



All Party Parliamentary Taxation Group

The Future of Income Tax Administration in the UK

May 2008

TITLE	All-Party Parliamentary Taxation Group			
PURPOSE	To look at and understand tax policy and taxation at all levels; to understand VAT and PAYE in the UK; to contact and talk to accountants and Revenue officials; to look at European tax affairs and international taxation.			
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BENEFITS RECEIVED BY GROUP FROM SOURCES OUTSIDE PARLIAMENT				
None.				
PAID EMPLOYMENT OUTSIDE PARLIAMENT OF STAFF WHO HOLD A PARLIAMENTARY PASS				
None.				
DATE OF GROUP'S LAST REGISTERED ANNUAL GENERAL MEETING				
6 February 2007				
CATEGORY OF GROUP				
On Approved List; All-Party Parliamentary Subject Group.				

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Foreword

Tax administration is not an area of public policy which has historically received the attention it deserves, given its importance in all our lives. Yet when the Government's self assessment website crashed at the end of January 2008, halting online filing of tax returns for ten of thousands of taxpayers and forcing the filing deadline to be extended, the issue rose dramatically up the political agenda.

The Group's final report on the Future of Income Tax Administration in the UK builds upon our preliminary findings produced last year. The report addresses the long term key challenges for both Pay as You Earn (PAYE) and Self Assessment. Drawing upon what has been learnt from international best practice, the report makes a series of recommendations to Government and Her Majesty's Revenue and Customs (HMRC).

I would like to thank Michael King of Manchester University for providing the intellectual rigour behind much of what is here as well as the US Internal Revenue Service (IRS), the Washington-based Information Technology and Innovation Foundation (ITIF) and the Free File Alliance for informing our understanding of the American approach to online tax filing. Finally I would like to thank the Chartered Institute of Taxation (CIOT) for reviewing our preliminary findings and providing useful comment throughout.

Ian Liddell-Grainger MP

Chair of the All Party Parliamentary Taxation Group

Executive Summary

For the majority of taxpayers, their income tax is collected through Pay as You Earn (PAYE). Employers deduct tax from their employees' pay according to PAYE codes which reflect the employees' personal circumstances. The amount withheld by employers and passed on to HM Revenue and Customs (HMRC) is designed to match exactly the tax liability for each employee.

The cost of administering PAYE falls disproportionately on small employers, causing a harmful distortion in the competition between small and large firms. The current system of PAYE tilts the 'playing field' against small businesses and discourages them from taking on new employees, limiting their growth. In recent years, a number of proposals have been made to address this problem.

Recommendation 1: The Government is currently reviewing the burdens that the corporation tax system places upon small businesses. A similar review focused upon the burdens that PAYE places upon small businesses is also needed. This should consider the benefits of removing some of the tax administration burden from small employers and asking their employees to take on some of this responsibility.

Increasing the numbers of taxpayers who take greater responsibility for their tax affairs would have the added advantage of compensating for some of the underlying changes in the labour market that are putting PAYE under strain. In 1999 the Treasury Select Committee concluded that the labour market was moving towards "more flexible ways of working – precisely the ones which PAYE finds hard to accommodate". A recent internal audit by HMRC estimated that 5.7 million taxpayers had paid too much or too little tax. This accounts for over 15% of the taxpaying population.

Greater involvement by taxpayers in their tax affairs could also over time help reduce errors by increasing scrutiny of HMRC's work. The general feeling is that taxpayers are unaware of the meaning of their PAYE codes and unlikely to check them. The Chartered Institute of Taxation (CIOT, 2008) commented in response to the Group's preliminary report that: "To many taxpayers HMRC are the experts...so they must be right!" Indeed CIOT (2008) pointed out that in some instances HMRC do not provide sufficient information to the taxpayer to check the Department's calculations.

An additional explanation is that taxpayers are unwilling to challenge HMRC's calculations because they do not wish to attract attention to their affairs. For example in a survey of employers, "HMRC" was associated with a "fear factor" and it was generally felt that the Department were not there to help.

Recommendation 2: The Government needs to ascertain why taxpayers are seemingly unwilling to challenge HMRC's calculations when so many taxpayers could be paying the wrong amount of tax. Moreover HMRC should always provide taxpayers with all the necessary information they need to calculate their own tax liability.

A not unrelated issue is the apparent failure of HMRC to channel the same energies towards identifying overpayments by taxpayers as it does towards identifying underpayments. CIOT (2008) commented that while HMRC will on occasions point out overpayments, in general it appears "resources are allocated out of preference to those

cases that are expected to give rise to underpayments as opposed to all cases where “the right amount of tax” has not been paid”.

