan White

From 1984 governments embarked upon wide-ranging reforms that transformed the tax system. Key features were:

- *Reductions in the number of tax rates*. The number of income tax bands was reduced from five to two and statutory rates were reduced from 20, 31.5, 45.1, 56.1 and 66 per cent in early 1984 to 24 and 33 per cent by October 1988.
- *Broadening of the individual tax base*. The original high income tax rates were accompanied by a large number of rebates and exemptions. Many of these were systematically removed.
- *Broadening of the corporation tax base. Company tax concessions and avoidance opportunities were greatly reduced*. First year accelerated depreciation was removed. These and other measures have increased the corporation tax base as a percentage of GDP from 5 per cent in 1984 to 15 per cent in 2001.
- *Broadening and simplification of indirect tax*. The previous wholesale sales tax covered less than a quarter of the total consumption base and had eight different rates. It (and some other indirect taxes) was replaced in 1986 with a 10 per cent goods and services tax. This had few exemptions, reducing distortions and simplifying record-keeping (the rate of the goods and services tax was raised to 12.5 per cent in 1989).

The Labour Government was replaced by a National Party administration in 1990. This administration reduced income tax rates and continued to abolish taxes and simplify the system. Key measures included:

- *The abolition of several taxes*. Estate duty (inheritance tax) was abolished in 1992 and stamp duty was finally abolished, following a phased reform, in 1999.
- *The simplification of tax depreciation*.
- *The attraction of foreign companies and investment*. The total tax imposed on most non-resident portfolio and direct investors in New Zealand was capped at 33 per cent through foreign investor credits.
- *The simplification of tax filing*. From 1999 a large number of taxpayers were no longer required to submit an annual reconciliation of income tax.

New Zealand retains one of the most efficient tax systems among developed countries. It has full imputation so the distortion between equity and debt financing has been cut. The corporation tax rate and the rate at which many individuals pay tax are aligned at 33 per cent. The OECD has concluded that:

> *"New Zealand's tax system is one of the most neutral and efficient in the OECD. Bases are generally broad and rates are moderate. The full imputation system for dividend payments works to reduce tax distortions for corporate financing decisions, while efficiency in corporate investment decisions is encouraged by the low level of targeted tax incentives. The tax system is also more neutral vis-à-vis private saving than in most other countries, in particular because no general incentives are provided to private pension saving."*[37]

Reform worked. In the 1990s New Zealand's tax system contributed to strong economic performance. Following the global economic slowdown in the early 1990s, economic growth averaged 3.8 per cent from 1993 to 2004. Unemployment also fell from over 10 per cent in 1992 to 3.7 per cent in 2005. In recent years, however, tax reforms have stalled and in some cases been reversed. For instance, in 2000 an additional top rate of income tax at 39 per cent was created for income above NZ$60,000. This is not only a new complication;[38] it also applies at only 1.4 times the average wage.

Australian tax simplification

In 1997, the Australian tax system was judged by one panel of economists to have the worst

37. Dalsgaard T," The Tax System in New Zealand: An Appraisal and Options for Change", OECD Economics Department Working Papers No. 281, 2001

38. Rennie P, "How to Fix a Leaky Tax System", *Issue Analysis, The Centre for Independent Studies*, no 74, 14 September 2006

overall compliance cost (the UK was second) among comparable countries.[39] In 1999, the OECD concluded that "…the Australian tax system has evolved largely in an *ad hoc* way over several decades…[it has] high marginal tax rates, too narrow a tax base, uneven distribution of the tax burden, distortions in resource allocation, imbalances in the funding of different levels of government, and high compliance costs."[40]

However, between 1998 and 2000 the Australian Government promulgated a series of tax simplifications to accompany reductions in capital, corporate and income tax rates. These included:

- A single "Pay as You Go" system for reporting and paying tax on business income.
- A simpler tax depreciation regime.
- Simpler indirect taxation to replace the wholesale sales tax and several state and territory taxes.

These initial reforms were followed by a long series of further simplifications, threshold raising, rate reductions and the abolition of minor taxes (for instance, stamp duty on share transactions in 2001). The principal tax simplification measures since 2000 have been:

- *2001*. A simplified tax system for some small businesses was introduced, thus allowing them to do their tax accounting on a cash basis with simpler depreciation and trading stock rules.
- *2003 and 2004*. A package of reforms to Australia's international taxation arrangements was introduced. These reduced the compliance costs associated with the controlled foreign company rules and reduced tax on certain forms of foreign business income and gains.
- *2006*. A draft Bill to remove inoperative provisions from the tax law was published. These provisions were estimated to account for 28 per cent of the law's total length.

Dutch tax simplification

In 2001, the Dutch Government embarked on an overhaul of its income tax system. Rather than continue with a structure bedevilled by exemptions, it classified income into three categories: income from work, home ownership and social benefits; revenue from substantial business interests; and income from wealth. This change included widespread cuts to marginal tax rates, but also the flattening of the levy on business revenue to 25 percent.[41] Overall, the OECD judged the reform "…a shift from direct to indirect taxes, the removal and reduction of tax exemptions, and a decrease in the replacement rate."[42]

With further reforms in the years to 2004, the OECD was able to conclude that

> *"…there has been a major shift from high marginal tax rates on labour income towards a broader income tax base and higher indirect taxation since 2000, resulting in a composition of tax revenues that is more supportive of economic growth."*[43]

Between 2004 and 2008, the Dutch Government also managed to reduce the regulatory weight of its tax system. Through simplifying its administrative rules and procedures, and by using its finance ministry to coordinate efforts to reduce the cost of taxation, it has saved around €4 billion per year. This amounts to around 25 per cent of the regulatory burden.[44]

Implications for the UK

Tax systems across the world are becoming better, cleaner, and simpler. This is a good thing. It will encourage investment, transparency and international understanding.

It would matter therefore if the UK were to fall behind in this area. Precisely because the UK *cannot* readily indulge in what the left terms a "race to the bottom" on tax rates, it would be foolish to lose out where the UK can easily compete – by having a simple and straightforward tax system.

39. Johnson D, Freebairn J, Creedy J, Scutella R and Cowling S, "A Stocktake of Taxation in Australia," *Tax Reform: Equity and Efficiency*, report no 1, Melbourne Institute of Applied Economic and Social Research, pp 94, 1997

40. OECD, *OECD Economic Surveys: Australia*, OECD, pp 89, 1999

41. OECD, *OECD Economic Surveys: Netherlands*, OECD, pp 46, 2002

42. OECD, *OECD Economic Surveys: Netherlands*, OECD, pp 45, 2002

43. OECD, *OECD Economic Surveys: Netherlands*, OECD, pp 75, 2004

44. OECD, *OECD Economic Surveys: Netherlands*, OECD, pp 57, 2008

Six drivers of tax complexity

Why is simplicity so difficult?

In practice, some degree of tax complexity *is* required. A "postcard" sized tax code might be elegant, but it would not work. Its application to even a moderately complex financial transaction would leave so many important practical questions unanswered as to create chaos. In such a scenario, questions over the profits of each party during the application of different accounting treatments, deals done at arm's length, and the issues of hedging or speculation would quickly arise. When, for example, would the profit from the trade be treated as realised for tax purposes?

Complex transactions need special tax rules. For example, suppose that a group of companies were intending to transfer some businesses to a new firm owned by some of the group's existing shareholders, and that a third company would immediately acquire the new business from those shareholders by paying them a mixture of its own shares, loan notes and cash. The intra-group transactions, share reorganisations and transfers involved in this proposal would need to be governed by special tax rules. A "postcard" tax system alone could not begin to give certainty or consistent results for different shareholders (who may, for example, apply different accounting policies, or indeed have no need to produce accounts reflecting these transactions).

But complicated transactions are not just the preserve of City bankers. The vast majority of medium and large British companies now rely on more than just "vanilla" loans, the simplest type of borrowing, to fund themselves.

If modern finance demands some tax complexity, so does globalisation. One critical feature of the international economy is the growth of globalised firms whose "value chains" are stretched across several countries. The OECD estimates that intra-firm transactions now account for 60 per cent of global trade.

In such cases the precise profit attributable in each jurisdiction can be highly obscure. For example, if a product is made in Malaysia, marketed in the UK, sold across the world and serviced by a call centre in India, the precise tax due in each jurisdiction depends on the internal charges to be attributed to different services the firm has delivered *to itself*. Without the right evidence and rules this is never going to be a simple matter. It is hard to envisage a future where some degree of tax complexity on this and other areas does not continue to exist.[45]

But while some complexity is necessary, why do so many economies end up with so much more than is strictly necessary? Why do almost 50 per cent of countries have multiple labour taxes when one would do? Why do 27 per cent have more than one profit tax? Why do 41 per cent have more than one property tax?[46] Governments do not deliberately set out to make their revenue-collecting frameworks as complicated as possible. But several phenomena, outlined below, drive the complexity and unpredictability in them.

- *The weight of past legislation*: constant, systemic tensions arise because a historic collection of tax rules has accumulated without any systematic review.
- *The desire to prevent tax avoidance*: the vicious cycle of complex anti-avoidance law interacts with an already complex system in ways which may not be fully appreciated in advance. Subsequent taxpayer circumvention requires even more complicated legislation.
- *The temptation to use tax to change society*: policy-makers often try to make

45. Other issues of necessary complexity include, for example, rules limiting tax relief for certain kinds of expenditure, rules for related persons, transactions within a group of companies, dividend payments to companies, and spreading lump sum receipts for tax purposes, among many others

46. World Bank and PricewaterhouseCoopers, *Paying Taxes 2008: The Global Picture,* World Bank Group and PricewaterhouseCoopers, pp 21-25, 2008

the latest change they want to society through using incentives and penalties in the tax system.

- *The need to "do something"*: the Chancellor always faces substantial cultural and legislative pressure to create some headlines on budget day, so will fiddle with the tax system to do so.
- *The desire to pluck the goose without it hissing*: policy-makers often want, or need, to raise taxes, but have long been afraid of raising, say, rates of Income Tax. They thus resort to raising revenue in ways that many people do not notice or understand, and thus add extra complexity to the system.
- *The problem of guarding the guardians*: because tax policy is now made and tested by HM Treasury, it does not receive the internal scrutiny that it should. This has lead to poor policy and a greater likelihood of mistakes, thus undermining the trust in, and stability of, the tax system.[47]

The weight of past legislation

Many tax systems are an aggregate of different tax codes developed over a long period of time without any overall review of how they link together. This creates an inbuilt and systemic tension in the way the rules combine in the real world, thus causing instability. There is a constant need to monitor interactions, plug gaps or resolve problems on a piecemeal basis.

In the UK, for example, company tax liabilities can be derived from Income Tax law; a separate Capital Gains Tax code; a capital allowances code and accounts based law for loan relationships; intangible fixed assets; and derivatives. Each one of these codes includes a large number of detailed rules used for calculating tax in specific situations. Worse, the code for taxing income is itself split into separate divisions for income from different sources under the schedular system. The timing of a sale is defined differently for trading, capital gains and capital allowances purposes. Incidental costs are defined differently. Anti-avoidance rules are framed separately. No clear principles apply to the pooling of losses and profits from different sources.

This artificial segregation means that all companies of any size have a permanent need to consider not just the accounting but, quite separately, the tax implications of their business decisions. It creates the need for much tax planning to ensure, for example, that effective tax relief is available by matching losses from one source against profits from another source.

The distinction between tax and accounting profits also leads to similar problems. For example, the accounting rules for depreciation and impairment of assets are quite different from the tax rules for capital allowances. Companies try to maximise the tax benefits through complex financing, leasing, or sale and leaseback mechanisms.

The desire to prevent tax avoidance

Tax planning is a fiduciary duty to the owners of a firm and is the *legal* minimisation of tax liabilities. Tax evasion is an *illegal* failure to pay due taxes. There is a grey area where planning, or avoidance, might be seen as artificial or illegitimate, even though strictly legal. Nevertheless, the Chief Financial Officer (CFO) of a company who needs to explain why his firm paid more tax then necessary would not be in a comfortable position.

That CFO faces several problems that are a function of a complicated tax system. Overlaps and differences between one tax rule and another produce contradictions and distortions. *They necessitate tax planning*. If a profit can be derived in several different ways, a firm needs to understand its options and how its decisions will affect its tax bill.

One driver of increasing fiscal complexity comes about when a government

47. Policy used to be initiated by Inland Revenue and Customs and Excise, and reviewed by the Treasury

engages in specific legislation to prevent one particular type of tax planning. This often has unforeseen consequences as the legislative change interacts with so many separate sections of the tax system, and tax professionals seek out further opportunities for their clients.[48] This is particularly the case when the proposed reforms are inadequately drafted – an outcome which is more probable as tax law becomes more labyrinthine.[49] Further changes are thus required in order, in the words of the Institute of Chartered Accountants of England and Wales, to "iron out many of the problems that arise in practice."[50]

Damon Lambert, a Tax Senior Manager at KPMG, has analysed how tax law complexity in a given area can often increase starkly over a two to five year period due to the possibilities created by an apparently simple change.

