



All Party Parliamentary Taxation Group

**The Future of Income Tax
Administration in the UK**

Preliminary Findings

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Forward

As with many of the United Kingdom's institutional arrangements, the way in which the state collects income tax, through Pay-As-You-Earn (PAYE), owes much of its form and structure to the peculiarities of the era in which it was devised. The financial strain that the Second World War placed upon the country meant the Treasury needed to collect more tax from many more people. This posed significant challenges to the Government of the day and the many workers and employers who had previously never come into contact with the tax system.

The solution the Treasury devised involved issuing every employee with a tax code which their employer would then use to deduct at source what tax the employee owed and pass it onto the Revenue. Although successive Governments have found reason to complicate the system further, the essence of the system has remained broadly the same for over sixty years. A significant change however has been the introduction of Self Assessment and Self Assessment Online where some taxpayers whose financial affairs have become too complicated to be dealt with through PAYE have taken on board greater responsibility for their own tax affairs.

In recent years there has been a significant amount of work done on PAYE and Self Assessment and I am pleased to say that a large proportion of this has been brought together in this report; I believe for the very first time. I would like to thank Michael King of Manchester University for providing the intellectual rigour behind much of what is here and all those who attended the Group's recent policy roundtable on the future of Self-Assessment Online upon which the report draws.

Those who travelled from the United States to attend the Group's roundtable described the perception there of the UK's tax system was as working perfectly at a minimum cost to Government and taxpayer alike. Whilst flattering it does not match the reality we face. Instead I hope that this report will provide the basis upon which the Group can engage with the various interested Governmental and non-Governmental bodies, producing our final recommendations later in the year and play a constructive role helping Government meet this challenge.

Ian Liddell-Grainger MP

Chair of the All Party Parliamentary Taxation Group

Introduction

Pay as You Earn (PAYE) has been with us for well over sixty years. It has two distinctive features:

1. Employers deduct tax from their employees' pay according to PAYE codes which reflect the employees' personal circumstances.
2. 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 net result is that the burden of tax collection falls upon the employers, rather than the employee. In recent years there have been concerns voiced that the burden of compliance with PAYE does not fall uniformly upon employers. Moreover, some argue that HMRC is facing increasing difficulties in administering PAYE. So after sixty years of service, in a new era of economic and social change, what does the future hold for PAYE?

For the minority of taxpayers, whose circumstances are too complicated to be incorporate within PAYE, normally those with multiple sources of income or the self-employed, they file a tax self assessment return in order to reconcile their tax liability against the tax that the HMRC has collected from them. Abolishing PAYE would greatly increase the number of individual returns received by HMRC.

For many years now it has been HMRC's objective for taxpayers to file their returns online. Slow growth in the uptake of electronic filing led the Government in 2005 to ask Lord Carter to review HMRC's progress towards this objective. In March 2006, he published his Review of HMRC Online Services containing a number of recommendations to improve the uptake of electronic filing in the UK. In his review, Lord Carter considered both immediate steps that HMRC could take to increase the percentage of tax returns filed online and the direction that HMRC should take in the longer term in order to improve this aspect of its service.

The changes Lord Carter recommends that HMRC should make to Self Assessment Online in the long term would be a profound departure from its current course and it is therefore appropriate to consider these and their possible impact upon the future of PAYE.

Part I: The Future of PAYE

1. PAYE Compliance Costs

Chittenden (2005) defined compliance costs as those 'costs incurred by taxpayers, or third parties, in meeting the requirements of the tax system, over and above the tax liability itself and over and above any harmful distortions of consumption or production to which the tax may give rise.' There is evidence that such costs can be sufficiently high to distort business decisions. KPMG (2006) concluded that the total administrative burden of the UK tax system upon business was £5.1bn per annum for 2005. Moreover, KPMG (2006) found that around 15% of all compliance costs were due to PAYE and NIC¹.

Compliance costs include objective costs such as collecting tax and acquiring knowledge of legal obligations as well as 'psychic' costs (i.e. anxiety). Chittenden (2005) argues that it is very difficult to directly measure psychic costs but suggests that some business owners employ accountants principally to reduce their anxiety, and implies that the cost of professional advisors is a good proxy for psychic costs.

A distinction should be made between gross compliance costs and net compliance costs. This is because employers enjoy cash flow benefits from administering PAYE, since deductions rest in the employer's current account before being passed on to HMRC. These cash flow benefits can be used to reduce a company's overdraft or even make short term loans. Inland Revenue (1998) found that cash flow benefits are particularly high in large businesses, to the extent that they actually enjoy a net benefit from administering PAYE-NIC. However, cash flow benefits can be ignored when considering the aggregate economic impact of compliance costs because such benefit are merely transfers from employees to employers.

