Would a ‘flat tax’ simplify the UK’s corporation tax legislation and reduce the associated compliance costs?

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A Thesis submitted to The University of Birmingham for the degree of:

Master of Science

Birmingham Business School

College of Social Sciences

University of Birmingham

January 2010

Abstract

Most parties with an interest in UK tax law appear to be able to agree on one thing: it is complex. Surveys show that the UK tax code is now the longest in the world, having recently overtaken India to claim that dubious title. It is equally the case that the amount, as well as the complexity of the legislation, increases every year, leading to increasing compliance costs for business.

One of the more stimulating tax debates of recent years in the UK has been over the merits of a flat tax. While to date the debate has focussed more on issues such as a potential economic stimulus on the introduction of such a tax, an important claim of flat tax supporters is that its introduction would simplify the current UK tax legislation.

There would therefore appear to be a clear and worthwhile link to explore between the complexity of the UK tax legislation and whether a flat tax might reduce it. However, little work has been performed to date on investigating such a link, either at a theoretical level or by considering data from countries that have introduced tax systems described as flat taxes. This might seem surprising considering the current substantial costs to business in complying with the UK tax legislation. The exploration of this link is the key focus behind this thesis.

This thesis only considers the case of corporation tax from among all the UK taxes due to time and length constraints. Many other countries have similar taxes known as ‘corporate income tax (CIT)’, which is levied mainly on companies, as opposed to ‘personal income tax (PIT)’, levied mainly on individuals. Where this thesis refers to ‘income tax’ this should be taken to refer to the latter, in line with current UK practice.

The thesis starts with a brief introduction to UK corporation tax and the theoretical background to a generic corporation tax. It then considers the nature of the current UK tax legislation and its apparent complexity, before looking at the corporation tax compliance costs incurred by UK business.

The fundamental issue of complexity of a tax system is a topic of sufficient magnitude to merit its own chapter, followed by a detailed examination of the concept of ‘flat tax’, considering both the theoretical Hall-Rabushka (HR) model and the real-life Eastern European flat taxes introduced. Potential simplifications for the UK of a flat tax are then considered, followed by evidence as to why a flat tax would not be the simplifying force that might be hoped.

The final two chapters consider real-life evidence and data, factors conspicuously absent in the UK flat tax debate to date. Evidence from those countries, mainly from Eastern Europe, that have introduced flat tax systems is considered, followed by a case study covering the proposed recent changes to the UK’s capital gains tax and the lessons it provides for any simplifying tax reform.

Introduction

A. Purpose of the research

The inspiration for this research came from the recent popularity of the concept of ‘flat tax’ in debates about the UK tax system and its potential reform. Claims of flat tax’s simplifying properties made by its supporters seemed to make a positive contribution into the ongoing debate about the apparent complexity of the UK tax system involving government, the tax profession and taxpayers. Given the recent emergence of the topic, significant gaps in the academic literature of flat tax simplification exist, the filling of which this work hoped to be able to contribute.

B. Importance

Most parties with an interest in UK tax law and the wider tax system appear to be able to agree on one thing: they are complex. Surveys show that the UK tax code is now the longest in the world, having recently overtaken India to claim that dubious title. It is equally the case that the amount, as well as the complexity of the legislation, increases every year, leading to increasing compliance costs for taxpayers.

One of the more stimulating tax debates of recent years in the UK has been over the merits of a flat tax. While to date the debate has focussed more on issues such as a potential economic stimulus on the introduction of such a tax, an important claim of flat tax supporters is that its introduction would simplify the current UK tax legislation.

There would therefore appear to be a clear and worthwhile link to explore between the complexity of the UK tax legislation and whether a flat tax might reduce it. However, little work has been performed to date on investigating such a link, either at a theoretical level or by considering data from countries that have introduced tax systems described as flat taxes. This might seem surprising considering the current substantial costs to taxpayers in complying with the UK tax legislation. The exploration of this link is the key focus behind this thesis.

This thesis only considers the case of corporation tax from among all the UK taxes due to time and length constraints, as well as this particular tax being the author’s area of practical expertise. Many other countries have similar taxes known as ‘corporate income tax (CIT)’, which is levied mainly on companies, as opposed to ‘personal income tax (PIT)’, levied mainly on individuals. Where this thesis refers to ‘income tax’ this should be taken to refer to the latter, in line with current UK practice.

C. Methodology

In keeping with the requirements of the research degree for which the thesis is submitted, the research is based on a review of all the available literature. This includes papers from academic journals, as well as a wide range of other sources such as the professional tax press and reports commissioned by think-tanks and a number of other bodies. Some criticism and analysis of the literature from the author's own practical experience has also been included where appropriate.

D. Structure of the thesis

The thesis starts with a brief introduction to UK corporation tax and the theoretical background to a generic corporation tax. It then considers the nature of the current UK tax legislation and its apparent complexity, before looking at the corporation tax compliance costs incurred by UK business.

The fundamental issue of complexity of a tax system is a topic of sufficient magnitude to merit its own chapter, followed by a detailed examination of the concept of 'flat tax', considering both the theoretical Hall-Rabushka (HR) model and the real-life Eastern European flat taxes introduced. Potential simplifications for the UK of a flat tax are then considered, followed by evidence as to why a flat tax would not be the simplifying force that might be hoped.

The final two chapters consider real-life evidence and data, factors conspicuously absent in the UK flat tax debate to date. Evidence from those countries, mainly from Eastern Europe, that have introduced flat tax systems is considered, followed by a case study covering the proposed recent changes to the UK's capital gains tax and the lessons it provides for any simplifying tax reform.

E. Contribution of the research

The most immediate result of the research was the presentation of a paper based on its findings at the 2009 IRS Annual Research Conference in Washington DC (subsequently published as Jelfs & Lymer, 2009). The paper was thus entirely based on the work of the author of this thesis.

The research has subsequently been presented in the UK professional press in *Tax Adviser* magazine, thus achieving recognition on both sides of the Atlantic.

As noted above, in the longer term, the research helps to fill a gap in the academic literature on the analysis of the link between flat tax and tax simplification. Flat tax appears to come to prominence on a fairly cyclical basis, and it is to be hoped that this research will be cited during its next appearance.

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1. UK Corporation Tax

1.1 Introduction

This chapter gives a very brief overview of UK corporation tax and the two different systems used since its inception. It then considers corporation tax on a more fundamental and largely theoretical level, looking at the need for such a tax, its incidence, the special case of small companies and inherent complexities.

1.2 Brief history of UK corporation tax

Until the First World War, companies in the UK were taxed under the provisions of the income tax in the same way as individuals. They were taxed separately from 1915 to 1924 and then again from 1937 onwards (James & Nobes, 1999).

UK companies are separate legal entities from their owners. During the nineteenth century, successive governments passed laws which gave companies a range of powers. These included perpetual succession as independent legal entities, the ability to sue and be sued in their own name and removal of the liability of owners for the debts of the company beyond their capital contributions i.e. shareholders have ‘limited liability’.

As an illustration of this separation between companies and shareholders, in the twentieth century companies and individuals started to be taxed differently. The driving force behind the changes was the need to finance rearmament spending for the two World Wars. A new profits tax was introduced in 1937 under the name of ‘national defence contribution’ in addition to the existing income tax levied on companies’ income.

In 1965 the Labour government introduced the corporation tax which replaced both income tax and profits tax previously paid by companies. The new tax was chargeable on a company’s chargeable profits i.e. its taxable income and capital gains. Among other objectives, the change gave government more flexibility to target either companies or unincorporated businesses with tax reforms.

Since its inception, corporation tax in the UK has been subject to many reforms. It has also been analysed on a more fundamental level, most notably in the Meade Report (1978), and more recently in the Mirrlees Review (2009), whose remit is ‘to identify the characteristics of a good tax system for any open developed economy in the 21st century, to assess the extent to which the UK tax system conforms to these ideals, and to recommend how it might realistically be reformed in that direction’.

1.3 Scope and administration of UK corporation tax

Corporation tax is controlled, as other UK taxes, by statute, case law and prevailing practices of HM Revenue & Customs (HMRC). Annual Finance Acts, which introduce tax changes, are the codification of Budgets and Pre-Budget Reports. HMRC may also issue guidelines or changes of interpretation at any time during the year. The due legal process of tax reform is considered in more depth in a later chapter.

The tax is chargeable on bodies corporate (UK resident companies and permanent establishments of non-UK resident companies that are trading in the UK) and unincorporated associations such as trade associations and members' clubs. It is not generally chargeable on partnerships, individuals, unincorporated businesses, most charities or local authorities.

Corporation tax is assessed under different schedules and cases depending on the nature of the income and is chargeable on a current year basis for a 'chargeable accounting period', usually the company's accounting period. The rate of tax to be used for each fiscal year (1 April to 31 March for companies) is laid down in statute.

1.4 Systems of corporation tax used in the UK

A number of different systems of corporation tax exist to deal with the difficult issue of the taxation of a company's profits. Companies that make profits either retain them or distribute them as dividends to their shareholders. If profits are only taxed on distribution, they could be retained in the company and tax could be postponed indefinitely. Where they are only taxed in the company, all shareholders would suffer the same rate of tax which does not fit well with the philosophy of a progressive income tax system, such as that in the UK. If they are taxed both in the company when earned and on the shareholder when distributed, economic double taxation occurs which may be both inefficient and inequitable. Economic theory suggests that a good system of corporation tax should be as efficient as possible i.e. revenue should be raised with minimum distortions to economic behaviour.

As a result of this dilemma, different countries have created different systems of corporation tax ranging from the classical to full relief, where the company is merely a conduit for corporate equity income taxed at the marginal income tax rate of the shareholder for distributed profits. There are also intermediate systems with some relief for shareholders of corporation tax on distributed profits, usually via a partial imputation system.

In the UK both classical and partial imputation systems have been used, and are further described below.

1.4.1 Classical system

Under the classical system of corporation tax, a company is treated as an entity in its own right and is taxed completely separately from individuals: both distributed and undistributed profits are taxed in the same way. Profits distributed as dividends are subject to corporation tax in the company and then income tax in the hands of the shareholder at his individual income tax rate.

James & Nobes (1999) note that this double taxation may be considered inequitable when compared to drawings from an unincorporated business which do not suffer corporation tax.

A number of other arguments against the classical system exist. Opponents of double taxation consider that it is inefficient as it influences companies not to pay dividends due to the heavy tax bill. Supporters of the classical system claim it encourages companies to invest since retained profits are taxed less heavily than distributed profits, while opponents point out that companies may not reinvest their profits wisely, and it is likely to be in their own business, whereas shareholders may reinvest their dividends in other companies with higher returns. However, it is unproven that companies with a good earnings record remain the most profitable (Whittington, 1971). In addition, companies may not actually retain more profits under this system as they may feel obliged to pay dividends anyway to meet shareholders' income requirements. Finally, low payouts may reduce capital in the market to invest in new, growing companies which are likely to be efficient and innovative. Opponents conclude that the classical system may encourage investment but it is not necessarily good quality investment.

However, James & Nobes (1999) comment that even if there were no corporation tax on distributed income, there would still be a bias against distribution if there were an income tax paid only when dividends were distributed. Partington and Chenhall (1983) have also argued for this reason that the burden of double taxation is not as serious as it may seem. The tax position for companies and shareholders is complicated by many factors including capital gains taxes or lack of them on increase in share values arising from retained profits, from different tax treatment of foreign investment by different countries and different tax bases in different countries.

Opponents of reform of a classical system have also in the past pointed out that any double taxation effect is likely to have been capitalised in a lowering of share prices and that giving dividend relief would be an unjustified bonus to existing shareholders e.g. Meade (1978).

1.4.2 Imputation system

Due to the perceived unfavourable characteristics of the classical system, the UK moved from a classical to an imputation system in 1973. An imputation system mitigates double taxation by imputing to shareholders who receive dividends some or all of the tax paid by the company and allowing a tax credit to reduce or remove their tax liability.

The UK's current imputation system is a partial imputation system where only part of the corporation tax paid by the company is imputed to the shareholders. This can remove double taxation and the bias against distribution where the tax credit cancels the personal liability, which is currently the case for basic rate taxpayers. A full imputation system would also act to remove double taxation.

1.5 Need for a corporation tax

On a more fundamental level, there is ongoing debate as to whether a corporation tax is necessary in a tax system. On first principles, a real life corporation tax system can have a number of goals; some of these were identified as follows in the US General Accounting Office (GAO) report of 1998:

- Raising revenue for government spending
- Redistributing income
- Stabilising the economy
- Achieving other social and economic objectives through the use of preferences

The greater the number of goals, the more complicated the tax system.

However, on a theoretical level the need for a corporation tax in a tax system is not an obvious one. Under an income based tax system, corporation tax may be seen as simply the integration of corporate source income with personal income tax, or alternatively as an additional 'absolute' tax. Proposals to integrate corporation tax and income tax were considered but rejected both in the USA during the 1986 tax reforms and by the 1978 Meade Report in the UK.

As noted above, Meade (1978) highlighted the argument that since corporation tax exists, it should not be removed since this would be a windfall benefit to shareholders who are already used to the tax. On a fundamental level, it is clear that companies need to be taxed in some form or there would be inequality with unincorporated businesses.

There are two main opposing views on the need for a corporation tax which were designated by Musgrave and Musgrave (1989) as integrationist and absolutist.

1.5.1. Integrationist view

The guiding principle behind this view is that all taxes must be borne ultimately by individuals and hence equitable taxation can only apply to individuals. Income should therefore be taxed as a whole regardless of its source. Holders of this view are critical of the double taxation arising under the classical system of corporation tax and consider that the extra tax is unjustified as all income (including corporate profits) should be taxed at the same rate. In their view, corporation tax should ideally be replaced by withholding at source income tax on corporate income.

1.5.1.1 Integration of corporation tax and income tax

Despite previous rejections of integration as mentioned above, the debate for doing so continues. Adjustments to the current UK tax structure would be required to integrate the two taxes. To achieve full integration, the tax treatment for retained earnings and dividends would need to be integrated either via the partnership method or by full taxation of capital gains.

1.5.1.2 Partnership method

This integration method imputes the company's total profits to its shareholders who are then taxed under the income tax. When profits are retained, the company informs the shareholders of the amount to be added to their equity which would then be taxed as income on the individual and added to the base cost of their shares, reducing the ultimate capital gains tax on sale. Under such a scheme it would be administratively useful for the company to withhold tax from shareholders' share of profit. Shareholders are thus treated for tax purposes as partners.

At first glance, treating profits of companies like partnerships would appear equitable and efficient avoiding distortions in organisational form.

However, this proposal does create objections of practicality and principle. From a practical point of view, this treatment would be relatively simple for distributed profits but there are difficulties for undistributed profits. Where personal income is subject to more than one rate, there is the difficulty in deciding which rate should apply to undistributed profits. No solution is satisfactory; attributing profit to shareholders and taxing at their individual income tax rates would be administratively very difficult, while taxing undistributed profit at a flat rate would only be an approximation which may be beneficial to richer shareholders. Any attempt at forcing companies to distribute all profits would also remove the commercial stability of reserves and would be likely to be strongly resisted by companies themselves.

Objections of principle exist in the argument that undistributed profits have less value than distributed profits to shareholders since they cannot immediately access them and should hence be taxed at a lower rate. On the other hand, it can be argued that company profits should be taxed at a higher rate than other personal income due to the privilege of limited liability. This issue also raises the question of whether such a rate should depend on the level of the company's profits.

Further problems with the partnership method arise where shareholders will be taxed on income not yet physically received in the case of their 'unrealised' gain, which could lead to cash flow difficulties for individuals and may be inequitable. However, much or all of the tax should be paid by withholding, reducing the potential cash flow difficulty, or the classic economic solution of selling some shares (which may be very difficult for an unlisted company). In addition, there would be significant administrative and compliance difficulties for frequent traders in shares in determining an accurate allocation of profits.

1.5.1.3 Capital gains method

The alternative method of full integration would be through taxation of all (including unrealised) capital gains and removal of corporation tax. Distributed profit would be taxed as dividend income for the shareholder and retained profit would be taxed as a capital gain. Again, this would be likely to be prohibitively complex to administer.

1.5.1.4 Partial integration

Full integration has been discussed as a model for the UK but never considered a practical solution, in substantial part due to the likely administrative difficulties noted above. At times in the USA, prevailing practice has provided a degree of partial integration by granting a dividend credit at the shareholder level, and as already discussed, in the current UK system.

1.5.2 Absolutist view

Holders of this view e.g. Murphy (2005) believe that the integrationist view of a company is unrealistic. In their opinion, a company is not a mere conduit for personal income but is a separate legal entity with an existence of its own, a powerful lobbying factor in economic and social decision-making and operated by a professional management subject to little control by the individual shareholder. As a separate entity it therefore has separate taxable capacity which is properly subject to an absolute tax. The concept of different tax treatment for retention or distribution of profits after tax therefore becomes irrelevant. The expression of the absolutist view is the classical system of corporation tax, as discussed above and seen in the UK in the past.

In general, the absolutist view is not favoured by economists. Musgrave and Musgrave (1989) comment ‘this absolute or classical view of the tax is hardly tenable’ and that ‘there is no valid argument for an absolute corporation tax on individual ability to pay grounds’. They acknowledge that large companies cannot act according to the wishes of all shareholders. However, they consider that this does not equate to companies being able to pay for themselves and being subject to a separate tax as all taxes fall ultimately on individuals. Corporate profits are hence part of the income of shareholders and should be treated as such.

The absolutist view also assumes that the corporation tax is not borne solely by shareholders and is passed on to customers, employees or other groups. The continuing argument over the incidence of corporation tax, discussed in further detail below, shows that this view is disputed. According to Musgrave and Musgrave (1989), there is therefore effectively no extra corporation tax: it is simply a type of sales or payroll tax without a place in an equitable tax system.

1.6 Other reasons for a corporation tax

Some of the traditional arguments for keeping a corporate level tax on profits are outlined below, many of which were highlighted by Musgrave and Musgrave (1989):

1.6.1 Benefit principle

The benefit principle is an extra argument in favour of separate taxation which is that a company should pay a price for its legal privileges.

This argument starts from the premise that government acts to benefit businesses – albeit not solely companies – so there may be some justification in calling for a separate business operations tax. The corporation tax therefore acts as a charge for public goods provided by government to the company. Certain government costs are incurred solely for the benefit of companies, although these are likely to be very minor. The privilege of limited liability is of great value to shareholders but can be argued to be of little cost to society.

An important issue regarding a benefit tax is the level at which it would be imposed; this is important since public benefits tend to occur at the lower and more local form of government. A second issue concerns the nature of the appropriate tax base as it is unlikely to be income profits; for example, fire services may best be measured by property value. Total costs in the locality may be an appropriate base although this is likely to be hard to measure.

A benefit tax is therefore likely to be different in form and raise less revenue than the current UK corporation tax.

Arguments against the benefit principle include the fact that the company has to comply with extra compliance and disclosure costs and any benefit cannot easily be measured. This and other arguments have been adjudged to be weak by Prest and Barr (1985). Kay and King (1990) consider that limited liability is a voluntary agreement between company and shareholder and can be adjusted to change the terms of acceptance or contribution of capital. They note that companies are owned by individuals so there is no separate taxable capacity in a company. Corporation tax will thus affect owners, employees and customers of a company.

In general, there is no clear link between a company's tax on profits and the value of the goods it enjoys. Defining the value of the goods is also difficult as benefit of infrastructure and public investments would be hard to allocate.

1.6.2 Influence over companies' behaviour

Another possible justification for a corporation tax is as a form of control over the company's behaviour.

- To restrict a company that has a monopoly – tax has not often been used for this purpose and might need to be based on the degree of monopoly rather than profits, which would be hard to measure

- To restrict the size of a company – in this case a progressive tax structure might be used although unlike income tax this would not be based on the company's ability to pay since the wealth of shareholders will vary. Progression would discriminate against larger firms and might need to be based on assets or turnover rather than profits. Such a system was recommended by the US government in the 1930s but rejected. To some extent this system is seen currently in the existence of the small companies' rate in the UK
- In times of crisis such as wartime, excess profits tax has been used when direct controls over prices and wages are needed. This was seen in practice in the UK and USA but was hard to administer due to difficulties in defining 'excess profits' – neither a standard rate of return nor a base period for profits proving entirely satisfactory. The windfall tax on utility companies in the UK was a recent example of a selective excess profits tax in operation.
- To stimulate growth, governments may seek to encourage profit retention over payment of dividends. This may be accomplished by exempting retained profits for tax while taxing dividends – as seen in the Estonian 2000 tax reforms. The reverse treatment may of course be undertaken – such a tax was seen in the US during the 1930s intending to stimulate consumer spending

In theory a corporation tax on economic profit can be designed to be efficient by leaving economic behaviour unaffected. This would be on profit above a chosen limit to justify an investment. However, such a tax could still influence economic decisions such as making a decision to set up in a lower tax state.

In conclusion, tax may be useful in influencing corporate behaviour but may need a form different from the current corporation tax.

1.6.3 Administrative reasons

As already noted, it would be administratively difficult to tax all capital income accruing to an individual including their share of retained profit in a company. The corporation tax therefore acts as a reasonable substitute for income tax even though rates may be different and may even be set in different countries.

1.6.4 Political considerations

A popular conception exists, parodying the absolutist view above, that companies should pay their 'fair share' of taxes. Economic theory suggests this is an invalid argument since individuals ultimately bear any tax, but it nonetheless remains an important factor for policy makers.

1.7 Incidence of corporation tax

There is no agreement on the incidence of corporate taxation, which is still open to debate as to whether owners, employees or customers truly bear the cost of the tax. Market imperfections for products, capital and labour all seem to play a role and econometric studies are also inconclusive (Musgrave and Musgrave, 1989). A recent study of 55,082 companies in nine European countries between 1996 and 2003 by Arulampalam, Devereux and Maffini (2007) concluded that ‘a substantial part of the corporate income tax is passed on to the labour force in the form of lower wages’.

Most economists believe that the corporation tax burden falls on capital invested in companies. However, business managers tend to see the tax as an absolute cost to the business and may be driven to seek to reduce it by various means including avoidance or passing it on to a third party. The first view is theoretically correct in markets which act to maximise profits. However, companies may seek to pass the costs on to customers or employees if the ideal market is not present.

In practice, theoretical analysis remains inconclusive and empirical evidence needs to be considered. Several attempts have been made to collect useful data, but the question remains as to what to look for. If corporation tax rates differed between industries, price changes as a result of a tax rate change could be examined and compared between sectors. This cannot be done since a similar effective rate of tax applies to all companies. Comparison of rates of return between companies and unincorporated businesses is not possible since there is not enough accurate data for the latter category. A final possibility is to look at companies’ reactions to a rate change in terms of rate of return on equity and profit margin. However, data is still not entirely useful as major changes in rates are rare. Results are generally confusing with a number of non-tax factors necessary to consider.

Econometric approaches have attempted to isolate the effect of the corporation tax but again results are controversial. Tax effects have not been able to be separated from other changes and the effective rather than the nominal headline rate of tax is critical.

Another sophisticated incidence argument is that corporation tax is passed to individuals but its effective incidence is borne by the owners of capital, so it is fair that companies should pay tax. This may be a useful justification for taxing non-resident shareholders. Huizinga and Nicodeme (2000) found that European governments would have reduced effective average corporation tax rates by about a quarter if companies had been fully owned by domestic citizens, explaining why rates have not fallen more rapidly in recent years with the sharp increase in capital mobility.

1.8 Inherent complexity of corporation tax

The immediate conclusion from the range of views above over fundamental issues regarding corporation tax is that it is an inherently complex tax. Musgrave and Musgrave (1989) consider that, given the legal complexities of corporations and their interrelationships, it is evident that a fair corporation tax cannot be a simple tax.

On the subject of corporation tax, Sandford (1989) et al comment that ‘above all, perhaps the situation is confused because economists have failed to provide clear guidelines and answers for the politicians on the various questions raised’. Head (1997) notes ‘company taxation has long been among the most controversial and inconclusive areas in the public finance literature’.

These conclusions will be investigated as this thesis develops, examining further the complexity of the UK’s corporation tax legislation and the compliance costs incurred by businesses in complying with its requirements.

2. UK tax legislation and its complexity

2.1 Introduction

Corporation tax merely covers one part of the UK's entire tax legislation. This chapter introduces the legislation and its process of creation. The focus of this thesis recognises that the UK's tax legislation contains complexity: this is discussed further looking in depth at the main causes and effects of legislative complexity, the difficulty on measuring it and a brief introduction to potential simplification strategies.

Although the chapter considers the UK tax legislation in its entirety, all of its points apply to corporation tax, unless specifically stated.

2.2 Introduction to the legislation

The UK's tax legislation primarily consists of a number of Parliamentary Acts and delegated legislation in the form of Statutory Instruments. Finance Acts are passed at least once a year, introducing new legislation and updating or repealing old law. Other Acts are passed as the need arises. Statutory Instruments are introduced throughout the year to enable continual updating of the tax legislation.