Recommendation 3: HMRC must be seen by taxpayers to be as focused upon overpayments as underpayments in order to retain the trust of the taxpayer that when it calculates their tax it is working in their best interests. This will encourage taxpayers to challenge the Department’s work and could over time help reduce errors. HMRC should estimate what proportion of taxpayers they believe are overpaying and underpaying tax and to what extent in order to benchmark its progress.

A minority of taxpayers, whose circumstances are too complicated to be dealt with solely within PAYE, normally those with multiple sources of income or the self-employed, file a tax self assessment return in order to reconcile their tax liability against the tax that the HMRC has collected from them through PAYE or otherwise. This is called Self Assessment.

HMRC is actively trying to encourage self assessment taxpayers to file their returns online. The Department has done this by providing their own free tax filing service through the HMRC website. Progress has nonetheless been slow and the original targets for uptake have been missed.

HMRC’s website has also suffered a series of technical difficulties. Most recently on January 31st 2008, the deadline day for returns to be received, HMRC’s website crashed leaving thousands unable to file their returns and forcing HMRC to extend the deadline. As the principle artery for online tax filing, any problems with the Department’s website leave the vast majority of taxpayers unable to file electronically.

Moreover it would seem that taxpayers find HMRC’s online software difficult to use. The National Audit Office (NAO, 2007) estimated that around £300 million is underpaid by self assessment taxpayers because of errors on their own behalf when completing their returns.

The slow uptake of the service led the Government to commission a review by Lord Carter of Coles of HMRC’s online services. On his recommendation from this year, self assessment taxpayers will not be able to file paper returns for the last 3 months of the filing period. Lord Carter also recommended HMRC examine the success that has been achieved in the US where the private sector has played a much more prominent role in the provision of online tax filing with considerable success.

Not only has US Internal Revenue Service (IRS) avoided having to provide its own filing service, many more taxpayers in the US file online at a fraction of the cost to the Department. The tax filing system is also not as exposed to single point failures, as have been experience in the UK, because there are a number of online services taxpayers can use.

Recommendation 4: In line with the findings of Lord Carter’s review, HMRC should urgently review the success that has been achieved in the US to consider whether it would be more beneficial to HMRC and taxpayers to leave software provision to the software industry and focus HMRC’s resources on the infrastructure for exchanging electronic data with customers, agents and other intermediaries. The comparison with the US experience would suggest that the free Government service provided by HMRC has suppressed the take up rate of online filing.

1. Pay As You Earn (PAYE)

1. For the majority of taxpayers, their income tax is collected through Pay as You Earn (PAYE). Employers deduct tax from their employees' pay according to PAYE codes which reflect the employees' personal circumstances. The amount withheld by employers and passed on to HM Revenue and Customs (HMRC) is designed to match exactly the tax liability for each employee.
2. The cost of administering PAYE falls disproportionately on small employers, causing a harmful distortion in the competition between small and large firms. Inland Revenue (1998) estimated that PAYE and National Insurance (NIC) compliance costs per employee were £288 per annum for employers in the 1-4 employee size band but only a little over £5 per annum for those in the 5000+ band. Both Chittenden (2005) and KPMG (2006) show a similar distortion.
3. Not only is this unfair it is also damaging to the UK economy. Firstly the PAYE-NIC compliance costs incurred when a small employer takes on their first employee make it more difficult for a new firm to enter a market; and so helps to shield established firms from competition. Secondly, it has a negative impact on employment. Inland Revenue (1998) claims that much of the growth in employment since 1981 was generated by employers with less than 10 employees. Hence, it is concerning that 32% of small employers said that the cost of taking on payroll activities deters them from taking on more staff (Chittenden, 2005).
4. Inland Revenue (1998) argued that because large firms, with large numbers of employees, were able to take advantage of economies of scale they could reduce their PAYE compliance costs compared to smaller employers. More recently Chittenden (2005) found that as a business grows the owners or directors of the enterprise can delegate administrative tasks, such as complying with the business's PAYE-NIC obligations to junior staff. So costs fall because the hourly rate paid to staff is much lower than the hourly value of owners/directors' time. Finally KPMG (2006) pointed to the 'smooth machine', set up by large firms to deal with their PAYE capable of reducing their costs as the key differentiator. In contrast, the population of small businesses will include new employers who are inexperienced at operating payrolls and need to invest time learning about their obligations.
5. The current system of PAYE tilts the 'playing field' against small businesses and discourages them from taking on new employees, limiting their growth. To remove this unreasonable burden Inland Revenue (1998) proposed that 'the government should, in the longer term, consider the costs and benefits of alternatives to collecting employees' tax and national insurance contributions from "small" employers.' The Small Business Council (SBC, 2006) have argued that micro businesses should make fixed monthly payments based upon the projected annual PAYE-NIC payments in the forthcoming year. Micro businesses would then be able to make one annual return (P35) based upon the annual salary of an employee reconciling the position with the final payment. Chittenden (2005) proposed that small businesses should be compensated directly for the costs they incur complying with PAYE-NIC and that this compensation ought to vary in accordance with the number of workers the business employs.
6. In practice the SBC's recommendation and what was proposed by Inland Revenue (1998) are very similar. Whilst the SBC's preferred approach would reduce the

burdens upon small employers, it would increase the responsibility placed upon their employees as it would not necessarily be the case that the tax they had paid would exactly match their tax liability. However it would leave small business owners and directors free to focus their energies on their core business activities.