Godwin (1989), Inland Revenue (1998) and KPMG (2006) estimated the annual compliance cost associated with PAYE and NIC for the years 1981, 1995 and 2006

¹ For comparison the administrative cost of VAT contributes 20% of the total burden.

respectively. This information can be used to show how compliance costs have changed over time (see table below).

PAYE and NIC Compliance Costs per Employee per Year

Author	Year	Compliance Costs (£m)	Compliance Costs Adjusted by the RPI (£m)	Compliance Costs per Employee* Adjusted by the RPI (£s)
Godwin (1989) ⁽¹⁾	1981	449	1153	55.36
Inland Revenue (1998) ⁽²⁾	1995	1323	1703	78.59
KPMG (2006)	2005	759	759	30.58

*Probably an over estimate because multiple employments are not accounted for

(1) Often referred to as the "Sandford Study"

(2) Often referred to as the "Bath Report"

The third column gives the annual compliance cost for each year, according to the relevant study. However, in order to compare compliance cost over time it was necessary to adjust for inflation and changes in aggregate level of employment. To permit such a comparison, the fourth column gives the average annual compliance cost per employee (in £s). The table shows that compliance costs increased between 1981 and 1995 but have fallen significantly in recent years. Whilst it would be wrong to rule out altogether the possibility that government reforms are having a marked impact in this area, further work needs to be done to ascertain whether or not this significant reduction in compliance costs is a true reflection of the situation.

2. PAYE Compliance costs and HMRC's relationship with Taxpayers

Clearly the relationship between HMRC and employers will be one of the determining factors towards the 'psychic' costs of compliance. For example if employers have faith in HMRC's processes and procedures one could reasonably expect their anxiety to be reduced. It is worth noting then that KPMG (2006) highlighted that the name "HMRC" is associated with a "fear factor" amongst employers and it was generally felt HMRC were not there to help.

There is no reason why employers who fulfil their legal obligations should have this perception of HMRC. Moreover there is anecdotal evidence to suggest that this is only one aspect of a wider problem in the relationship between HMRC and the taxpaying population at large. This evidence suggests that many taxpayers are reluctant to challenge the calculation HMRC makes of their tax liability in the belief that it is better just to accept HMRC's calculations rather than draw HMRC's attention towards their tax affairs.

Moreover the Public Accounts Committee reported in 2006 that "Taxpayers without professional advisors are less likely to challenge the Department's [HMRC's] errors in tax assessments, codes and penalties." This matches the fears expressed by organisations such as the charity TaxAid, who provide free advice to taxpayers who can not afford professional advice, that many low income taxpayers pay the wrong amount of tax and have no avenue for recourse.²

Launching HMRC's new initiative "Agents and intermediaries: A Fresh Start" aimed at improving its relationship with tax agents earlier this year, HMRC Director General Dave Hartnett identified cultural change within HMRC as the greatest challenge facing HMRC to improve their relationship with tax agents and taxpayers more widely.³

The Chairman of the Public Accounts Committee recently express his surprise that whilst HMRC did estimate the extent to which self assessment taxpayers underpaid their tax, it did not estimate the extent to which they overpaid their tax.⁴ HMRC calculates a taxpayer's liability and then enforces its collection. HMRC needs to be perceived 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.

² See for example the evidence of David Brodie, Director of TaxAid, to the Treasury Committee in 1999.

³ See "Agents and intermediaries: A Fresh Start" at <http://www.hmrc.gov.uk/podcasts/>

⁴ See NAO (2007) and the Chairman's press release at http://www.parliament.uk/parliamentary_committees/committee_of_public_accounts/pacpn070427.cfm

3. PAYE Compliance Costs and Small Businesses

3.1 Introduction

The cost of administering PAYE-NIC falls disproportionately on small employers, causing a harmful distortion in the competition between small and large firms. The current system of PAYE-NIC tilts the 'playing field' against small businesses and discourages them from taking on new employees, limiting their growth. Moreover, a strong and dynamic entrepreneurial base is an essential driver of productivity and prosperity and so government should seek to avoid regulation that undermines the competitiveness of small businesses. Consequently, policy makers should consider revising the way in which income tax is collected and administered in the UK in order to level the 'playing field'.

3.2 Evidence that PAYE-NIC related compliance costs are 'regressive'

A tax system is said to be 'regressive' if it effects those who can least afford to pay the most (relative to the resources available to them). One way to analyse the regressive nature of the current system is to look at PAYE-NIC compliance costs per employee for small and large employers. According to Inland Revenue (1998) the compliance cost per employee was £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. Moreover, the first employee will cost a small employer £5.50 in compliance costs per week; whereas, for a large firm the weekly compliance cost per employee was just 10 pence.