Laws relevant to all taxes are often grouped together in book format for use by tax professionals, one of the classic reference works being Tolley's Tax 'Yellow and Orange' handbooks. Aside from the primary and secondary legislation, the handbooks also contain a large amount of material produced by HMRC to provide their interpretation of the law. In addition, there are judgements from tax cases which are usually not included in the handbooks but with which a tax practitioner would be expected to be familiar. Some of these decisions will ultimately be incorporated into the legislation.

Lord Wedderburn (1965) in his book 'The Worker and the Law' commented concerning UK law 'most people want nothing more from the law than that it should leave them alone'. However, this is hardly possible with tax law, which is one of the few branches of law to touch the lives of almost everyone.

2.3 The making of tax legislation

The making of tax law follows an established procedure and usually starts from an initiative from one of the Government's executive branches such as HMRC or HM Treasury. There is no statutory requirement for consultation before a Bill is drawn up, although informal discussions with interested parties often occur.

Parliament has no formal role in generating or consulting on proposals until the publication of the Finance Bill, when it is considered by Members of Parliament (MPs) on the Finance Bill

Committee. Given the technical nature of the Bill, MPs often rely on interpretation provided by external bodies. The Committee only sits for about six weeks due to the time constraints in passing the legislation through Parliament. Backbench MPs are often encouraged not to delay the process and the House of Lords has no scrutiny role of the Finance Bills.

2.4 Complexity of the UK's tax legislation

2.4.1 Introduction

The consensus among commentators appears to be that the UK's tax legislation is complicated. Martin (2005b) is typical when he states that the UK tax legislation is 'lengthy and intricate but is usually drafted in a dense style that makes it inaccessible to the layman'. In a similar vein, Vann (1995) describes lengthy Australian tax legislation as 'tax rule madness'.

2.4.2 History of tax complexity

The complaint that the UK's tax legislation is too complex is not a new one. In 1853 MPs urged William Gladstone, then Chancellor of the Exchequer, to see that income tax legislation was made intelligible even to those without a legal education. He replied:

'To bring the construction of these laws within the reach of [everyone is] no doubt extremely desirable, but far from being easy…the nature of property…and its very complicated forms [render] it almost impossible to deal with it for the purpose of the income tax in a very simple manner.'

By 1981, the Presiding Special Commissioner referred to Gladstone when he said 'the plea today is that it would be some advance if laws of this kind were intelligible to those who *have* received a legal education'.

Very similar comments have also been made in the USA. The 1927 Report of the Joint Committee on Internal Revenue Taxation stated 'it must be recognised that while a degree of simplification is possible, a simple income tax for businesses is not'.

Both quotations recognise that tax itself is an inherently complex subject, so it should come as little surprise that tax legislation is also complex.

2.4.3 Reasons for complexity

There are a number of fundamental reasons why the UK's tax legislation is complex. Complexity can arise simply from increasing length as the more pages in the tax legislation, the less likely it is that an individual can be familiar and feel comfortable with all of its provisions. On first principles, tax law increases in length due to new tax law enactments each year exceeding the amount of material repealed, and the data quoted below shows that the UK's tax legislation increases in length each year. Martin (2005a) notes that this is in part due to Government introducing political policy measures with little pressure or incentive to reform ineffective legislation or to try to simplify the legislation. In his opinion, these have been introduced piecemeal over a long period with little regard to principles which could have created a simple, coherent system.

Complexity can also arise from the language used in the legislation which may be difficult to understand or stylistically poorly drafted. The Tax Law Rewrite project, discussed in detail below, set out to simplify the language of the legislation, but its effectiveness is being called into question.

Martin (2005b) also notes the unique nature of tax law compared to other law in that its primary purpose is not to help taxpayers; as a result, criticism that it can harm business through its complexity can be deflected.

2.4.4 Other relevant factors

A number of other factors have been identified as leading to complexity in tax legislation; some of these were identified by Martin (2005a) from a UK perspective and Gale (2001) from the USA.

2.4.4.1 Conflict between policy goals

Gale (2001) states that most people agree that taxes should be simple, fair, conducive to economic prosperity and enforceable, but cannot agree on the relative importance of each goal. When governments implement policy, it will therefore represent a balance between the goals and legislative complexity is a consequence of trying to achieve this.

It is generally thought that more equitable or fairer taxes usually conflict with tax simplification, although the relationship may be more subtle – Milliron (2001) and Carnes and Cuccia (1996). Tax burdens are often tailored via legislation to the circumstances of individuals, improving equity but increasing overall complexity of the tax system by increasing the length and complexity of the legislation. In addition, tax rates that vary with individual characteristics create opportunities for tax planning and avoidance, which may in turn require the passing of anti-avoidance legislation.

2.4.4.2 Fiscal incentives

Successive UK governments have shown a desire to promote or discourage certain types of behaviour among taxpayers by providing tax or fiscal incentives. However, these targeted subsidies often increase complexity by creating more distinctions between taxpayers and sources or uses of income.

Academic literature has widely analysed this area and generally concluded that acting in a particular way for tax reasons impairs economic efficiency, distorting the market and giving rise to costs known as the ‘excess burden of taxation’ which arises from actions that would not otherwise have been performed (James and Nobes, 1999).

In general, taxes with a wide base are less distorting and more efficient than those with a narrow base. In some situations the market is inefficient, an example being a polluter maximising profits while imposing remediation costs on the community. Governments often use tax as a policy instrument to discourage such behaviour, or to encourage actions thought to benefit the community such as enhanced tax relief for research and development expenditure.

Martin (2005b) considers incentives based on this premise to be likely to produce unsatisfactory results, along with situations where the basis for providing incentives is unclear in itself, giving examples of incentives introduced in the UK and subsequently withdrawn such as profit-related pay and the business expansion scheme, both victims of unwanted tax avoidance schemes. Expanding on his observations, it is evident that in order to prevent such abuse, special reliefs become so full of conditions or require such extensive redrafting that they greatly add to complexity of tax legislation.

2.4.4.3 Prevention of tax avoidance

Tax avoidance is the arrangement of one’s affairs to pay the minimum amount of tax, as spelt out by Lord Tomlin in the case of *Duke of Westminster v CIR* ‘Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be … however unappreciative the Commissioners of Inland Revenue or his fellow tax payers may be of his ingenuity, he cannot be compelled to pay an increased tax’. It is within the letter, if not always the spirit, of the law, unlike tax evasion.

As the UK’s tax legislation has grown more complex, tax advisers have increasingly exploited loopholes to create complex avoidance schemes. Loopholes are often created by the specific statutory language and HMRC are highly likely to challenge any such scheme in the courts; where the taxpayer is successful, government will act to reduce revenue loss in areas where significant avoidance occurs by enacting new legislation. Taxpayers and their advisers will then seek new opportunities for avoidance. This creates a cycle of increased complexity in both tax laws and avoidance strategies.

Some commentators hold the view that tax advisers are responsible for the generation of such legislation by the avoidance schemes they devise and promote to business. Others consider the role of legislators who have added successive layers of anti-avoidance legislation by ‘tinkering’ with the system to be more significant. One example which highlights such behaviour was identified by PwC and the World Bank (2006) of a single transaction of borrowing in the UK which may require up to six sections of anti-avoidance legislation or case law to be considered before treatment for tax purposes may be ascertained, namely:

- s209 ICTA 1988 – whether interest is dependent on the results of the business and hence a distribution
- p13 Sch9A FA1996 – loans for unallowable purposes
- Sch28AA ICTA 1988 – thin capitalisation and transfer pricing
- s24-31 & Sch3 FA(no.2) 2005 – anti-arbitrage provisions
- s349 ICTA 1988 and SI 1970/488 – treaty clearance from UK 20% withholding tax

- relevant case law e.g. *WT Ramsay, Furniss v Dawson*

Possibly the most common form of avoidance is the manipulation of tax affairs to take advantage of other provisions of tax law. The more tax law in existence, the more such opportunities exist, and new tax law presents new opportunities to move profits to a lower rate of tax. This may involve artificial steps, or even lead to tax evasion. Anti-avoidance legislation is required to prevent such schemes from succeeding, but is usually particularly complex and obscure as a result of the complex nature of its target.

In the past, legislation to block such schemes was passed on an individual scheme basis. More recently, HMRC has tried to move towards 'principle-based' anti-avoidance legislation such as the recent 'disguised interest' legislation drafted in 2008. It is designed to repeal piecemeal legislation by identifying the avoidance principle at stake, removing length and complexity from the legislation. However, such legislation is proving very difficult to draft satisfactorily, throwing into question whether the predicted simplifying benefits will ever materialise.

As an indication of the importance of anti-avoidance legislation in adding to the complexity of the UK tax legislation, a piece of research carried out on behalf of the Tax Justice Network (2007) looked at the purpose of all 1503 pages of the Finance Acts from 2004 to 2006. While the purpose of legislation is often open to debate, the report nonetheless shows the importance of anti-avoidance provisions in adding length to the legislation. It found that 48 pages dealt with routine issues such as tax rates, 841 were government-driven initiatives and 614 (41%) were anti-avoidance measures.

2.4.4.4 Tax Law Rewrite project

The Tax Law Rewrite project is a UK-specific project initiated in 1996 to rewrite tax law in plain, modern English but without changing the underlying law. However, the implication that the project is meant to reduce the overall complexity of the tax legislation is probably misplaced. Simplification was not a remit of the project as the rewritten Acts had to be fast-tracked through Parliament.

PwC and the World Bank (2006) claim that the project is responsible for a 50% increase in length of the rewritten provisions and note that, at the date of the report, less than half of UK tax law had been rewritten. Other criticisms of the usefulness of the project have included the fact that the general public are unlikely to want to read tax law regardless of the language's clarity, and that many tax professionals were content with the old terminology which had been defined by the courts.

In 1995, Avery Jones (subsequent chairman of the IFS Tax Law Review Committee) commented concerning the new Tax Law Rewrite project 'My real objection to rewriting is that I do not find much of a connection between the causes [of complexity] and the proposed solution. The solution seems to me to be an implied acceptance that nothing can be done to remove the real causes of complexity which are deeply rooted in our whole legal culture'.

This observation was largely borne out in that, as Gammie (2007) states, '...expressing concepts in plain English does nothing to simplify the concepts themselves…complexity of language has been replaced by the complexity of legislative volume as more words (albeit simpler ones) have been required to retain precision'. The worth of the project remains a subject for keen debate.

2.5 Effects of tax complexity and responses

2.5.1 Increase in length of the UK legislation

Tax legislation in both the UK and the USA continues to increase in length and hence complexity. By 2008, Tolley's Yellow Tax Handbook, containing the UK primary and secondary direct tax legislation, could only be fitted on to 10,134 pages by using a smaller format text than the previous year, up from 5,952 pages as recently as 2001.

Truman's (2008) case study into the effect of Finance Act 2008 on the length of the UK tax legislation revealed the following:

- Abolition of taper relief removed between 8,000 and 9,000 words but these remain in Tolley's Yellow Tax Handbook to enable taxpayers to calculate their liability in future years, giving the illusion of failure to simplify
- The introduction of entrepreneurs' relief to appease the outcry from taxpayers and advisers over the abolition of taper relief will add back about half of the words removed above
- The changes in residence and domicile laws will add about 5,000 words to the legislation
- Income-shifting provisions of 700 words provide a good example of the worst kind of 'legislation by guidance' – the legislation is vague and wide-reaching and required over 9,000 words of interpretative guidance
- The major causes of extra legislation often concerns a very small number of taxpayers such as anti-avoidance legislation for insurance companies

Truman (2008) describes the efforts to reduce legislative complexity as 'a rout' and repeats his suggestion from the 2007 Hardman Lecture that government needs to set a target of legislative reduction within a certain number of years for any realistic hope of simplification occurring. He acknowledges that his suggestions of a 25% reduction in length within 5 years currently show little sign of being achieved.

2.5.2 Taxpayer desire for simplification

PwC and the World Bank (2006) highlight the unfavourable consequences of large volumes of legislation making it impossible for tax advisers in industry or practice to read or understand all relevant legislation and having to rely on more specialists, including those at HMRC. Their report notes that, as a result, large to medium companies may have to make a decision whether obtaining tax advice is of benefit using a cost/benefit analysis.

The report concludes that increasing complexity probably leads to lower international competitiveness, and voluminous legislation reaches a point where the level of compliance drops through ignorance rather than evasion. As a result, business leaders and their representatives often make public their concerns over the complexity of tax legislation and the negative effect this has on running their business, chiefly the time and cost of compliance, both of which increase with increasing complexity e.g. National Audit Office (NAO, 2007a).

One such study was the Tenon Forum Think Tank's 2005 report which interviewed directors of small and medium sized businesses in the UK. 77% claimed the UK tax system was too complicated and 73% wanted a flat rate tax scheme. The Think Tank was divided on whether this was a plea for simplification as some members felt that lack of understanding of a flat tax meant it was incorrectly being positioned as a solution to complexity. They also raised the issue that a simple tax system could easily become complicated very quickly and this size of company often benefit from targeted exemptions, a classic source of legislative complexity. However, the conclusion of the study was apparently clear in that UK businesses want simplification of the tax system and legislation, although, a result shared with other studies.

2.5.3 Government's inability to reduce complexity

While successive UK governments have often expressed their desire to reduce complexity of the tax legislation, the trend is inexorably towards greater length and complexity.

Gale (2001) points out that the simplest tax system would be a consumption tax at a flat rate with universal deductions, exemptions and credits and withheld at source. However, the UK system bears no resemblance to this model as a progressive income tax with targeted exemptions and withholding for a small number of income types.

Simplification of the UK tax system remains a prominent topic and leading figures still pronounce on the subject. The incoming 2008 President of the Chartered Institute of Taxation (CIOT) highlighted it as one of the themes of his presidential year, and the government reaffirmed its 'commitment to tax simplification' at various times including the 2007 Pre-Budget Report. The new Chancellor of the Exchequer, in his first speech in July 2007, stated 'we must continue to simplify the tax system wherever we can'. Continuation of a process, however, implies that it has already started, and there is little evidence of simplification occurring before or after his speech.

Indeed, government pronouncements on the issue have a long history. Even after the first Income Tax Act of 1799, the 152 pages of the Act were proving sufficiently complex for the government to publish a guide entitled 'A Plain Short and Easy Description of the Different Clauses of the Income Tax so as to render it Familiar to the Meanest Capacity'.

2.6 Difficulties in comparing and measuring complexity

Apart from the difficulty of defining the concept of the UK's legislative complexity, it is not a simple matter to attempt to measure it given the lack of obvious comparisons.

A study performed by PwC and the World Bank (Paying Taxes – The Global Picture 2006) compared the GDP of a number of countries with their tax administration burden, as measured by the number of pages of primary federal tax legislation, which provides a measure of legislative complexity. The results are shown below:

Country	GDP ranking	GDP $m	Number of pages (ranking)
USA	1	11,711,834	5,100(5)
Japan	2	4,622,771	7,200(4)
Germany	3	2,740,551	1,700(10)
UK	4	2,124,385	8,300(2)
France	5	2,046,646	1,300(13)
China & Hong Kong	6	1,931,710	2,000(9)
Italy	7	1,677,834	3,500(7)
Spain	8	1,039,927	530(17)
Canada	9	977,968	2,440(8)
India	10	691,163	9,000(1)
Korea	11	679,674	4,760(6)
Mexico	12	676,497	1,600(12)
Australia	13	637,327	7,750(3)
Brazil	14	603,973	500(18)
Russia	15	581,447	700(=15)
Netherlands	16	578,979	1,640(11)
Switzerland	17	357,542	300(20)
Belgium	18	352,312	830(14)
Sweden	19	346,412	700(=15)
Turkey	20	302,786	350(19)

Comparison of GDP with number of pages of primary federal tax legislation (PwC/World Bank 2006, p16)

The report acknowledges that certain countries levy taxes at state and local levels; in these cases the number of pages data above is likely to be severely understated.

The authors make two key conclusions: the volume of a country's primary federal tax legislation is not directly proportional to its economic size and the volume of legislation is increasing. It is generally accepted that the UK's tax legislation is now the longest in the world, having overtaken India since the report was published, so on a first viewing it might seem that the UK has a disproportionately complex and lengthy tax legislation. It is also interesting that the top three places in terms of size of legislation are all Commonwealth countries, from which it might again be concluded that the UK legislative system, on which other Commonwealth systems are based, is inherently complex.

However, in a later study the authors claimed that this work was only intended to stimulate debate and not to represent an accurate comparison of complexity. Factors such as print size were not taken into account, which, taken with the possible understatement mentioned above, casts considerable doubt on the usefulness of the above data as a comparison study. It is somewhat surprising that the results of this study were not linked to those of another by the same authors comparing compliance times for a range of countries to see if any connection with the length of legislation existed. This is performed in a later chapter.

2.7 Tax law simplification strategies

Strategies other than ‘flat tax’ are regularly put forward to attempt to reverse the growth of the tax legislation’s complexity. However, only simplifying the language of tax law will not address the underlying complexity, as noted above with the Tax Law Rewrite project, which arise from different demands made of the tax system and the constraints under which it operates.

The 1994 Tax Law Review Committee’s final report listed three types of complexity – linguistic, policy and compliance – which would all need addressing by comprehensive reform. It also stated ‘without policy changes the benefits from rewriting tax legislation are limited’. Similar sentiments were expressed by the Tax Law Improvement Project in Australia.

Martin (2005a) considers that three quarters or more of tax law could be removed with a commitment to simplification. The principles behind this strategy would include:

- Refocusing on the primary objective of direct tax to identify and tax profit, using accounting profit as the starting point for calculating taxable profit. Any departures from accounting profits should only made with reference to clear principles; all profits would be taxed in the same way and the schedular system abolished
- The approach should be purposive with detailed rules replaced with statements of underlying principles, and backed up by wider use of rulings from HMRC both before and after the transaction
- Reviewing to ensure all parts fit coherently, including combining and aligning tax rules currently used in different situations

Martin (2005a) considers that simplification is possible given political will, although he acknowledges that not everyone is so optimistic, pointing to failed simplification programmes in Australia and New Zealand. Efforts to this end should be appreciated as long as the sense of direction was clear, although both taxpayer and government could lose out under individual simplification proposals. He notes that a number of sections of tax law would have to remain such as group relief, to prevent companies having to distort their group structures to offset any loss as it arises, and rollover relief to prevent a disincentive to replace business assets.

In addition, simpler taxes would be unlikely to remove the desire of taxpayers to undertake tax avoidance. They would probably require simpler anti-avoidance laws, but these would still be required in areas such as diverting profits overseas to lower tax jurisdictions and disguising interest as a tax free dividend from a UK company.

Martin (2005b) notes that his proposals for simplification can be achieved without altering tax rates. He states ‘the question of whether simplifying tax and reducing tax rates are connected, or whether they are independent objectives, needs to be properly analysed’, noting that simplification has its limits and review of existing law is more likely to establish them rather than discarding all current law and starting again.

2.8 Conclusion

The concept of ‘complexity’ is not easy to define, measure or compare. Although there exist many opinions about the complexity of the UK’s tax legislation, almost all to the effect that it is excessively complex, actual evidence is in much shorter supply.

A number of factors can be identified which contribute to the complexity of the UK tax legislation. It is also clear that it is continually increasing in length (and hence presumably complexity), and appears to be longer than that of most other countries. Beyond this, however, great care must be taken before concluding on the issue of whether it is excessively complex.

3. The UK’s corporation tax compliance costs

3.1 Introduction

While there are large number of costs involved in complying with the UK tax system, they are generally grouped into two categories: compliance (incurred by taxpayers) and administration (incurred by tax authorities).

The costs necessary to comply with the requirements of the UK tax system were studied in some depth over a number of years by Sandford and co-workers at the Centre for Fiscal Studies, University of Bath. To reflect the central question behind this thesis, this chapter focuses solely on compliance costs incurred by taxpayers, considering their fundamental nature and measurement, paying particular attention to those relating to corporation tax. The definition and measurement of such costs are considered, including a brief analysis of a recent Organisation for Economic Co-operation and Development (OECD) report on the subject.

3.2 Definition of compliance costs

Compliance costs were described by Sandford et al (1989) as ‘costs incurred by taxpayers or third parties, notably businesses, in meeting the requirements laid on them by a given tax structure (excluding the payment of the tax itself) and any distortion costs arising from it’. Such costs are also known as ‘private sector costs’.

An alternative definition from the OECD Forum on Tax Administration: Taxpayer Services Sub-Group (2008) is ‘total costs incurred in complying with tax regulations’. There is some contention in academic circles as to what actual ‘costs’ are comprised in this definition such as whether it should include discretionary planning costs and as to what allowance should be made for the ‘time value of money’ in respect of, for example, employees’ taxes withheld at source and therefore available to business for their use before having to be remitted to revenue bodies.

3.3 Background to compliance costs

Sandford et al (1989) identified a number of costs which the imposition of a tax generates for the private sector:

- Sacrifice of purchasing power that tax payment entails
- Welfare costs arising from distortions the tax generates (often called the ‘excess burden’ of taxation)
- Costs incurred meeting the legal requirements of the tax system, for example completing returns and keeping the necessary accounts

The boundary between compliance costs and distortion costs is often not clearly defined. Distortion costs are both a function of the existence of a tax and the manner in which it is imposed e.g. on raw material or finished product, which may lead to taxpayers changing their economic behaviour to minimise the tax paid.

While the third type of cost in the above list is that traditionally associated with the term ‘compliance cost’, it can be seen that the scope of costs incurred by business is much wider.

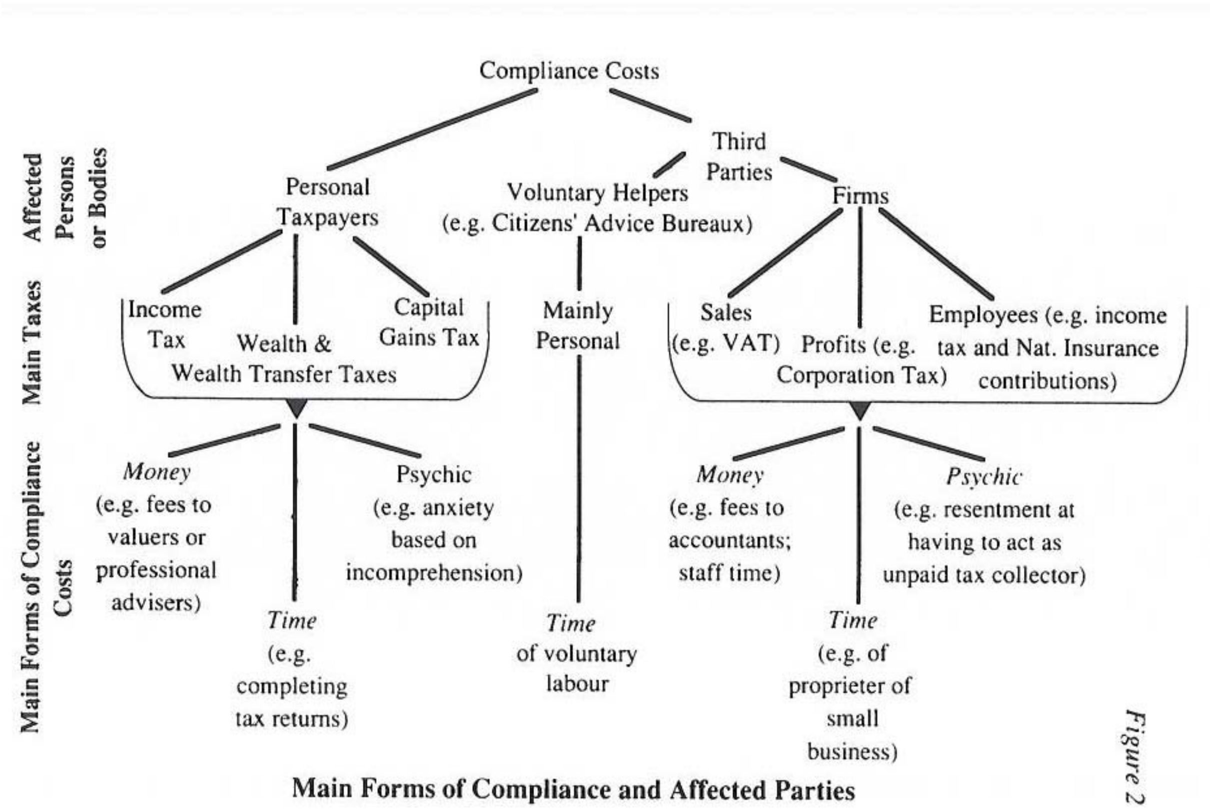
3.4 Nature of compliance costs

Sandford et al (1989) note that the term ‘compliance costs’ itself is somewhat ambiguous as it could refer to costs of the authorities securing compliance or costs incurred by the taxpayer. The practice of the literature is to confine the term to the latter, with the former designated as ‘enforcement costs’.