7. **The Government is currently reviewing the burdens that the corporation tax system places upon small businesses. A similar review focused upon the burdens that PAYE places upon small businesses is also needed. This should consider the benefits of removing some of the tax administration burden from small employers and asking their employees to take on some of this responsibility.**
8. Increasing the numbers of taxpayers who take greater responsibility for their tax affairs would have the added advantage of compensating for some of the underlying changes in the labour market that are putting PAYE under strain. In 1999 the Treasury Select Committee concluded that the labour market was moving towards “more flexible ways of working – precisely the ones which PAYE finds hard to accommodate” (HCTSC, 1999).
9. Inland Revenue (1998) noted that PAYE “works best for large, rather “static” payrolls, i.e. payrolls with hardly any staff turnover or casual or part-time employees. For much of society this is still an appropriate model but in an increasingly flexible labour market the employer-employee nexus becomes much weaker.” CIOT (2008) added that “there is also considerable complexity added when benefits-in-kind, especially share schemes, are provided and when the employer is required to become involved in statutory payments and deductions such as statutory sick pay or student loan deductions.”
10. A recent internal audit by HRMC estimated that 5.7 million taxpayers had paid too much or too little tax (NAO, 2006). This accounts for over 15% of the taxpaying population.
11. These difficulties can only worsen. NAO (2006) noted that there is a growth in employment groups that PAYE finds difficult to deal with, including students who often have more than one job and working pensions. The introduction of university tuition fees and reform of the pensions system will accelerate the increase in numbers of people working within these groups. There is also rising turnover in the working population. Approximately 20% of jobs last less than one year and 5% are for periods of less than three months.
12. Greater involvement by taxpayers in their tax affairs of the kind proposed by Inland Revenue (1998) could also over time help reduce errors by increasing scrutiny of HMRC’s work. The general feeling is that taxpayers are unaware of the meaning of their PAYE codes and unlikely to check them. CIOT (2008) commented: “To many taxpayers HMRC are the experts...so they must be right!” Indeed CIOT (2008) pointed out that in some instances, such as tax credit notifications, HMRC do not provide sufficient information to the taxpayer to check the Department’s calculations.
13. An additional explanation is that taxpayers are unwilling to challenge HMRC’s calculations because they do not wish to attract attention to their affairs. For example KPMG (2006) found in a survey of employers, “HMRC” was associated with a “fear factor” and it was generally felt that the Department were not there to help.

14. **The Government needs to ascertain why taxpayers are seemingly unwilling to challenge HMRC's calculations when so many taxpayers could be paying the wrong amount of tax. Moreover HMRC should always provide taxpayers with all the necessary information they need to calculate their own tax liability.**
15. A not unrelated issue is the apparent failure of HMRC to channel the same energies towards identifying overpayments by taxpayers as it does towards identifying underpayments. NAO (2007) found that for self assessment taxpayers, whilst HMRC did estimate the extent to which they as a group underpaid their tax, the Department did not estimate the extent to which they overpaid their tax. CIOT (2008) commented that while HMRC will on occasions point out overpayments, in general it appears "resources are allocated out of preference to those cases that are expected to give rise to underpayments as opposed to all cases where "the right amount of tax" has not been paid".
16. **HMRC must be seen by taxpayers to be as focused upon overpayments as underpayments in order to retain the trust of the taxpayer that when it calculates their tax it is working in their best interests. This will encourage taxpayers to challenge the Department's work and could over time help reduce errors. HMRC should estimate what proportion of taxpayers they believe are overpaying and underpaying tax and to what extent in order to benchmark its progress.**