Chittenden (2005) found that the PAYE-NIC compliance costs incurred by small employers had stayed broadly the same, if not increased, between 1996 and 2001. Chittenden (2005) estimated the annual compliance costs per employees for small to medium sized firms (these results are reproduced in the table below).

Table 4. PAYE and NIC Compliance Costs per Employee per Year

<i>IR Bath Study (conducted in 1996)</i>		<i>MBS 2001 – Sample (N = 372)</i>	
<i>Size Band (Employees)</i>	<i>Compliance Costs* (Average) in 2001 (£s)</i>	<i>Size Band (Employees)</i>	<i>Compliance Costs Average (& Median) (£s)</i>
1–4	308	1–4	335 (170)
5–9	153	5–9	170 (119)
10–49	95	10–49	123 (91)
50–99	62	50–99	56 (26)
100–499	44	100+	21 (9)
500–999	31		
1000–4999	31		
5000+	5		

Note: *Adjusted by the Consumer Prices Index which in 2001 stood at 106.9 (1996 = 100).

Source: Chittenden (2005)

It might be hoped that the situation will have improved since 2001 due to Government initiatives. Using information from KPMG (2006) and Inland Revenue (1998) it is possible to investigate how the distribution of PAYE-NIC compliance costs has changed over the last decade.

The table below records the percentage of the compliance cost born by all employers below various size thresholds. The percentage of the compliance cost born by all employers below a particular size should be compared against the percentage of employment accounted for by these employers⁵. For example, in 2005 firms with less than 50 employees bore 86 % of the PAYE-NIC compliance cost but accounted for 34 % of employment⁶.

⁵ The missing values in the table are due to a different choice of size thresholds in the original studies.

⁶ For 1995 the percentage of PAYE-NIC paid is used in place of employment because such employment data was not readily available. However, employment and PAYE-NIC tax-take are strongly related and so for the purpose of this analysis they will be treated as equivalents. Having said this, large employers tend to pay higher wages than small employers and so the percentage of PAYE-NIC paid by small employers is likely to under estimate their contribution to employment.

The Distribution of PAYE-NIC Compliance Costs by Firm Size for 2005 and 1995

number of employees	2005		1995	
	cumulative % of compliance costs ⁽¹⁾	cumulative % of employment ⁽²⁾	cumulative % of compliance costs ⁽³⁾	cumulative % of PAYE-NIC paid
< 10	69	17	45	7
< 50	86	34	65	23
< 250	92	48		
< 500			85	45

(1) Section 3.3.3, KPMG (2006)

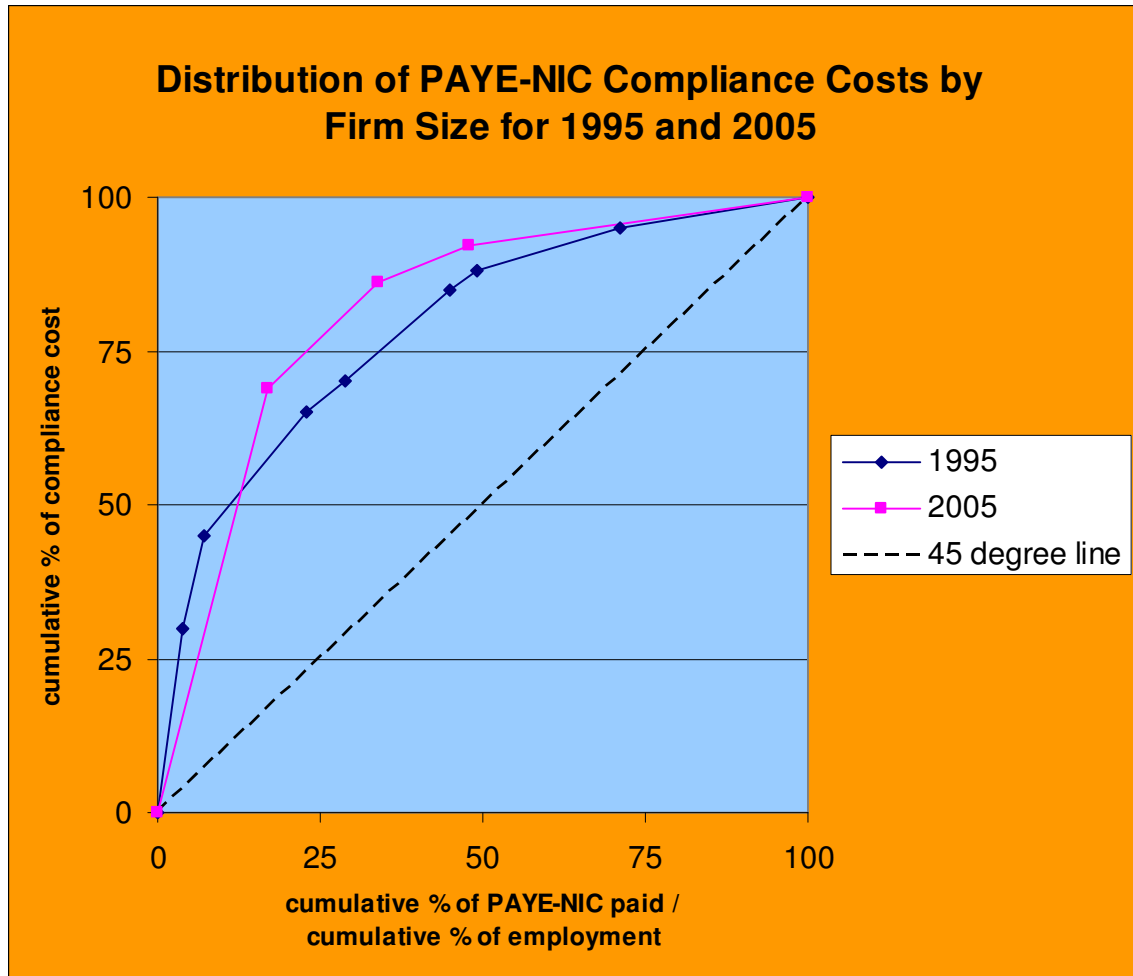
(2) Table 6, KPMG (2006)