Compliance costs for a company have a wide scope. They include the costs of collecting, remitting and accounting for tax on its profits and wages and salaries of employees, as well as the costs of gaining the knowledge to meet legal requirements and avoid penalties. Costs of maintaining records for the time specified by HMRC should also be considered. Other costs include those of keeping up to date with changing legislation and seeking opinions on transactions where the tax treatment is not obvious. Finally, costs of representative bodies incurred in activities such as lobbying for tax change and undertaking legal defence against HMRC challenges should be included.

Other examples of compliance costs include psychic costs and social costs and benefits. Psychic costs are difficult, if not impossible to quantify, but are an important part of compliance costs. For a company, an example of a psychic cost might be frustration, anxiety or stress amongst staff in dealing with an insensitive HMRC enquiry. The operation of a tax may generate social costs or benefits; for example, data required to comply with one tax may make it simpler for the authorities to check possible evasion of another.

A summary of compliance costs for taxpayers by Sandford et al (1989) is shown in the diagram below:



(Sandford et al, 1989, p11)

In a similar vein, Gale (2001) notes from an American perspective that compliance costs include those incurred during the following activities:

- Time spent preparing and filing tax returns
- Learning about the law
- Maintaining record-keeping for tax purposes
- Time and money spent in avoiding or evading taxes
- Responding to tax audits
- Costs imposed on third parties e.g. employers

Gale (2001) also notes the following administrative costs, incurred by government but considered by him to be ultimately borne by individuals and include:

- Budget of the tax collection agency
- Tax-related budgets of other agencies that help to administer tax programs e.g. social security

3.5 Other aspects of compliance costs

3.5.1 Costs of tax planning

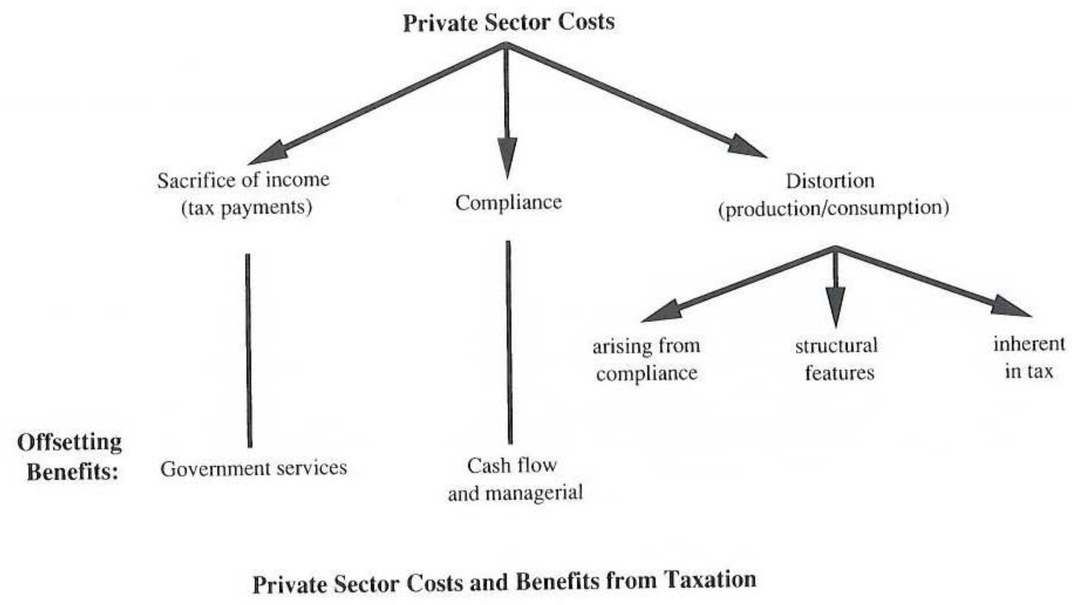
Sandford et al (1989) note that compliance cost literature following Johnston (1961) distinguishes between unavoidable (mandatory) and avoidable (voluntary or discretionary) costs. Unavoidable costs are incurred meeting legal requirements while avoidable costs relate to tax reduction by planning. Tax planning costs are considered by some not to be a true compliance cost as they are voluntary (OECD, 2008), but this is countered by the argument that they would not exist without the existence of the tax.

Further distinctions can be drawn such as that between artificial planning and planning involving genuine transactions. The claiming of relief foreseen by the legislation may not fit the definition of an avoidable cost. However, further distinctions of this nature between costs may be of little practical value.

3.5.2 Offsets to compliance costs

Sandford et al (1989) point out that certain benefits in complying with tax systems may arise such as maintaining proper records giving the business access to better quality financial information. The measurement of net compliance costs takes into account these offsetting benefits.

An analysis of private sector costs and associated benefits by Sandford et al (1989), summarising some of the above, is shown below:



(Sandford et al, 1989, p15)

3.6 OECD administrative costs report

The OECD Forum on Tax Administration: Taxpayer Services Sub-Group (2008) prepared a paper on programs to reduce administrative burdens of tax regulations in countries including the UK.

The Standard Cost Model, which is the model used in the report to quantify the administrative burden of tax regulations, states ‘Proper compliance with the laws, including tax laws, requires businesses to undertake a range of administrative activities, generally using their own internal resources but increasingly with the assistance of external parties (e.g. in a tax context, these include tax advisors and payroll agencies). The categories of administrative activities that typically arise with any legislation, including tax laws, have been defined for the purposes of modelling thus:

1. Familiarisation with the information obligation – the resource consumption of businesses in connection with familiarising themselves with the rules for a given information obligation
2. Information retrieval – retrieving the relevant figures and information needed to comply with a given information obligation
3. Assessment – assessing which figures and information are necessary for the authorities to accept a report
4. Calculation – performing the relevant calculations needed for the public authorities to accept the report
5. Presentation of figures – presenting the calculated figures in tables or the like
6. Checking – checking the calculated figures e.g. by reconciliation with other data

7. Correction – if the business's own checks reveal errors in the calculations, corrections are made afterwards
8. Description – preparation of description e.g. the directors' report
9. Settlement/payment – payments of tax, charges or the like
10. Internal meetings – meetings held internally between the various personnel groups involved in complying with the information obligation
11. External meetings – meetings held in cases where compliance with the information obligation requires meetings with an auditor, lawyer or the like
12. Inspection by public authorities – businesses must assist external inspectors when they carry out their inspection at the business
13. Correction resulting from inspection by public authorities – if the external inspection identifies faults/defects, corrections are made afterwards
14. Training, updating on statutory requirements – relevant employees must be kept up to date with rules that change frequently (at least once a year)
15. Copying, distribution, filing etc – in some cases the report is copied, distributed and/or filed in order to comply with the information obligation. It may also be necessary to store the information obligation with a view to subsequent production in connection with an inspection
16. Reporting/submitting information – in cases where compliance with an information obligation requires the submission of information on the business, the information must be sent to the relevant authority

The OECD's points may be seen to break down further the compliance costs identified by Sandford (1989) and Gale (2001) above.

According to the OECD (2008), the administrative burden on a business (essentially the same as compliance costs) resulting specifically from tax regulations is influenced by a number of factors:

1. The number of taxes it has to deal with
2. The administrative design of those taxes
3. The nature and size of its operations (including the size of its workforce)
4. The range of administrative activities it must undertake from the list above
5. The degree of support received from the revenue body

3.6.1 OECD findings relating to UK tax regulations

The OECD report quotes 2005/6 statistics that show that the administrative burden on business resulting from tax regulations as a proportion of the overall burden is 25% for the UK. This is comparable the other countries studied in the report: 30% for the Czech Republic, 25% for Denmark, 27% for the Netherlands and 28% for South Africa. It also claims that although comparable information is hard to construct, the administrative burden on taxpayers exceeds the administrative costs of HMRC, a finding which complements that of commentators from the USA such as Gale and Holtzblatt (2000).

The report also quotes the UK National Audit Office (NAO) report (2007) giving the total administrative burden on business imposed by government regulations as about £20 billion. Tax related costs from 2005/6 total £5.1 billion of which corporation tax comprises £608 million or about 12%. In 2004 the administrative costs incurred by HMRC’s predecessor agencies was £3.14 billion, significantly less than those incurred by business.

The statistics for the OECD’s report on the UK came from the HMRC Measurement Project (2006). This found that 41% of the taxpayers’ costs represent internal costs (costs of activities that business undertakes to be compliant), 49% represents external costs (costs of working with intermediaries) and 9% represents acquisition costs (non-time costs incurred by business).

An interesting initial finding from the OECD report is that significant reduction in the total administrative burden in the UK will require radical change in the tax system as 85% of the tax burden is created by only 85 information burdens (out of over 2,600 identified), which means that a number of simplifying reforms could result in only a small reduction in compliance costs

Another NAO report (2007b) surveyed 2,000 UK businesses as to what aspects of complying with regulations businesses find burdensome, and their priority areas for attention in tax:

Rank	Aspects of complying with regulations that businesses find burdensome	Burden reduction measures in order of importance to business – tax law
1	Having to keep up to date with changes in existing regulations	Simplification of complex rules
2	The length of time it takes to go through the whole process of complying	Improved access to information setting out in clear and simple language which regulations apply to a business
3	Finding information about which regulations apply to your business	Ensuring businesses do not have to provide duplicate information to Government
4	Completing paperwork, including filling out forms and keeping records	Provision of guidance that sets out in clear and simple language what a business has to do to comply with a regulation
5	Having to provide the same information more than once to the Government	Consultation with business before any change to regulation takes place or new regulation is made
6	Finding guidance and advice explaining what you have to do to comply with a given regulation	Higher levels of stability and less frequent changes to regulations
7	Preparing and reporting facts and figures to Government	Improving regulators and inspectors understanding of business

8	Being ready for and complying with inspections	Provision of background information that explains what the purpose is of a given regulation
9		Improvement to and more use of on-line tools such as electronic forms and information

Burdensome Aspects of Complying with Regulations (NAO, 2007b, p23-25)

Simplification of complex tax law is the top priority for business showing the apparently serious nature of the issue, a result seen in other surveys e.g. Tenon (2005). However, as later discussed, following the observations of the recent UK CGT reforms, the true importance of the issue is subject to debate.

3.7 Measurement of compliance costs

3.7.1 Difficulties in measurement

Sandford et al (1989) note that the measurement of compliance costs involves identifying opportunity costs to calculate monetary values; that is, the value of the next best use of resources expended specifically because of the existence of the tax, or how much could be saved if the tax were abolished. These are not easy quantities to measure.

Difficulties for companies in obtaining these amounts would include factors such as the legal requirement for companies to prepare and file annual accounts which would provide data anyway for the tax computation. The marginal cost of a tax department complying with one extra tax may be very small, but clearly the department would not be there if there were no taxes.

Overhead allocation is also an issue as smaller company taxation work is often undertaken by accounting staff who would still be required even if there were no taxes. The larger the company, the greater the percentage of overheads allocable to tax compliance work especially if a separate tax department exists. Time costs are difficult to analyse where no separate tax department exists.

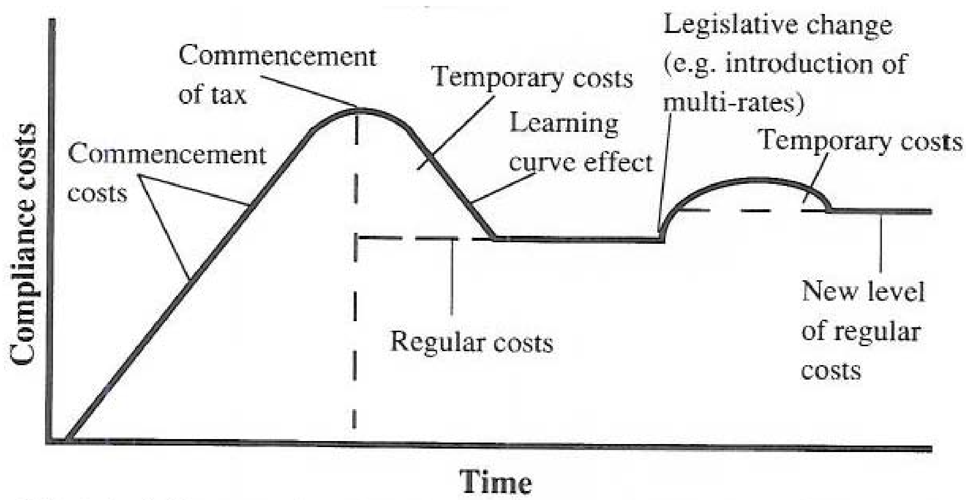
3.7.2 Costs of change and regular costs

Commencement costs occur with introduction of a tax or a major change in existing legislation and include costs such as setting up a new computer system or training tax staff. This might be recorded more accurately as spread over a period of time rather than solely at the time of change.

Temporary costs are incurred by both the taxpayer and HMRC when tax staff are receiving training to update their tax knowledge.

Regular costs are the continuing costs of a company meeting with tax compliance requirements. Temporary costs relating to tax change may be present at all times if frequent changes are made to the tax system.

These three categories are represented diagrammatically below by Sandford et al (1989) following the introduction of a new tax:



Model of Changes in Administrative and Compliance Costs with a New Tax

(Sandford et al, 1989, p17)

Any analysis or measurement of compliance costs must consider which part of the cycle is under investigation; immediately after a change costs may be high, but then fall over time. However, allocation of costs to the right category is not necessarily easy; for example, legal fees relating to a tax dispute may be one-off or regular if legislation is unclear.

3.7.3 Other aspects of measurement

3.7.3.1 Costs as a percentage of revenue or liability

In the quantification of compliance costs, Sandford et al (1989) note that percentage measures are widespread and may be useful in showing a relationship between input and output, but need careful interpretation especially if an attempt is made to compare efficiency of different tax administrations. Changes in tax rates, national incomes or the tax structure may change ratios without affecting absolute compliance costs e.g. on first principles, doubling the tax rate would halve the cost to revenue ratio.

3.7.3.2 Relationship of public and private costs

Sandford et al (1989) define total tax operating cost as the combination of public and private costs and there are number of links between the two. This equates to the 'total resource cost' of Slemrod (1996) noted elsewhere. Tax simplification may reduce both types of cost, or only one if the responsibility for complying with a tax lies with one of the sectors. Both areas therefore need considering by tax policy makers making decisions.

3.7.3.3 Time valuation of labour and cash

Sandford et al (1989) highlight two areas given limited consideration to date: the value of time spent on compliance and the timing of tax payments.

The largest part of compliance costs is the cost of labour incurred to perform the work, which may be further analysed into four categories of cost:

- Professional advisers' time – represented by the fee charged to the client
- Employees' time – the general consensus is that this is measured by the employees' wage rate
- Time of self-employed – in principle this is measured as the opportunity cost to the business. This could be measured by using an average rate of remuneration or charge-out rate (which may include a profit element). However, valuation of time is likely to be unique to the individual and not easy to compare
- Leisure time – valuation of time which, but for tax compliance, would have been leisure; this is hard to value and many economic studies have been performed. Sandford summarises the two key points arising: time value is a function of how it is constrained to be spent, and people are not uniform in their attitudes and their valuations are hence different

Time lags in payments of tax to HMRC may offset compliance costs for taxpayers. For corporation tax, this lag is from the date profit is earned until the date of payment, which can be up to nine months after the end of the accounting period, representing a substantial cash flow benefit.

3.8 Conclusions

Despite the difficulties in defining and measuring compliance costs, some useful conclusions can still be drawn.

The study of compliance costs has a strong academic tradition and their theoretical basis has been documented thoroughly. Equivalent studies undertaken in the USA and Europe provide useful comparisons with the UK.

Results from such studies provide a range of conclusions about the UK’s compliance costs. Key findings include Sandford et al’s (1989) studies revealing that costs fell disproportionately on small firms and the OECD (2008) report’s findings (backed by US studies) that the compliance cost burden on UK businesses exceeds the administrative costs of HMRC.

The NAO (2007b) finding that corporation tax is only about 12% of the total tax administrative burden for UK companies, a relatively small proportion, although the overall tax burden for companies is a significant proportion of their total administrative burden, is also significant.

4. Complexity of a tax system and effect on compliance costs

4.1 Introduction

UK businesses incur compliance costs in dealing with the country's overall tax system. The complexity of the UK's tax legislation was introduced in a previous chapter and is a significant contributor to the overall complexity of the tax system. This chapter considers further the issue of complexity of generic and real-life tax systems, especially the link between complexity and compliance costs. It also discusses briefly the factors to consider should simplification of the system be considered desirable.

4.2 Definition and measurement of complexity of a tax system

There are a number of possible definitions of tax complexity. Slemrod's (1996) widely recognised definition of the complexity of a tax system is the 'total resource cost' or the sum of compliance costs (incurred by individuals and businesses) and administrative costs (incurred by government) incurred in complying with the system's requirements. This definition thus provides a basic link between tax complexity and costs of compliance.

4.3 Reasons for complexity of a tax system

Tax systems become complex for a number of reasons. Donnelly and Young (2007) note that the responsibility for tax complexity 'has been placed on all members of the tax community – judges, practitioners and governments'. Perhaps due to their ultimate responsibility for a tax system, the role of government tends to attract the most attention.

As noted above, legislative complexity arises from factors including government policy preferences and the growth of anti-avoidance legislation. In addition to these two factors, Donnelly and Young (2007) consider a third cause of complexity to be government inaction 'Complexity…does not always arise from endless amendments of intricate rules, but can equally be caused by the lack of formal rule-making. When the legislature fails to provide, uncertainty is created. Taxpayers who are uncertain find it difficult to comply; therefore, we argue that complexity is reduced by tax measures that facilitate compliance'

The concept of equity is also significant for government to consider when contemplating change i.e. that taxpayers should be treated fairly. However, the relationship between equity and simplicity is not clear cut, and James (2006) notes that 'Existing research disagrees whether there is a positive or negative correlation between simplicity and equity or whether the relationship is far more complex and subtle c.f. Milliron (1985) and Carnes and Cuccia (1996)'.

4.4 Structural factors leading to complexity

Gale (2001) notes that legislative and overall complexity of a tax system can be influenced by structural elements such as the tax base, rate structure and allowable deductions as well as administrative features of the tax code.

4.4.1 Tax rate structure

Tax rates are either graduated, like those of the current UK income tax, or flat. Graduated rates may provide incentives to arbitrage and reduce overall liabilities across time or people leading to tax avoidance opportunities. Flat rate taxes can also allow more efficient administrative structures to function leading to lower compliance costs, since tax can easily be withheld at source.

However, there is debate over the influence of tax rate structure on the complexity of a tax system. The number of tax rates might on first principles be thought to contribute to tax complexity, but in fact are generally thought not to do so. Slovenia is one Eastern European country that considered but rejected introducing a flat tax system. Analysis by Cajner et al (2006) noted that 'there is little disagreement among tax system experts that the complexity of a tax system generally stems from deductions, exemptions and special treatments, while the number of tax brackets is largely irrelevant'.

The analysis quoted Slemrod (1989), who in studying the effect of tax simplifying measures on compliance costs, concluded 'significant resource savings can be expected from eliminating the system of itemised deductions, although no saving from changing to a single-rate structure can be confidently predicted'.

Other commentators such as Hall (1996) agree. He notes that direct tax complexity relates to issues with the tax base such as timing and the definition of taxable transactions rather than multiple rates of tax. In his opinion, a flat tax on a cash flow basis would remove these definition and timing issues for taxable income and hence increase simplicity.

4.4.2 Deductions

Universal exemptions, deductions and credits should in general cause relatively little complexity. However, when targeted, eligible taxpayers or activities can be hard to define and such confusion may provide tax planning opportunities and compliance difficulties (Teather, 2005).

Different administrative systems can also affect complexity; for example, withholding tax at source or removing the need to file a return could reduce compliance costs for individuals.

4.4.3 Other issues leading to complexity

Gammie (2008) considers that complexity is generated by the concepts on which the legislation is built, the structure of the system in terms of tax rates and taxable units and the extent to which government achieves policy using the tax system. Reinforcing the principles of Gale (2001) above, he states 'the growth in legislation is symptomatic of the complexity of the underlying concepts that need to be explained. Without any simplification of those underlying concepts – what it is we are trying to tax (the choice of tax base) and the tax structure (tax rates and taxable units) – the achievements in terms of tax simplification are likely to be small'.

4.5 Measurement of complexity

Slemrod (1996) notes that a number of issues may arise in trying to measure complexity of a tax system:

- Permanent and transitory costs may differ – a new provision may raise costs initially as people learn about it but reduce costs over time
- Only incremental costs should be included – companies would still keep records to meet legal obligations
- Tax complexity is only a part of government policy which includes spending and other regulations – if tax complexity is reduced but recreated as part of spending overall complexity may rise

More fundamentally, James (2008) notes that 'the lack of a strict definition of 'complexity' or 'simplicity' or of a robust quantifiable measure … makes it impossible to accurately ascertain any progress'.

4.5.1 Conceptual issues in measuring complexity of a tax system

Slemrod (1996) highlights a number of issues with the total resource cost. Firstly, it does not distinguish for the taxpayer between involuntary costs to comply with the law and discretionary costs incurred to evade or avoid taxes. A measure of how far a tax system encourages certain groups to incur large discretionary costs is often called 'transactional complexity'. Administrative costs include both those of running the system and minimising evasion, and each should be considered in assessing the system's simplicity. Similar points were raised in the UK studies of Sandford et al (1989).

Secondly, the resource cost refers to social rather than private cost of collection. Costs of compliance are often tax deductible, so the private cost for the taxpayer is less than the social cost. Employers also earn interest on withheld taxes from employees before passing them on to HMRC, reducing their overall compliance costs.

The total resource cost measure is useful, but may sometimes produce counter-intuitive results regarding simplicity. As noted above, Slemrod (1996) points out the limitations of total resource cost and an apparently counter-intuitive result where record keeping and calculation to claim a credit are relaxed to require only half the previous resource, the number of taxpayers claiming the credit increases and any measures to make up lost revenue do not increase other collection costs. Using the cost-based measure of simplicity, the system is now more complex. He considers this the correct result in that while the credit procedure is simpler, the overall tax system is more complicated. Equity and efficiency of the change will also have to be considered along with simplicity when analysing the success of the policy change.

4.5.2 Difficulties in measuring complexity of the current system

Slemrod (1996) identifies some difficulties in measuring the cost of the current tax system. Incremental costs are hard to measure for smaller firms in identifying accounting steps that could be foregone in the absence of taxation. Larger firms may be able to measure costs incurred by other departments more easily. More generally, records may still be required for certain purposes such as grants, so claims of cost savings should be treated with great care.

In general, any attempt to make estimates of the costs involved will always have limitations, an example being that taxpayers who are dissuaded from economic activity by tax complexity are rarely included in samples.

4.6 Disadvantages of complexity

On the basis that complexity and compliance costs are linked, business will suffer increased costs when complexity of the tax system increases. James (2008) notes some further disadvantages of complexity in a tax system:

- Making economic decisions more difficult by reducing clarity and certainty
- Reduce taxpayer compliance, whether deliberately or through ignorance of the rules
- Generating unfairness as not all taxpayers can take advantage of complexity in the system
- Making discussion of tax policy and improvements more difficult

In a similar vein in the USA, Hall (1996) identifies two types of economic cost created by the growth and regular revision of the tax code:

- Overhead cost associated with tax planning, compliance and litigation
- Economic opportunities foregone due to taxpayer uncertainty

He notes that where tax cost cannot be easily predicted with certainty, business plans and investments are delayed and may reduce economic growth.

4.7 Effect of complexity

Following Slemrod’s (1996) definition of complexity above, the obvious way therefore to decide whether an actual tax system is complex is to measure its compliance and administration costs. A number of studies have attempted to do this, although numbers quickly become outdated, limiting the application of results over time. However, a recurring theme is the difficulty in measuring costs, and especially in comparing them with other tax systems or countries.

The US Treasury (2002) and Slemrod (1996) have estimated compliance costs of Federal income taxes to amount to 10% of revenue collected or about 1% of GDP. Slemrod mentions that the UK has a cost of 5% of revenue, but as already noted, predicting such figures is notoriously inaccurate.

Gale and Holtzblatt (2000) state that the basic administrative goals of tax policy are that 'taxes should be easy to understand and comply with, and they should be enforced and administered in a competent and fair manner'. However, they note that these are difficult issues both for academics in putting a cost on compliance, and for policymakers where the goals conflict with each other, or other tax policy goals such as efficiency and equity.

Their survey in 1993 concluded that the total cost for the Fortune 500 companies of corporation tax compliance was $1.055 billion, which they acknowledge is 'difficult to dismiss'. Comparison with other countries was difficult due to different size of company used in the samples. The compliance costs for companies were shown to be much larger than the cost of administering the system.