He estimates that within, say, one month, advisory firms appreciate the unintended possibilities for circumventing or exploiting the proposed amendment. Then, within two to six months tax products are being marketed to relevant taxpayers (with disclosure to HMRC under the Disclosure of Tax Avoidance Schemes regime). Between six months and two years later, the sale of these products has proliferated, and it is seen that the new legislation has either had more limited scope than originally intended by HMRC, or has been turned on its head by advisors to benefit those in the opposite circumstances.

In some cases HMRC may challenge the tax planning that is taking place in the courts, although, as cases can take between three to ten years to settle, this can merely accentuate uncertainty even more. In addition to any court action, within two to five years a further set of new legislative amendments come into force to deal with the consequences of the first change. The amendments may take effect from the date of a press release, which leaves the exact scope of the subsequent changes unclear until the new law is enacted. Further, the

48. For example, the rules for taxing amounts economically equivalent to interest

49. For example, see the comments by the Institute of Chartered Accountants of England and Wales (ICAEW), ICAEW Press Release, 8 September 2005

50. ICAEW Press Release, 8 September 2005

51. Tax Reform Commission, *Tax Matters: Reforming the Tax System, The Report of the Tax Reform Commission*, Tax Reform Commission, pp 106, 2006

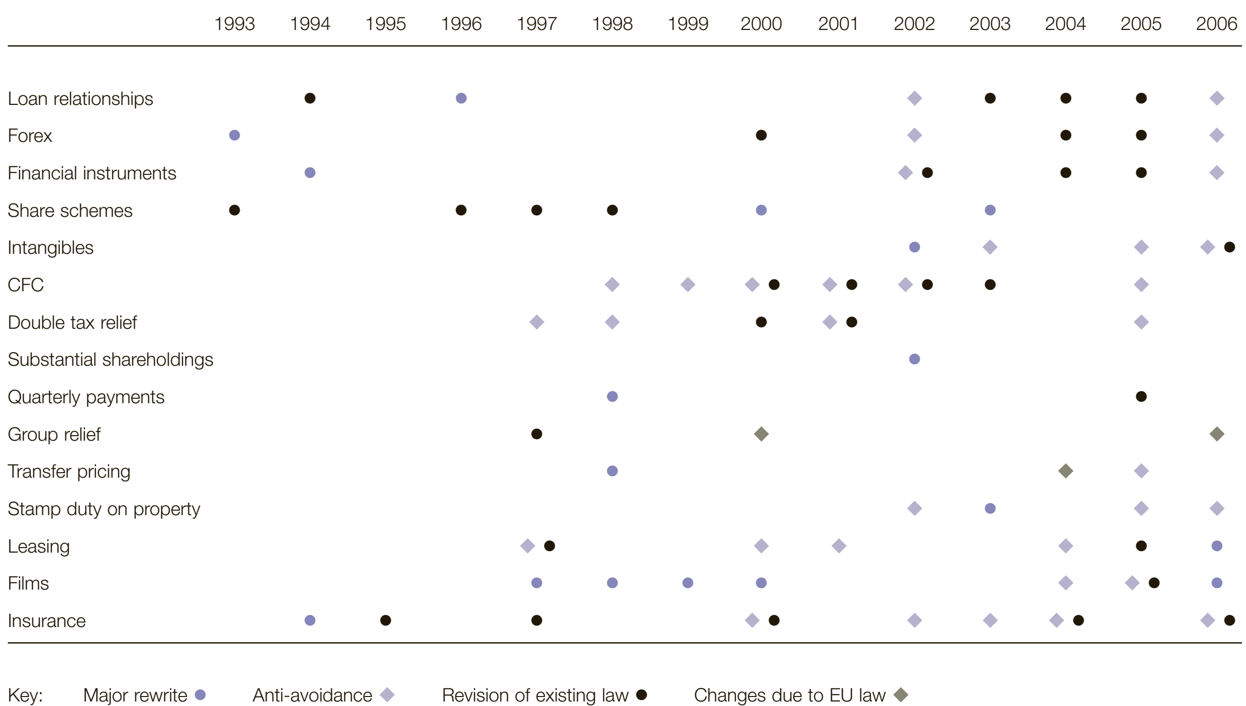


Table 3: Changes to the UK tax system by year, 1993-2006[51]

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Loan relationships		Revision of existing law		Major rewrite						Anti-avoidance	Revision of existing law	Revision of existing law	Revision of existing law	Anti-avoidance
Forex	Major rewrite							Revision of existing law		Anti-avoidance		Revision of existing law	Revision of existing law	Anti-avoidance
Financial instruments		Major rewrite								Anti-avoidance, Revision of existing law		Revision of existing law	Revision of existing law	Anti-avoidance
Share schemes	Revision of existing law			Revision of existing law	Revision of existing law	Revision of existing law		Major rewrite			Major rewrite			
Intangibles										Major rewrite	Anti-avoidance		Anti-avoidance	Anti-avoidance, Revision of existing law
CFC						Anti-avoidance	Anti-avoidance	Anti-avoidance, Revision of existing law	Anti-avoidance, Revision of existing law	Anti-avoidance, Revision of existing law	Revision of existing law		Anti-avoidance	
Double tax relief					Anti-avoidance	Anti-avoidance		Revision of existing law	Anti-avoidance, Revision of existing law				Anti-avoidance	
Substantial shareholdings										Major rewrite				
Quarterly payments						Major rewrite							Revision of existing law	
Group relief					Revision of existing law			Changes due to EU law						Changes due to EU law
Transfer pricing						Major rewrite						Changes due to EU law	Anti-avoidance	
Stamp duty on property										Anti-avoidance	Major rewrite		Anti-avoidance	Anti-avoidance
Leasing					Anti-avoidance, Revision of existing law			Anti-avoidance	Anti-avoidance			Anti-avoidance	Revision of existing law	Major rewrite
Films					Major rewrite	Major rewrite	Major rewrite	Major rewrite				Anti-avoidance	Anti-avoidance, Revision of existing law	Major rewrite
Insurance		Major rewrite	Revision of existing law		Revision of existing law			Anti-avoidance, Revision of existing law		Anti-avoidance	Anti-avoidance	Anti-avoidance, Revision of existing law		Anti-avoidance, Revision of existing law

Key: Major rewrite ● Anti-avoidance ◆ Revision of existing law ● Changes due to EU law ◆

final result is that the new anti-avoidance rules often block "innocent" transactions and thus increase the compliance burden.

As Table 3 shows, one topic after another within the British tax system has been subject to increasingly rapid and complex changes in the last decade. Such reforms are often not completed and continue to accelerate.

The temptation to use tax to change society

A generation ago, when much of British industry was state-owned, the Government had many means available to achieve its ends. With the commanding heights of British industry now in private hands it has fewer tools in its kit bag.

The temptation to use the tax system to effect social ends is always present and must be hard to resist. There is nothing necessarily wrong with this. Most voters would probably accept, for example, the case for high tobacco duties to restrain smoking. An increasing number would also accept the need to cut alcohol consumption through the use of high prices. It seems that the tax system will also be extensively used to encourage "green" behaviour over the next few years. Many individual actions are hard to argue against on any individual level.

The problem, however, is twofold. Firstly, many reliefs are in themselves ineffective (for example, the tax exemption for profit-related pay, which became the subject of widespread abuse, had to be withdrawn). The fact that many reliefs are not index-linked, and their real value diminishes over time, demonstrates that the Government has ceased to believe in their rationale.

Secondly, even when they work, the reliefs and exemptions laid into the system over time build up into layers of interacting complexity and confusion. At times, studying the British tax system seems more like studying the geological strata of previous political priorities than a rational way to fund Government expenditure. This has to change. Governments have to build policy ends into the tax system, but at the very least they should remove one old set of political priorities from the system when they put in new ones.

The need to "do something"

One further driver of tax complexity is the combined impact of the constitutional need for annual Finance Acts and a political culture which encourages "action."

Since its first introduction in the Napoleonic wars and its recreation by Sir Robert Peel, income tax in Britain has always been a temporary levy which expires each year on 5 April and needs to be re-applied by Parliament in an annual Finance Act. Its abolition was constantly promised during the nineteenth century although its continued existence has been accepted during the twentieth. The constitutional necessity to renew income tax is quite attractive, but has unfortunately encouraged many Chancellors to regularly introduce further changes.

This is a major driver of tax complexity – backed up by the weight of expectation and media pressure for the Chancellor to "do something." Chancellors certainly face no shortage of ideas at Budget time. Special interest groups press their case for reforms. Professional bodies have their own suggestions. Further proposals arise from within the Treasury and HMRC. Politicians layer on further ideas to achieve their policy ends or bolster their party's electoral position. The media will also have a say. What could be worse than a boring budget to indicate that a government has "run out of ideas?"[52]

The process of real reform is not enhanced by this annual ritual. It particularly tends to reinforce short-term thinking or even panic-driven changes, without a

52. In 2008, Matthew Engel, a political commentator at the Financial Times, wrote of Alistair Darling's first budget that "It wasn't a *bit* boring, it was an absolute crasher. Mr Darling didn't have little to say, he had next to nothing." Engel M, "Speech Bereft of Secrets and Light on Soundbites," *Financial Times*, March 13 2008

connecting thread linking one set of alterations introduced in one year with what may follow in the next year. Tax reform has therefore lacked a sense of direction and long-term strategy.

The desire to pluck the goose without it hissing

Jean-Baptiste Colbert, a Finance Minister to the French court in the seventeenth century, is reputed to have said that "the art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."

He was right that the goose can hiss. From the Peasants Revolt of 1381 to the poll tax riots of the 1980s, taxpayers on this side of the Channel have shown that mistakes in the art of taxation can lead to uprising and rebellion.

Attempts to raise taxes surreptitiously are the consequence. Not increasing personal allowances in line with earnings, with the result that tax liabilities become a higher proportion of earnings, is one method. This does not complicate the tax system, though it does make it more regressive. Other ways to increase tax revenue on the quiet, for example by changing complex rules, can be major drivers of complexity. Recent examples abound, such as the treatment of loan relationships between related parties, or the treatment of dividends as interest for the tax purposes of the recipient only. The civil servant who suggests such changes is unlikely to damage their career prospects, particularly where such new law can be presented as tackling "avoidance."

The problem of guarding the guardians

As salaries at the top of the professions have increased, some national tax authorities have found it hard to hire a sufficient number of highly skilled and knowledgeable tax professionals who understand the full implications of proposals which may have a very wide impact. For example, in the UK, although HMRC has some very respected senior officials, both long-serving and recently recruited, some senior tax lawyers are concerned about the "strength in depth" that exists.

Tax problems are exacerbated in the UK by the lack of internal scrutiny that tax policy currently receives. Before the merger of the Inland Revenue and HM Customs and Excise in 2005 both organisations had tax policy functions. It was then the job of HM Treasury to test and challenge their proposals. Since the merger, tax policy has been the preserve of the Treasury, with HMRC merely responsible for implementing and enacting policy.

This distinction can be justified: it follows the logic of many agencies whose delivery role has been separated from the ministerial departments who set policy. Unfortunately, in practice the Treasury seems to have suffered from a lack of internal challenge and to have been inadequately informed by tax specialists within HMRC as to the implications of its own actions. Some former officials certainly believe tax-making policy in the UK is essentially broken for want of expertise and rigour.[53]

It would appear to be no coincidence that a rush of recent tax proposals have been ill thought through or misunderstood, whether the abolition of the 10p tax band; the changing of the Capital Gains Tax system (without recognition of the special issues that affect entrepreneurs or some forms of investment); the introduction of over-complex and unjustified rules for non-domiciled taxpayers; the publication of a controversial consultative document on the taxation of foreign earnings; or the rise in vehicle excise duty for old cars. There are lessons to be learned from these mistakes, however. These are addressed further below.

53. These opinions were expressed during private conversations with the authors

Tax complexity – towards an evaluative framework

The Problem

As debate over tax complexity has grown in the last few years, analysts and commentators have found it hard to gauge complications in the system. Many discussions fall back on a short range of readily available and widely cited measures: the length of Tolley's tax handbook, the average length of annual Finance Bills, and business opinion surveys.

Used carefully these individual tests are perfectly acceptable – they can be telling measurements of tax complexity and volatility. However, they do not provide objective measures in the same way as, for example, a comparison of marginal tax rates, or tax revenues expressed as a portion of GDP. Nor are they readily comparable internationally (there is no Tolley's in Europe) or historically (Finance Bills were once published in A5). Tax legislation may sometimes be clearer if it is not précised too much. Similar tax law may be reproduced separately for companies and for individuals without actually doubling tax complexity. The tests can therefore add misunderstanding as well as enlightenment.

In the absence of one utterly comparable "killer fact" (such as tax as a portion of GDP as a measure of the level of taxation) it is better to use a range of metrics which can serve as a measure of relative and absolute tax complexity.

Such an evaluative framework needs to:

- Focus on the primary malign impacts of tax complexity (such as cost, distortion and the bias against smaller enterprises).
- Cover all primary areas of tax (income, indirect, corporate and transactional).
- Be (at least partially) capable of historic comparison.
- Be (at least partially) capable of international comparison.

One possible evaluative framework of tax complexity

We set out below one possible framework to measure tax complexity across time and between nations. It is our attempt to start the process of evaluating the changes in tax complexity over the years, and thus help policy-makers thinking about simplification of the tax system to understand the magnitude of the problem.