(3) Section 3.3.3, Inland Revenue (1998)

If PAYE-NIC was not a regressive system of tax administration, then compliance costs would be proportional to employment⁷. In order to see the extent to which the compliance cost deviates from this proportional relationship it is useful to plot a graph of the cumulative compliance cost against cumulative employment; this is shown below. The area between the 45-degree-line and the curve provides a measure of the extent to which PAYE-NIC is regressive. Hence, it is clear from the graph that the system of PAYE-NIC has become more regressive over the last decade despite Government efforts to remedy the problem⁸.

⁷ For example, if employers with less than 50 employees accounted for 34 % of employment, then these employers would bare 34 % of the PAYE-NIC compliance cost.

⁸ The distribution for 1995 is likely to be less regressive than the graph suggests because the contribution of small employers to employment is greater than their contribution to the PAYE-NIC tax-take.



3.3 Why is the regressive nature of the PAYE-NIC compliance an economic concern?

The regressive nature the compliance costs associated with of the PAYE-NIC is not only unfair but may also have a negative effect on the UK economy.

Firstly, by disproportionately increasing the costs of small firms PAYE-NIC raises the 'barriers to entry'. The threat of competitors entering a niche market helps to discourage an incumbent firm from seeking excessive profits by charging high prices and restricting output. The PAYE-NIC compliance costs incurred when an employer takes on their first employee makes it more difficult for a new firm to enter a market; and so helps to shield established firms from competition. Moreover, if regulation leads to the closure of small

firms, then the market share of the surviving firms will increase. Since market share is strongly related to market power there is an enhanced risk of uncompetitive behaviour.

Secondly, small businesses are a particularly important element of the economy. HMRC (2005) claims that 'small business plays an important role in delivering enhanced economic growth ... [and] that a strong and dynamic entrepreneurial base is an essential driver of productivity and prosperity in a modern economy'. In particular, it was found that productivity growth among small businesses has outstripped productivity growth in large businesses.

Thirdly, the current system discourages some small businesses from taking on their first employees, which 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. Small businesses employ around half the private sector work force and Carter (2001) argued that small firms continue to contribute disproportionately to employment growth. 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). The Small Business Council concluded recently: 'Many of the smallest businesses fail to grow because of the perceived and actual complexities of employing people. This hampers enterprise unnecessarily and the Council believes that there are specific measures that the Government should take to address this specific issue.' (Small Business Council, Annual Report (2005))

Fourthly, the current system also distorts what should be purely commercial decisions about the legal form of a small enterprise⁹. Owners of unincorporated firms are not subject to PAYE on their drawings, whereas the director of a limited company is legally an employee and has to account for PAYE-NIC on their earnings¹⁰. Whilst there are a number of factors involved in these decisions, this could potentially discourage some micro businesses from becoming limited companies.