A study by Slemrod and Blumenthal (1996) considered the factors in the American tax system most likely to create high compliance costs for large companies as 'depreciation rules, measurement and taxation of international income, the corporate alternative minimum tax and co-ordinating federal and state income taxes' (the last two do not feature in the UK tax system).

As noted above, however, compliance cost studies apparently carried out on a rigorous basis can give wildly contrasting results. Gale (2001) maintains that 'the magnitude of compliance costs and the impact of tax complexity on firm operations is controversial'. He quotes two examples, the first being the multi-national group Mobil whose officials testified in Congress that its US tax return cost $10m to prepare, which only worked out at 0.25% of group profits, which seems very small. However, Seltzer (1997) claimed that Hewlett-Packard, then with annual turnover of $38.4 billion, was able to process its US federal tax return with only three full-time tax professionals, suggesting that its corporation tax compliance costs were not excessive, and the reason for the difference from Mobil's total costs is unclear.

4.8 Other compliance cost studies

A number of other studies of compliance costs have been performed, some of whose results are noted below.

Hall's testimony in 1996 to the Ways & Means Committee compared the annual $157 billion cost of complying with the federal income tax as the economic waste involved in 'destroying every vehicle produced by the Ford Motor Company and more than one third of the vehicles produced by the Chrysler Corporation in 1995'.

Hall's calculations show a total compliance cost to American business in 1996 of $105 billion which falls disproportionately on smaller businesses, a result which confirms that of Sandford (1989) in the UK mentioned above. He notes that a VAT study in the UK by Sandford in

1986 found that the compliance burden on the smallest companies was 647 times larger than those on the largest companies.

However, Hall's figures have been widely challenged. Slemrod believes Hall's compliance figure is too high – although the total time spent as calculated by Hall is less than his own estimate, the average value of time is much higher, based as it is on a value in excess of wage rate.

Several compliance cost studies have also been carried out in the UK. Apart from those of Sandford (1989) already mentioned, a PwC survey (2007) for The Hundred Group found that the 51 of the largest listed UK companies had on average 11.8 full time employees dealing with UK tax compliance work, and this number was considered to underestimate the true time spent.

The study concluded that the total cost of UK tax compliance for the companies was calculated as £65.6m of which 49% related to corporation tax. On average, this represented 0.4% of their tax payments (taxes borne and collected). Data on time spent was converted to a monetary cost using a standard salary and benefits cost by grade and adding a percentage for overheads. The survey also attempted to include time spent by staff other than members of the central tax department on tax affairs – the 'shadow' tax department.

The above give merely a flavour of the large amount of academic literature on compliance costs and the complexity of tax systems, the breadth of which only serves to illustrate the cost magnitude and importance of the issue.

4.9 Simplification of a tax system

4.9.1 Definition of tax simplicity

Cooper (1993) has suggested there are at least seven issues to consider for a tax rule to be called simple, which can easily be extended to consider a whole tax system:

- Predictability – the rule and its scope were easily and accurately understood by taxpayers and advisers
- Proportionality – the complexity of the solution was no more than reasonably necessary to achieve the intended aim
- Consistency – dealt with similar issues in the same way without needing to make arbitrary distinctions
- Compliance – easy for taxpayers to comply without incurring excessive costs
- Administration – easy for a revenue authority to administer
- Coordination – fitted appropriately with other tax rules – complicated if its relationships with other rules were obscure
- Expression – clearly expressed

Cooper (1993) reasons that simplification throughout a tax system can be at different levels, namely:

- Choice of tax base

- Design of the rules applied to the tax base
- Expression of those rules
- Compliance requirements imposed on taxpayers

As a result, therefore, simplification in one area or level will therefore not necessarily simplify the overall tax system.

4.10 Simplest theoretical tax system

Slemrod (1996) answered his own query ‘which is the simplest tax system of them all?’ with ‘a lump-sum tax’ for the following reasons:

- The base is clearly and easily defined, such as being a resident over the age of 21
- The levy itself is clearly and easily defined
- The taxpayer cannot easily manipulate either the rate or base – in particular the latter. The base does not depend on any economic decision of the taxpayer

He considers the main reason for the scarcity of such taxes to be their perceived inequality with persons earning different incomes paying the same amount of tax, as evidenced in the English poll tax riot of 1381. In more recent times, the 1989 UK ‘Community Charge’ was not a success and administrative costs of collection more than tripled in its first year. Compliance issues were important; to enforce a tax, taxpayers must be located and dealt with when they do not pay. Slemrod (1996) commented on the issue of non-compliance ‘the simplicity of a tax system can be assessed only with respect to a standard of enforcement’. This is likely to be a significant factor in a comparative analysis of the simplicity or complexity of different tax systems.

4.11 Desirability of tax simplification

Gale (2001) has identified three key issues that are relevant in deciding if simplification of a tax system is desirable:

- The fundamental question is not the overall level of complexity but whether the tax system provides good value for the complexity it creates. This depends on the size and incidence of the costs and benefits of complexity, which includes the extent to which it achieves other policy goals

- Factors that generate complexity in tax systems such as policy trade-offs, politics and taxpayer avoidance are not features of tax policies and would remain in force even if the tax system were reformed. Analysis of how policy changes will affect tax complexity should incorporate these factors

- There is an important distinction between private and social costs. Taxpayers taking advantage of a targeted subsidy would not regard the complexity it created as unfavourable, but such a subsidy may have to be balanced by an initial higher rate

It may therefore be seen that the need to simplify a tax system may not necessarily be obvious, and any such simplification process may not be easy. Slemrod (1996) acknowledges that there are many less complex ways to raise the current amount of revenue (looking specifically at the US tax system), but whether these should be adopted depends on what the current complexity achieves or ‘personalisation’. He notes that some complexity gives perceived fairness while others give none and attempt to encourage certain types of behaviour, which causes distortion and complexity.

4.12 Benefits of a simpler tax system

Gale (2001) identified a number of general benefits of less complex taxes:

- Reduction of taxpayers’ costs of complying with the system in terms of money, time and mental anguish – this would reduce the overall taxation burden
- Simpler provisions are more likely to be used
- Compliance rates may rise as evasion will fall. To some extent people do not pay tax if they do not understand tax law, and simple tax rules should be easier to enforce. Evidence also suggests people evade tax if they think it unfair or that others are reaping more benefit from the system
- Generation of more public support and hence part of any effort to improve delivery of government services. Graetz (1997) finds the biggest complaint about the tax system for many is not the amount of tax they pay but the sheer and apparently needless complexity of what seem to be everyday tax situations

Stepanyan (2003) also notes the importance of simplicity in designing a tax system. In his view, complexity undermines administration due to enforcement difficulties and may hence lead to a fall in compliance. Multiple rate structures and numerous exemptions mean that administrations with limited resources may struggle to prevent significant evasion. He notes that non-revenue objectives, including simplification, are not easily quantified, and hence the measurement of a tax reform’s success usually focuses on quantities easy to measure such as revenue generation.

Nicholson (2006) identifies a number of advantages of a simple tax system for the UK His observations are relatively uncontroversial, but he makes no attempt to quantify such benefits, some of which may not be significant:

i) Lower compliance costs

A simpler tax system would lead to quicker and easier assessment and collection and reduce time and money spent on completing tax returns by individuals and businesses. Tax complexity and the need for tax advice both act against less wealthy members of society.

ii) Lower collection costs

A simpler system would require fewer administrators and leave fewer loopholes to be exploited and then closed.

iii) Transparency and accountability

Simpler taxes make the overall tax burden more transparent and help voters make more informed decisions.

iv) Improved parliamentary scrutiny

Long and complex finance bills make effective scrutiny difficult. A survey of MPs in 2001 by the CIOT found that 82% are unable to complete their own returns correctly, calling into question their ability to perform their scrutiny role.

v) Fewer errors

Complexity of the system is partly responsible for the large number of errors in the system including one eighth of taxpayers under PAYE paying at the wrong rate (2007a NAO report).

vi) Less distortion

Simpler taxes means economic behaviour is less distorted by complexity in the tax system.

Nicholson (2006) describes flat tax as ‘the ultimate expression of tax simplification’. He notes that all the current complexity in the forms of deductions and exemptions were made in the pursuit of equity or encouraging certain desirable economic or social behaviour, and that simplification by removal of such distortions is bound to leave some taxpayers worse off.

He also notes some ways in which taxes could easily be simplified. His suggestions for corporation tax include allowing companies to carry all types of losses forwards or back against any form of profit, thus abolishing the complex existing rules for different types of loss. Another suggestion is a single capital allowance treatment for all types of business asset, again simplifying the complicated existing capital allowance rules.

4.13 Simplifying an existing tax system

From the above, given that the simplest theoretical ‘lump sum’ tax system is unlikely to be possible to put into practice, it would seem necessary to start any process of simplification from within an existing system.

4.13.1 Principles

Gale (2001) states ‘the key to tax simplification is to make fewer distinctions across economic and personal characteristics…In short, broadening the base and reducing the rates, which in general may be considered efficiency-enhancing, would also simplify taxes’. He gives the following principles necessary to achieve this:

- Taxes should be imposed on a broad base at relatively low rates that do not vary by income source or expenditure type
- Progressivity should be embodied in the rate structure and tax base, not specific provisions
- Universal exemptions, deductions and credits are much simpler than targeted ones
- Taxing capital gains as ordinary income directly removes major sources of complexity
- Using revenue raised to increase standard deductions removes people from the tax system and reducing tax rates reduces the value of sheltering and cheating
- Increasing the numbers with the same basic rate facilitates withholding at source which further simplifies taxes and increase compliance

These plans have been called ‘populist simplification’ by Slemrod (1996) in that they may make taxes simpler for many people, but the overall compliance cost saving may be small.

4.13.2 Legislative process

James (2008) states ‘the way to achieve lasting improvement in terms of simplification is to include it systematically in the process of tax reform generally’. Simplification is incidental to government in setting tax policy (Slemrod and Blumenthal, 1996), but he gives four main ways to achieve this:

- Evaluate the importance of different aims of tax policy
- Incorporate simplification into the tax policy process itself
- Develop a simplification culture
- Monitor and review progress

The 2006 Tax Reform Commission suggested creation of a Joint Parliamentary Select Committee to improve parliamentary scrutiny of tax legislation, as well as an Office of Tax Simplification (OTS) reporting to the Committee. The OTS would review current tax law and propose simplification, and examine proposed legislation to see if it was consistent with principles of tax law and reasonably simple. However, James (2008) acknowledges the danger of such a body being sidelined by tight deadlines, and repeats his thoughts of simplification being incorporated into tax reform as being a more effective solution.

The creation of such bodies is not an idea unique to the UK. Dalsgaard (2005) notes the formation in the USA of an Advisory Panel on Tax Reform by the Secretary of the Treasury, one of whose aims is to submit a revenue-neutral proposal which will ‘simplify federal tax laws to reduce the costs and administrative burdens of compliance with such laws’.

4.14 Potential success of simplification strategies

Slemrod and Blumenthal (1996) point out that reduction of compliance costs through simplifying the tax process has not been an important part of government’s tax policy because there is no natural constituency and little data concerning total costs or alternative policies. As a result, more complexity has been the inevitable result.

However, studies do show that simplification of a tax system may be possible. The authors note that tax simplification can occur in either tax base simplification or tax rate simplification. Their study investigated the effect of simplification of the tax base on compliance costs using tax professional advice as the indicator. While its use is not a perfect indicator of the complexity of the tax system, the authors agree with Gale and Rohaly (2003) that it is ‘simple and straightforward’ and is evidence of the taxpayer’s view of the system’s complexity.

The study shows that tax base simplification reduces use of tax advice, indicating a reduction in complexity of the system and compliance costs by about six per cent.

4.15 Conclusion

Complexity and simplification of a tax system are by nature wide-ranging and intellectually demanding topics. While causes and effects of complexity are not difficult to identify, its measurement is controversial. Compliance cost studies have a valuable part to play, but their results need to be analysed with care. While simplification appears at first glance achievable and desirable, the practical chances of its occurrence remain subject to debate.

5. Flat tax – theoretical background

5.1 Introduction

The history of flat tax falls into two distinct phases. The first phase was the development of a theoretical tax system by American academics throughout the 1980s and 1990s, the most dominant model being the Hall Rabushka (HR) flat tax. The second phase was the actual introduction of tax systems known as ‘flat taxes’ from the early 1990s to date, pioneered by a number of Eastern European countries, henceforth classified by this thesis as ‘EE flat tax’.

It is vital to bear in mind that the flat taxes of the second phase bear little relation to the HR flat tax or its associated theoretical models. It is obvious that certain commentators do not appreciate this fact, leading to a general lack of coherence in the flat tax debate which has been described by Keen et al (2006) as ‘marked more by rhetoric and assertion than by analysis and evidence’. Much of the argument to date has focussed on issues such as the reduction in marginal rates of tax paid by the highest earning individuals on the introduction of a flat tax system, and whether overall tax revenue would decrease. Other aspects of the ‘flatness’ of flat tax, including its proposed simplifying features, have been subject to little analysis.

This chapter considers generic definitions of the flat tax concept before examining separately the theoretical properties of both the HR and EE flat taxes.

5.2 Definitions of ‘flat tax’

Generic definitions of flat tax may apply to both HR and EE flat tax systems. A short but useful description was provided by the UK Treasury in their 2005 report which defined a flat tax as ‘A tax structure that has a single positive marginal tax rate’.

In the USA, the US General Accounting Office (1998) prepared a report which noted that the term ‘flat tax’ could refer to any system with a single tax rate using either a consumption or income base, but chose the HR flat tax to analyse. The Joint Committee on Taxation produced a report in 2005 discussing issues relating to flat tax proposals which considered a flat tax to be ‘any tax system with only one marginal tax rate [above zero] and a broad base’. Many flat tax systems, both theoretical and actual, substantially alter the existing tax base, a point deemed important enough to be included in this generic definition of a flat tax.

A final definition is provided by Weisbach (2000) who considered the design and implementation of the HR flat tax. He identified immediately the problem of defining the term ‘flat tax’ and gave a generic definition of ‘any tax that has a proportional rather than progressive rate structure’.

5.3 Hall-Rabushka (HR) flat tax

5.3.1 Background

The first use of the term ‘flat tax’ was coined in the work of two American academics: Robert Hall and Alvin Rabushka of the Hoover Institution, Stanford University. Their proposed flat tax system was published in the Wall Street Journal in 1981 and expanded in their book ‘The Flat Tax’ (1995). The HR flat tax system was put into a draft legislative form by Richard Armey and Richard Shelby and given political prominence by a number of American politicians, most notably the Republican Steve Forbes (2005), who used its principles in his bid for nomination as his party’s presidential candidate.

The HR flat tax is a theoretical model tax system designed to replace the entire American tax system. Its publication originally stimulated debate in the USA throughout the 1980s and 1990s and reached Europe during this second decade, especially following the novel tax reforms seen in Eastern European countries.

In practice, no country has adopted the HR flat tax in its pure form and it remains a theoretical model only. None of the countries that have introduced tax reforms described by some as ‘flat taxes’ have altered their tax base from income to consumption, probably the single most significant difference between the HR flat tax and the current UK and US tax systems. All countries which have introduced flat taxes already had a consumption tax in the form of a value added tax (VAT), a tax which does not exist in the USA.

5.3.2 Definition

A succinct definition of the HR flat tax is provided by the Congressional Research Service of the Library of the US Congress (2005) who describe it as ‘a wage tax and a cash-flow tax on business (A wage tax is a tax only on salaries and wages; a cash flow tax is generally a tax on gross receipts minus all outlays)… It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level’. Both taxes are levied at the same, single, ‘flat’ rate, with a tax free personal allowance for individuals.

Businesses pay tax on the difference between their gross sales and the sum of wages, pension contributions and purchases from other businesses, including the cost of materials, services and capital purchases. Individuals pay tax on their wages (including benefits in kind) and pension disbursements, less personal exemptions.

Feld (1995) provides a more comprehensive definition of the HR flat tax:

‘The [HR] flat tax converts the income tax into a national tax on consumption, whose economic effects resemble those of a value-added tax. It consists of two parts, a tax on individuals and a tax on businesses. The two taxes, taken together, create an ‘airtight’ system for including income in the tax base once and only once, as close to the source as possible. The rate is the same for both taxes. It hovers around 20% and varies with the proposal.

The tax on individuals generally includes only wages and other compensation paid in cash and pensions. (Correspondingly, businesses may deduct these payments). Dividends, interest, rent and capital gains are not taxed to individuals. Nor may individuals claim the personal deductions currently available for mortgage interest, state and local taxes, charitable gifts, medical expenses and the like. The individual tax becomes progressive at the lower end through a personal allowance or standard deduction. The earned-income credit[1], however, would disappear.

The business tax is intended to act as a comprehensive withholding tax on all types of income other than wages. The business tax covers all businesses, including partnerships and sole proprietorships. Accounting for business transactions is intended to follow cash receipts and disbursements.

The tax base consists generally of gross receipts for the sale or exchange of property or services less the cost of business inputs, wages and retirement contributions. No deduction may be claimed for fringe benefits, employer's national insurance or local (including property) taxes. The tax provides current expensing of all property purchased for a business; thus, if a corporation purchases a factory, it may deduct the cost of the land, buildings and equipment. The tax eliminates depreciation and inventory accounting, defers deductions until payment and repeals percentage depletion. The current deduction of all business inputs has the effect of exempting from tax the future income derived from business assets calculated at a normal rate of return. Current expensing of business investment essentially converts the business income tax base into a value-added tax base.

Businesses may claim no deduction for interest or dividends paid and do not include financial income when received. A special set of rules applies to banks and other financial institutions to tax income on services 'bundled' with lending transactions. Any excess of deductions over income carries over into the following year with interest added at the 3 month Treasury bill rate'.

5.3.3 Comparison with current UK tax base

It is abundantly clear from the table below that the HR flat tax is very different from the current UK tax system. The key difference between the two is the tax base; the UK's income tax and corporation tax are levied on income whereas the HR flat tax is levied on consumption i.e. spending (Murphy, 2006). The consumption basis of the HR flat tax is described in detail below.

1 A refundable tax credit on earned income for low to moderate income working individuals and families. Congress originally approved the tax credit legislation in 1975 in part to offset the burden of social security taxes and to provide an incentive to work. When EITC exceeds the amount of taxes owed, it results in a tax refund to those who claim and qualify for the credit.

A comparison of the flat tax base with existing system for a business is shown below:

	Current UK system	HR flat tax
Sales of goods and services	Taxable	Taxable
Sales of business assets	Gain included	Included
Sales of financial assets	Gain included	Not included
Loan and new stock issues	Not included	Not included
Purchases of goods and services for business purposes	Deducted	Deducted
Purchase of capital goods	Depreciated over time	Deducted immediately
Wages paid	Deducted	Deducted
Interest paid	Deducted	Not deducted
Dividends paid	Not deducted	Not deducted
Charitable donations	Deducted	Not deducted
Capital gains	Taxable	Not taxable

Comparison of HR flat tax base with the current UK system (Murphy, 2006, p12)

5.3.4 Claimed benefits of an HR flat tax

The following summary (Murphy 2006) lists the benefits claimed for the introduction of the HR flat tax in the USA by Hall and Rabushka and other supporters:

Simplification

- Simplifying the tax code
- Reducing the burdens on individuals who have to file tax returns
- Simplifying business administration
- Cutting the number of state employees who administer tax
- Reducing the number of taxpayers

Enhance the credibility of the tax system

- Reducing the average tax rate
- Reducing the incentives for tax evasion
- Cutting or eliminating tax avoidance
- Closing all loopholes used for tax abuse
- Increasing the fairness of the tax system

Boost the economy

- Stimulating the economy
- Reducing inflationary pressure
- Reducing interest rates
- Encouraging saving
- Stimulating investment
- Encouraging international competition
- Improving corporate transparency

Increase social well-being

- Providing increased incentives for work
- Protecting wealth
- Supporting the family
- Enhancing the status of government

In a similar vein, Paulus and Peichl (2003) consider the following three potential benefits of a flat tax to be most attractive for Western European countries (although they considered EE rather than HR flat tax, the apparent advantages still apply):

- Enhance labour supply incentives – especially for highest earners which has issues for equity
- Increase compliance and reduce evasion through lower rates – an effect expected to be more prevalent in developing countries starting from a lower base
- As a part of fundamental tax reforms income taxation can be significantly simplified

From a specifically UK perspective, Grecu (2004) promotes an HR flat tax for the UK on the basis that it would attract international business activity to the UK and stimulate the economy, based largely on the historic linking of tax cuts under Thatcher in the UK and Reagan in the USA in the 1980s with the observed economic outperformance at the time. In his opinion, the main benefits would be:

- Elimination of double taxation on savings and investments
- Increase in government revenue
- Considerable reduction in the time and cost of completing tax forms
- The end of special interest lobbying, which is responsible for the growing complexity of the tax regime
- Exemption of the poor from paying any tax by means of a generous tax-free allowance
- More control by individuals over their money and reduction of government infringements on privacy
- Reduction of interest rates because interest would be tax-free
- Reduction of tax evasion by lowering the benefit from avoiding taxes
- The British fiscal system would be more attractive to foreign investment
- Simplicity, economic efficiency and fairness

It would at first sight be fair to say that the majority of these claimed benefits are subject to much debate. However, it is apparently common ground among both supporters and opponents of both an HR or EE flat tax for the UK that simplification of tax legislation and indeed the whole tax system would occur on introduction. This might be predicted to lead to a reduction in compliance costs. The claims of simplification are the particular focus of this thesis as the flat tax debate in the UK has often appeared to take this as given and focus more upon the issues of equity and redistribution of the tax burden.

With the continuing importance of the desire for tax simplification, the claims of flat tax advocates on this issue need more detailed examination.

5.3.5 Consumption tax base

5.3.5.1 Background

One of the more radical features of the HR flat tax, especially unusual to UK observers, is its consumption base. The following section provides some theoretical background on the nature of such a base, based largely on the work of Weisbach (2000).
The majority of observed tax systems are predominantly based on one of two tax bases: consumption or income. The aim of a consumption tax is to capture all consumption; rather than a direct tax on consumption, this can also be done starting from income on the basis that income is the sum of consumption and change in savings for a period. This will need to be done on a cash flow rather than accruals basis, as is the case for the HR flat tax.

Two important consequences of the cash flow basis are that:

- Investments are expensed under a cash flow consumption tax but not under an income tax (relief is obtained on recovery of the investment)
- A consumption tax does not tax the yield on investments

As the table above shows, these are key differences from the UK income-based tax system.

A consumption base may be created in different ways:

- Measure directly all acts of consumption – this would be difficult in practice requiring a new reporting framework and definition of taxable consumption activities
- Use the definition of consumption as income minus saving by including income from all sources then allowing a savings deduction – this would be administratively difficult
- Include only earned income in the tax base – taxpayers claim no savings deduction but returns are tax-free (as in the HR flat tax)

5.3.5.2 Taxation of capital

A cash flow consumption tax can be replicated by not taxing the gain on assets sold and giving no deduction for the purchaser. This method is known as yield exemption and is used in the HR flat tax for non-business assets such as housing. If these two methods (cash flow consumption tax and yield exemption) are equivalent, this would imply that the cash flow consumption tax is simply a wage tax as there are two types of resource: labour and capital (the return to which is exempt).

Weisbach (2000) points out two exceptions to this equivalence:

- A cash flow tax taxes certain returns in excess of the market rate of return (known as inframarginal[2] returns)
- Transitional effects on moving from an income to consumption tax will be significant as on the date of change, existing wealth is taxed on its present value

To summarise:

- A cash flow tax taxes wages, inframarginal returns to capital and all existing capital on a one time basis
- A yield exempt tax taxes only wages; inframarginal returns are exempt as is the yield on all capital

5.3.5.3 Existing forms of consumption tax

A number of different consumption taxes are already in existence. A retail sales tax is a direct tax on consumption purchases, calculated on each purchase and remitted by the vendor. If applied to all purchases it would be equivalent to a cash flow consumption tax.

A VAT (value-added tax) is a method of collecting a retail sales tax which collects tax at each stage of production rather than just at the point of retail sale. This makes avoidance more difficult as transactions may be linked together by the revenue authorities. A VAT that deducts purchases and includes sales is called ‘subtraction method’. There is no deduction for wages and deductions are only allowed on items where the tax has already been paid.

Several European countries including the UK operate a ‘credit invoice’ VAT where businesses get credit against tax for taxes already paid by the supplier instead of a deduction although the effect is the same.

5.3.5.4 Basis of the HR flat tax

The HR flat tax acts as a subtraction method VAT but businesses get a deduction for wages and individuals are taxed on their wages. Individuals are not taxed on investment income and wages could be taxed on a progressive basis if required.