The framework is very much, however, a work in progress. With further analysis we think it could be substantially expanded and strengthened; at the moment it is simply a good starting guide to how complex the British tax system really is and thus, we hope, of assistance to the policy-makers that really need to assess the scale of the issue.

It is not perfect. But it is an attempt to open up discussion on this issue and we would welcome feedback from readers on this framework.

The ABCD framework

- *Acceleration*: is the tax system in an accelerating cycle of complexity?
- *Bias*: is the tax system unfair towards smaller firms and the less well-off?
- *Cost and complexity*: how much absolute and relative cost does complexity in the tax system add to the deadweight cost of taxation? How comparatively complex is the system?
- *Distortion*: does the tax system distort fundamental allocation decisions?

Our suggested measures of tax complexity are listed below. Each measure is tentatively scored on a scale of -1 (no significant complexity or volatility/falling complexity or volatility); 0 (some complexity or volatility);

or +1 (significant or worsening complexity or volatility). The (tentative) parameters we have used to set out these scales for each test are shown below in Table 4. An overall grade, calculated by combining all the results, is at the end of the assessments (because of the number of tests, the range is +9 to -9).

- **Acceleration**
  - *Test one*: the increase in length of the annual Finance Act over the preceding twenty five years.
  - *Test two*: the speed of increase of the annual Finance Act compared to prior years.
  - *Test three*: level of capital tax volatility over time, compared internationally.
- **Bias**
  - *Test four*: the cost per employee of tax regulation carried by small firms compared to the cost per employee for large firms.
  - *Test five*: typical marginal tax rates for the bottom income decile compared to typical tax rates for the top income decile. While this measure is driven by benefits as well as tax complexity, the increasing convergence of the tax and benefit systems in the UK (through tax credits) makes the test eminently defensible.
- **Cost and complexity**
  - *Test six*: the number of pages of primary tax legislation in the UK compared to the non-weighted international average.
  - *Test seven*: the total cost of reliefs and exemptions as a proportion of the total tax take, compared historically (and ultimately internationally).
- **Distortion**
  - *Test eight*: the number of reliefs in the tax system.
  - *Test nine*: the number of separate and distinct tax codes by which business profits can be calculated (again ultimately compared internationally – though we have not attempted that below).

We have tried in part two, below, to apply this framework to the UK tax system today in order to start to make historical and international comparisons.

54. Edmiston K, "Tax Uncertainty and Investment: A Cross-Country Empirical Examination", *Economic Inquiry*, vol 42, pp 425-440

Table 4: The parameters for each test

Possible Test	Specific Metric (where relevant)	Criteria for grading -1	0	+1
One: increase in Finance Act	Length of last five years / length of act 20 – 25 years ago (percentage)	<50%	<150%	>150%
Two: speed of increase in Finance Act	Increase during last 10 years / increase 15 to 25 years ago	<1	<1.5	>1.5
Three: level of capital tax volatility	Edmiston's measure of capital tax volatility[54]	<100	<500	>500
Four: cost per employee of tax regulation	Cost per employee for firms of 9-49 employees/ cost per employee for firms of more than 5,000 employees	<5	<20	>20
Five: marginal tax rates for poorest	Marginal tax rates for a non-parent working full-time on the minimum wage/marginal tax rates for highest level of Income Tax	<0.5	<1.5	>1.5
Six: number of pages of primary tax legislation		<500	<5,000	>5,000
Seven: cost of reliefs as a percentage of total tax take	Not including exemption of low earnings. "Principal" reliefs only	< 5%	< 20%	> 20%
Eight: number of reliefs in tax system	Not including exemption of low earnings. "Principal" reliefs only	<50	<100	>100
Nine: number of tax codes for business profits		1	<3	>3

Part 2

British tax complexity – a historical and comparative analysis

The ABCD framework can be used to provide an overview of the tax system in the UK, in order to understand its historic and comparative competiveness.

Acceleration

Income Tax was introduced to fund the Napoleonic wars. The rules have been changing ever since. However, until recently it was possible, every 30 years or so, to consolidate all the law for taxing income into one combined act, thus reflecting changes in the law since the last time round. The Income Tax Act 1952 provided a complete code at that time for both individuals and companies. It consisted of 532 sections and 25 schedules, and ran to a total of 528 pages of the Law Reports volume of Statutes.

The last major consolidation was the Income and Corporation Taxes Act 1988, the title reflecting the fact that a separate corporation tax had been introduced for companies. This Act consisted of 845 sections and 30 schedules. It filled 1,318 pages of the Statutes. This represented significant growth (150 per cent) from 1952. Furthermore, the rules for capital allowances and Capital Gains Tax were *not* included in the 1988 Act. Nevertheless all this tax law could still be conveniently published in one volume of a Tolley's tax handbook. A professional tax adviser would expect to carry this handbook to meetings, and could easily look up the law in the course of a meeting. One of the current authors remembers habitually doing so.

Since then, however, there has been an explosion in the amount of new tax law generated. There is now far too much law for consolidation in a single Act. Most Income Tax law is currently contained in three acts: the Income Tax (Earnings and Pensions) Act 2003 (725 sections and 8 schedules); the Income Tax (Trading and Other Income) Act 2005 (886 sections and 4 schedules); and the Income Tax Act 2007 (1,035 sections and 4 schedules). The combined total is 2,536 sections and 16 schedules. This does not include any tax law for companies, which is reproduced separately. It does not include the Capital Allowances Act (which affects Income Tax liability), statutory instruments applying to Income Tax, or, of course, Capital Gains Tax.

Tolley's Direct Tax Handbooks are now four in number, each of them being larger than the 1998 handbook. They are an astonishing 11,000 pages long. This is five times the length of a typical Bible. No professional tax adviser would now dream of regularly carrying the combined weight of all these tax handbooks to a meeting.

The same process can be seen in the growing length of the Finance Act. The average length of the Finance Act has increased from under 200 pages in the 1970s to over 500 in the last five years. The Finance Act 2004 was particularly noteworthy, with 328 sections and 42 schedules requiring 634 A4 pages.

Despite current efforts at simplification the law continues to expand. This year's Finance Bill consisted of another 160 sec-

tions and 46 schedules. Some simplification will result (such as through the abolition of the taper relief rules), but this is more than counterbalanced by the new laws being introduced (such as the entrepreneurs relief for Capital Gains Tax and the new law for non-domiciled persons).

Most professional bodies involved with tax law have expressed their strong concerns. The Institute of Chartered Accountants of England and Wales believes that "The UK tax system is spiralling out of democratic control .... the complexity of the system has developed in such a way that even highly numerate taxpayers are struggling to understand the implications of their actions."[55] By applying our tests to the accelerating problem of complexity, we can see the following results:

- *Test one: the increase in length of the annual Finance Act over the preceding twenty five years.*
  - This has increased sharply over the last quarter century. Over the 2000-05 period the Finance Act averaged 481 pages compared to 157 in the early 1980s, an increase of 206 per cent.[56]
  - **Score: +1**

- *Test two: the speed of increase of the annual Finance Act compared to prior years.*
  - British Finance Acts are not just getting more complicated. They are rapidly getting longer too.
  - The average length of Finance Acts from 1985-89 was 57 pages longer than in the five preceding years. In 2000-05 it was 168 pages longer than in the previous five years. The rate has increased nearly three-fold.[57]
  - **Score: + 1**

- *Test three: the level of capital tax volatility over time, compared internationally.*
  - British capital tax volatility (as measured by Edmiston between 1982 and 2002)[58] was 203 as compared to an unweighted average of 287, a low score of 8.5 (Spain) and a high score of 1,431 (Finland).
  - **Score: 0**

Bias

In 2006-07 an estimated 1.72 million households had an effective marginal deduction rate in excess of 60 per cent. Of these, 160,000 had a rate in excess of 80 per cent and 30,000 had a rate in excess of 90 per cent.[59] Almost all of these households were on below average incomes. These high marginal rates are caused by the combination of paying Income Tax combined with the withdrawal of tax credits, often exacerbated by the withdrawal of other benefits, such as housing benefit. By contrast, the marginal deduction rate for those on the highest incomes is never more than 41 per cent.

It is not just that the less well off pay high marginal tax rates. Were it not for tax credits and other benefits, the proportion of gross income paid in tax by the poorest in work would be as high as 90 per cent.[60] This is not just unfair, it also wastes public spending in a merry-go-round of tax and benefits.

Thus some of the poorest in society face some of the highest marginal rates of tax if they attempt to improve their circumstances by moving from low paid or part-time work. The fact of high marginal tax rates is not wholly a function of complexity, but because of the complexity people are unable to work out the consequences of trying to increase their income. This can lead to paralysis. Having once navigated through the complex tax and benefits system to reach a stable, if relatively impoverished position, there is naturally great reluctance to take steps which may lead to a very uncertain outcome. This problem,

55. Policy Briefing by the Institute of Chartered Accountants

56. The Tax Reform Commission, *Tax Matters: Reforming the Tax System*, The Tax Reform Commission, pp 30, 2006

57. The Tax Reform Commission, *Tax Matters: Reforming the Tax System*, The Tax Reform Commission, pp 31, 2006

58. Edmiston K, "Tax Uncertainty and Investment: A Cross-Country Empirical Examination", *Economic Inquiry*, vol 42, pp 425-440

59. HM Treasury, *Pre-Budget Report 2005*, HMSO, pp 89, 2005

60. When Income Tax, NICs, VAT, excise duties and net council tax are accounted for. See the Office for National Statistics for details

of the complex inter-relationship between tax, tax credits and benefits, is well beyond the scope of this paper. It is a very serious problem, however, and must be addressed if large numbers of people are to be able to improve their circumstances and to be freed from dependency.

There are many other examples of how complexity affects the smaller firms or the poorer families, disproportionately. One such is the disproportionate payroll compliance costs which fall on small business (see test four below). Furthermore, ordinary individuals and small firms are not able to pay for expensive advice to exploit an over complex system to their advantage. For example capital gains are now charged at 18 per cent. The less well off are not usually in a position to realise capital gains and take advantage of this rate, or the separate annual allowance for capital gains. Still less are they able to enter into schemes for turning their income into capital – an area which is likely to be an increasingly lucrative source of fees for the tax planning industry.

Application of our tests to these issues shows that things are getting worse:

- *Test four: the cost per employee of tax regulation carried by small firms compared to the cost per employee for large firms.*
  - The smallest firms pay many times the tax compliance cost per employee that large firms do. Firms employing between 10 and 50 people pay on average nearly 18 times more per employee than do those employing over 5,000. Sole traders pay around £330, the largest firms only £5.[61]
  - Overall, small firms pay a disproportionately large share of the nation's tax administrative burden (56 per cent) even though they only account for 28 per cent of total UK turnover.[62]
  - **Score: 0**

- *Test five: typical marginal tax rates for the bottom income decile compared to typical tax rates for the top income decile.*
  - The marginal tax rate for anyone in the highest income bracket is 41 per cent.
  - For a single non-parent working full time on the minimum wage (and thus earning around £11,000) their marginal tax rate is likely to be 70 per cent, a combination of tax and NICs at 31 per cent and working tax credit withdrawal at 39 per cent (if they are also receiving housing or council tax benefit it could be even higher). This is a multiple of 1.7 times the highest earners' marginal tax rate.
  - **Score: +1**

Cost and complexity

Managing tax and tax risks absorbs significant manpower and capital in the private sector, which could be more productively employed elsewhere. HMRC Measurement Project, which was published in March 2006, estimated that the administrative burden of UK tax regulation on UK businesses was £5.1 billion.[63] Application of our tests shows that this burden helps to make the UK system more complex and less competitive.

- *Test six: the number of pages of primary tax legislation in the UK compared to a non-weighted international average.*
  - PricewaterhouseCoopers have compared the number of pages of primary tax legislation in a basket of different countries. The test is not perfect (it is obscured by differences of language in the legal code), but the findings are startling.
  - At 8,300 pages, the UK has the second longest tax code of any measured country, the longest of any developed economy and is two

61. The Tax Reform Commission, *Tax Matters: Reforming the Tax System*, The Tax Reform Commission, pp 77, 2006

62. "Tax administrative burden" means the compliance costs, costs of working with intermediaries and acquisition costs borne by firms when then they comply with UK tax law. "Small" firms means companies with between 1 and 49 employees, i.e. an amalgamation of the "nano", "micro" and "small" definitions of companies described in footnote 31. Sources: KPMG, *Administrative Burdens: HMRC Measurement Project*, KPMG, 2006; BERR Enterprise Directorate Analytical Unit

63. KPMG, *Administrative Burdens – HMRC Measurement Project*, 2006

and three quarter times the mean of the twenty countries with the longest tax codes.[64] See Table 5 below.