⁹ See for example: *Tax Faculty of the Institute of Chartered Accountants in England and Wales - Key Issues for the 2005 Pre-Budget Report (October 2005)*

¹⁰ Chittenden (2005) found that incorporated businesses reported the highest level of compliance costs when compared to the self-employed and sole traders.

Finally, it could provide an incentive for micro-businesses, in order to compete with larger firms, to fail to comply with their PAYE obligations and by doing so undermine the efficiency of the system.

3.4 Explanations for the regressive nature of compliance costs

Inland Revenue (1998) argued that larger employers were able to reduce compliance costs because they were able to take advantage of economies of scale. Completing end of year returns is a significant fraction of the PAYE-NIC compliance cost. This fixed cost is fairly independent of the number of employees and hence becomes negligible for very large payrolls, once distributed among all employees. According to Inland Revenue (1998) savings per employee per annum from using a bureau were approximately £10, but payroll bureaux were not normally interested in payrolls with less than about 50 employees.

Chittenden (2005) offered an alternative explanation for the regressive nature of compliance costs. It was argued that “the primary reason for the regressive nature of these costs is the number of hours that business owners and directors spend upon PAYE”.

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. Costs fall because the hourly rate paid to staff is much lower than the hourly value of owners/directors’ time, as is clearly evident in the table below.

Table 10. Additive PAYE Compliance Costs per Payroll by Business Size (£s)

<i>Payroll Size Bands</i>	<i>Owner- Managers Costs (£s)</i>	<i>Internal Staff Costs (£s)</i>	<i>Internal Non-Staff Costs (£s)</i>	<i>External Costs Accountants (£s)</i>	<i>Total Costs (£s)</i>
1-4	248	28	8	51	335
5-9	91	33	9	37	170
10-49	60	40	7	16	123
50-99	19	26	4	7	56
100+	6	11	3	1	21

Source: Chittenden (2005)

KPMG (2006) found that 'much of tax administration works reasonably well once it is certain and has been around for long enough for business to set up a smooth machine to deal with the administrative requirements'. Large established firms are likely to have set up a 'smooth machine' to deal with their PAYE-NIC obligations. 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. Moreover, uncertainty and anxiety may lead such employers to seek professional help. Chittenden (2005) argued that small businesses are more likely to involve external accountants in operating the PAYE system. It was argued that professional advice reduces the uncertainty that owners face with regard to complying with their obligations under PAYE-NIC but raises their costs.

4. Implications of Emerging Trends in the UK Economy and Tax System

4.1 Introduction

According to Comptroller and Auditor General's Standard Report on the Accounts of the Inland Revenue 2004-05 by the National Audit Office (NAO), HMRC's internal audit revealed that 3.8 million taxpayers had paid too much or too little tax. The following year, *The Comptroller and Auditor General's Standard Report* on HMRC annual report, this figure rose to 5.7 million. This accounts for over 15% of the taxpaying population.

To some extent the rise in administrative errors can be explained away by the existence of temporary administrative problems within HMRC. For example, HMRC introduced a new computer system to process returns automatically but the implementation of this system was delayed causing a significant backlog, some of which required manual processing (NAO (2006)). Furthermore, some PAYE resources were diverted to other areas of work, such as Working Families Tax Credits. However, in addition to these

temporary administrative problems, underlying changes in the labour market and the tax system are putting PAYE under increased strain.

Moreover because it is thought that the majority of taxpayers do not check that their PAYE codes are correct, this may well be an underestimate of total number of taxpayers paying the wrong tax.

4.2 Increased volume

According to NAO (2006), the size of the UK workforce has increased steadily from 25.3 million in 1993 to 28.7 million in 2005, which has produced more work for HMRC and employers in administering the PAYE system. In addition, the number of PAYE schemes is currently growing by approximately 100,000 (net) each year. Hence, HMRC and employers are administering PAYE for a growing number of people and a growing number of schemes.

4.3 More flexible labour markets

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”¹¹. This built upon the analysis of Inland Revenue (1998):