Weisbach (2000) described the HR flat tax as a consumption-type, origin-based value added tax (VAT) collected by the subtraction method supplemented by a non-refundable tax credit against labour income. The tax base of a subtraction VAT is the difference between a business’s sales and purchases; for a consumption-type VAT capital goods are also excluded. An origin-based VAT taxes exports but not imports and is thus a tax on goods produced in the country; the more usual destination-based VAT exempts exports and taxes imports so the tax base is domestic consumption.

2 An investment has an inframarginal return if one cannot invest additional cash at the same rate. The inframarginal return is the return on the investment above the normal rate of return i.e. the rate of return on any additional cash invested

As the HR flat tax has a wage tax and a consumption tax taxes wages, inframarginal returns and existing capital, as discussed above, the only reason for the business-level tax must be to tax existing capital and inframarginal returns, which is very different from European VAT where the business-level tax taxes all consumption.

The business-level tax does not apply to all capital e.g. personal residences are taxed under the yield-exempt method. Multiple methods of taxing capital under the HR flat tax are not necessarily efficient. Capital that is tax exempt may mean more of the tax burden falls on labour and transition tax (see below) will be avoidable by schemes such as buying exempt assets.

Weisbach (2000) summarises the above in making the following three main points about the HR flat tax:

- It is a progressive consumption tax (i.e. two rates of zero and the 'flat' rate)
- The business-level tax exists only to tax existing capital wealth and inframarginal returns
- It imposes multiple methods of taxing capital

5.3.6 Transition rules

The need for transition rules during implementation of an HR flat tax is an important issue since, as indicated above, moving from an income to consumption base would lead to a one-off tax on existing capital. Different kinds of transition rules are possible: a yield exempt system would not tax existing capital but a retail sales tax would. The HR flat tax has no specific rules and thus presumably attempts to tax existing wealth.

Any attempt by government to offer relief from a one-off transition tax raises issues of economics, equity and policy. Most efficiency analyses assume some form of relief is inevitable since the amounts of wealth and tax involved without it would be large. However, removal of the tax liability on existing wealth, usually held by the most wealthy taxpayers, would severely reduce the efficiency and progressivity of the new system.

To reduce avoidance of any transition tax, the HR flat tax would need to introduce a number of rules which would greatly add to the complexity of the tax system.

5.4 Eastern European (EE) flat taxes

As noted in the introduction, there are two very different types of flat tax: the theoretical HR model (and its associated variants) and the real-life EE flat taxes. It is this latter category that has reignited the flat tax debate in the UK.

During the last fifteen years a number of Eastern European countries have reformed their tax systems by introducing regimes which have collectively become known as 'flat taxes'. Similar systems had already been introduced in certain countries including Hong Kong (1947), Jersey (1940) and Guernsey (1960), but the more recent adopters may be grouped conveniently into two 'waves'. The first wave commenced with Estonia in 1994 and the second with Russia in 2001. Although flat taxes have been debated keenly in the UK and the rest of Western Europe, none of these countries has yet adopted similar systems, so the results of the new tax systems have been analysed with some interest.

5.4.1 Background

The EE flat tax systems vary widely in their design, as will become evident. Their only common feature is that their tax on labour income may be described in symbolic form, as per Keen et al (2006):

$$T_F(Y) = \max[t.(Y\text{-}A_F),0]$$

Where:

$T_F(Y)$ is the tax liability on income of Y

t is the single marginal rate of tax (the 'flat' rate)

A_F is a tax-free allowance given to the taxpayer

Keen's formula still meets the UK Treasury's (2005) generic definition of a flat tax. The flat rate used to calculate the tax may be the same for both corporation and income tax, as under the HR flat tax, but in practice this is unusual among the EE flat taxes. Keen's (2006) analysis of the Eastern European flat taxes only considers tax systems that follow the above equation for PIT, incorporating as it does a personal allowance which is an important design component of these real-life flat taxes.

5.5 Theoretical analysis of the EE flat taxes

Keen et al (2006) undertook a detailed analysis of the EE flat tax systems and their results are discussed below. There is a large amount of academic literature on behavioural and overall tax revenue effects of changing tax rates (Heath, 2006), issues which, as already noted, have been prominent in the flat tax debate. However, there has been little analysis of the effect of 'flatness' per se, although as Keen et al (2006) point out 'it is difficult (perhaps impossible) to disentangle these empirically from those of the accompanying tax increases or reductions that movement to a flat tax implies'.

5.5.1 Possible optimality of a flat tax

Keen et al (2006) note that there is a tradition of academic work which seeks to see if a flat tax rate could be an optimal rate. Early work on income tax optimality by Mirrlees (1971), well before the advent of flat taxes, concluded that '[p]erhaps the most striking feature of the results is the closeness to linearity of the [optimal] tax schedules'. The work considered that given the practical difficulties of a non-linear tax schedule, including administration, compliance and potential for tax avoidance by arbitrage between different rates, this implies that a flat tax is close to the best possible form of income tax.

Later work such as Tuomala (1990) disputes these conclusions, and further chapters of this thesis will dispute the scale and ability of flat tax to solve the above 'practical difficulties'. However, there remains no clinching theoretical reason why the optimal tax schedule is progressive i.e. one where the average tax rate increases with increasing levels of income. Despite this, the UK and other Western economies maintain a progressive system, probably driven by political concerns over the perceived equity of the tax system.

A different case in support of linear rates appears in analysis of tax evasion and corruption in the tax collection process. Hindriks, Keen and Muthoo (1999) showed that a linear tax, set at an appropriate rate and combined with an appropriate penalty structure and simple wage payment to tax inspectors, maximises revenue without inducing tax evasion or bribes. These were significant issues for those Eastern European countries who have adopted the flat tax. However, such arguments are much less significant in the UK which has a far more developed and less corrupt collection system.

There is also a political argument for linearity from those who see government as wasteful rather than benevolent, in a tradition dating from Brennan & Buchanan (1977) and continuing to Hall and Rabushka and other flat tax supporters today. A flat tax may act to restrict government's ability to spend by reducing overall tax revenue (Murphy, 2006).

5.5.2 Progressivity

A progressive tax is one where the average rate of tax increases with increasing income, and a flat tax with a tax-free personal allowance achieves this for individuals. When analysing the impact of a flat tax upon progressivity, therefore, the issue at stake is how it compares to the tax structure it replaces.

5.5.2.1 Introduction

Keen et al's (2006) analysis assumes that pre-tax income is independent of the income tax structure in place although the effect of tax evasion on moving to a flat tax is also considered.

The fundamental concept at stake is that a tax structure is more progressive than another if, under its provisions, the poorest per cent p of taxpayers pay a smaller share of tax revenue for all p.

5.5.2.2 Progressivity comparison with full compliance

The examples below first consider the case where the flat tax and its predecessor raise the same revenue, and then move on to the scenario where this is not the case. Finally, the effect of non-compliance on progressivity is examined.

5.5.2.3 Revenue neutral comparison

Progressivity will be affected by both the new tax-free allowance and the new flat tax rate. Considering the allowances first, Keen et al (2006) note that where the tax-free allowance under a flat tax is lower than its predecessor progressive tax, following the above the flat tax is clearly less progressive. This was the situation under the Georgian flat tax where there is no allowance, but they note that the reform was not revenue neutral so comparison of progressivity before and after reform is difficult. Where the allowance is greater under the flat tax the picture is not so clear. Clearly, more people will pay no tax so the reform cannot definitely lead to less progressivity.

When examining the effect of the change of rate on progressivity, two situations can be envisaged. Where the flat tax rate is at least equal to (or higher than) the highest marginal rate under the progressive tax, the flat tax is definitely more progressive. This was the situation with the Lithuanian flat tax, but again the reform was not revenue neutral.

The second situation arises where the flat tax rate is between lowest and highest pre-reform marginal rates, typically seen in those countries in the second wave after Russia. Here, neither tax structure is definitely more progressive. In addition, none of the second wave reforms were revenue neutral.

In general, Keen et al (2006) note that all things being equal, a flat tax is more likely to be more progressive than the progressive system it replaces the higher the rate at which it is set. However, as none of the reforms were revenue neutral, this conclusion is presently of academic interest only.

5.5.2.4 Non-equal yield comparisons

Keen et al (2006) note that in this scenario it is necessary to distinguish between the effect of introducing a flat tax on the distribution across the population of taxpayers of tax payments (related to progressivity) and the distribution of their after-tax income. Where total tax revenue is unchanged, as above, the effect is obviously the same. Where tax revenue differs, the change in distribution of net income reflects changes in distribution of tax payments as well as their overall level.

Hemming and Keen (1983) show the results in the above section still apply if re-expressed in terms of normalised tax or net income schedules which are derived from actual numbers by dividing by each aggregate yield. The relevant comparison is now between pre-reform tax and a notional flat tax with the same allowance as the actual flat tax but marginal rate equal to the actual rate multiplied by the ratio of revenue raised by pre-reform tax to flat tax.

Where reform led to a revenue loss, the Georgian reform shows clearly less progressivity whereas in more typical second wave reforms the effect on distribution of tax payments remains unclear. Where revenue increased such as in Lithuania the impact on distribution of tax payments is unclear, both due to the lack of clear data.

It is clear that a number of other considerations are involved in assessing distributional impact on incomes, but the above analysis shows the wide range of potential impacts.

5.5.2.5 Effect of non-compliance on progressivity

As noted above, an important objective for several Eastern European countries in moving to a flat tax was to improve compliance from its existing weak level; non-compliance may thus affect the distributional impacts of reforms.

Using a compliance behaviour model in the style of Slemrod (2001), Keen et al (2006) show that non-compliance leads to the flat tax becoming more progressive with the less well-off gaining a greater proportional benefit than the better off by evading tax. The situation is exactly the opposite for the pre-reform progressive tax, but the authors stress that these results must be taken with care, due to the lack of clear data available on sensitive areas such as non-compliance.

5.5.3 Work incentives

5.5.3.1 Principles

The comments of Paulus and Peichl (2008) as noted above are typical among supporters of flat tax such as Heath (2008), who claim that incentives to work would be enhanced, driven by a lower marginal rate of tax. However, Keen et al (2006) conclude that from a theoretical point of view, the effect of moving to a flat tax on work incentives is ‘replete with ambiguities’.

Among the highest earners, who see the greatest change in tax rates, the income effect i.e. working to maintain income, suggests lower efforts. However, the substitution effect, where reward for surrendering leisure is increased, acts in the opposite direction and suggests greater efforts. This is the group of taxpayers that in theory would act to increase their overall output after seeing their tax rates fall. Previous work such as Goolsbee (1999) found that the response of this group to changes in tax rates was very limited.

The impact of introducing a flat tax on encouraging people into work is also ambiguous. The enhanced personal allowance may act to encourage lower paid workers to work harder or to join the workforce, while middle earners facing a higher marginal rate may in theory withdraw from the workforce. This behaviour may be reinforced if, like the Slovak Republic, the benefit system is reformed at the same time to encourage people into work (Miklos et al, 2005).

5.5.3.2 Evidence

Keen et al (2006) note that the consensus of academic literature reviewing the impact of tax reform on labour supply decisions is that the effect of changes on primary workers is modest and could be used to simulate the effects of introducing a flat tax.

Russia is the only EE flat tax country to have been studied in detail. Ivanova et al (2001) used household panel data (Russian Longitudinal Monitoring Survey) taking the large group of taxpayers little affected by the cut in the income tax rate as a control and comparing them to those whose tax rates were significantly reduced. The difference between the two groups before and after reform, assisted by the existence of a ready made control group, should in theory have thrown some light on the reform itself.

However, the study uncovered little evidence that reform had a great effect on work effort – neither taxpayers' gross income nor hours worked increased more in the treatment group than the control group. In fact, whenever the difference in work effort was significant, increased effort was shown in the control group who were supposedly not affected by the reform.

While bearing the above in mind, it is clear that decisions by individuals about their working patterns are influenced by many factors other than tax, so it is maybe unsurprising that no clear trends are observed.

5.5.4 Compliance, administration and simplicity

Supporters of a flat tax e.g. Grecu (2004) claim that its introduction will simplify the tax system, leading to improved compliance and reduced administration and compliance costs, all of which are linked. Rabushka (in Hall & Rabushka, 1995), one of the HR flat tax creators, commented 'the whole purpose of a flat tax is really to simplify the system and produce a more efficient economy'.

Keen et al (2006) note a few obvious simplifications arising from the flatness income and corporation tax rates including reducing incentives to reallocate income, making withholding simpler and simplifying income averaging. However, the tax free allowance means that none of these problems disappear since there are two marginal rates (the flat rate and zero). PAYE would still be problematic for individuals with more than one job to ensure that the tax-free allowance is only claimed once. Income averaging is a negligible part of the overall complexity burden.

In Georgia, the tax free allowance was eliminated and Keen et al (2006) note that there is some anecdotal evidence that compliance improved following the flat tax reform. However, given the substantial structural changes in tax administration at the time of the flat tax reform, it is impossible to quantify the effect due solely to flatness.

More importantly, it is generally agreed that the rate structure is not the main source of complexity in a tax system e.g. Krajcir and Odor (2005). Factors to which complexity can largely be attributed include difficulties in defining the tax base due to legislative exemptions and special treatments which may be disputed at length between taxpayer and tax authority. This issue is discussed in a previous chapter in detail.

Overall, there is little tangible evidence for the introduction of an EE flat tax leading to tax system simplification. Some indirect survey evidence from Ivanova et al (2001) in Russia did not suggest that individual taxpayers thought the tax system much simpler post reform.

5.5.4.1 Impact on compliance

Keen et al (2006) note that the model of Hindriks, Keen and Muthoo (1999) suggests linearity is theoretically conducive to compliance but the level and structure of tax rates also matter. It is widely propagated by flat tax supporters, especially Hall and Rabushka (1995) that cuts in tax rates will reduce incentives for evasion, but this is clearly a simplistic view and will depend on many factors including the level of costs involved in evasion.

Research by Slemrod shows that an increase in marginal rate increases the amount of income concealed. However, the work of Allingham and Sandmo (1972) and Yitzhaki (1974) concludes the exact opposite, modelling tax evasion as a gamble and concludes that tax cuts increase income and lead to taxpayers investing in more risky assets so evasion actually increases.

Hence, the theoretical impact of tax cuts on compliance is not clear. Moving to a flat tax would, for highest earners, reduce evasion under Slemrod (2001) but increase under Allingham and Sandmo (1974) and Yitzhaki (1974). This opacity is seen in the conclusion of Andreoni, Erard and Feinstein (1998) that empirical evidence on the impact of tax on income concealment is mixed.

Again, there is little tangible evidence from the EE flat taxes given the difficulty in measuring rates of non-compliance. Some evidence of improved compliance in Russia was found by Ivanova et al (2001) by looking at respondents' consumption rather than income.

The Slemrod (2001) model would therefore seem the better of the two on the Russian evidence – possibly where tax enforcement is weak tax evasion becomes less a gamble than an inconvenience. However, the Russian results are complicated by the effect of the strengthening of tax administration and anti-corruption political rhetoric, especially of President Putin at the time of the reform.

5.5.5 Automatic stabilisation

Keen et al (2006) note that the consensus view is that a flat tax will weaken the automatic stabilisers i.e. factors which act to stabilise the national income or workforce without any direct government action. However, it is under a flat tax that highest and lowest earners see their marginal tax rates reduced while middle earners see theirs rise, so the overall response is unclear.

Keen et al (2006) show that the level of the tax free allowance is crucial; where it is nil the aggregate marginal tax rate falls, as expected on moving to a flat tax, weakening the stabilisers. However, the level of the threshold and the income distribution can give results that strengthen the stabilisers, so there is no simple answer.

5.5.6 Political motivations

Keen et al (2006) note that political considerations cannot be discounted when investigating the reasons for the popularity of flat taxes in Eastern Europe. Most of the reforms were introduced by incoming governments starting with Mart Laar in Estonia (1994) and continuing through to Mikhail Saakashvili, elected in Georgia after the ‘Rose Revolution’ in 2004. The combination of a new leader with a populist electoral reform mandate, in economies with weak track records of tax compliance where income tax raised relatively little revenue, appears fertile ground for introduction of a flat tax to demonstrate internationally a move to a market based economy, banishing echoes of a Communist past.

In certain flat tax countries the reforms accompanying the flat tax also demonstrate a government desire to be seen to be firm, as in Russia and Georgia where enforcement was increased (the CIA 2006 Factbook states that Georgia ‘suffered from a chronic failure to collect tax revenues, however the new government is making progress in reforming the tax code, enforcing taxes and cracking down on corruption), and even-handed as in the Slovak Republic and Ukraine where the income tax base was greatly broadened across sectors and activities.

Of course, in many cases all sectors and individuals saw a reduction in their average rate of tax, i.e. the reform was Pareto-improving[3], which would have smoothed its introduction. Where a wider package of reforms was introduced, not all groups would have benefited; some commentators have highlighted the speed of introduction of the reforms as a factor in their successful implementation.

However, simply because a flat tax is Pareto-improving does not imply that a move towards flatness is necessarily sustainable. Modelling work by Bohn and Stuart (2003) showed that the winning tax structure will redistribute from upper and lower incomes to middle ones, exactly the opposite from that of a typical flat tax. It is a widely held mainstream political view that middle income earners are the key to electoral success and this is likely to be a significant factor in the apparent rejection of flat taxes by the governments of Western Europe.

It is also noticeable that these flat tax economies saw inequality increase quicker than other OECD countries pre-reform. Milanovic (1999) shows that the Gini[4] coefficient of the former Soviet Union and Eastern Europe rose from 0.25 to 0.35 during the 1990s. Empirical evidence shows, counter-intuitively, that more unequal societies redistribute less e.g. Lindert (2000) and the ‘Robin Hood paradox’; explanations for such behaviour remain open to debate.

3 A change in the allocation of resources making at least one person better off without making anyone else worse off

5.5.7 Other considerations

It should be noted that the EE flat tax reforms apply to personal income tax, not social security contributions. In many of the flat tax countries e.g. the Baltic states, these contributions are substantially higher than the UK. It is important to realise, therefore, that introducing an EE flat tax does not mean that the overall tax burden on individuals is necessarily greatly reduced.

Where the tax base has been significantly changed with the introduction of a flat tax, removal of exemptions and deductions increases progressivity, as demonstrated by Peichl (2006) for a hypothetical German flat tax. Even when not removed, a flat tax equates the value of such allowances for all taxpayers making their effect less regressive, since all taxpayers have the same marginal rate.

Flat tax reforms have often been accompanied by reforms to other taxes to offset revenue loss. Such changes have included increasing excise rates or removing VAT exemptions (the Slovak Republic fundamentally changed its VAT structure at the same time). As such, the distributional impact of the whole tax system needs to be analysed when reviewing the effect of EE flat taxes rather than only considering income taxes. Fuel duties increased in several cases and may have been progressive as car ownership is higher among the more well off as noted by the Slovak Ministry of Finance (2005). However, indirect tax reform is unlikely to have increased progressivity as they are by nature regressive taxes.

Capital income also needs to be considered when analysing flat tax reforms. Certain lower income groups could include pensioners living on income from savings who may not benefit from the increased tax free allowance as interest income may be taxed by withholding. In general, Keen et al (2006) note that wealthy mobile earners have greater opportunity to reduce their tax rates so will benefit less from a flat tax than may be predicted.

5.6 Conclusion

While HR and EE flat taxes are very different in format, there is plenty of theoretical analysis in the academic field for both. The HR flat tax is dominated by its cash flow, consumption base, a truly radical departure from the UK's current income base. Keen et al's (2006) detailed analysis of EE flat taxes is comprehensive but, although analysing real-life systems, many of its conclusions remain untested due to a lack of clear data available from these countries.

4 A statistical measure of inequality of a distribution

6. Potential simplifying benefits of a flat tax

6.1 Introduction

This chapter considers the potential simplifying benefits that both HR and EE flat taxes can offer the current UK tax legislation and tax system in general. Since compliance costs are so closely bound to the overall complexity of a tax system, the effect on these is also considered, both on a theoretical basis and using modelling studies from the USA and Western Europe.

Supporters of flat taxes, both HR and EE varieties, have long held that significant simplification of the current UK tax system would occur should their favoured system be implemented e.g. Heath (2006). Indeed, even opponents have often implicitly accepted the claim, while sometimes questioning the extent of the impact of their introduction e.g. Murphy (2006). A typical view of flat tax supporters is that of Davidson (2006), who agrees with Mitchell (1998) that ‘two of Mitchell’s benefits are unambiguously correct: a flat tax is simple and honest’. The McLeod Report (2001), a study of New Zealand’s tax systems, concluded that a proportional income tax (or flat tax) would ‘be simple and resolve several complex taxation issues’.

In addition, HR flat tax proponents such as Armey (1996) routinely claim that compliance costs would be should it be introduced, and by implication this can be extended to the UK. The claim of its creators Hall and Rabushka that individuals and companies would be able to file their tax returns on a postcard-sized form, and the hint that lengthy tax legislation can be swept away by a simple law, were important factors in the HR flat tax’s initial appeal.

Considerable academic work on the simplifying properties of the HR flat tax has been performed on this subject in the USA, which has somewhat surprisingly seldom been used in the recent European flat tax debates. As discussed above, the EE flat taxes have a common property of a flat rate of tax, but are much less radical in design than the HR flat tax.

6.2 Basic simplification

On first principles, a single rate of tax would simplify the calculation of tax liabilities. However, as already noted, the chief source of complexity in calculating a liability is defining the tax base e.g. Krajcir and Odor (2005), and many UK companies already only include one rate in their calculations. Any simplification arising is therefore likely to be modest.

It has already been noted from work by Keen et al (2006) that the real life EE flat tax systems did not introduce any significant simplification solely due to their property of ‘flatness’. This was not a surprising observation as simply changing a tax rate is predicted to have little effect on the much deeper, inherent complexity seen in real life tax systems. The summary of the UK Treasury report (2005) agrees with this viewpoint ‘having a progressive rate schedule with a reasonably low number of income brackets is probably not much more complex than having a single rate from an administrative point of view’.

Feld (1995) identified four features of the then current American tax system (also relevant to the UK) which cause statutory or transactional complexity that would be removed by the HR flat tax. His first feature applies equally to EE flat taxes where the same flat rate is used for all sources of income:

- The single rate removes bracket arbitrage where taxpayers with different marginal rates utilise deductions at high rates and include income at low rate

This feature would include prevention of arbitraging between the tax treatments of businesses and individuals since the HR single rate applies for both sources of income. Individuals are likely to prefer to be paid as wages from their own business under the HR flat tax so they can take advantage of the personal allowance. To some extent, therefore, such arbitraging will continue in the taxation affairs of individuals.

This simplifying feature could also remove the rate differential between capital and income, removing the inspiration behind many current tax avoidance schemes. As a result, certain anti-avoidance legislation may no longer be necessary. This scenario is especially relevant for EE flat taxes, as capital gains are not taxed under an HR flat tax.

Feld's (1995) other features are:

- Current expensing of investment removes the rules over depreciation and basis

This feature only applies to the HR flat tax. under its provisions, the complex UK capital allowances legislation would be removed since immediate tax relief would be available for capital expenditure on business assets.

- Removal of the capital gain/income distinction removes the need to designate transactions under the more favourable category

As noted above, this would apply to both HR and EE flat taxes and remove the need for associated anti-avoidance legislation.

- Accounting on a cash basis removes arbitrage between different accounting systems

This feature only applies to the HR flat tax.

However, it must be noted that the obvious simplifying factors and associated compliance cost reductions may be qualified in practice. For example, the expensing of investments gives rise to a large number of tax planning opportunities as identified in the next chapter. These would be likely to require complex anti-avoidance legislation to be passed by government to prevent unacceptable revenue loss. Benefits arising from cash accounting are also qualified since the use of accrual accounting in preparing statutory accounts is now firmly accepted practice in the UK. Adjustments would therefore need to be made to a cash flow basis for tax purposes, creating compliance costs for taxpayers.

All of these factors should in theory lead to increased clarity in the UK tax system and remove sources of tax avoidance planning to exploit the current system. Significant amounts of anti-avoidance planning, and hence blocking legislation, are concerned with the often artificial differences between capital and income. In addition, the complicated capital allowances legislation would be removed, providing genuine simplification and compliance cost savings. However, as noted above, any such simplification may well be counterbalanced by increased complexity in other areas.

6.3 Tax base simplification

Aside from Feld's (1995) points above, the most important area where flat taxes could offer some simplification and associated reductions in compliance costs is in the simplification of the UK's current corporation tax base.

The HR flat tax should serve to simplify the tax base by removing a number of deductions and exemptions, meaning that taxable profit can be calculated with fewer adjustments from accounting profit, reducing compliance costs for business. EE flat taxes do not have any intrinsic base-simplifying properties, but the flattening of tax rates has often in practice been accompanies by simplification of the tax base e.g. the Slovak Republic's reforms.