- **Score: +1**

Table 5: Number of pages of primary tax legislation in the world's top economies[65]

Country	Number of pages of primary tax legislation
India	9,000
United Kingdom	8,300
Australia	7,750
Japan	7,200
United States	5,100
Korea	4,760
Italy	3,500
Canada	2,440
China and Hong Kong	2,000
Germany	1,700
Netherlands	1,640
Mexico	1,600
France	1,300
Belgium	830
Russia	700
Sweden	700
Spain	530
Brazil	500
Turkey	350
Switzerland	300

- *Test seven: total cost of reliefs and exemptions as a proportion of total tax take compared historically (and ultimately internationally).*
  - The principal structural reliefs or allowances embedded in the tax system have an aggregate cost to the Treasury of £209 billion, not including the personal allowances. In 2008-2009 the total HMRC tax take is projected to be £470 billion.[66] Reliefs thus account for 44 per cent of the actual tax take.
  - **Score: +1**

Distortion

Distortion occurs when two taxpayers who do similar things are taxed differently. One of them may need to carry out a transaction in one way rather than another way to take advantage of available reliefs or through using some other method to avoid unacceptable taxation, even though the commercial result is similar. There are many examples:

- Capital gains are taxed very differently for incorporated and unincorporated businesses (a company may claim indexation relief but otherwise pay the full rate of tax on capital gains, whereas individuals pay tax at the new 18 per cent rate only). This and many other tax factors could determine the incorporation of a business.
- A lease premium is taxed differently from rent paid in advance, even if the economic effects are exactly the same.
- A hire purchase agreement is taxed differently from a finance lease, even though their economic effects may be identical.
- Very different tax consequences ensue if a company pays a salary or dividends to its controlling shareholder.
- Income can sometimes be recast as a capital gain, which is generally taxed more lightly.
- Pension contributions paid by employees do not save National Insurance Contributions (NICs), whereas similar contributions by employers do save NICs.

Tax can therefore lead to decision-making which would be irrational in the absence of tax considerations. One of the major professional services firms which gave evidence to the Tax Reform Commission said "Advice [our firm] provides often .... sets out steps to "force" commercial transactions to comply with extremely uncommercial tax rules."[67]

Economists state, however, that where behaviour of a business is changed for tax reasons, the overall efficiency of the econo-

64. World Bank and PricewaterhouseCoopers, *Paying Taxes 2008: The Global Picture,* World Bank Group and PricewaterhouseCoopers, pp 21-25, 2008

65. World Bank and PricewaterhouseCoopers, *Paying Taxes: The Global Picture,* World Bank Group and PricewaterhouseCoopers, pp 16, 2006

66. HM Treasury, *Budget 2008*, HMSO, 2008

67. Evidence provided to the Tax Reform Commission by one of the major professional services firms. See The Tax Reform Commission, *Tax Matters: Reforming the Tax System*, The Tax Reform Commission, pp 78, 2006

my is impaired, even if the business is able to improve its own after tax position. Tax law should therefore seek to remove unnecessary distortions, and economically equivalent transactions should be, as far as possible, taxed on an equivalent basis. Some parts of the UK system mean that, as our tests show, unnecessary distortion is taking place.

- *Test eight: the number of reliefs in the tax system.*
  - The tax system has 104 principal structural reliefs or allowances embedded in it.[68]
  - **Score: 0**

- *Test nine: the number of separate and distinct tax codes by which business profits can be calculated (again ultimately compared internationally, though we have not attempted that below).*
  - UK tax is calculated by aggregating the results of four separate tax codes (Income Tax law, the Capital Gains Tax code, the capital allowance tax code and more recent accounts-based law). There are further rules on how to combine the separate calculations.
  - **Score: +1**

Overview of the UK

Our draft ranking of the UK tax system has thus assessed the UK as having significant or worsening tax complexity or volatility on six out of nine measures. It is somewhat complex or volatile on the remaining three measures. This gives an overall score of six on a range of -9 to +9. Though things could be worse, the UK is clearly a complex and volatile tax environment. We do not expect this conclusion to change.

68. HMRC Data Table 1.5

Personal Tax Complexity

This section sets out nine key problems with the tax system as it affects individuals:

1. How the complexity of personal tax law leads to incomprehension, errors and unfairness.
2. How the rules for National Insurance Contributions are needlessly distinct from the Income Tax rules.
3. How the system is clogged up with ineffectual reliefs, which not only complicate but also serve to increase tax rates for everyone.
4. How too many separate rules apply to the taxing of employee benefits.
5. How complex personal allowances and effective tax rates – the tapering rules – mean that pensioners can face the most complex calculations of all.
6. How the low paid and savers face tax rate volatility.
7. How capital tax complexity has been changed, not reduced by recent tax volatility.
8. Why there are too many investment schemes, thus undermining equity and their own effectiveness.
9. How inheritance tax is overly complex and needs review.

How the complexity of personal tax law leads to incomprehension, errors and unfairness

Tax legislation applicable to individuals is now so complicated that it is effectively a no-go area for the layman. HMRC is obliged to publish extensive guidance to try and explain it.

To help complete the basic individual tax return, for example, HMRC provide a 28-page set of guidance notes. If the taxpayer is unfortunate enough to need to complete the additional supplementary pages there is a further 32-page set of notes that explains how to do it.

Having warmed up with this the taxpayer may then need to complete up to eight sets of further information sheets, also forming part of the tax return, covering such matters as employment or self-employed income and capital gains. To assist with this there are a total of 67 Help Sheets which supplement further sets of guidance notes. However, the Help Sheets only deal summarily with some issues. HMRC draw attention to 13 Inspectors' Manuals which contain more complete information (with luck, it should not then be necessary to consult any of the other 61 Inspectors' Manuals, some several volumes long, which are less likely to be relevant for an individual tax return).

There are of course separate tax returns, and yet more help sheets, for individuals who happen to be trustees or in partnership etc.

Having completed the tax return there may be a lot more work to do for a taxpayer who wants to carry out his own calculation of the tax due. For 2007-08 there are 39 pages of notes to help with the completion of the tax calculation summary. The unwitting taxpayer needs to beware, however. In about a dozen special situations even all these notes are inadequate. The taxpayer is then advised to consult his advisor or HMRC to complete the calculation.

Who is affected by this complexity? Around 30 million people pay Income Tax in the UK, of whom there are 8.8 million self-assessment taxpayers. 56 per cent of these use agents.[69] Employing a tax advisor to provide guidance through the various rules, reliefs and allowances could easily cost £250 a year for relatively simple matters. For many it costs much more. This is particularly unfair for those

69. HMRC, *Review of HMRC Online Service*, HMRC, March 2006

on relatively low incomes who need to employ an agent. Overall, these figures suggest that people who pay an adviser to help them with their self-assessment tax forms pay out £1.25 billion per year.

22 million employed taxpayers trust that their PAYE and NICs have been accurately computed. They are not always wise to do so. HMRC estimate that inaccurate processing led to 2.8 million errors on PAYE in 2006-07.[70]

How the rules for National Insurance contributions are needlessly distinct from the Income Tax rules

National Insurance contributions are complicated. Compared to Income Tax, they are pointlessly calculated in many different ways:

- Income Tax is based on annual thresholds. It is not charged on the first £6,035 of income (2008-09 tax year), but then levied at 20 per cent for the next £34,800 and charged at 40 per cent above that.[71] By contrast, employees' NICs are not charged on the first £105 of weekly income, are then charged at 11 per cent on all income up to a weekly maximum of £770 per week and at one per cent on earnings above £770 per week.[72]
- The amounts on which employees' National Insurance contributions and on which Income Tax is calculated are not the same. An employee is not liable to NICs in respect of the value of many benefits in kind which an employer might provide on top of salary, even though those benefits are subject to Income Tax.
- NICs and Income Tax are based on different periods. National insurance contributions are based on when income is earned. PAYE is normally based on when income is paid. This can create anomalies. For example, when overtime is worked in the last week of a tax year, but paid in the first week of the following year, the two liabilities are owed at different times.
- NICs do not operate on a cumulative basis like Income Tax under PAYE. A fresh calculation of liability for NICs (having regard to such matters as holiday pay, back pay, the earnings threshold etc) has to be made for each earnings period.
- Finally, unlike Income Tax, NICs are calculated separately for different employments. An individual with several employments may therefore escape NIC liability by being below the earnings threshold for each employment. This would be unlikely for Income Tax, for which purpose all income is aggregated.

The interplay between Income Tax and NICs produces further anomalies – for example the pension contribution anomaly referred to above.

The Treasury has recently reviewed the issues, but has proposed no substantive reforms, let alone the possibility of abolishing NICs by merging them into Income Tax.[73] An interim paper published by the Institute of Fiscal Studies, however, makes plain that the Treasury could have considered fundamental issues further before coming to its conclusions. For example, the basic Treasury premise that the NIC system gives effect to the contributory principle, and should be retained for that reason, is undermined by the IFS analysis.[74]

How the system is clogged up with ineffectual reliefs, which not only complicate but also serve to increase tax rates for everyone

The tax system has embedded in it 104 principal structural reliefs or allowances. Their aggregate cost to the Treasury is £199 billion, not including the personal allowances.[75]

In addition there is an unknown number of minor exemptions introduced for

70. National Audit Office, *HM Revenue and Customs: Accuracy in processing Income Tax*, National Audit Office, 2007

71. These figures apply following the Chancellor's announcement of compensation for the loss of the 10 per cent tax band. They are simplified, however, and do not take account of issues such as age-related allowances and differential savings rates

72. Although the Government has attempted to bring into line the threshold at which the 11 per cent rate reduces to 1 per cent and the threshold at which the higher rate of 40 per cent income tax applies, the very recent subsequent reduction of the 40 per cent income tax threshold (under the revised proposals for withdrawing the 10 per cent band) demonstrate that the two thresholds remain disconnected

73. HM Treasury, *Income Tax and National Insurance Alignment: An Evidence-Based Assessment*, HMSO, 2007

74. Adam S and Loutzenhiser G, *Integrating Income Tax and National Insurance: An Interim Report*, Institute for Fiscal Studies, 2007

75. HMRC Data Table 1.5

one purpose or another over the years, whose impact on revenue the Government itself has admitted is "not known". HMRC lists over 200 of these but there are certainly more.[76] The HMRC list reads like a social history of varying priorities over the decades. Many reliefs have been allowed to reduce in value in real terms over time to such an extent that they have become meaningless. However, they have never actually been repealed. Other reliefs come with complicated pre-conditions, which are hardly worth navigating to obtain the tax benefit concerned.

Available exemptions include those for 15p luncheon vouchers, for welfare counselling and for eye tests. Some exemptions support travelling to work (there is an exemption for support to public bus services) or travelling in general (incidental overnight expenses are exempted up to £5). Others discourage it (there is an exemption or £2 or more for extra household expenses for home workers). Some exemptions are pro-car (there is an exemption for car parking at or near a workplace). Others are anti-car. There are exemptions for free meals on cycle to work days, cyclists' safety equipment and relief for a work's bus. Some exemptions seem designed to help the better off (presumably city workers gain the most from the late night taxi exemption). Some seem to reflect the bias in favour of organized labour of another age. For instance, some trade union investments are exempt from Income Tax. Many reliefs are just obscure. Why on earth should the tax system exempt payments under staff suggestion schemes?[77] We believe that most of these minor reliefs could be swept away.

In addition, many of the more substantial reliefs, even where their origin is less mysterious, should be abolished. For instance, relocation relief was introduced to help encourage a flexible labour market. However, its real value has withered away and now seems difficult to justify. The cap has remained constant for 15 years and the value to a higher rate taxpayer is £3,200 (40 per cent of £8,000). This is a small fraction of the likely actual costs of moving house, so is unlikely to be a material factor in encouraging job mobility.

> "All reliefs should be reviewed to see whether, for reasons of administrative efficiency or for other reasons, their retention is justified"

The foreign service allowance could also be abolished. It relieves crown servants living outside the UK from tax payments reflecting extra costs of living abroad. Why not just pay them more, as private sector employers do?

The tax exemption for benefits to "lower paid" employees who earn less than £8,500 per year should also be reviewed. Following the introduction of the minimum wage the relief now mainly applies to part-time workers. It is not clear why part-time workers should be preferred in this way, particularly if a part-time worker is proportionately better paid than a full-time colleague. The exemption is not an effective or well targeted anti-poverty measure.

A further significant relief is for payments to employees on the termination of employment. An exemption is currently available for the first £30,000 of a termination payment to a departing employee, provided (very broadly speaking), the employee was not expecting to receive the payment while still working. Its abolition, or the restriction of the relief to any statutory redundancy payment, would be a major advance in tax simplicity. The existing law is so complicated that the latest (second) edition of Tolley's "Tax on the Termination of Employment" runs to 367 pages. The extra tax could, for example, then be used by the Government to increase the statutory redundancy payment.

76. See the following page on the HMRC's website: http://www.hmrc.gov.uk/stats/tax_expenditures/00ap_b2.htm

77. Particularly when one bears in mind that an employer can "gross-up" an award if he wants it be received "tax free"

All reliefs should be reviewed to see whether, for reasons of administrative efficiency or for other reasons, their retention is justified. But there should be a burden of proof to be discharged before any relief is kept.