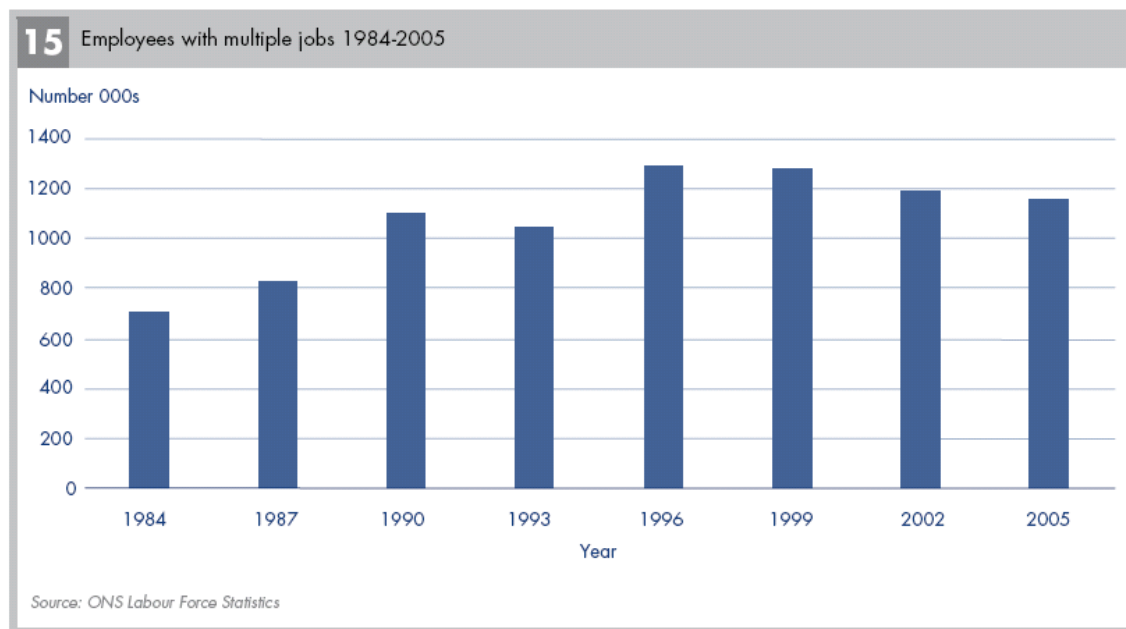
It [PAYE] works best for large, rather “static” payrolls, i.e. payrolls with hardly any staff turnover or casual or part-time employees. For much of society this is still an appropriate model but in an increasingly flexible labour market the employer-employee nexus becomes much weaker.

Similarly, NAO (2006) identified a number of growing trends which PAYE found hard to accommodate. There has been a growth in employment of groups for whom PAYE is difficult to operate, including students who often have more than one job and working pensioners. There is every reason to expect this growth to continue if not accelerate; for

¹¹ *Treasury Committee, Sixth Report, Inland Revenue, 1999*

example students are now expected to contribute more to the cost of their education than previously had been the case and this will have an impact upon the numbers of students taking employment.

Moreover, HMRC's records are structured around employments, rather than individual taxpayers. As a result, HMRC can have difficulty in ensuring that taxpayers with more than one source of income pay the correct amount of tax because it may not know about additional sources of income (NAO (2006)). Finally, HMRC's internal audit for 2005-06 found that in 21 per cent of cases where individuals had more than one job, the correct code had not been issued. Such errors increase administrative costs for HMRC, inconvenience for employees and ultimately the numbers of taxpayers who pay the wrong amount of tax.



Source: NAO (2006)

The rising turnover in the workforce is a second trend that PAYE finds hard to accommodate. Approximately 20 per cent of jobs last less than one year and 5 per cent are for periods of less than three months (NAO (2006)). Inland Revenue (1998) warned about the high cost of dealing with 'casuals and joiners'. The average marginal cost of each fulltime joiner was of the order £73 whereas for a medium sized employer the average marginal compliance cost of an employee was £14. The authors commented

that "This is a very important result: the number of joiners is far and away the largest single determinant of compliance costs".

Much of the extra cost associated joiners is thought to stem from the need to gather extra information in order to establish the right tax-codes. The system runs into particular difficulties when an employee's P45 form is lost. According to NAO (2006) in around 70 % of job changes employees do not immediately provide their new employers with a P45 form. HMRC's Internal Audit found that employers were not always using the latest tax code despite being instructed to do so. This increases the risk that employees are paying incorrect amounts of tax and may necessitate further work by HMRC to repay any overpayments or collect any underpayments (NAO (2006)).

4.4 Growing complexity of the tax system

Over time additional requirements have been placed on employers through the mechanics of the PAYE system. PAYE was originally set up in 1944 with the limited objective of collecting income tax. The scope of the PAYE system has been expanded to cover certain self assessment liabilities, student loan repayments, statutory payments, and - until April 2006 – the payment of tax credits via employers (NAO (2006)).