The Tax Reform Commission in the UK published a report in 2007 entitled 'Tax Matters: Reforming the Tax System'. Introduction of a flat tax of the EE variety in the UK was considered, largely drawing on the work of Heath (2006). The Commission concluded that a flat tax could simplify the tax system since with fewer taxes and exemptions it would be simpler and cheaper to administer. This would possibly have the beneficial effect of bringing transactions out of the 'grey' economy, leading to an increase in tax revenue.

In a similar vein from the USA, the GAO (1998) noted that consumption-based taxes such as the HR flat tax may remove some difficulties in defining and recognising taxable income of the current system, thus reducing both compliance and administrative costs.

Teather (2005) notes that the removal of allowances and deductions is practical under a generic flat tax system because they become less important with a single, low rate of tax. He also notes that the single rate in the flat tax is itself a source of simplicity, which is commonly extended by removal of allowances and deductions from the system. The Slovak flat tax reforms (Krajcir and Odor, 2005) were notable among the EE flat taxes for the removal of multiple exemptions from the country's tax legislation, a reform considered to have had a significant impact on reducing complexity in the tax system.

The Tax Reform Commission (2007) report highlights the point from a UK perspective that 'some of the benefits of simplicity attributed to flat rate taxes arise from proposed changes in what sources of income are included in the tax base rather than from replacement of a multiple tax rate system with a single tax rate', suggesting that base simplification is the more important effect of the system.

6.4 Potential reduction in UK compliance costs

While the promise of simplification of a tax system by supporters of flat tax is attractive, the prospect of associated substantial reductions on compliance costs is of immense interest to business taxpayers. One of the well known claims of the HR flat tax made by its founders Hall and Rabushka is that tax returns can be made on a postcard-sized form due to the extreme simplicity of calculating tax liabilities.

The GAO report (1998) summarises a number of potential impacts on tax compliance for American business on the introduction of the HR flat tax; at first glance, a modest reduction in compliance costs appears to be the predicted outcome.

Burden	Under current system	Impact of HR flat tax
Return filing	All businesses file	All businesses included
Records kept	Records supporting income and expenses supposed to be kept	Businesses responsible for wage reporting to individuals; records for items such as depreciation not needed except for possible transition
Calculations made	Complicated provisions included for provisions such as depreciation	Fewer calculations such as for depreciation and multiple rates required; possible fringe benefit calculations
Complexity faced	Detailed rules involved; complexity reflected in areas such as depreciation; difficulties existing in defining and recognising income	Without exemptions and multiple rates, tax simplified; fringe benefits calculations complicated, if broad range taxed at individual level
Requirement to furnish information returns	Several information and withholding documents filed	Returns still needed for wages but not investment earning; withholding possibly still required

Impact on Tax Compliance for US business on introduction of the HR flat tax (GAO 1998, p163)

6.4.1 Processing returns

Under an HR flat tax, businesses would continue to file returns so the number processed might be similar compared to the current UK tax system. Dates of filing and payment of taxes are not specifically mentioned in the original HR flat tax plan. The GAO report (1998) claims that the return form would be much simpler which would ‘facilitate automation of data entry and document matching, making the process less error-prone and costly and providing timely data for auditors’.

6.5 Compliance costs studies

6.5.1 HR flat tax studies

Studies which attempt to estimate the effect on compliance costs with the introduction of the HR flat tax have been carried out, among others, by both Slemrod (1996) and Hall (1996) in the USA.

An aggressive proponent of the benefits of the HR flat tax, Hall (1996) claimed that its introduction would cut the cost of compliance by 94% if introduced in its pure form. He notes that a cash flow tax such as the HR flat tax would remove the complexities associated with the following items, which he claims contribute the most to compliance costs, noting that the Tax Foundation in the USA found that 45.5% of the income tax compliance costs spent by the Fortune 500 companies relate to foreign source income:

- Depreciation and capital allowances
- Foreign source income rules
- Inventory capitalisation
- Amortisation of intangibles
- Long term contracts

Hall (1996) comments that the HR flat tax would, in his opinion, remove almost every area of complexity identified in the Tax Foundation sponsored survey of senior corporate tax officers investigating complex areas in the current tax code.

In terms of actual numbers, ignoring transition costs and potential costs of reintroducing social policy (both of which are potentially significant), Hall (1996) estimated the cost of record keeping, learning the new laws, preparing and sending the tax forms would cost $8.4 billion. Businesses (both incorporated and unincorporated) would take three hours and twenty-four minutes annually to comply with the HR flat tax compared to over two hundred hours for the average company under the current system. The reduction is achieved in all aspects of the paperwork burden. The compliance burden of the pure HR flat tax was estimated using the same methods that the IRS used to calculate the current system's compliance costs, which estimate taxpayer paperwork burdens using the various characteristics of the tax return forms and the content of the instructions.

However, it should be noted that the accuracy of these calculations has been questioned. Gale (2001) describes some of the figures for time estimates as 'implausibly low' and points out the absence of many compliance costs such as tax planning and auditing.

Slemrod's (1996) study makes the more realistic conclusion 'it is impossible to confidently forecast the collection cost of the business part of the flat tax on the basis of observable systems, because none exists'. He makes an educated guess that business compliance costs would be cut by one third (from $17 billion individual income tax and $20 billion corporation tax) to about $25 billion. Individual filing costs would reduce by 70% from $33 billion to $10 billion giving total compliance costs of $35 billion, which is half his compliance cost estimate for income tax at 0.5% of GDP in 1995. Such calculations still imply a considerable saving in compliance costs is achievable

6.5.2 Western European modelling

Compliance costs have also been modelled in Western Europe following interest generated from the EE flat tax reforms; these consider a tax system resembling EE rather than HR flat tax.

Fuest et al (2007) state in their flat tax simulation for Germany that 'flat tax reforms are thought to reduce administration and compliance costs' and quote Fuest et al (2006), whose study for Germany showed that revenue neutral simplification of the tax base can reduce compliance costs by about 8%.

Fuest et al (2006) consider whether tax simplification leads to efficiency in an empirical analysis for Germany. They point out the importance attributed to simplification in debates on tax reform but note that little empirical research exists. In their opinion, this is in part due to the fact that 'tax simplification itself is not a clearly defined concept', and hence changes in tax law may not clearly increase or decrease the complexity of the system. Broadening the tax base is usually considered to be a simplification, but Slemrod (1984) gives a case of imputing rent to owner-occupied housing as an example where complexity increases on base broadening.

The group takes the use of professional tax advice as an indicator of the complexity of the tax system and its associated compliance costs. Tax simplification is modelled as abolition of a set of deductions from the tax base, a feature of both HR and EE flat taxes. While the study relates to personal income tax it applies equally to corporate income tax. Unsurprisingly, perhaps, simplification leads to a modest reduction in tax advice.

6.6 Conclusion

On a superficial level, flat taxes appear to be able to offer some significant simplifications for the current UK system. Broadening of the tax base ad removal of bracket arbitrage are benefits offered by both EE and HR flat taxes. The HR flat tax offers further simplification in the removal of capital/income distinctions and expensing of business assets.

However, the extent of simplification appears to be overstated by flat tax supporters. Weisbach (2000) concludes on this issue 'the claims of simplicity by proponents of the flat tax are wildly overstated. Overall, one should expect a system that is simpler than current law, but not extremely so'. Compliance cost studies such as those of Hall (1996) and Slemrod (1996) would therefore appear to paint a false picture of the benefits of an HR flat tax. In addition, introduction of a flat tax would generate new forms of compliance and further compliance costs of unknown magnitude but which cannot be overlooked.

Slemrod (1996) notes that any comprehensive tax system will have inherent structural complexity with difficult issues such as the capital and income distinction. Consumption based taxes such as the HR flat tax have some simplifying features such as exempting ordinary return on capital. In addition, they avoid problems of measurement and transactional complexity when different ways of taxing capital are not taxed in the same way. Any simplicity gains depend, though, on the implementation of the system, and whether the pure HR flat tax is practical to introduce.

Slemrod (1996) also questions whether a consumption basis is needed for major simplification of the existing tax system. He considers that a ‘clean-base, return-free income tax system with a single rate’ would achieve much, but capital income taxation complexities remain. An HR flat tax on the surface provides major simplification but the implicit subsidies for certain behaviour are possibly the biggest barrier to true simplification.

Should the simplification claims of the HR flat tax prove to be significantly overstated, Weisbach (2000) warns ‘Without the claim of simplicity, and with the claims of efficiency correspondingly reduced, the case for the flat tax becomes extremely weak’. The next chapter introduces a range of arguments as to why significant simplification is unlikely.

7. Evidence that a flat tax would not reduce complexity of the UK tax system

Despite some apparently simplifying features of flat tax noted above, there is substantial evidence that the overall effect on the UK's corporation tax legislation and compliance costs may in fact be very limited.

One of the first studies in this area was made by Feld in 1995 in the early days of the discussion of the HR flat tax. This was quickly followed by a number of commentators in the USA such as Calegari (1998), who identified new tax avoidance opportunities arising under the HR flat tax not in the current system, as well as cases where the HR flat tax removes barriers to avoidance constructed by the tax authorities. These would require legislation to block and would thereby increase the complexity of the tax legislation and the time needed to comply with it.

The majority of this chapter refers to the HR flat tax given the claims made over its simplifying powers and cost savings as detailed in the previous chapter. The EE flat taxes and the effects of their introduction are considered in the next chapter.

7.1 Effect on legislative complexity

Martin (2005) considered the effect of introducing an EE flat tax in upon the UK tax legislation. He agreed that such a flat tax would remove many of the reliefs that cause legislative complexity and broaden the tax base. However, he points out that abolishing all of the reliefs noted by Teather (2005) would be likely to repeal only 1% or 2% of current direct tax law, doing little to remove complexity generated by length.

Martin (2005) concludes that 'simplification of the tax system is ultimately a matter of political will and conviction. An attractive panacea – such as the flat tax – will not in itself solve the problem of complexity'. He notes that supporters of flat taxes and their potential for simplifying the UK tax system should beware of the danger identified by Mencken (1920) 'for every complex problem, there is a solution that is simple, neat and wrong', with sources of complexity remaining and new sources created.

7.2 New opportunities for tax avoidance planning

A number of studies suggest that it appears likely that the HR flat tax legislation will simply provide different opportunities from the current system for tax avoidance. These are likely to be sought out quickly and exploited by tax advisers and taxpayers. Government will then have to act to block the unintended loopholes with new anti-avoidance legislation, and there is no reason to think that these will be any simpler and create less complexity than the current regime.

Feld (1995) concludes that to avoid revenue loss, the HR flat tax will either generate complex business transactions (to skirt the simple rules) or complicated tax laws (to reduce the gaming possibilities) or both.

Bankman and Schler (2005) note the possibility that tax professionals may leave the field when faced with a simple tax code in which is harder to find loopholes. However, they feel that this is unlikely to happen due to the potential rewards at stake, and a great deal of effort by the tax avoidance industry is likely to be expended. The fact that even professionals cannot forecast the next legislative loophole, and hence avoidance opportunities in tax law, means it may be almost impossible to predict the effect of introducing a flat tax.

7.2.1 Openness of the HR flat tax

Weisbach (2000) identifies the unusual feature of ‘openness’ of the HR flat tax as the key reason for new opportunities for tax avoidance planning. Openness means that businesses can claim tax deductions for transactions that are not necessarily matched by being taxed elsewhere. An example is the sale of land by an individual to a business; under the HR flat tax, the individual is not taxed but the business can claim an immediate tax deduction for the purchase price. This openness comes from the lack of a requirement for invoices for domestic transactions, and the territorial treatment of international transactions.

Credit invoice VAT systems, which bear some resemblance to the HR flat tax, are usually closed systems, as is the current UK corporation tax system. This means that the above scenario will not occur, with any transaction being treated symmetrically for tax purposes. Where such symmetry breaks down, it will be exploited by tax avoiders and usually require new legislation to close the loophole.

7.2.2 International operation of the HR flat tax

The HR flat tax taxes exports and exempts imports whereas other VATs do the exact opposite. This makes the flat tax internationally open.

7.2.3.1 Background

The HR flat tax is territorial as it does not tax foreign income, unlike the current UK tax system. It is an origin based tax since the taxpayer gets a deduction for imports and pays tax on exports. Since other countries have destination based taxes, the flat tax will doubly tax exports and not tax imports in any country that introduced it, which would not be a politically popular result.

Economists may argue that exchange rates would adjust automatically to remove this distortion with the currency of the flat tax state weakening. However, these arguments would be likely to face political opposition since a double tax is an obvious and immediate result, unlike a currency adjustment.

7.2.3.2 Origin base

Weisbach (2000) is not clear why the HR flat tax is designed to be origin based, considering that Hall and Rabushka deliberately refer to the HR flat tax as an income tax for political reasons. He comments ‘The question is whether this cosmetic difference is worth the disadvantages: being inconsistent with other consumption taxes, relying on currency adjustments to avoid adverse effects on US exports and being open internationally’.

7.3 Tax avoidance planning strategies

7.3.1 Introduction

Stiglitz (1985) put forward three general principles which may form the basis of successful tax avoidance planning:

- Postponing taxes into future periods
- Arbitrage across different income streams with different tax treatment (source-based)
- Arbitrage across different tax rates (rate-based)

In a similar vein, Scholes and Wolfson (1992) state that effective tax planning requires three main considerations:

- Tax implications of a transaction to all parties
- Explicit and implicit taxes and tax clienteles
- Costs of implementation

Scholes and Wolfson (1988) show that tax avoidance strategies can incur significant non-tax costs. For example, under an HR flat tax, postponing tax liabilities by borrowing to purchase equipment may lock into unfavourable investments that are costly to reverse. In addition, Stiglitz (1985) notes that tax avoidance effects cannot be analysed by considering a single taxpayer, since another taxpayer’s liability may have increased.

7.4 Strategies

Weisbach (2000) considers five key areas that form the basis of much current tax planning and are hence responsible for complexity of tax law. All of these areas will present new opportunities for tax avoidance planning under the HR flat tax, and are discussed in greater depth below:

- Accounting methods
- Financial transactions
- Losses and structure of the business tax
- International transactions
- Small businesses

7.4.1 Accounting methods

The HR flat tax uses a cash flow basis to determine taxable profit. This goes against recent accounting developments in the UK which require accounts to be prepared on an accruals basis. Accounts prepared on a cash accounting basis can easily be distorted by delaying or bringing forward payments close to the year end, both of which would directly impact the taxpayer's liabilities.

7.4.1.1 Accounting methods and periods

Weisbach (2000) notes that some commentators have argued that the fact that the timing of a transaction is determined by the date of payment is the principle argument in favour of a consumption tax over an income tax. Complexity generated by rules of timing under accruals-based accounting is thus removed. However, this property can easily be manipulated as mentioned above by transactions close to the period end, as discussed below.

7.4.1.2 Postponing recognition of sales income

Postponement of taxes is easy in a cash flow based tax, since sales income arising in the current year can be delayed being received until the next year, either by collusion with the customer or delay in issuing a sales invoice, leading to postponement of tax payment for one year. In a growing business, this represents effective permanent deferral of tax. Under accruals accounting, such planning is ineffective.

Calegari (1998) points out that the HR flat tax does not contain any guidance on allowed tax accounting periods, as noted in other studies such as Feld (1995). Since this presents an easy opportunity to avoid taxes, such as by paying connected companies with different year ends, he assumes that all taxpayers would have to use the same year end.

The scheme does have some practical difficulties. The plan may depend on the customer agreeing to the payment pattern and a taxpayer business will be unlikely to do so as they will not obtain a deduction until payment is physically made. There may also be some cash flow risks. Companies with losses may be prepared to defer payment, but transaction costs and the HR interest adjustment to carried forward losses may be an issue. There is also the potential to defer income by instalment sales.

Commentators are split on whether the ability to defer income is a serious issue. Bankman (2005) does not believe that the present value of the tax liability for the company will alter whereas Schler (2005) highlights the immediate drop in revenue for government as a serious issue in the short term.

7.4.1.3 Accelerating purchases

Since purchases are deducted from income to arrive at taxable profit, accelerating them will serve to reduce the business's tax liability for the period and give a cash flow benefit. This is the converse of the above strategy and again requires the agreement of the other party in the transaction. To obtain such agreement, implicit taxes in the shape of higher purchase prices are likely to become a factor, potentially negating the strategy. The HR flat tax is not clear as to whether assets purchased under an instalment plan receive an immediate deduction for the full cost.

The HR flat tax does provide an incentive to purchase assets from non-business sources e.g. land used for personal or investment purposes where the seller recognises no income. Where the seller is an exempt organisation or a retirement plan this strategy will also work. Business owners can therefore effectively shelter income using investments. This tax planning idea is discussed at length below.

7.4.2 Financial transactions

7.4.2.1 Reclassification of income

The HR flat tax is vulnerable to source-based arbitrage planning due to its openness, because several sources of income are exempt from tax under its provisions. Examples of exempt income include investment or personal use income, so there would be an obvious incentive to convert business income into one of these categories. It should, however, always be borne in mind that, where the costs of identifying an appropriate counterparty and negotiating exceed the tax saving, the strategy is not worth pursuing.

The HR flat tax will certainly need new rules to deal with financial instruments as opposed to usual goods and services. The current UK tax system has complex rules to distinguish financial returns and disguised interest. However, the HR flat tax's rules would probably need to be more comprehensive given the difference in tax treatment at stake.

A number of examples of such reclassification schemes are discussed below:

7.4.2.2 Conversion of sales to interest income

Under the HR flat tax, interest income is exempt whereas income from sales of goods and services is taxable. Both are taxable under the existing UK system. This gives a clear incentive for companies to designate income as interest, which can easily be achieved using complex financial instruments or by more straightforward planning.

Sales income may be converted to interest income by offering the buyer a lower sales price in return for a high rate of interest on an instalment paid in a later tax year. However, the success of this planning depends on the other party to the transaction. A business customer who is independent of the seller is unlikely to agree as they will lose the benefit of a full deduction for tax. However, an individual is more likely to agree as the purchase has no tax consequences for them. Anti-avoidance solutions such as legislating maximum rates of interest would be complex.

7.4.2.3 Converting interest payments to purchase of goods

Under the HR flat tax, purchases of goods and capital assets are deductible for a business, but interest payable is not. Both are deductible under the current UK system. Again, tax planning to reclassify interest payments as purchases would be an attractive option.

One simple scheme is the converse of the above where businesses can purchase assets from individuals and pay above market value during the next accounting year, effectively taking a loan without having to account for interest. The financial return is thus shifted to the exempt individual, a consequence of the openness of the flat tax.

7.4.2.4 Asset expensing

Under the HR flat tax, a company’s liabilities can be offset by buying any asset which receives an immediate tax deduction. It does not have to be used in the business. Such an opportunity of perfectly legal avoidance is likely to be unacceptable to revenue authorities.

The HR flat tax treats rental income from a property or land investment as a business activity. Feld (1995) gives the example of a business owner buying a field let out for nominal income and being able to deduct the purchase price of the field in full against other business income. Under current UK law no deduction would be available since the field is classed as an investment asset.

There is disagreement between commentators as to the seriousness of this issue, loosely split between economists and tax advisers. Economists such as Bankman (in a joint paper with Schler below, 2005) do not view this as a problem since the total liability remains unchanged although its present value will reduce. The risk of tax rates decreasing would be balanced by the risk of them increasing meaning, among other factors, that deferral would not be the automatic option for companies. Tax advisers such as Schler (2005), however, feel that deferral is a fundamental flaw and reason enough to reject the HR flat tax on its own. A single avoidance scheme that achieves its purpose could remove all accumulated tax liabilities of a company and the temptation to do so would be too great for most businesses. In his opinion, government revenues would be likely to suffer seriously both in the short and longer terms.

7.4.3 Loss planning

Company losses have traditionally been an area of extensive tax planning in the UK to reduce liabilities and much anti-avoidance legislation has been written in this field such as that to stop companies buying others solely to utilise their tax losses. Similar provisions do not seem to exist under the HR flat tax and again it is likely that complex rules would need to be introduced. Feld (1995) comments from a USA perspective ‘the logical conclusion of unregulated allocation of deductions would allow free transferability of losses. Historically, however, the outcry against the opportunity by wealthy businesses to purchase exemption from income tax has produced the existing restrictions on the transfer of loss corporations and repeal in 1982 of the finance lease provisions of the 1981 tax act'.

7.4.3.1 Refundability

Rules covering losses and business transactions such as formation, liquidation and mergers are closely linked. Under the HR flat tax, no refund for losses is allowed (unlike VATs). This is likely to be due to the openness of the system and lack of invoices meaning fraudulent inclusion of losses where no corresponding gain is recorded becomes likely. The various fraudulent missing trader VAT schemes in the UK testify to the attractiveness of such schemes.

Under the HR flat tax, losses are carried forward with a rate below that of the market, presumably as a compromise measure. In practice, complications would arise if the rate of interest changed in calculating the amount of losses to carry forward and rules governing order of loss offset may also be required.

Weisbach (2000) notes that some commentators have argued that carrying forward losses under the HR flat tax would not be a good idea since enforcing loss restrictions under the tax would be costly and difficult. A refundable scheme has been proposed; however, this would seem impractical when combined with the ability to deduct non-business asset costs immediately from profits and obtain cash from the government. Fraud and elaborate tax planning to create artificial losses would be certain to be problematic.

Since losses are not refundable, tax effects arise on transactions between businesses. This could lead to non-arm's length pricing to avoid cash flow disadvantages, and appropriate anti-avoidance legislation would need to be introduced.

7.4.3.2 Transferability

Losses are easily transferred under the HR flat tax between parties acting in concert to manipulate transfer prices.

Martin (2005) has identified that some form of group relief will be likely to be required, even though the HR flat tax makes no provision for loss transferability. Similar rules to those restricting the use of losses after a change in ownership might also need to be introduced if the non-transferability provisions were relaxed, adding further complexity.

As Weisbach (2000) says, 'effectively, much of current law ends up being recreated in the flat tax'.

7.4.4 International transactions

The HR flat tax would change the current UK system of taxing a company's worldwide income, with credit for foreign taxes and other rules under the double tax treaties. Goods and services exported from the UK would be included in receipts, business inputs imported into the UK would be deducted but income from activities abroad would be excluded from the tax base.

This provision would give wide scope for tax avoidance by companies able to move transactions overseas. The UK currently taxes a company's worldwide income where the company is UK resident or centrally managed and controlled in the UK. It is likely that complicated transfer pricing legislation would be required to prevent substantial erosion of the tax base.

Under the HR flat tax, overseas earnings of businesses would not be taxed. Hall and Rabushka considered that international business would be attracted to the US due to their low rate of 19% which would counter the initial loss of revenue. As already noted, some simplification would result under the HR flat tax with problems administering foreign tax credits being removed. However, the future of double tax treaties under the HR flat tax is unclear and other countries might change their own international tax rules in response.

7.4.4.1 Transfer pricing

Under the HR flat tax, for the reasons noted above, interest income would ideally be moved into the flat tax country where it would be untaxed, and interest expense moved abroad where it would get a tax deduction. A low rate of HR flat tax might encourage companies to locate more activity in the flat tax country; this could then lead to double tax treaties being renegotiated requiring legislative changes under the flat tax (Hines 1996). Transfer pricing legislation would be required to prevent these abuses, but the international scale of business for larger companies would still serve to make this a difficult area to administer. The HR flat tax is therefore likely to need rules similar in scope and complexity to current rules.

7.4.4.2 Treaties

Avi-Yonah (1995) suggests that renegotiation of all treaties would be required as the HR flat tax would not qualify currently as an income tax, and as it removes withholding tax on dividends, the chief negotiating tool, this could be a major and costly exercise. Weisbach (2000) disagrees, noting that, although the flat tax is not an income tax, in periods before where tax on capital was zero due to enhanced depreciation and investment credits, there was no renegotiation necessary. He does concede, however, that in practice withholding may need to be retained as leverage against renegotiation.

7.5 Potential complicating reforms required on introduction

7.5.1 Political pressure

Feld (1995) identifies some companies who would lose out under an HR flat tax and would be likely to lobby for the current system to be retained:

- Companies benefiting from special deductions

- Labour-intensive companies – companies that rely on machinery rather than labour would benefit from full expensing of plant and machinery whereas labour reliant companies would be unable to deduct employer's national insurance and other fringe benefits
- Home builders – in the US where mortgage interest is tax deductible for individuals the HR flat tax might be expected to lower house prices since it abolishes this relief – this could affect UK companies with US operations

Opposition might also come from those unsure about the future unknown consequences of such a major change of tax systems and those philosophically opposed to such as shifting of the tax burden.

Some companies would face massive increases in their tax liabilities. Hall and Rabushka (1995) note that General Motors' liability would rise from $110 million in 1993 to $2.7 billion under a 19% HR flat tax. Despite economic theory on the incidence of corporation tax mentioned in a previous chapter that individuals rather than companies ultimately bear the tax, companies' management are unlikely to accept such a change without protest, possibly demanding extra relief or a smaller tax base.