How too many separate rules apply to the taxing of employee benefits

Simplifying the code for taxing benefits for employees is also required. There are 155 sections in the Income Tax (Earnings and Pensions) Act 2003 which apply to the taxation of benefits other than shares.[78] These provisions could be simplified and standardised to apply the basic principle that the taxable amount is the cost to the employer of providing the benefit. Special rules are often not justified and should be re-examined. The rules for cash vouchers, non-cash vouchers and credit tokens could be standardised, while the rules for benefits provided for past employees and families could be rationalised. Car benefit rules could be simplified, as there are 58 sections in the Act applying to car benefits alone. The rules for living accommodation, introduced when most houses cost less than £75,000, should be updated and simplified.[79]

Even more complex are the further 162 sections and four lengthy schedules which apply to benefits derived from shares.[80] The current share benefits legislation could be re-written so that it is focused on principles.[81] This approach would also help simplify highly complicated returns required from employers.[82]

How complex personal allowances and effective tax rates – the tapering rules – mean that pensioners can face the most complex calculations of all

During the last decade a range of Government actions to raise revenue or reduce headline rates has created personal tax rate volatility, particularly for savers and the low paid.

In 1999 Gordon Brown introduced the 10 per cent rate for income up to the first £1,500 over the personal allowance. In 2008-09 he abolished it.[83] The abolition was claimed to be a tax simplifying measure. It was not. The 10 per cent rate still applies for certain savings income – complexity therefore remains. The change was primarily intended to fund the 2p cut in the basic rate of Income Tax. Fortunately this latter change *did* achieve simplification as there is no longer any difference between the savings rate tax of 20 per cent and the new basic rate of tax.

In April 1999 Gordon Brown took his now infamous decision to make the tax credit on dividends non-refundable to UK pension funds.[84] As is well known this had the net effect of raising the Government's takings by £5 billion per year and making savers and future pensioners worse off by the same amount – in the process severely discouraging saving. Less well known is that this step also created substantial distortion by undermining the imputation system of tax. Put simply, investment in equities became much less tax efficient for pension funds than investment in debt. This exacerbated the tendency for companies to leverage themselves too highly, one of the several drivers of recent problems.

Two further changes introduced at that time were

- The introduction of the reduced tax credit of 10 per cent for dividends; and
- New special rates of Income Tax of 10 per cent and 37.5 per cent for dividend income.

It is likely that the main reason for making these changes was to reduce the amount of dividend credit refunded to non-UK shareholders under double tax treaties.[85] It created, however, additional and probably

78. HM Government, *Income Tax (Earnings and Pensions) Act 2003*, HMSO, sections 63 – 191 and 201-226, 2003

79. HM Government, *Income Tax (Earnings and Pensions) Act 2003*, HMSO, sections 103- 106, 2003

80. HM Government, *Income Tax (Earnings and Pensions) Act 2003*, HMSO, sections 417 – 554 and schedules 2-5, 2003

81. This is a simplification measure which would be enacted on an aggregate basis so that it did not result in an increase in taxation on individuals or companies

82. The HMRC's Form 42, which applies for non-approved benefits, is 12 pages long

83. The nil per cent rate of tax for small companies suffered a similar fate

84. It was also made non-refundable to individuals with incomes below the level of the personal allowance

85. The Schedule F rates are 10 per cent for basic rate taxpayers and 32.5 per cent for high rate taxpayers

unwarranted complication in the calculation of tax for UK taxpayers.

How the low paid and savers face tax rate volatility

The Government's actions have added to the existing complexity as well as introduced instability into the system. The decision to increase personal allowances to compensate for the withdrawal of the 10 per cent tax band was probably the simplest and quickest way out of the problem that the Government created for itself. However, it did create anomalies. It conferred a benefit on those whose earnings are near the top of the basic rate band which was not really intended. Although less publicised, it also conferred a similar unwarranted benefit on savers who were still entitled to the 10 per cent rate, and did not therefore need to be compensated. It will be interesting to see what further proposals are introduced next year if the Government tries to reduce the long-term costs of these measures which took effect from April 2008.

The system of personal allowances was complicated at the same time by withdrawing them for non-domiciled people who claim the remittance basis of taxation. This not only appears harsh but also adds to the difficulties of non-domiciled persons who are also faced with a horribly complicated new law for remittances. It will be very difficult for many to decide on the optimum tax elections and to carry out the necessary calculations. Perhaps worse, it will be hard to decide on the financial implications of coming to the UK in the first place.[86]

The system of age-related allowances and married couples' allowances is a major difficulty for many pensioners, due to their high taper rates as the allowances are withdrawn with increasing income.

There are at present two higher personal allowances for the over 65s and the over 75s of £9,030 and £9,180 respectively. The complex tapering rules apply where income exceeds £21,800.[87]

In addition there is a married couple's allowance which is available where at least one of the married partners was born before 6 April 1935. This allowance (of either £6,535 or £6,625, depending on whether the person is aged 75 or over) gives relief at 10 per cent. It too is subject to a tapered reduction for those on higher incomes. There are very complex rules relating to the transfer of the married couple's allowance between husband and wife.

The rules are inconsistent and create much confusion for a section of society that may not be well placed to cope with complexity. In addition, at income levels where tapering of these allowances applies, pensioners are subject to marginal tax rates of 70 per cent.[88]

How capital tax complexity has been changed, not reduced by recent tax volatility

Until 2008 the Capital Gains Tax payable on the disposal of an asset had the advantage of being reasonably internationally competitive and the disadvantage of being staggeringly complex. The competitive effect resulted from the low rate of 10 per cent tax available for "business assets". The complexity was largely derived from the twin system of indexation in use for assets purchased before March 1998 and taper relief used on assets purchased since that date.[89]

The Government has now simplified the Capital Gains Tax code by abolishing taper relief and replacing it with a flat 18 per cent charge on all capital gains.[90] The effective increase in tax on entrepreneurs, and the clamour of complaints about the speed and lack of consultation with which this change were introduced, are well known. The need to reinstate further relief to entrepreneurs (through a system which

86. Andrew Hodge, head of employer and personal taxes at Deloitte, has recently referred to this as a "compliance nightmare." He asked "How can anyone believe that such a complex regime is suitable for individuals other than the very wealthy?" Houlder V, "Foreign Workers Face Compliance Headache over Tax Plans," *Financial Times*, May 19 2008

87. The HMRC's P161 form is issued to persons approaching retirement age. However, it is difficult to complete when income is typically subject to change. As a result "There is failure by the Revenue to give people their allowances, a failure to tax people correctly and ignorance by the taxpayer of what they are entitled to. It is a recipe for disaster." Paddy Millard, director of Tax Help for Older People

88. The taper rate applicable to the age allowance is 50 per cent which in addition to the basic rate of tax at 20 per cent gives a combined marginal tax rate of 70 per cent

89. Indexation was a process through which the acquisition cost of an asset was increased for tax purposes by an amount equal to the RPI. Taper relief reduced the gain that would otherwise arrive by a percentage that depended on how long after 1998 the asset was owned

90. HM Government, *Finance Bill 2008*, HMSO, 2008

caps relief to £1 million of lifetime gains and requires tracking of the amounts of relevant gains realised by an individual over his whole lifetime – a proposal which few regard as practical law-making) has starkly reduced the simplification which was originally expected.

It has been less appreciated, however, that the change had further limitations when evaluated as a tax simplification measure. This is because the interaction with Income Tax becomes even more difficult. The 18 per cent flat rate applies even if the asset has been held for a very short time – perhaps for only a few weeks or a few days. As a result it will become even more difficult to distinguish between income and capital gains and more reliance will need to be made on old and unsatisfactory case law for this purpose. The very complex statute law which has been introduced to differentiate capital gains from income in certain circumstances or to deem income to be capital in other circumstances will also become even more important.[91] This means existing highly complex avoidance legislation will be used more often, and probably more such legislation will be required in the future.

We are likely to find, for example, one person selling his second home within a short time and being taxed at 40 per cent because it is held that he intended to resell the house at a profit when he bought it. He may wonder why, in practice, another person who sold his second home within a similar period only paid tax at 18 per cent.

HMRC will need to strictly police the border between income and capital gains, even though it is often almost invisible on the ground. Without any statement from Government as to the principles which have led them to introduce such different rates of tax for assets which have been held for only a short time, HMRC and the courts will often find it extremely difficult to make the required distinction.

Nor is it clear that the new situation is equitable. The shop assistant working at Tesco, taxed at an effective rate of 43.8 per cent may, to put it mildly, need a lot of convincing that it is fair that someone selling their second home should only pay tax on their gain at 18 per cent.[92]

The real problem is that a powerful case can be made for different approaches to Capital Gains Tax reform. For example the capital gains system could have been further integrated with the Income Tax system (it will be recollected, for example, that companies pay the same rate of tax on income and capital gains). Although reliefs for entrepreneurs, employee shareholdings and perhaps for savers (for example by exempting savers' income and gains from tax until withdrawn for personal expenditure) would then be appropriate, the system could have been substantially simplified compared with at present. Robust distinctions could be made for those matters qualifying for relief, unlike the current hazy capital/income distinction. As it is the opportunity for a full and principled consultation and consideration of the issues has been lost.

The tax avoidance industry will already be gearing up to find schemes for turning income into capital. It is unlikely, in our view, that a stable framework for taxing capital gains has been achieved. A whole new minefield for complexity has been laid.

Why there are too many investment schemes, thus undermining equity and their own effectiveness

There are currently many different tax regimes for different investments, with different applicable tax rates. Examples include:

- Ordinary companies and investment trust companies (dividends taxed as explained above);

91. Examples of special rules for deeming capital gains to be income include rules for offshore funds, the accrued income scheme, rules for deep discounted securities, employee share schemes, rules for premiums for leases, rules for certain transactions in securities, rules for sales of occupational income, rules for certain transactions in land, rules for certain payments made from trusts, rules for certain gains from assets transferred abroad, rules for gains derived from repos, rules relating to the sale of patents, rules for disposals of futures and options with guaranteed returns, rules for taxing gains from with profit bonds, and rules for payments on termination of employment. This list could be continued

92. 43.8 per cent equals the basic rate of 20 per cent, plus employees' NICs of 11 per cent plus employer's NICs of 12 per cent. Economists generally reckon that the effect of employer's NICs is to reduce an employee's pay commensurately. Of course the payment of NICs gives entitlement to contributory benefits, but the value of those benefits is not likely to equate to the NICs paid

- Share based unit trusts (distributions taxed like dividends);
- Bond based unit trusts (distributions taxed like interest);
- Pension based savings (tax relief for investment, within qualifying limits, and tax relief for investment profits within the pension fund);
- Qualifying endowment policies (no Capital Gains Tax on encashment, but possibility of higher rate Income Tax);
- National savings (sometimes taxable, even if interest not paid out, sometimes exempt);
- Guaranteed equity bonds (profits usually taxed as income);
- ISAs – no tax provided conditions satisfied; and
- Venture capital schemes and enterprise investment schemes (complicated rules for tax relief on initial subscription for shares and subsequent tax reliefs on gains).

This list is not complete. Further investment possibilities, with yet more varying tax rules, are unauthorised unit trusts, non-qualifying pension or life policies, children's bonus bonds, offshore funds, friendly societies, permanent interest bearing shares, Government stocks, onshore and offshore bank accounts, community development finance institutions, real estate investment trusts, direct investments in real estate and investments in commodities such as wine or stamps.

Even something apparently simple like a corporate bond might prove very complicated if the accrued income scheme applies, or if there is a dispute with HMRC as to whether interest payments should be treated as dividends for tax purposes.

So many rules for investment schemes undermine their own effectiveness as an incentive to saving and underline distortions in the system. Tax advisors (who are more affordable for the well off) are required to help confused taxpayers. A coherent and integrated framework for savings is needed to give simplicity and transparency for savers. This could provide an incentive for saving which would be as important as the overall level of taxation.[93]

How inheritance tax is overly complex and needs review

Inheritance tax is essentially a charge on assets held on death. In these circumstances it is clearly necessary to have a rule to bring death-bed gifts into charge. In the UK, however, this rule (which is derived from the old capital transfer tax rules, which taxed cumulative lifetime transfers) extends to gifts made in the seven years before death. This may give rise to a form of retrospective taxation which may not be fair for an inheritance tax. Thus, for example, two 50-year-olds, both in good health, may each make a gift of £1 million. One survives for seven years, and the gift is tax free. The other is run over by a bus after just one year and the gift (charged at a marginal rate of 40 per cent) gives rise to a tax liability of £400,000. It is not clear what justifies this difference in the tax treatment of the gift. Furthermore, the rules have developed over time into further complexity, such as the tax regime for pre-owned assets.[94]

A principled re-evaluation of inheritance tax may be justified. Such a re-evaluation of what is to be taxed, and why, may lead to significant simplification.

93. See, for example, Investment Managers Association, *Investing in Savers: A Fresh Approach*, Investment Managers Association, 2004

94. An individual who gifts an asset but continues to enjoy a benefit from it may be subject to income tax on the market rent value of the asset. Such a rule would not have been required under the old capital transfer tax regime, because a lifetime transfer could be taxable. Irrespective of the date of death

Indirect tax complexity

This section sets out what we believe are the key existing and (given current trends) *potential* problems with the indirect tax system:

1. VAT is much more complex than it needs to be.
2. Despite some improvements, stamp duty still creates complexity and distortion in both property and share markets.
3. To date, environmental taxes have not been based on clear principles, have often been ineffective and have been highly regressive. There is a serious risk that further moves towards environmental tax will introduce yet more layers of complexity into the system unless they are accompanied by matching simplifications.