14 Expansion of the PAYE system

1944	Introduction of PAYE to collect income tax
1948	Collection of National Insurance Contributions
1976	Changes in taxation of Benefits in Kind
1983	Statutory sick pay
1987	Statutory maternity pay
1997	Introduction of Self Assessment
2001	Collection of Student loan repayments.
2002	Tax credit payments to employees. ¹
2003	Statutory adoption and paternity pay

Source: HMRC

NOTE

1 Payment of Tax Credits via employers was withdrawn in April 2006.

Source: NAO (2006)

NAO (2006) concluded that there is a problem arising from the complexity of the tax system with which new employers and other businesses are confronted. The complexity of the system contributes to compliance costs because employers have to put effort into reading and understanding the relevant literature. This can be treated as a fixed cost because it is largely independent of the number of employees in a firm. As argued above, such fixed costs contribute to the regressive nature of the PAYE-NIC system. KPMG (2006) also noted that complexity is the principal determinant of compliance costs.

5. Previous Recommendations and Policy Initiatives

5.1 The Bath Report (1998)

The Bath Report (Inland Revenue (1998)) recommended closer collaboration between Inland Revenue and Customs and Excise in order to reduce level of duplicated effort on the part of employers and streamline communication with tax authorities. In response Government promoted ever closer collaboration and the two agencies were eventually amalgamated into HMRC.

To remove the unreasonable burden that PAYE places on small employers the authors of the Bath Report suggested 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.’ In its response to the Bath Report, Government accepted that at some point in the future it may be worth considering an alternative to PAYE for small employers but for the time being “it is clear that it is generally fair and efficient to collect income tax and NICs via employers, and unlikely to be practical or sensible to shift the burden to individuals.”¹² However, to help address the regressive nature of PAYE-NIC compliance costs the Chancellor announced the quarterly payment scheme in his 1999 Budget. Through this scheme small businesses are permitted to make payments to the Inland Revenue quarterly instead of monthly, thus improving their cash-flow position.

The Bath Report suggested that the introduction of ‘smart cards’ would reduce the burden of leavers and joiners. Providing individuals with a card detailing their allowances would make it easier for employers and HMRC to cope with a higher turnover of labour. The introduction of smart cards was rejected by the Government but the Treasury Committee (1999) urged the Government reconsider its decision.

¹² *Government Response to the Bath Report Recommendations on Tax Compliance Costs for Employers of PAYE and NICs in 1995/96 (April 1999)*

5.2 The Small Business Council (2001)

In 2001 the Small Business Council recommended that further action was needed in order to reduce the compliance costs that PAYE imposed on small businesses. It was suggested that the Government should introduce a flat rate payments system for small businesses. They wrote:

For those micro businesses employing less than 10 people the Government needs to ensure that the collection of taxes is simple and easy to understand and straight forward to administer. The SBC believe that the Government should introduce a system whereby micro businesses can make PAYE payments and National Insurance (NI) deductions by 12 monthly flat rate standing orders. The monthly payment would be based upon the projected annual PAYE and NI payments in the forthcoming year divided by 12 equal instalments. 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, to be made not later than 2 months after the end of the tax year.

The Government rejected this recommendation on the grounds that by undermining the cumulative nature of PAYE in this manner, it would increase the numbers of employees who would pay too much or too little tax.

5.3 The Carter Review (2001)

The Government asked Patrick Carter to review the market for payroll services to small enterprises in the UK in the hope of reducing the total costs to business. Carter (2001) concluded that small businesses should be encouraged to make better use of new technology. In addition payroll services should be provided for small businesses through the Small Business Service¹³ because of the reluctance of payroll bureaux to provide services to small employers. The Carter review recommends cash incentives (up to £250 per annum) for smaller employers to encourage electronic filling of end of year returns with the IR over a period of five years. The Government accepted Carter's

¹³ Operating under the auspices of the DTI

recommendations and in 2005-06 HMRC paid £225 million in incentives to encourage small businesses to file their PAYE returns online.¹⁴

Chittenden (2005) argues that Carter's compensation scheme would help to increase online filing without reinforcing the distortion of competition between small and large firms that the PAYE-NIC system creates. Chittenden (2005) implies that Carter's approach is in line with their own recommendation that the playing field should be levelled through the provision of compensation for small firms. 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 employs¹⁵. Compensation would be delivered through deductions from the PAYE-NIC collected on behalf of HMRC. Chittenden (2005) welcomed the implementation of Carters recommendation but says that it did not go far enough to level the playing field.