Other companies with large profits would pay no taxes upon introduction of an HR flat tax. Income from financial assets such as interest is not taxable under the HR flat tax; although this is consistent with the flat tax theory, this situation in the past led to anti-avoidance legislation. On the other hand, companies with losses may have large liabilities, especially those with large interest payments, health insurance, payroll taxes and state and local income taxes (a particular problem in the US), none of which would be deductible. Gale (2001) comments that such companies would likely press to retain deductions for these items which could account for half the business tax base.

Truman (2008) highlights the difficulty for government in passing simplifying legislation where an increase in liability was the result 'it was no surprise that the main attempt in the [2008] Budget to genuinely simplify an area of tax, taking CGT back to its roots, came under withering fire, which forced at least a partial retreat'. The results of this recent tax reform are discussed in a later chapter.

Moving to a HR flat tax would entail a radical change to the current system and could give rise to perception issues for companies, potentially leading to opposition. Possibly the greatest issue would be the change from an accruals to a cash flow basis and the company's profit in its accounts would not form even the starting point for taxable profits. Changing the logic and structure of corporation tax will create perceived problems even though they make theoretical sense under the HR flat tax model.

7.5.2 Transition tax

Introducing a HR flat tax without any transition measures would remove existing tax bases with no more deductions for amortisation, equivalent to a lump sum tax on existing capital. There is no mention of transition relief in the HR flat tax. While this would raise political and economic problems, some form of relief might be the simplest solution.

Some economists including Bankman (2005) think that not introducing transition relief is efficient, since no distorting factors for spending that capital arise, and equitable since taxing existing capital is progressive. Others such as Schler (2005) argue that it is inefficient, since taxpayers will change behaviour to avoid paying the tax, and inequitable as it is applied to consumption on after tax savings. However, political pressure is likely to produce a form of transition relief. On a practical level, were a HR flat tax to be implemented, Pearlman (1996) notes ‘we should expect near unanimity that it will be necessary to provide transition relief’. Zodrow (2000) agrees that relief is ‘virtually inevitable’. Both discuss areas that would require relief including lost capital allowances, losses brought forward and foreign tax credits. The radical change in the tax treatment of interest would also be a candidate. On a more general note, transition to a new tax system could affect existing legal contracts. Pearlman (1996) concludes ‘inevitably, any approach will make the new law more complex for a long time’.

There would still be opportunities for taxpayers to avoid transition tax and the necessary anti-avoidance rules would be complex. Taxpayers would attempt to recover existing basis, for example by selling assets to non-taxpayers prior to transition and then leasing back or purchasing after transition. Shifting assets between group companies is likely to occur, again leading to necessary anti-avoidance measures, complicating the existing tax legislation. Rules to prevent this may not be successful; a retrospective date to eliminate basis would be simple but unpopular, and anti-avoidance provisions for leases would be very complicated. Long term contracts, including financial instruments, may be significantly dislocated.

Transition relief would reduce these problems but still complicate the legislation. A dual system would exist which would probably be more complex and expensive to maintain than the present law.

7.6 Impact on compliance and administration costs

7.6.1 Information reporting and filing frequency

Under the HR flat tax, businesses would still need to keep accounting records. Businesses would continue to submit records to employees and HMRC showing employees’ wages and salaries. Calculation of capital allowances would be eliminated, as would foreign tax credits, investment income and foreign income records, unless a transition period were introduced.

Businesses would probably file similar returns and make similar payments to the existing systems, although Calegari (1998) notes that there is no mention of due dates for returns or payment of tax for companies in the HR proposal.

There is no reliable data to evaluate the compliance cost of a HR flat tax, given that no such tax system has been implemented in practice. As mentioned previously, Slemrod (1996) estimated overall compliance costs as half his estimate for the current US system with business costs cut by one third, although Gravelle (1996) points out that his compliance figures, although reasonable from the data available, are based on weak data, difficulty in identifying marginal costs and exaggeration.

7.6.2 Impact on tax administrators

The GAO (1998) produced the following table comparing the administration requirements of the then current US tax system compared with the HR flat tax. Although the results are only qualitative, they do highlight that significant administration costs reduction is an unlikely outcome.

Item	Current tax	HR flat tax
Impact on number of returns processed	Millions of returns and other material received	Returns simplified; although similar number less information required as interest and dividends not taxed
Impact on refund processing	Millions of refunds issued	Refunds still required for excess payments
Impact on examination approach	Tax returns matched with information returns	Auditing business records still needed
Continuation of old compliance problems	Compliance problems relating to income definition, unreported income and more specific issues such as transfer pricing, depreciation, deductibility of business expenses, small businesses, contractors and the underground economy	Problems will mainly continue
Resolution of old compliance problems	Not applicable	Compliance problems with depreciation and income definition eliminated
Creation of new compliance problems	Not applicable	Tax avoidance encouraged for employees paid other than by cash; sales characterised as interest received and fringe benefits audit could be complicated
Impact on collections from tax delinquents	Many investigations and accounts disposed of	Collection follow up reduced by less information; employment tax problems likely to continue
Impact on individuals' questions received	Many taxpayer queries received	Some questions unnecessary when income and deduction items eliminated

Comparison of administration requirements of US tax system with HR flat tax (GAO, 1998, p167)

7.6.3 Audit & examination

Examining business records would still take up much of HMRC's time under an HR flat tax. The GAO (1998) report points out that tax authorities would have to create a new risk system to identify returns of interest; given that no HR flat tax has been implemented this would have to be based on the current system and would take time to develop.

Current problem areas of compliance would remain under the HR flat tax such as understatement of income, and the underground economy would also be likely to remain. Grubert and Newlon (1995) have noted that abusive[5] transfer pricing would remain, especially given the opportunities for avoidance under the HR flat tax discussed above.

7.6.4 Taxpayer services

The GAO report (1998) acknowledges the need for an initial education period given the scale of changing to an HR flat tax, which would lead to several one-off costs. The business tax would require initial extra audit time by HMRC to ensure compliance with the new system. Major changes such as capital expensing would need significant time to explain to taxpayers, and if a transition system was operated, complying with two systems would likely require more expenditure on education and services for taxpayers.

7.6.5 Impact on compliance costs

Calegari (1998) suggests business will incur significant costs restructuring to avoid tax on introduction of a HR flat tax. He also considers that compliance and enforcement costs will be lower under a HR flat tax but that the authorities will have to conduct extra audits for business, increasing administration costs.

Gravelle (1996) analyses likely effects on compliance costs by breaking down the introduction of a HR flat tax into five stages:

- A general base broadening
- Imposition of single-level tax of capital income
- Adoption of a territorial base eliminating foreign tax credits
- Adoption of a single flat rate with exemption for individuals
- Shift of the tax base from income to consumption by allowing expensing

5 Manipulation of transfer prices so that they no longer reflect economic reality in order to reduce tax liabilities

Looking at the stages in detail, Gravelle (1996) comments that in the final stage compliance issues are of low importance since businesses will still require books of accounts, even under an expensing regime. Transition issues will be far more significant with a potential lump sum tax on old capital, and the complexity of potential transition legislation. The fourth step leads to a similar conclusion since most taxpayers already have an effective flat rate with an exemption.

The territorial base is important for large firms but Gravelle (1996) is unconvinced it will simplify the system as more pressure will be placed on transfer pricing rules. She notes that the first two steps would be likely to achieve compliance cost savings, but could also be achieved by simplifying the current system reducing complexity in income reporting for tax purposes.

7.7 Conclusions

Weisbach (2000) makes the telling point that ‘Most students of the tax law generally had the intuition that once details of the [HR] flat tax were spelled out, the claims of extreme simplicity would be discredited. The analysis here confirms this intuition. The flat tax cannot be as simple as claimed and still both raise revenue and not create adverse incentives. Many of the implementation issues in the flat tax would be extremely complex, and one can expect rules close to the level of detail and complexity of those in current law. The flat tax would not come close to living up to the prediction of postcard returns’. Feld (1995) agrees; his conclusion, which he describes as ‘modest’, is that ‘the flat tax cannot achieve all its goals of a simple statute and simple taxpayer reporting at a low uniform rate and raise the revenues produced under the current income tax regime’ and ‘something will give way in their resolution: the revenue yield, the simplicity of the tax or the simplicity of the business transactions…The imagination of practitioners and the need by government to preserve its chief revenue source will pull the statute in different directions and inevitably create complexity’.

Weisbach’s (2000) specific conclusion about claims of simplicity is that ‘the regime will be complex and difficult to implement, although still somewhat simpler than current law…Without the claims of simplicity and efficiency, the argument for the Flat Tax becomes extremely weak’.

This lack of simplicity is largely due to the HR flat tax, in the words of McLure and Zodrow (1996), containing ‘unacceptable opportunities for abuse’, and benefits such as equating the tax treatment of debt and equity are offset by the creation of new distortions as shown by the many examples above.

8. Experience of countries with EE flat taxes

The previous two chapters have considered the largely theoretical evidence of the impact of introducing a flat tax upon the UK's corporation tax legislation and compliance, considering especially the HR flat tax.

This chapter briefly describes the real life flat tax systems introduced in some Eastern European countries. It then considers the evidence for simplification and reduction in compliance costs in those countries as a result of the reforms to their tax systems. While the EE flat tax reforms have been considered to some extent in the UK flat tax debate, analysis of available data has seldom been used.

8.1 Introduction

A number of countries in Eastern Europe have introduced flat taxes which by and large follow Keen et al's (2006) definition above in the last few years. The table below shows the change in rates for both income tax and corporation tax between the year of the reform and the previous year. Data is taken from Keen et al (2006) and Alvin Rabushka's blog at http://flattaxes.blogspot.com

	'Flat tax' adopted	Income tax rate %		Corporation tax rate %	
		Before	After	Before	After
Estonia	1994	16-33	26	35	26
Lithuania	1994	18-33	33	29	29
Latvia	1995	25 & 10	25	25	25
Russia	2001	12-30	13	30	30
Serbia	2003	10-20	14	20	14
Ukraine	2004	10-40	13	30	25
Slovak Republic	2004	10-38	19	19	19
Georgia	2005	12-20	12	20	20
Romania	2005	18-40	11	25	16
Macedonia	2007	15-24	12	15	12
Montenegro	2007	16-24	15	15 & 20	9

Albania	2008	5-30	10	20	10
Czech Republic	2008	12-32	15	24	21
Bulgaria	2008	20-24	10	10	10

Change in tax rates observed for EE flat tax adopters (Keen et al, 2006, p6)

The table demonstrates that the reforms were, in general, radical ones in terms of changes to tax rates, becoming more so with later adopters. Although an obvious point, it serves to highlight the importance of the concept of flat tax and its need for further study.

Some of the more significant corporation tax reforms are considered below in more detail in order of date of adoption of the flat tax.

8.2.1 Estonia

Estonia is generally regarded as the pioneer of the EE flat tax movement. The rate of corporation tax has remained the same as income tax; both have been reduced consistently since the year of reform and are scheduled to be 20% by 2009. However, the best known feature of the Estonian corporation tax was not part of the initial reform but was adopted in 2000 whereby undistributed corporate profits were untaxed and distributions (in the form of dividends, other profit distributions, gifts, donations, representation expenses and other expenses deemed unrelated to business activity) taxed at the flat rate.

As seen in the table below, revenue from the corporation tax fell relative to GDP on movement to a flat tax.

8.2.2 Russia

Russia's flat tax reform attracted widespread interest e.g. Gorodnichenko et al (2007), Sinelnikov-Mourylev et al (undated), not least because it has the largest economy of the reforming countries by some considerable distance, and substantial cuts in the higher marginal rates of income tax were concurrent with an increase in revenue collected. Debate ensued as to whether there was any causal link between the two. The reform was also notable for its significant broadening on the income tax base by elimination of exemptions, and an accompanying major reform in the rates for social security contributions.

It should be noted that the Russian flat tax did not strictly meet Keen et al's (2006) definition of flat tax above as the personal allowance is withdrawn with increasing income; once the allowance is exhausted 13% becomes the taxpayer's average as well as marginal rate.

The effects of the corporation tax reforms have generated less discussion than the income tax. In fact, under the Russian reform the corporation tax rate actually initially increased as extra municipal levies were allowed to be levied, increasing the rate from 30% to 35%, although the main corporation tax rate has now fallen to 24%.

Gaddy and Gale (2001) investigated the Russian 2001 tax reforms focussing on the observations of increasing tax revenue and GDP. They claim that Rabushka, one of the architects of the HR flat tax, ‘link the two repeatedly, being careful never to explicitly assert causation’ and HR flat tax supporters ‘often refer to the Russian example as evidence in their favour’. Among their conclusions is that the income tax component of the reforms bore little resemblance to the HR flat tax, which is supported by the observations below. Capital income tax was retained, another difference from a pure HR flat tax.

Gaddy and Gale (2001) also note that income tax compliance increased significantly following the reform, but was more likely due to changes in administration and enforcement and other structural changes rather than taxpayers becoming less incentivised to undertake avoidance due to lower rates of tax. They describe the tax system before the reforms as ‘primitive’ and consider that measures such as provision of ID numbers, indirect assessments, authorisation of tax audits and a general atmosphere of coercion were more important than any reduction in tax rates. Corporation tax compliance was not specifically mentioned, but these conclusions are still valid since a large number of EE reforms were accompanied by more fundamental changes to the tax system.

Their report considers that it would also be dangerous to take improved compliance as evidence that the system appeared simpler for taxpayers, as the specific anti-avoidance measures introduced are likely to have played a significant part. However, the authors acknowledge that the reform did close many existing loopholes and exemptions.

8.2.3 Slovak Republic

The Slovak Republic was the first country to introduce an identical rate (19%) for income tax, corporation tax and VAT. Under law 595/2003 – Collected Laws on income tax, which codified the tax reform, the reform’s reduction in the corporation tax rate from 25% was accompanied by more rapid tax depreciation and more generous carry-forward provisions. This was accompanied by a major reduction in exemptions for companies including tax payment holidays for new companies, limits on deductibility of charitable giving and stricter rules for provisioning and reserves.

The introduction of the flat tax was accompanied by a major reform of the benefits system. Following reform, revenue from corporation tax fell by 0.4% of GDP, but was largely offset by increased indirect tax receipts, mainly from VAT.

Miklos (2005) noted ‘Many say Slovakia now has one of the simplest, most transparent and least distortive tax systems in the world’. This was presumably as a result of reduction in the number of tax rates and removal of a number of exemptions. This is a bold claim and is not reflected in the statistics for ease of corporation tax compliance discussed below.

The Slovakian flat tax reform is generally accepted to be the closest of the Eastern European reforms to the pure HR flat tax, although it still retains significant differences from that theoretical model. Krajcir and Odor (2005) analysed the effects of the flat tax one year after its introduction. Surprisingly, the effect on compliance and administration costs was not analysed by the report, although it was felt that one year was too soon to obtain meaningful results. One possible problem identified was that of start-up costs of taxpayers becoming used to the new system, which could exceed past operating costs and produce distorted results.

Another analysis of the Slovakian flat tax reforms one year after their introduction was performed by Golias and Kicina (2005). As already noted, one of the aims of the reforms was to eliminate all exceptions, exemptions and special regimes. Their report noted that the old tax system included 90 exceptions, 19 sources of untaxed income, 66 tax-exempt items and 37 items with specific tax rates, virtually all of which were abolished by the reform making the system ‘much simpler and transparent and eliminated speculation aimed at paying lower tax rates’.

Under the reforms of corporation tax, loss treatment became more generous with the ability to offset taxable income for up to five years. Other reforms included the removal of tax base deductions for sectors such as agriculture and forestry and other investments incentives reduced such as abolition of tax holidays up to 10 years for new companies, serving to broaden the tax base.

Golias and Kicina (2005) note that only two reforms have been analysed in the literature: Russia (2001) and the Slovak Republic (2004). They speculate that research on these recent reforms is hampered by a lack of good quality data to analyse for the period before the reform.

8.3 Comparison of the EE flat taxes

8.3.1 Differences

Analysis, principally by Keen et al (2006), reveals a number of differences between the EE flat tax regimes:

8.3.2 Rates

The first wave of Baltic State reforms (Estonia to Latvia) tended to cut income tax rates to a level near to the existing highest marginal rate of tax, whereas the second wave commencing with Russia set income tax rates closer to the lowest rate. This contrast is much less clearly defined for corporation tax rates as can be seen in the above table. In general, cuts in corporation tax rates are much lower than income tax, and certainly the tax-cutting rhetoric seen in the flat tax debate has not tended to consider the case of companies to the same extent.

8.3.3 Structural

Estonia, Latvia, Slovak Republic and Romania set their rates of corporation tax and income tax at the same level. This serves to remove tax rate distortions over whether to conduct business via a company or a sole trader (there are, of course, a large number of other distorting factors in reaching this decision), subject to dividends and capital gains being untaxed. In these cases, the flat tax comes closest to the pure HR flat tax although capital expenditure is still not fully expensed in the year of purchase; capital allowances are claimed instead.

Other features of the HR flat tax are also not present in these EE flat taxes including taxes on interest income and capital gains (except Latvia where they remain exempt as before the reform) and the retention of a traditional destination-based VAT.

Of the other four countries considered by Keen et al (2006), three have higher corporation tax than income tax rates while Lithuania does not, illustrating the range of different structures. All four retained withholding taxes on dividends although Russia introduced a credit against the personal tax liability.

8.4 Comparisons with the HR flat tax

It is abundantly clear, even from a cursory analysis, that the Eastern European 'flat tax' reforms bear very little resemblance to the proposals of the HR flat tax.

Murphy (2006) has produced the following table showing how none of the EE flat tax systems contain all, or even a majority, of the key elements of the HR flat tax. An HR flat tax would answer 'no' to all the questions in the table. In addition, none of the flat taxes use a cash flow basis to calculate taxable income for corporation tax purposes and none of them offer immediate expensing for all business assets, two key tenets of the HR flat tax.

Comparison of EE flat tax adopters (Murphy, 2006, p22, NK = not known)

	Savings taxed	Pensions taxed	Overseas earnings taxed	Capital gains taxed	Inheritance tax	Pension contributions attract relief	Charitable contributions tax deductible	Relief for mortgage interest paid	Other tax deductions and reliefs
Estonia	Y	Mainly	Y	Mainly	N	Y	Y	Y	N
Lithuania	Y	Some	Y	Y	Y	Y	Y	N	Y
Latvia	Y	N	Y	Y	N	Y	Y	N	Y
Russia	Y	Y	Y	Y	Y	N	Y	Y	Y
Serbia	Y	Y	Y	Y	N	N	Y	N	Y
Slovakia	Y	Y	Y	Y	N	Y	N	N	N
Ukraine	Y	Y	Y	Y	Y	Y	Y	Y	Y
Georgia	Y	N	NK	Y	NK	NK	Y	NK	NK
Romania	N	Y	Y	NK	N	NK	NK	NK	NK

8.5 Similarities

There are some features of the above EE flat taxes that have recurred to some extent directly affecting the corporation tax:

- Introduction of a flat tax has often been accompanied by a reduction or elimination of exemptions – for example, bringing capital income into tax or eliminating preferences for certain groups of taxpayers or activities. It is apparently this observation that leads supporters of the Eastern European tax reforms to link simplification and flat taxes. However, data below throws into question whether any simplification at all occurred in these countries
- In many cases, reform included a reduction in the corporation tax rate and was followed by further reductions which were larger than those in the income tax rate. In all cases, marginal rates of tax were reduced after reform (although not immediately for Russia)

In general, however, Keen et al (2006) note that the EE flat tax reforms of recent years are very different in design and there is little empirical analysis which make generalisation possible. A few key points do emerge:

8.5.1 Effect on revenue

The following table shows corporation tax revenues before and after the flat tax reforms as a percentage of GDP:

Tax revenues before and after EE flat tax reforms (Keen et al, 2006, p6)

	Year before reform %	Year after reform %
Estonia	4.8	3.5
Lithuania	5.3	2.5
Latvia	2.0	2.4
Russia	5.5	5.8
Slovak Republic	2.8	2.4
Ukraine	5.0	4.7
Georgia	1.6	1.9
Romania	2.7	2.4

Flat tax has in general lead to a relative reduction in revenue from the corporation tax; behavioural responses may have reduced the loss but no Laffer effect of increasing revenue due to reduced avoidance and evasion from the lower tax rate has been observed. The reforms have not funded themselves, and in many cases the gap was filled by increased revenue from indirect taxes.

In the case of Russia, Ivanova et al (2001) consider that the revenue increase was due to strong outperformance of the whole economy, not due to the flat tax itself. The reason for the Georgian revenue increase is unclear.

8.5.2 Compliance and simplification

Ivanova et al (2001) show that income tax compliance improved in Russia, but consider that there is no evidence that this was due to the reform rather than concurrent changes in enforcement. This is nonetheless in accordance with the Hindriks, Keen and Muthoo (1999) findings for countries where administration is weak, so may apply to the other EE flat tax countries although no analysis in this area appears to have been done.

Limited survey evidence from Russia does not suggest that the flat tax reform was seen by taxpayers as simplifying, and data below seems to corroborate this for other Eastern European countries.

Engelschalk (2004) notes that several Eastern European countries which have introduced the so-called ‘flat tax’ reforms have not seen significant impacts on overall business obstacles, and hence presumably a reduction in compliance costs, due to non-reform of all the other business taxes.

8.5.3 Equity

Where reforms were accompanied by tax base broadening via elimination of exemptions (e.g. Ukraine where this was estimated to have increased GDP by one point), this is likely to have increased horizontal equity, efficiency gains and greater simplicity. However, this effect does not seem to have been studied in any of the flat tax countries.

8.5.4 Sustainability of flat taxes

Keen et al (2006) note that the future of EE flat taxes and their imitators remains unclear. They consider that the flat tax will lose the radicalism of its statement as it is easy to imitate, and while other states may introduce similar systems, it may not be long before one of the pioneers abandons it, although the reforms seem robust to date.

8.6 Compliance data

While the reports above highlight the simplifying features of some of the EE flat tax reforms, they provide little in the way of data and analysis to back up these claims. It is therefore necessary to look for alternative sources of information, not produced as a result of flat tax studies, to consider the true impact of the reform in the areas of interest in this thesis.

8.6.1 Corruption analysis

PwC and the World Bank (2006) produced a report which appeared to imply that flat tax reforms which simplified existing tax regimes by cutting rates and exemptions reduced corruption in tax administration. Georgia saw a fall in perceived corruption of tax officials from 44% in 2002 down to 11% in 2005 – the greatest fall in the survey of 27 transition economies. Romania and Slovakia, also flat tax reformers, saw falls from 14% to 8% and 11% to 5% respectively.

However, as already discussed, such results should be treated with caution especially when trying to make a causal link between the two. Other factors such as increased promotion of a culture of compliance, as seen in Russia, and noted above, are very likely to be of significance.

8.6.2 Compliance time

The PwC and World Bank report (2006) also investigated compliance time differences between countries by considering the number of tax payments made per year and the number of hours spent complying per year for corporation tax for a sample small, manufacturing company. Data on tax payments and compliance times was collected from the local PwC office. The size of the company was adjusted to allow meaningful comparisons to be made between countries.

On first principles, a country with a simple tax system would be expected to show low compliance times and a small number of tax payments. One would therefore expect to see countries with flat tax systems, if the claims of simplification attributed to flat tax are correct, to rank highly on both counts compared to countries without such systems.