VAT complexity

VAT was introduced in 1972. It replaced the former purchase tax in order to satisfy the requirements of European law. Many of the old distinctions under purchase tax between different kinds of goods and services were not required by Europe. Nevertheless, many of them were retained in UK VAT law.

However, there has been no rationalisation of the position since 1972. There remain far too many different categories for fully taxable, exempt and zero rated supplies. This means that, all too often, different rates of tax apply for very similar supplies because of very fine tax distinctions. Who understands why cakes are zero rated, but chocolate biscuits are standard rated? Or why yoghurt is zero rated, unless it is frozen yoghurt which is standard rated, apart from frozen yoghurt which is unsuitable for immediate consumption which is, of course, zero rated?

Children's clothing is also zero-rated. One does not need to be naive about the political difficulties of changing this rule to recognise the anomalies it creates or its imprecision as a tool of public policy. Taxpayers may be subsidizing a sixth pair of designer jeans for a child from a wealthy family. Tall but poor children pay the standard rate earlier than small but rich children of the same age. Belts may be zero rated as "clothing", but ear muffs do not qualify.[95] However, if the Government were to address these issues, then it must do so without harming the poorest people who benefit. This would mean, for example, increasing child benefit or other help to compensate for the change.

Many other VAT distinctions result from the desire to achieve worthy ends. However, they create complexity which may not in fact be justified. This complexity is often experienced most directly by the retailer who is required to administer the fine distinctions, often through complicated VAT retail schemes.

Having different rates also exacerbates the difficulty of charging VAT on multiple supplies (made at the same time but charged at different rates) and the need to differentiate such supplies from composite supplies (where it is held that there is only one supply for VAT purposes, with the VAT charge determined by the "dominant element" within the supply). Sales promotions, where one item is given "free" on the purchase of a different item but where different rates apply to the two items, are another fruitful source of disputes with HMRC.

Of course it can be argued, with more force than is possible on other tax issues addressed in this paper, that now it is easier not to rock the boat and to leave things as they are. People have got used to the

95. A recent paper written for the Mirrlees Review makes a powerful case for broadening the VAT base by removing special VAT reliefs, thereby simplifying VAT and saving costs, and using the extra revenue to reduce direct tax or increase other benefits. See Crawford I, Keen M, Smith S, *Value-Added Tax and Excises*, *Institute for Fiscal Studies*, 2008

existing rules. If similar arguments had succeeded in 1971, however, we would still be using pounds, shillings and pence. Even where simplification causes short-term disruption, it may be justified by long lasting future benefits.

Stamp duty complexity

Stamp duty has in some respects been considerably simplified. Whereas it used to apply to sales of *all* forms of property, the Government has restricted it to transactions in shares and property. However, the introduction of stamp duty reserve tax on share transactions and stamp duty land tax on property sales *has* served to increase complexity.

Stamp duty land tax, for example, was introduced in 2003 following some hasty and unsuccessful legislation enacted to counter avoidance in 2002. Avoidance of duty on land transactions was indeed becoming widespread at that time, particularly because of the increased rates of stamp duty that had been enacted.[96] The law for stamp duty land tax ran to 83 sections and 17 schedules in the Finance Act 2003, but commentators also described this legislation as ill thought through, with many gaps which had to be dealt with by further regulations, bulletins and "customer newsletters." Further amending legislation was again required in the Finance Act 2007.

In the 2008 budget there were, however, some welcome administrative reforms relating to reporting thresholds and completion of returns.

One important respect, however, in which stamp duty land tax continues to produce unwarranted complexity and distortion affects ordinary small scale domestic land transactions. Duty is currently charged at 1 per cent on sales from £175,000 to £250,000, at 3 per cent on sales over £250,000 and up to £500,000 and at 4 per cent on sales over £500,000. This means that a sale for £501,000 attracts duty of £20,040, which is £5,040 higher than the duty of £15,000 on a sale of £500,000 exactly. Similar anomalies occur at sales close to the £175,000 and £250,000 thresholds for the same reason: the duty applies to the entire price paid, not just that part of the price which exceeds the threshold. This regime is not only unfair. It also produces distortion in the market pricing of properties, and encourages exaggerated prices to be attributed to non-stampable household items sold with the house. There is an easy technical answer to this problem, although there would be a cost to the Treasury. For example, sales could be charged at 2.5 per cent on any value over the £175,000 threshold and at 4 per cent on any value over the £250,000 threshold. Nobody would pay more duty than at present, but a serious anomaly would be removed.

> “The commercial effects of share transactions can and increasingly are being replicated through derivatives which are not subject to stamp duty”

Stamp duty (or stamp duty reserve tax) is payable at the rate of 0.5 per cent on share sales. However, it is not payable on transfers of loan stocks and is more easily avoided on transfers of equities issued by overseas companies. The commercial effects of share transactions can and increasingly are being replicated through derivatives which are not subject to stamp duty. This all creates potential distortion and tax planning opportunities. The levy of stamp duty or stamp duty reserve tax on shares has the commercial effect of reducing share values. It indirectly increases the costs of raising capital and has a strong negative impact on the City of London as a financial centre. Stamp duty also distorts the international market in share transac-

96. The schemes were particularly popular where the land had substantial commercial value, so that the implementation costs of the schemes were justified. These schemes might have involved the use of partnerships (varying the partner's profit shares to achieve the desired commercial result), the use of overseas trusts, the packaging of land in a company which was then sold, or the artificial splitting of land into freehold and leasehold interest which were then sold separately

tions. The market in exchange traded funds is moving overseas for this reason.

Stamp duty reserve tax has also been constantly revised over recent years and thereby become increasingly complicated.

For all these reasons the best way to simplify duty on shares would be to abolish it. There would be a substantial cost to the Treasury. However, there would be very significant claw backs of the cost through increased Capital Gains Tax (share values would immediately rise) and increased commercial activity.[97]

Complexity has been exacerbated by the technical problems of having three overlapping sets of rules, stamp duty, stamp duty reserve tax and stamp duty land tax. Many of the provisions aim to tackle the same mischief, but different wording is used in the different taxes. Even if duty on shares were not abolished, substantial simplification might be achieved by combining the three sets of rules into one coherent framework.

Environmental taxes

Most environmental taxes are not, in themselves, complex or unstable. Most voters would also support their existence. It seems sensible after all to tax "bads" (e.g. pollution) not "goods" (e.g. going to work). Complexity *is*, however, certainly created by the number of environmental taxes which have been introduced over the last 15 years. Taxes with a primary or secondary environmental purpose now include

- *Fuel duty*. Some form of this has been with us for over a century and it is now a fixed charge on each litre of fuel. The charge is normally due to increase every year in line with inflation, but in fact has decreased in real terms since the fuel escalator was abolished in 1999. The planned 2008 increase (from 50.35p per litre to 52.35p per litre on petrol) has been postponed until the autumn (and it may be postponed further as a result of public disquiet concerning spiralling petrol and diesel prices);
- *VAT on fuel*. This is charged at the usual rate of 17.5 per cent on the aggregate of the basic fuel price and fuel duty. It is estimated that the Government has received an extra £500 million in VAT in the first six weeks of the current tax year as a result of the increased price of oil;
- *Vehicle excise duty (VED)*. This is a duty on any vehicle not kept off the roads. The rates are currently between £0 and £400 p.a. depending on the engine emissions of the vehicle. They are scheduled to increase sharply in future;
- *Landfill tax*. This is charged on waste disposed of by way of landfill. It was introduced in 1996 at a standard rate of £7 per tonne. The rate is £24 per tonne in 2007/08 and will be increasing to £32 per tonne in 2008/09 and to £40 per tonne in 2009/10;
- *Aggregates levy.* This was introduced in 2002 at a rate of £1.60 per tonne on aggregates production. It is currently charged at £1.95 per tonne;
- *Air passenger duty*. This was introduced in 1993 at a rate of £5 per passenger for a flight within the EU and £10 for a flight going outside the UK. The rates are now £10 to £20 for flights within the EU and £40 to £80 for those outside the EU, depending on the class of travel. It is proposed to replace this duty with a new aviation duty from 2009, payable per plane instead of per passenger; and the
- *Climate change levy*. This was implemented in 2001 as a charge on energy suppliers. It is currently charged, for example, at 0.456p per kWh for electricity. This has increased little since 2001.[98]

97. HMRC Table 15.1. The total cost would be about £3bn, before the claw backs mentioned

98. Tobacco products duty and alcohol duty are not included in this list of environmental taxes

However, the picture is even more complex than this list implies. Other taxes are also often used to achieve environmental objectives – the calculation of Income Tax on company cars is one example. The stamp duty exemption for "zero carbon" homes is another. Increased capital allowances are given for energy saving plant. There are further regulations and charges which, while not strictly taxes, may still have a financial impact. These include water abstraction charges and emissions trading schemes. There can be little doubt therefore that taxes driven by environmental considerations have already substantially increased British tax complexity. Is this necessary or justified?

As one usually finds with complex taxation the underlying cause of the complexity is, at least in part, the lack of clear underlying principle.[99] Are environmental taxes intended to discourage the activity which is being taxed, or are they intended to raise money for the Government?

The strongest argument for levying such taxation may well be the "polluter pays principle," i.e. that the polluter should pay for the cost on society caused by his activities. Although different measures have been estimated, one can certainly attribute a cost to the use of carbon, for example.[100] However, governments have generally declined to base environmental taxes soundly on this principle. One can see at least two reasons why.

Firstly, a number of taxes would not be easily justifiable on this basis. For example, vehicle excise duty applies no matter how many miles a vehicle is driven. Yet this tax is scheduled to double from £210 to £430 in 2010 for a car having emissions greater than 225g of CO_2 per km, even if that car was purchased as far back as March 2001 (unless, as seems more than likely at the time of going to press, the Government is forced to make another U-turn on this issue in the autumn). This not only gives rise to an element of retrospective taxation (the extra tax could not have been foreseen when a vehicle was purchased in 2001), it also fails to reflect the cost on society of using the vehicle. A little-driven car should cost less than a much-driven one.

Furthermore, the issue of whether the tax reflects the cost on society is clouded by the possibility of double or even triple taxation. Not only is vehicle excise duty payable, but fuel duty (in addition to VAT) is payable on petrol. The driver may also be liable to tax, if it is a company car, on a benefit in kind, which is also calculated by reference to the emissions of the car. All these taxes make a rational decision as to what car to purchase, whether to scrap a car which has become subject to higher taxes, or whether an employee should take extra salary instead of a company car and buy a car privately, extremely difficult to calculate.[101]

The second point is that if environmental taxes were intended to pay for the environmental damage caused it would follow that governments should spend the money raised on that problem. Again the connection between the taxes raised and the money spent by Government is usually missing.

There is a very serious risk therefore that environmental taxes have generally become "stealth taxes", a way of raising Government revenue without either (as is strongly arguable) making a substantial impact on behaviour or paying for the environmental damage. Environmental taxes also tend to be regressive, because they are not matched with the ability to pay. And they have substantially increased the complexity in the tax system. Any further environmental taxes (and there almost certainly will be more) should be based on clear principles and should be accompanied by matching tax simplifications. To do otherwise would be to needlessly undermine the competitiveness of the British economy.

99. See Fullerton D, Leicester A, and Smith S, *The UK Tax System and the Environment,* Institute for Fiscal Studies, 2008 for a helpful discussion of rival views concerning the purpose of environmental taxes

100. See Taxpayers' Alliance, *The Case Against Further Green Taxes*, The Taxpayers' Alliance, 2007 for various possibilities

101. We will spare the reader an explanation of the special rules for capital allowances and for input VAT on motor cars which further complicate the tax calculation for company cars

Business tax complexity

The uncompetitive nature and instability of the British tax system became the subject of very stark business complaints in the first half of 2008. The simultaneous high profile fit of tax instability did real harm to Britain's reputation for tax administration. However, this is a manifestation of problems that have been developing over a much longer period. Several themes stand out:

1. Companies have to negotiate a minefield of different rules to work out their profit for tax purposes.
2. The UK has become a systemically less attractive tax environment for business due to growing complexity and instability.
3. The UK is now a less attractive place for highly skilled non-domiciled citizens to base themselves.
4. Recent volatility has gravely undermined the UK as an attractive place to headquarter an international company.
5. There is scope to remove corporate tax reliefs, to widen the tax base and reduce corporate tax rates.

Companies have to negotiate a minefield of different rules to work out their profit for tax purposes

As we saw above, tax is calculated by aggregating the results for different sources of profit under four separate tax codes. Each source is subject to a very large number of rules. And there are further rules on how to combine the separate calculations. The four underlying sources are:

- Income Tax law, which reflects the schedular system, whereby income derived from defined sources is separately calculated and then aggregated together;
- A separate Capital Gains Tax code (which could be seen as an additional schedule for a further source of profit with its own computational rules);
- A capital allowances code conferring tax relief (in various ways) for the capital cost of specified assets; and
- Accounts-based law for loan relationships, intangible fixed assets and derivatives, which has been introduced for companies.