2. Self Assessment

17. A minority of taxpayers, whose circumstances are too complicated to be dealt with solely within PAYE, normally those with multiple sources of income or the self-employed, file a tax self assessment return in order to reconcile their tax liability against the tax that the HMRC has collected from them through PAYE or otherwise. This is called Self Assessment.
18. HMRC is actively trying to encourage self assessment taxpayers to file their returns online in order to reduce errors arising from simple mistakes on paper forms and reduce administrative costs. The Department have done this by providing their own free tax filing service through the HMRC website. Progress has nonetheless been slow and the original targets for uptake have been missed.
19. Nearly 2.9 million income tax self assessment returns were filed online in 2006-07 of the almost 10 million HMRC receives each year. In 1999 the then Cabinet Office Minister Dr Jack Cunningham MP published the Modernising Government White Paper (Cabinet Office, 1999), which set in place targets for the Inland Revenue (Inland Revenue, 2000) that by 2005 100% of services of the Department's services would be offered electronically, wherever possible through a common Government portal, and take-up rate for these services would be at least 50%.
20. HMRC's website has also suffered a series of technical difficulties. Most recently on January 31st 2008, the deadline day for returns to be received, HMRC's website crashed leaving thousands unable to file their returns and forcing HMRC to extend the filing deadline. In addition in May 2002, taxpayers reported a number of security breaches to the service that resulted in HMRC having to temporarily halt online filing for a number of weeks. Then over the weekend of 29th/30th January 2005, ahead of the deadline of 31st January, around 80,000 taxpayers did not receive confirmation that their returns had been received due to the system's failure to deal with the numbers of returns received. The filing period was extended by a further two weeks past the original deadline.
21. As the principle artery for online tax filing, any problems with the Department's website leave the vast majority of taxpayers unable to file electronically. Moreover it means the Self Assessment system is vulnerable to either future accidental failures or even intentional cyber attack.
22. It would also seem that taxpayers find HMRC's online software difficult to use. The National Audit Office (NAO, 2007) estimated that around £300 million is underpaid by self assessment taxpayers because of errors on their own behalf when completing their returns. A recent survey (CIOT, 2007) found that almost half of self assessment taxpayers found it 'very' or 'fairly' difficult to understand whether they are paying the right amount of tax.
23. The slow uptake of the service led the Government to commission a review by Lord Carter of Coles of HMRC's online services. On his recommendation from this year, self assessment taxpayers will not be able to file paper returns for the last 3 months of the filing period.
24. Lord Carter also recommended HMRC examine the success that has been achieved in the US where the private sector has played a much more prominent role in the provision of online tax filing with considerable success. Carter (2006) noted:

In the USA, IRS practice has been to work co-operatively with the software vendors rather than competing in providing the means to e file. The IRS does not provide any electronic filing software, instead leaving the market completely open to the software companies. Through discussions with the industry, it emerged that the software companies also did not want IRS to offer a free service in their market place. Last year, the industry provided free internet filing software to identified groups (e.g. US military, those over a certain age, income under a certain limit), covering 78% of taxpayers, by creating a joint industry non-profit entity, the 'Free File Alliance'.

25. In their evidence to the Group's enquiry the Free File Alliance explained that Alliance is made up a tax software companies who make their tax return products available free to taxpayers below certain incomes via the IRS website. In total the Alliance provides this free service to all taxpayers earning below \$52,000, equivalent to around 70% of the taxpaying population, slightly below the figure noted by Carter (2006). Not every member of the Alliance has to make all their products available free to all of these individuals however the Alliance as a whole must ensure that every individual who earns below this limit has a choice of at least two free software products. Since its inception five years ago, the Alliance has helped 18 million taxpayers file their returns online and it estimates saved these individuals around \$500 million in the process. Moreover the Alliance believes that with greater publicity of its work, it could expand its service to many more low income taxpayers.
26. From the perspective of the software companies who join the Alliance such an arrangement protects their market from Government intrusion. Even though they are prepared to give away their products to 70% of their potential customers, they still feel that remaining 30% is significant enough to leave room for private sector enterprises to drive general uptake of online filing and to invest in new innovate products.
27. As a result, not only has IRS avoided having to provide its own filing service, many more taxpayers in the US file online at a fraction of the cost to the Department. In the USA over 54% now file online, which is 73 million returns in total. Moreover according to HCCPA (2006) excluding overheads it costs HMRC £13 to process an electronic return compared to £22 to process a paper return. In their evidence to the Group the IRS stated that comparable processing costs in the US are \$2.65, or around £1.40, for paper returns, and \$0.29, or around £0.15, for electronic returns.
28. The US tax filing system is also not as exposed to single point failures of the kind experience in the UK, because there are a number of online services taxpayers can use. It is also not so vulnerable to an intentional cyber attack precisely because there is not one single centralised Government pathway upon which the whole system relies to be targeted.
29. **In line with the findings of Lord Carter's review, HMRC should urgently review the success that has been achieved in the US to consider whether it would be more beneficial to HMRC and taxpayers to leave software provision to the software industry and focus HMRC's resources on the infrastructure for exchanging electronic data with customers, agents and other intermediaries. The comparison with the US experience would suggest that the free Government service provided by HMRC has suppressed the take up rate for online filing.**

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