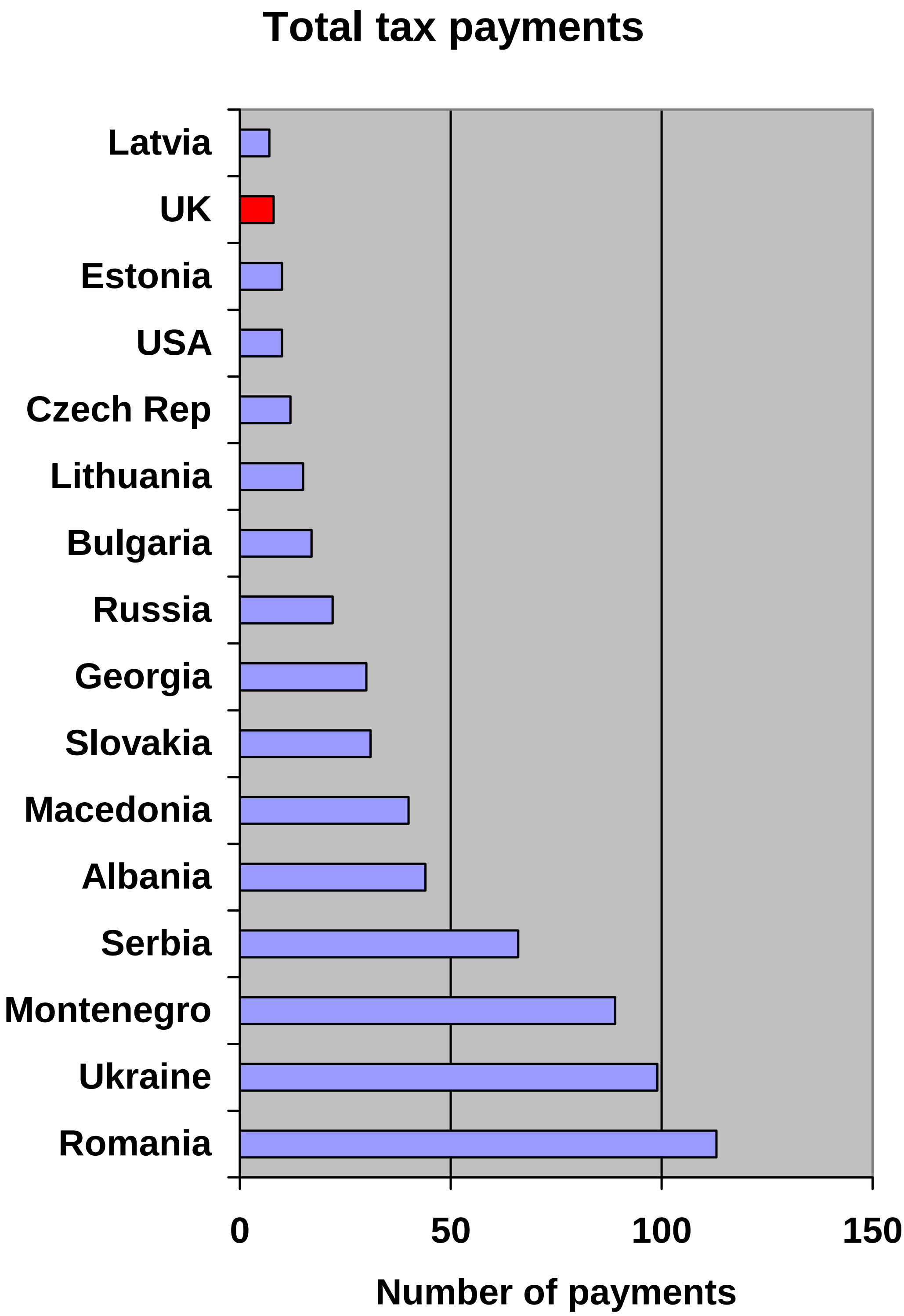
The report acknowledges that for Romania and Ukraine ‘flat rate corporate profits taxes have been introduced, but the number of payments required and the contribution of other taxes are so significant and so mitigate the perceived benefits of the flat tax system’. These two countries are among the bottom four countries in the world with the highest number of tax payments required to be made by a company in the year. This conclusion appears to hold for most of the other EE flat tax countries.

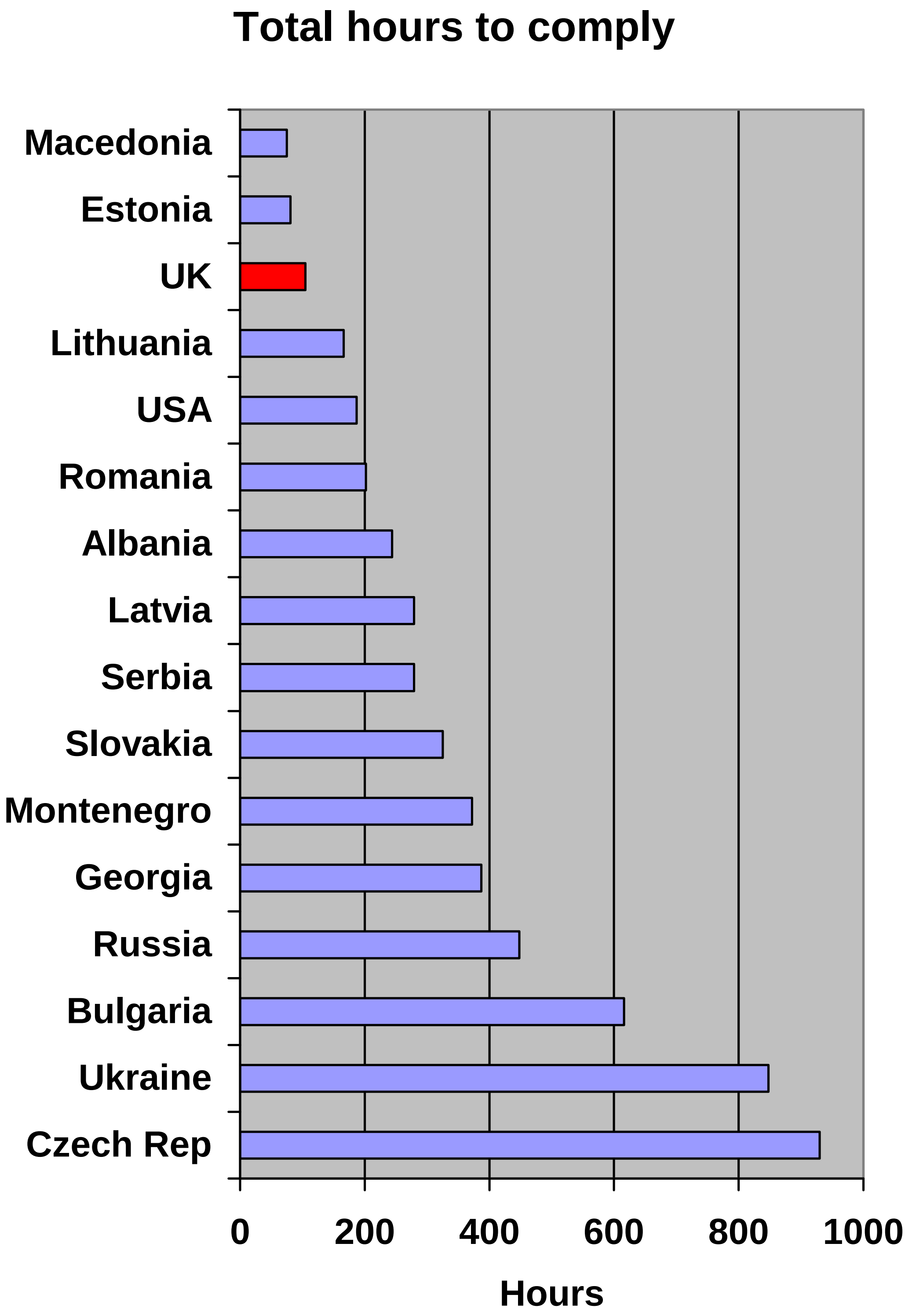
The study was repeated for the year ended 31 December 2007. Data for the EE flat tax countries is shown below, with the UK and USA (neither of which have flat tax systems) included for comparison purposes.

Effects on compliance for EE flat tax adopters (PwC/World Bank, 2009, p76-81)

Country	CIT payments	Total tax payments	Payments ranking	CIT hours to comply	Total hours to comply	Time ranking
Estonia	1	10	26	20	81	17
Lithuania	2	15	44	32	166	58
Latvia	1	7	7	31	279	117
Russia	1	22	70	160	448	155
Serbia	12	66	172	48	279	117
Ukraine	6	99	178	186	848	172
Slovakia	1	31	94	61	325	129
Georgia	4	30	92	140	387	145
Romania	4	113	181	32	202	74
Macedonia	12	40	127	25	75	11
Montenegro	12	89	177	43	372	141
Albania	13	44	140	120	244	95
Czech Rep	1	12	33	150	930	174
Bulgaria	2	17	52	40	616	167
UK	1	8	10	35	105	24
USA	2	10	26	99	187	65

Total tax payments and hours to comply refer to a country’s entire tax system covering all taxes. 181 countries were include in the survey. The ranking position in the survey reflects the total tax payments and total hours to comply to give a fuller measure of a country’s overall tax system rather than solely considering corporation tax. The data is shown below in pictoral form.


Total tax payments
Latvia
UK
Estonia
USA
Czech Rep
Lithuania
Bulgaria
Russia
Georgia
Slovakia
Macedonia
Albania
Serbia
Montenegro
Ukraine
Romania
0
50
100
150
Number of payments



Tax payments made and compliance times for EE flat tax adopters (PwC/World Bank, 2009, p76-81)

Such data should be treated with extreme caution given the highly artificial scenario and the potential for not comparing like with like. However, a few useful general observations can be made:

8.6.2.1 Number of tax payments

This is a measure of compliance costs incurred by companies under their particular tax system. The EE flat tax countries do not compare particularly favourably to other countries in the world without flat tax systems in terms of the number of payments that have to be made. It is also clear from the data that many countries with an EE flat tax have very inefficient payment structures with high numbers of payments required each year. Indeed, Romania actually has the highest number of payments of all countries sampled in the world. The UK has a lower number of payments than all the EE flat tax countries apart from Latvia.

8.6.2.2 Number of hours to comply

Again, flat tax countries show no evidence of reduced compliance times compared to countries with progressive systems. The UK has less onerous compliance time requirements than all except Estonia and Macedonia.

The accuracy of some of the data should be treated with caution with some surprising results such as Macedonia's small number of compliance hours compared to its very large number of payments required. On first principles, one would expect a high number of payments to require a large amount of compliance time to process. Nevertheless, no evidence of simplification is clear to see.

8.6.2.3 UK and USA tax systems

In passing, it should be noted that both the UK and USA tax systems score favourably in the survey for both number of payments and compliance times compared to the rest of the world. Arguments that the UK's tax system is excessively complex rarely make reference to such data, which may force a revaluation of such criticisms.

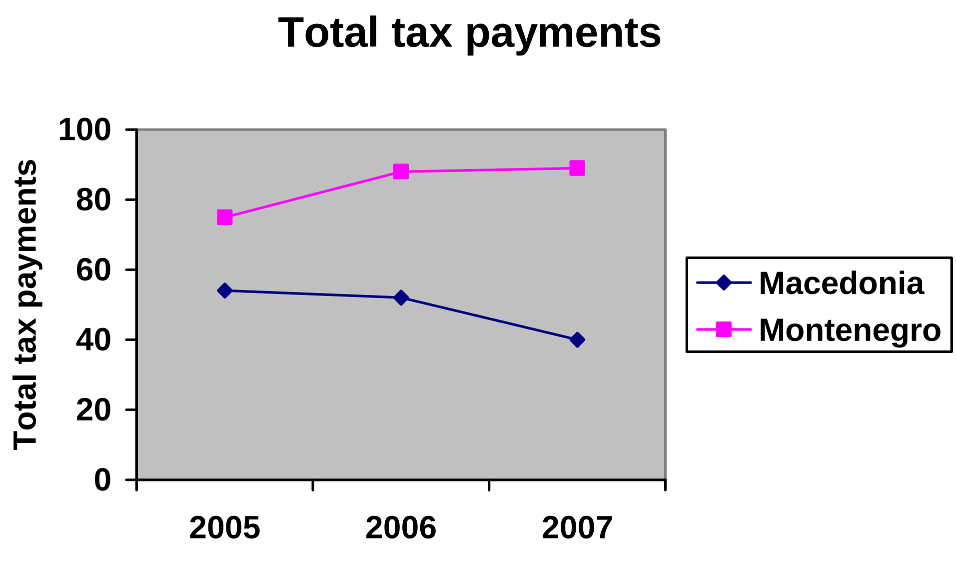
8.6.3 Introduction of a flat tax

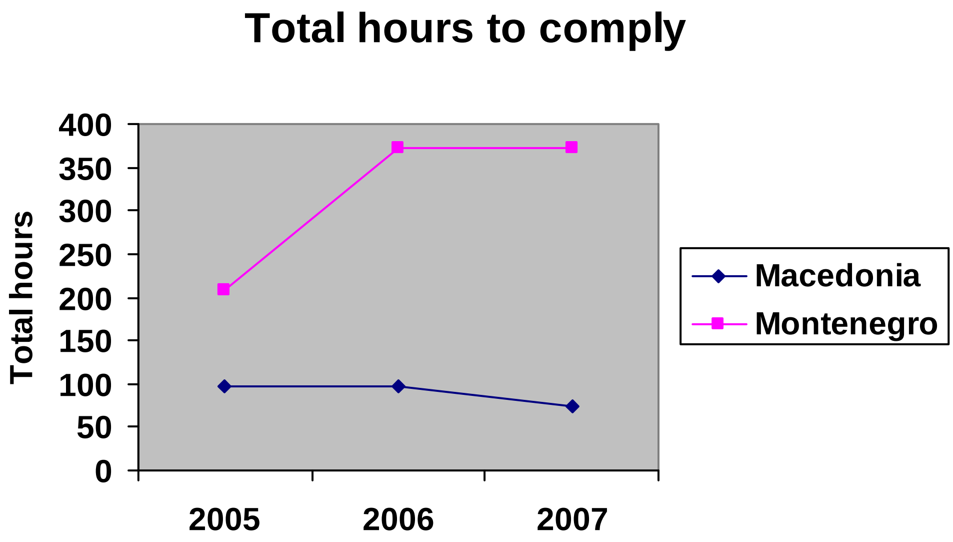
A further interesting extension to the analysis of the data is to consider the effect upon compliance times and number of payments required on the introduction of an EE flat tax system. Macedonia and Montenegro are relevant cases in that their flat tax systems were introduced during 2007 (1/1/07 for Macedonia, 1/7/07 for Montenegro), so comparison of this data to that from earlier reports might be expected to show any impact of the new flat tax system.

In the case of Montenegro, there is no change in either total number of tax payments or total hours to comply in 2007 compared to 2006 apart from a single extra tax payment, so the new flat tax appears to have had no impact upon compliance. However, 2006 shows a significant increase in both quantities over the equivalent 2005 data. It is not clear why this increase in compliance time is the case, or whether the introduction of a flat tax can really have had so little impact. The reliability of the data may be an issue with the possibility of the local PwC office simply returning the prior year figures to the survey without undertaking a proper review.

Macedonia does show an improvement from 2006 to 2007 in both number of tax payments (falling from 52 to 40) and total hours to comply (96 falling to 75). Whether this fall can be attributed to the new flat tax as opposed to other factors is not clear; no studies have yet been performed so the trend must be treated with extreme care. However, it does at least provide some justification for simplification, and the 2005 figures are very similar to those of 2006, as might be expected with similar tax systems in place.

Country	CIT payments	Total tax payments	Payments ranking	CIT hours to comply	Total hours to comply	Time ranking
2007						
Macedonia	12	40	127	25	75	11
Montenegro	12	89	177	43	372	141
2006						
Macedonia	12	52	148	30	96	17
Montenegro	12	88	173	43	372	137
2005						
Macedonia	12	54		30	96	
Montenegro	12	75		16	208	





Tax payments made and compliance times for Macedonia and Montenegro (PwC/World Bank, 2009, p76-81)

The above data comparisons are extremely brief, but still provide a compelling case that many of the tax systems of the EE flat tax countries are very complex and compare unfavourably in this respect to the progressive tax systems of the UK. Such a result should not be surprising for, as noted by the many commentators already quoted e.g. Krajcir and Odor (2005), simply changing a tax rate will have little impact on the much deeper, inherent complexity of a national tax system.

8.7 Conclusion

It is very difficult to draw any clear conclusions about the introduction of the EE flat taxes. The chief reason for this situation is the lack of clear data comparing the situation in the relevant countries before and after the reforms. This is extremely surprising as simplification of the tax system is often given as a driver of the reforms. While it may be acknowledged that data might be difficult to collect and that a greater timescale is needed to draw any firm conclusions, in the absence of evidence to the contrary it may be inferred that any simplification effects were minimal, as predicted by commentators including Keen et al (2006). The limited data available suggests that EE flat tax countries have tax systems which are complex and time-consuming to comply with.

9. UK Case Study : The 2008 Capital Gains Tax (CGT) Reform

9.1 Introduction

One of the most significant issues in the UK flat tax debate, as already mentioned, is that no economy of a similar size and complexity to that of the UK has ever introduced any form of flat tax. As a result, the debate has remained largely theoretical with only very limited real life data for either side used to back up their arguments.

However, during the preparation of this thesis, an extremely significant event occurred in the UK, when the government announced a major and unexpected reform to the capital gains tax (CGT) system. Under its proposals, a flat tax rate of 18% would be introduced and a complicated exemption in the form of taper relief abolished, a genuinely simplifying move.

Although CGT is a relatively minor tax in terms of revenue raised, and the focus of this thesis is on corporation tax, the reform was nonetheless of great interest, chiefly because of the response of parties who had previously been calling for simplification of the UK tax system.

9.2 CGT reform in the UK

On 9 October 2007 the UK Chancellor, Alistair Darling, announced an unexpected reform to the UK CGT system, effectively proposing a flat tax rate of 18% on capital gains for individuals and unincorporated businesses. The proposal was without doubt a simplifying one as it removed the need for complex calculations of taper relief, which reduced a capital gain depending on the number of years of ownership of the asset, as well as whether the asset had been used for ‘business’ purposes. The result was a range of effective CGT rates from 5% to 40%.

Taper relief was originally introduced by the incoming Labour government to encourage entrepreneurship and create jobs. Endacott (2008) notes that the government was influenced by US thinking, including a study of the venture capital industry by Gompers and Lerner (1998) which highlighted a negative correlation between a CGT rate and the magnitude of venture capital investment. It should, however, be noted that the report noted that the tax rate was only one of several factors to consider and described it as a ‘blunt instrument’.

However, the legislative provisions for taper relief were lengthy and complex. The concept of a ‘business asset’ was chosen to promote active risk-taking rather than passive investment, but its definition was complex and often apparently arbitrary. The far more generous relief that such assets attracted compared to ‘non-business assets’ was in some cases very hard to justify. In addition, the increasing relief depending on the length of time the asset was held was criticised by some as introducing arbitrary time limits to distort investment decisions.

9.3 'Flat tax' connection

It was somewhat ironic that the UK government introduced the proposed reforms using some of the rhetoric of supporters of 'flat tax' e.g. Heath (2006), especially in regard to simplification of the tax system. While the US has a long and distinguished history of flat tax debate, the concept is much newer in the UK and has met with little favour to date in government circles. HM Treasury produced a critical report in 2005, mainly on equity grounds, and the debate largely subsided.

Admittedly, the proposed UK CGT reforms bore little resemblance to the original flat tax model of Hall and Rabushka and its subsequent development in the US. Under their HR flat tax model, capital gains are not taxed at all. However, useful comparisons can still be made as to how the flatness of a tax rate impacts upon the simplicity of the underlying tax system.

In addition, it should be noted that the 2005 Treasury report highlighted the fact that no flat tax system had been introduced in an economy similar to the UK, so any conclusions about its effectiveness would be largely speculative. While CGT is a minor tax in terms of the revenue it raises, such a comment is now a less valid one.

The connection between the reform and the flat tax debate was not discussed in any detail at the time of the reform, and its most significant mention to date was in a paper presented at the 2009 IRS Annual Research Conference in Washington DC (Jelfs and Lymer, 2009).

9.4 Taxpayer response

Given the purported desire for tax simplification in the UK (NAO, 2007b), it might have been expected that this proposal would have met with a broadly favourable response from taxpayers and their advisers. However, the exact opposite occurred. The reforms were bitterly denounced by representatives of small business, principally on the basis that under the old system, many of their constituents would have expected to pay a rate of no more than 10% on disposal of shares in their companies (Truman, 2008). Emotive phrases such as '80% tax rise' succeeded in attracting much media attention. Simplification proved to be a principle readily sacrificed to avoid even a modest tax increase, with the General Secretary of the Trades Union Congress describing the Chancellor as having 'called the bluff of those business leaders who have long called for tax simplicity'.

Other arguments from the reform's opponents included the need for stability in a tax system, the damage to the country's entrepreneurial culture with the prospect of wealth generators choosing to set up business in lower tax jurisdictions and the prospect of a 'finance gap', deterring external investors from financially supporting small businesses (Endacott, 2008).

The behaviour of tax practitioners in response to the reform was predictable. After initial complaints that the reforms had not undergone a proper consultation process, a number of schemes were devised for clients based on draft contracts of sale dated before 6 April 2008 (the date the reforms took effect) to take advantage of the lower tax rates under the previous regime. This pragmatic approach was demonstrated in the actions of the prominent tax consultant Kevin Slevin who was quick to denounce the reform as 'the Darling Raid on small businesses', yet by 17 July 2008 he had written the first book to market on the subject of entrepreneurs' relief, available for sale to fellow practitioners.

9.5 Government reaction

In the event, the Government gave in to the reform's critics and introduced further legislation known as entrepreneurs' relief, based on repealed legislation known as 'retirement relief'. This effectively gave taxpayers the ability to continue to pay only 10% on the first £1 million of capital gains with any excess taxed at 18%.

From a simplification point of view, this response was disastrous leading to greater volume of tax law and maintaining the complexity of calculating a capital gain. As with taper relief, with which it shares a number of similarities while not providing as generous a relief, entrepreneurs' relief creates distortions and influences investment behaviour. Endacott (2008) points out that the relief introduces substantial complexity for the small amount of relief it provides. The Chartered Institute of Taxation, the representative body for chartered tax advisers, noted that retirement relief provisions, which formed the basis for entrepreneurs' relief, contained elements that were 'notoriously difficult to apply and, in practice, gave rise to a number of problems for both taxpayers and HMRC'.

9.6 Conclusions

In summary, the recent experiences of the CGT reforms provide evidence of the difficulty any government would face in trying to introduce significant simplification to the UK tax system, be it by flat tax or any other means, given the response to proposals to modify one minor tax. They also show that, even if a simple tax system could be introduced, the pressures for special interest groups may be too much for government to ignore, leading to further legislation and increased complexity, a fact noted by US commentators on the HR flat tax e.g. Feld (1995).

The reforms would also appear to demonstrate that taxpayer support for simplification of the UK's tax legislation, and indeed the tax system in general, is somewhat overstated by published studies e.g. Tenon (2005), NAo (2007b).The response would suggest that the rate of tax at which a taxpayer must pay is the more important consideration for him.

Whilst not providing any evidence per se for the effect of a flat tax on the UK tax system, the political considerations and impact, which given that tax reform is driven by government is of critical importance, may suggest that introduction of a more comprehensive flat tax system in the UK is unlikely to happen in the near future.

Conclusion

The introduction of a flat tax in the UK would appear to produce a few simplifying features for the current corporation tax system. Both EE and HR flat taxes may offer a broader tax base and the removal of bracket arbitrage as a means of avoidance. The HR flat tax has some additional simplifying features including the removal of capital/income distinctions and immediate expensing of business assets.

Compliance cost modelling also appears to show some simplification may be possible on introduction of a flat tax. HR flat tax studies from the US e.g. Hall (1996) and Slemrod (1996) predict a substantial reduction in costs. Western European studies on EE flat taxes (Fuest, 2007) predict a modest decrease in compliance costs.

However, the evidence for no significant overall simplification is far greater in quantity and is drawn from a variety of sources. Compelling cases can be made both that little genuine simplification would occur, and that the flat tax in question would generate additional complexity on its introduction. There is a substantial amount of academic work on the subject; early work in the USA on the HR flat tax , notably by Weisbach (2000) and Feld (1995), identifies a number of flaws in its design that would lead to the necessary generation of tax system complexity to avoid significant revenue loss from tax avoidance schemes. In addition, considerable obstacles in the form of transition tax and political pressure are identified as major stumbling blocks to an HR flat tax introduction.

The simplifying benefits of EE flat taxes have also been questioned. Theoretical work in the UK by Martin (2005) predicts little legislative simplification on introduction. This work is reinforced by the lack of any significant simplification seen on introduction of the EE flat taxes (Keen et al, 2006), as well as the results of the proposed UK CGT reforms.

Compliance cost studies predicting substantial reductions remain controversial. Commentators such as Gravelle (1996) note that such studies are based on weak data, and their conclusions appear to be inconsistent with evidence suggesting little simplification would occur and extra complexity would be generated by the introduction of flat taxes.

Such scepticism on the issue of compliance costs appears to be backed up by the results of brief studies of real-life EE flat tax systems. The overriding conclusion from the data, as collated by PwC and the World Bank (2005-8) is that countries with flat tax systems do not necessarily have simpler tax systems than those countries without. The complexity of a tax system appears to be a property with far more variables than simply the number of rates of tax. The limited data available suggests that the UK’s tax system is not overly complex compared to the rest of the world, which could be a significant (and rarely quoted) observation.

The recently attempted CGT reforms in the UK appear to demonstrate further the critical issue of political considerations when considering tax reform and cast doubt upon the relative importance of simplification in such reforms, both for government and taxpayers.

In summary, the claim that flat tax is a force for simplification appears to have very little foundation. At first glance, this might seem a surprising conclusion, given the apparent importance of the issue of simplification and the fact that flat tax supporters still use reduction of complexity as a supporting argument for their preferred tax structure. However, the unwillingness of such supporters to refer to work performed on both HR and EE flat taxes in support of their simplification claims may mean this conclusion is easier to understand.

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