Various other provisions, above all anti-avoidance provisions, straddle the boundaries between these tax law categories. The aggregation of different tax codes creates complexity in itself. What causes even more difficulty is that the rules in these tax codes do not always fit comfortably together.[102]

The rules also leave gaps. For example, there is no general relief "for tax nothings" (capital expenses written off as incurred). There is no general relief for depreciation, even though, for a businessman, depreciation is as real a cost as salaries or heating bills. These gaps have not originated from sound policy planning. They are historical anomalies arising from the piecemeal development of tax law.

The result is a quagmire of legislation. An individual's business tax profits are worked out under the Income Tax (Trading and Other Income) Act 2005 (approximately 886 sections and 4 schedules, 465 pages), the Capital Allowances Act 2001 (approximately 581 sections and 4 schedules, 341 pages), and the Taxation of Chargeable Gains Act 1992 (approximately 291 sections and 12 schedules, 482 pages), together with many more regulations made under these Acts.

Under the current system too many tax rules result in far too many boundaries and

102. For example the timing of a sale may be different under the capital allowances code (section 28 TCGA 1992 cf section 572(4) CAA 2001). Numerous other examples could be given

"all or nothing" tax outcomes. For example, an asset is either plant and machinery or it is not plant and machinery for tax purposes. There are many borderline cases, where either generous tax relief may be available if the asset falls inside the boundary and qualifies as plant and machinery, or no tax relief is available if it falls outside the boundary. If the asset is plant and machinery one still needs to check whether special rules for short-life or for long-life assets apply. Is the asset not a long-life asset because special exemptions apply, or is the asset a fixture? Whenever there is doubt over whether an asset falls inside or outside one of these definitions there is substantial tax uncertainty. These legal difficulties and "all or nothing" outcomes would not occur if tax relief were given for commercial depreciation, regardless of whether the asset is plant and machinery and regardless of all the other rules.

The plethora of tax rules tends to obscure underlying principles which are required for the sensible interpretation of legislation – whether by HMRC, the taxpayer or the courts. It becomes difficult to see the wood for the trees. All these rules also tend to sever the relationship of tax with the real world as seen by economists or businessmen. Examples of unnecessary tax rules are:

- Rules based on distinctions between income derived from different sources under the schedular system, and for calculating capital profits separately from income profits. These rules also lead to further very complex rules governing the utilisation of losses from one source against profits from another source;
- Rules which create distinctions between hire purchase contracts and finance leases, advance rentals and premiums paid for leases, and arbitrary delineations between assets in the Capital Allowances Act;
- Tax rules for wasting assets, Government grants, options, appropriations to and from trading stock, gains on insurance contracts, disposal of the right to annual payments, sales of debts by individuals, tangible movable property, and passenger vehicles and many, many more; as well as
- Rules based on inadequate or out-dated tax definitions.[103]

There are currently substantial differences between business tax law for individuals and for companies, which further complicates the picture. For example, some accounts-based rules only apply to companies.[104] Business capital gains for individuals benefit from the 18 per cent rate, but companies pay the full rate of tax on capital gains, after deducting the indexation allowance. Business tax law is being drafted separately for individuals and for companies under the tax law rewrite project.

It seems sensible that a similar tax approach should be applied to business activities of companies and individuals. Naturally there would have to be some differences:

- For instance, UK dividends received by companies should be tax free to prevent several charges to tax arising as dividends are paid by one company to another.
- Special rules are also needed for transactions within a group of companies.

But subject to such exceptions a similar tax code should apply to all businesses, whether conducted by individuals or companies.

A more accounts-based tax approach has been supported by business. In the Tax Reform Commission survey 63 per cent of respondents either agreed or strongly agreed that a system which used accounting based profit to calculate corporation tax using a tax rate so as to leave the total

103. For example the concept of "disposal" and "part-disposal" for tax purposes depends, at root, on the distinction between whether the taxpayer still owns the asset or has ceased to own it. In modern commercial transactions there is, however, a wide spectrum of possibilities for dealing with an asset, from pure financing secured on the asset, to limited recourse financing, to a range of finance lease or HP contracts, sales with specified repurchase terms, sales retaining specified risks, effective sales achieved through derivative contracts etc. The accounting concept of "realisation", based as it is on whether significant risks and benefits in the asset have been transferred, seems more adequate for these purposes than the tax concept of "disposal"

104. Such as rules for loan relationships, derivatives and intangible fixed property

tax burden unchanged would be "beneficial to my business". Only 9 per cent disagreed or strongly disagreed.[105] The recent report by the CBI tax task force has also strongly endorsed a more accounts-based approach.[106]

The UK has become a systemically less attractive tax environment for business due to growing complexity and instability

A range of specific tax issues influence business decisions. The UK would be more attractive to business with simpler and better rules for

- The taxation of overseas profits;
- Transfer pricing;
- Controlled foreign companies (CFC) legislation;[107] and
- Start-up costs.

On these types of issues, the UK tax system is becoming less attractive to business than many international regimes. Recent legislative changes have exacerbated this trend. As one director of group tax at a FTSE 100 firm put it

> *"Other EU countries have become more attractive from a tax point of view, while the UK has become less attractive."* [108]

Tax law for business is becoming increasingly complicated. The HMRC Measurement Project found that there are 6,614 data requirements relating to business taxation.[109] The Tax Reform Commission's survey found that 78 per cent of business executives believe that the level of complexity in the tax system had increased over the preceding five years.[110]

Tax stability suffers just as surely as tax simplicity does. A stable and predictable tax system allows business to invest and budget with confidence. This has become increasingly hard over the last decade. For example, the 10 per cent additional impost on oil companies (announced with hardly any consultation or warning to the companies affected) was a good example. It has been followed by unexpected and substantive changes to the capital allowances regime, the rules for non-domiciled individuals and, potentially, the taxation of foreign profits. An example of a change which was soon reversed is the creation and subsequent removal within 48 months of the zero per cent starting rate for corporation tax.

From 2005-06 to 2007-08, the Government managed to increase its corporation tax receipts by nearly £5 billion (without increasing headline rates) as a result of significant changes to HMRC's interpretation of tax law.[111] A different approach has sometimes been applied retrospectively. Examples include a range of changes affecting the insurance and private equity industries.

Anti-avoidance legislation is being introduced to raise as much tax as possible without increasing headline rates, rather than to counter artificial tax avoidance schemes. Furthemore, the Government has often announced what it deems to be anti-avoidance legislation without consultation or adequate discussion in Parliament.[112]

The UK is now a less attractive place for highly skilled non-domiciled citizens to base themselves

There is clearly some justification for charging some tax on non-domiciled people who may live in the UK for long periods and who, in the past, have paid little or no tax on their offshore income and gains. However, by their very complexity the new rules have caused unwarranted problems for these people. They may well end up discouraging further new immigrants from coming to the UK, many having highly rated skills to offer. The new rules also impact directly on employers, who have to

105. Tax Reform Commission, *Tax Matters: Reforming the Tax System, The Report of the Tax Reform Commission*, Tax Reform Commission, pp 85, 2006

106. CBI, *UK Business Tax: A Compelling Case for Change,* CBI, pp 39, 2008

107. The UK's controlled foreign companies legislation is designed to bring into the UK tax net profits which are held offshore

108. Director of Group Tax at a FTSE 100 firm cited in Tax Reform Commission, *Tax Matters: Reforming the Tax System, The Report of the Tax Reform Commission*, Tax Reform Commission, 2006

109. KPMG, *Administrative Burdens – HMRC Measurement Project,* KPMG, Table 1, March 2006. This figure includes the data requirements for VAT

110. Question 9 of the Tax Reform Commission joint survey, see Tax Reform Commission, *Tax Matters: Reforming the Tax System, The Report of the Tax Reform Commission*, Tax Reform Commission, pp 165, 2006

111. HMRC Data Table T1.2

112. Naturally it may sometimes be appropriate to do this to prevent the burgeoning use of a new tax avoidance scheme. But, for example, in 2006 the Government changed the taxation of certain life assurance products with no advance notice. Likewise in 2005 transfer pricing rules were applied to private equity structures without warning at a time when detailed discussions were taking place between the British Venture Capital Association and the Government on the taxation of private equity. Another example is from 2000 when changes were made to the taxation of general insurance, that again were not pre-announced

operate the PAYE system. Individuals do not need to decide until January 2010 whether to give up their personal allowances in order to keep the remittance basis of taxation for the current tax year. What PAYE code should apply in the meantime?[113]

> Serious damage has already been done by further loosening many UK companies' commitment to the UK.

Recent volatility has gravely undermined the UK as an attractive place to headquarter an international company

One of the most important issues for UK holding companies is how to tax dividends from foreign subsidiaries. What anti-avoidance rules are appropriate to prevent profits being artificially diverted from the UK to lower taxed jurisdictions overseas?

UK companies have long complained about the complexity of our controlled foreign company and other tax legislation which applies.[114] They have drawn attention to such tax regimes as the Netherlands, which confer a complete exemption for most dividends from overseas subsidiaries. In June last year HM Treasury published a consultative paper. The paper did suggest exempting foreign dividends for large companies. However there were four important problems:

- There were no clear principles being applied;
- The exemption was not to be available for smaller companies; and
- The sheer variety of proposed tax treatments was not likely to have produced simplification;[115]
- Worst of all, the paper contemplated new avoidance legislation to catch "passive income" accruing to overseas subsidiaries. This could have caught ordinary commercial activity, or prevented ordinary commercial development of overseas businesses.

In the business survey carried out for the Tax Reform Commission in 2005, 19 per cent of respondents said that the complexity of the UK tax system had already forced them to consider transferring operations outside the UK. In 2008, high profile decisions to relocate outside the UK have been taken by Shire Pharmaceuticals, the UK's third biggest pharmaceutical company; United Business Media, a publisher; Regus, an office services firm; Charter, an engineering business; Henderson, an asset management firm; and WPP, one of the world's biggest communications firms.[116] Many others, such as Google, have simply never moved here but set up their European headquarters elsewhere.

Matters have got even worse recently following the Treasury discussion paper, which seriously unnerved a number of businessmen. The Treasury has now convened a new high level working group to consider these issues, and assurances have been given that proposals will not be effected that are not broadly acceptable to business. Unfortunately, serious damage has already been done by further loosening many UK companies' commitment to the UK.

There is scope to remove corporate tax reliefs, to widen the tax base and reduce corporate tax rates

Reliefs and exemptions are an obstacle to reducing tax rates, create complexity and may not be effective or efficient. To cite a few opinions:

> *"We believe that our members regard the delivery of incentives through the tax system as largely ineffective. The combined*

113. Mike Templeman, a member of the CBI tax committee has said "There may not be a solution....this is a potentially serious worry for employers in the City". Eaglesham J, "Warning over New Non-Dom Rules," *Financial Times,* 20 May 2008

114. The rules for calculating underlying tax credits for dividends routed through offshore "mixer companies" in the Finance Act 2000 are notorious examples of other such complex tax law. Many others could be cited

115. The question of whether capital export neutrality or capital import neutrality should apply was especially confused

116. Houlder V and Brown JB, "Darling under pressure to ease jitters over tax," *Financial Times*, August 30 2008; Houlder V, "Tax factor beats patriotism in WPP relocation," *Financial Times, October 6 2008*

survey results suggest that the complexity of the tax system makes such incentives virtually incomprehensible to small businesses, and that this contributes to making such businesses reliant on help from their accounting and tax advisors." [117]

"It was pointed out that, for many businesses, other features of the tax system were probably more important [than R & D tax credits], particularly the headline corporation tax rate on income flows resulting from R&D." [118]

"Tax credits for research and development … are restrictive and the expense of claiming them largely outweighs the tax credit received." [119]

"Research and development tax credits have not worked as they were meant to." [120]

A recent PricewaterhouseCoopers report confirmed these sentiments. It found that only 11 per cent of businesses took advantage of Government tax relief schemes such as capital allowances on energy saving technologies and R&D tax credits. Only 7 per cent of the smallest companies (those with a turnover of £2 million or less) took advantage of these reliefs.[121]

In addition, film tax credits have failed to achieve their purpose of increasing British film production.[122] The Treasury has also conceded that they have led to widespread tax avoidance.

The scope of tax incentives should be reviewed. The withdrawal of just two reliefs, for R&D Tax Credits and film credits would simplify the tax code and enable about £1.2 billion to be returned to taxpayers through lower headline tax rates.

117. Institute of Chartered Accountants of Scotland, *First Contact Survey*, Institute of Chartered Accountants of Scotland, 2005

118. Abramovsky L, Griffith R and Harrison R, *Background Facts and Comments on 'Supporting growth in innovation: Enhancing the R&D Tax Credit'*, Institute for Fiscal Studies, pp 18, 2005

119. Submission provided to Tax Reform Commission by a representative body

120. Leader, *Financial Times,* 28 July 2006

121. PricewaterhouseCoopers, *Enterprise in the UK: Impact of the UK Tax Regime for Private Companies,* PricewaterhouseCoopers, 2006

122. See, for example, UK Film Council, "Statistical Yearbook: Annual Reviews, and Research and Statistics Bulletin," vol 3 no 2, UK Film Council, March 2006, for evidence of this

Part 3

A false awakening and how to really change things

Calls for simplification

Over the past decade many professional bodies, such as the Chartered Institute of Taxation (CIOT); Institute for Chartered Accountants in England and Wales (ICAEW); Confederation of British Industry (CBI); Institute of Directors (IOD); British Chambers of Commerce (BCC); and the Investment Management Association (IMA), to name but a few, have become both united and ever louder in their calls for tax simplification and stability. This was also a key concern for the Shadow Chancellor of the Exchequer, George Osborne, when he established the Tax Reform Commission in 2005. It was instructed under its terms of reference to advise on policy options which would improve the economic efficiency, transparency, simplicity and fairness of the tax system.

The government response

The Government's first significant response to these increasing calls for reform came in 2007. In the Pre-Budget Report of that year the Chancellor identified tax simplification as a priority.[123] Three simplification reviews were announced as part of the programme to achieve this:

- The first review focused on anti-avoidance legislation, with a particular emphasis on the rules for taxing returns in the same way as interest if they were economically equivalent to interest and taxing sales of income streams as income. Draft legislation was introduced to achieve this. However, it was so heavily criticised that it did not appear in the 2008 Finance Bill. It is now subject to further review.
- The second review focused on certain VAT rules. It has resulted in minor changes to the option to tax land and some limited administrative changes.
- The third review focused on the simplification of corporation tax rules for related companies. This has resulted in a minor simplification of the associated companies rules relating to the small companies rate of taxation.

Other areas identified for further work, such as transactions in securities and premiums for leases are also very limited in their scope.[124]

The Government has announced a number of other detailed issues on which they have already achieved simplification, or where they plan to do so, in the 2007 Pre-Budget Report and in the 2008 Budget.[125] As a separate exercise this year's Finance Act has also repealed some outdated anti-avoidance provisions which are no longer used.

Perhaps the most important intended simplification was the change to Capital Gains Tax. As discussed above, however, the simplification may prove to be more apparent than real.

The Government is also addressing the simplification of administrative matters,

123. See, in particular, HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, HMSO, paragraph 4.51, 2007

124. Utilisation of capital losses, value shifting, certain employee shareholding rules, aligning rules for "unallowable purpose" etc. are also included

125. HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, HMSO, Box 4.6, 2007; HM Treasury, *Budget 2008*, HMSO, Box 3.5, 2008

although these do not directly impact on the underlying complexity of tax law. Examples are given below:

- HMRC published a paper "*Making a Difference: Delivering the Review of Links with Large Business*" in March 2007. The targets set out in that paper have been reviewed in the 2008 budget.
- A further paper "*Delivering a New Relationship with Business: Progress on HMRC's Plans to Improve the SME Customer Experience*" was published during the 2008 Budget.
- The Government is also conducting an on-line survey to try and find ways of simplifying tax calculations and returns for small companies.
- Simpler requirements for returning employee share benefits have been introduced.

> "The underlying problems of tax complexity are not being resolved"

A critique of the government response

These very detailed proposals are welcome. Sadly, however, they will have limited overall impact on most taxpayers most of the time. The underlying problems of tax complexity are not being resolved. The simplification reviews have been deliberately limited in their scope. For example, the review of anti-avoidance legislation has not addressed whether the underlying tax law that has given rise to the need for complex anti-avoidance law is appropriate or sensible. Furthermore, and most importantly, the reviews have lacked any sense of strategy or direction.

The ICAEW, in their 2008 budget submission to the Government, welcomed the Government's explicit commitment to tax simplification. But they said that they were "concerned that the Government had "dived into the detail" without first articulating an agreed tax simplification strategy. At the present time there appear to be a number of different initiatives but there is no clarity as to the overarching strategy and principles that we believe should underpin a major work of simplification."[126] Similarly the CIOT indicated that a more wholesale review would be required in order to achieve substantial simplification than merely identifying some isolated points to work on.[127] The CBI tax task force reached the same conclusion in its recent tax task force report.[128]

The Government is looking to find pieces of tax law which it can simplify without attempting to identify and address more fundamental issues. This means that underlying principles are not being addressed. The efforts are well intentioned. However, they are not commensurate with the scale of the problem. They will have no major impact on the current volume of tax law. As a result of other provisions in this year's Finance Act, with its 166 sections, 46 schedules, its new rules for non-domiciled individuals, its raft of new capital allowance rules, a further collection of anti-avoidance law and much else besides tax law is *en route* to becoming more complicated than ever.

Possible next steps

A bold approach

Radical steps were first taken over twenty years ago to eliminate the worst excesses of high tax rates. Top rates of income tax were reduced from 98 per cent to 40 per cent. The full rate of corporation tax is now 28 per cent instead of 52 per cent. Comparably fundamental reform is now required to simplify and stabilise the British tax system. This might sound impractical or even risky. In fact, we believe that as long as approached carefully and with meaningful consultation and review, it is not only

126. The Institute of Chartered Accountants in England and Wales, *2008 Budget Submission*, The Institute for Chartered Accountants in England and Wales, pp 5, 2008

127. See their letter dated 19 December 2007 to the Treasury on the use of accounts for computing business profit

128. CBI, *UK Business Tax: A Compelling Case for Change*, CBI, pp 39, 2008

achievable but will win the profound support of British business and anyone seriously concerned about the British economy. This is more than ever the case in the current "credit crunch" environment. Once the strategy and direction of reforms had been determined, reforms should be made incrementally and carefully. This would minimise the risk of confusing taxpayers or of imperilling public finances.

Potential specific measures
The Government needs to lead a debate. What are the basic principles that should be applied to tax areas targeted for reform, and what strategy is appropriate for actually implementing those principles? This should lead to substantial, probably radical, simplification in most areas. There needs to be a willingness to take radical steps when the right principles have been determined, even though it may be appropriate to achieve that in incremental stages.

In particular, we recommend the following changes:

- *Accounting and tax profits*: to improve our tax law, we should adopt the principle that the taxable profits of a business should, except in limited situations, equal its accounting profits.
- *Employed and self-employed taxation*: policy-makers should look at the differences in tax treatment and abolish any unjustified distinctions.
- *Capital and income*: the distinction between the two is not justified in many instances. Where it is, the Government needs to make sure that it is sufficiently clear.
- *Reviewing reliefs*: policy-makers should cut unnecessary reliefs and develop a way to make sure that new ones are not adopted when not needed.

To further push the simplification debate, the Government must also urgently look at the following areas:

- VAT: Would it be worthwhile to simplify distinctions made on supplies of goods or services for VAT purposes?
- *National Insurance and Income Tax*: the rules for calculating NICs and Income Tax should, at the very least, be amalgamated. It may be that NICs should be abolished altogether.
- *Business and non-business profits*: would it be sensible to distinguish between business and non-business profits for tax purposes (as commonly occurs overseas) rather than delineate between profits derived from the different tax schedules that exist under the current system?
- *Taxation of various kinds of investments*: can the plethora of rules governing different investment vehicles be rationalised as a means to encourage savings?
- *Stamp duty, stamp duty land tax and stamp duty reserve tax*: could these separate rules be aligned and combined?
- *Integrating tax credits into the tax system*: can the two systems be merged or otherwise combined, so as to achieve greater transparency and simplicity? HM Treasury and HMRC should consider ways that they could be.
- *The imputation system of taxing dividends (or what is left of the system after the abolition of repayable tax credits on dividends)*: HM Treasury and HMRC should look at ways this system could be improved so as to reduce distortion and complexity.

Making tax law
As we showed above, the debate about tax complexity and volatility has suffered from a lack of comparative measures and data points as well as from a difficulty in understanding the multiple implications of specific tax proposals. A government committed to tax reform would:

- Make a public commitment to not making up tax policy "on the hoof"

and commit to minimum periods of consultation wherever possible.

- Invest time in really understanding and publicly testing the impact of specific proposals on both the tax system and the economy ("Tax Impact Assessments"?).
- Commit to corresponding reductions in tax complexity for any new social or environmental uses of the tax code

Simplifying tax in the context of reducing tax

It is in the nature of tax reform that winners and losers will be created. It is a commonplace that the losers are more vociferous than the winners in expressing their concerns. Reform may therefore require considerable political courage and conviction. The rewards, however, of simplifying tax and removing some privileges currently enjoyed by special interest groups would be very great. Most individuals would benefit. So would the economy at large.

Nevertheless it is clearly easier from a practical political point of view if the changes are implemented in the context of reducing tax rates generally. "Base broadening" (the use of money saved by the Treasury for eliminating exemptions and reliefs to reduce headline tax rates) clearly helps in this respect. There also remains the possibility of rebalancing the system by reducing direct tax and increasing indirect tax such as VAT at the same time. This approach would conform with that recommended by many academic studies in order to maximise economic efficiency from the time of the Meade Committee in 1978. It is likely that the Mirrlees review, also established under the auspices of the Institute for Fiscal Studies, which is due to report later this year, will shed further light on fundamental issues affecting the direction for tax policy.

Tax simplification office

A working party chaired by Lord Howe of Aberavon has very recently published its report entitled "Making Taxes Simpler" which recommends that an Office of Tax Simplification ("OTS") should be established, reporting to a new Joint Parliamentary Select Committee, and overseen by a Steering Committee appointed by the Chancellor of the Exchequer. The report also recommended that changes to tax law having a technical content should be proposed no later than the Pre-Budget Report before the Finance Bill in which they are to be included, to allow sufficient time for consultation and scrutiny.

The OTS is an exciting proposal. We hope very much that it can be established. It will of course need to be managed carefully. Furthermore, once proposals are in the public domain, it may be appropriate to give assurances or confirmations to the public up front as to the timing or extent of any possible changes. The OTS should, however, be a powerful instrument for effecting the reforms in tax law that the UK so badly needs.

Appendix 1: The relationship between tax, and GDP growth[129]

Study	Coverage	GDP impact
Cashin (1995)	23 OECD countries over the 1971-1988 period	1 percentage point increase in the tax-to-GDP ratio lowers output per worker by 2 per cent
Engen and Skinner (1996)	US modelling together with a sample of OECD countries	2.5 percentage point increase in tax-to-GDP ratio reduces annual GDP growth by between 0.2 and 0.3 per cent
OECD – Liebfritz, Thornton and Bibbee (1997)	OECD countries over the 1965-1995 period	10 percentage point increase in tax to GDP ratio reduces annual GDP growth by between 0.5 and 1 per cent
Liebfritz et al (1997) additional model simulations	European Commission Quest 2 – model simulations	1 percentage point of GDP rise in labour taxes reduces UK GDP by 2.4 per cent versus baseline level
Bleaney, Gemmell and Kneller (2000)	17 OECD countries over the 1970-1994 period	1 percentage point of GDP increase in distortionary tax revenue reduces annual GDP growth by 0.4 per cent
Folster and Henrekson (2000)	Sample of rich OECD/non-OECD countries over the 1970-1995 period	10 percentage point increase in tax-to-GDP ratio reduces annual GDP growth by 1 per cent
Bassanini and Scarpetta (2001)	21 OECD countries over the 1971-1998 period	1 percentage point increase in tax-to-GDP ratio reduces per capita output levels by between 0.3 and 0.6 per cent
Gemmell and Kneller (2001)	12 OECD countries over three- year periods from 1987-89 to 1995-97	1 percentage point of GDP increase in distortionary taxation reduces average annual GDP growth by 0.4 of a percentage point
PricewaterhouseCoopers (2003)	18 OECD countries over the 1970-1999 period	1 percentage point of GDP increase in distortionary taxation reduces annual GDP growth by between 0.2 and 0.4 per cent
OECD (2003)	OECD countries over the 1980-2000 period	1 percentage point increase in tax-to-GDP ratio reduces output per capita by 0.3 per cent, or 0.6-0.7 per cent if the effect on investment is taken into account

129. Tax Reform Commission, Tax Matters: Reforming the Tax System, The Report of the Tax Reform Commission, Tax Reform Commission, pp 15, 2006

This report argues that the Government must make the UK tax system fundamentally simpler. To be economically competitive, Britain needs to reduce the burden of tax complexity on businesses and individuals. At the moment, it is getting out of control. At 8,300 pages, the UK has the second-highest amount of primary tax legislation among the world's top economies.

To prevent the problem of complexity in the tax system getting worse, the way that tax legislation is made needs to be changed. During Budget time, the Chancellor is always under pressure to "do something", and faces a plethora of suggestions from the Treasury, HMRC, professional bodies and the media about what should be done.

However, to start reversing the problem of tax complexity now, the Government must accept the principle that the taxable profits of a business (whether operated by an individual or a company) should normally equal its accounting profits; abolish unjustified differences between employed and self-employed taxation; reconsider the distinction between capital and income; and cut unnecessary reliefs.

By making these changes and adopting a principled approach, the Government might also start to remove unwarranted exemptions in the tax system. At the moment, there are many reliefs that incentivise environmentally friendly behaviour, and a few reliefs that discourage it. Furthermore, many measures that are meant to help certain groups are largely unknown. Overall, these problems make the tax system more regressive than it need be. Empirical evidence, collected for the first time in this report, shows that people and firms who cannot afford to hire tax advice suffer most from complexity.

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