5.4 Recent Policy Changes and Initiatives

Chittenden (2005) argued that much of the effort devoted to reducing compliance costs had been undermined by saddling employers with the obligation to administer Working Families Tax Credits (WFTC) in 2002. Chittenden (2005) found that 86 % of small employers thought that the introduction of WFTC had increased the complexity of the system considerably. However, in April 2006 HMRC transferred the responsibility for administering WFTC from employers to HMRC¹⁶. Relieving employers of the responsibility for administering WFTC is a significant step towards reducing the complexity of the PAYE system. The Bath Report concluded that "Simplification is especially important for small employers whose very high compliance costs per

¹⁴ *HM Revenue & Customs 2005-06 Accounts: The Comptroller and Auditor General's Standard Report (July 2006)*

¹⁵ The deductions would start at around £200 per employee per annum for the smallest businesses and would decline with the size of the business, reaching zero for business with 100 or more employees. Chittenden (2005) estimates that this would cost the Treasury £371m per annum

¹⁶ 'Abolishing payment of tax credits via employers between November 2005 and April 2006 – reducing annual payroll costs that hit the smallest employers hardest by an estimated £90 million' (HMRC (2005)).

employee largely arise from the time involved in reading the relevant literature, understanding the literature and keeping up-to-date with changes."

Currently HMRC's records are structured around employments, rather than individual taxpayers. As a result, HMRC can have difficulty in ensuring that taxpayers with more than one source of income pay the correct amount of tax because it may not know about additional sources of income (NAO (2006)). HMRC plans to improve its internal processes as part of its 'Modernisation of PAYE Processes for Customers (MPPC)' project. This project should also provide a complete view of an employee's tax affairs by making better use of the information HMRC already holds. This initiative should make it easier for PAYE to cope with more flexible working patterns.

6. Policy Implications

6.1 Introduction

Putting to one side those who argue for significant changes to the tax system itself, of the literature reviewed, there are three directions for reform available:

1. In line with Chittenden (2005), compensate small businesses directly for the time they spend complying with PAYE.
2. Continue to look for ways of reducing the time small businesses spend complying with PAYE.
3. In line with the Bath Report (1998) move some of the burden of PAYE from small businesses onto their employees.

6.2 Compensate Small Employers

Compensating small employers for administering PAYE-NIC would directly address the charge that PAYE is a regressive system of tax administration. HMRC recently invested

in a model developed by KPMG which would enable them to estimate PAYE-NIC compliance costs for small businesses on a yearly basis. Chittenden (2005) estimated that such a compensation scheme would cost around £370m per annum, which is relatively modest.

However, it could be argued that Government ought to be considering how to best reduce the time small businesses spend fulfilling their PAYE obligations, rather than merely offsetting the costs of this activity.¹⁷

6.3 Reduce the Time Employers Spend Complying with PAYE

Government could expand and promote the payroll services offered by the Small Business Service (i.e. a Government sponsored payroll bureaux). The provision of such a service by government would be more efficient than simply compensating small businesses for administering PAYE because it would enable economies of scale to be realised.

Government could continue to reorganise the structure of income tax administration in response to more flexible working patterns. For example, HMRC should restructure their records around individuals rather than employments (a reform that is already under way). Such a move would make it easier to introduce 'smart cards' as recommended by the Treasury Committee in 1999.

Government could further reduce the complexity of the PAYE system by relieving employers of the responsibility for administering student loan repayments or paternity pay. Such moves would put more responsibility on to HMRC and employees (as occurred when responsibility for administering WFTC was transferred).

¹⁷ There is no reason to believe they are not. See for example *Progress Towards a New Relationship: How HMRC is working to make life easier for business* (March 2006): "Every hour spent dealing with tax or complying with regulations is an hour not spent running the business and generating wealth for the economy."

6.4 Relieve Small Employers of the Obligation to Administer PAYE

Government could introduce a flat rate payment system for small businesses as recommended by the Small Business Council in 2001. In other countries, employers do deduct tax according to fixed withholding rates but in order that the employee pays the right amount of tax they file an end of year return with the appropriate revenue authority.¹⁸ To ensure employees do pay the correct tax liability and for the SBC's recommendations to be workable, the employee could take on some of the PAYE compliance burden, as the Bath Report proposed. This could substantially reduce the time that small employers have to spend fulfilling their payroll obligations. Moreover as changes to the labour market continue at pace – with more taxpayers having multiple sources of income and changing employments more frequently – and given the difficulties noted by Inland Revenue (1998) and others that PAYE finds accommodating such changes, this option may look increasingly advantageous.

¹⁸ For further information on other national practices, see for example: *Tax Administration in OECD Countries: Comparative Information Series (2004)*.

Part II: The Future of Self-Assessment Online

1. The Carter Review (2006)

Nearly 2.9 million income tax self assessment returns were filed online in 2006-07 of the almost 10 million HMRC receives each year. Although this represents a significant improvement on previous years, it compares unfavourable internationally. For example in the USA over 54% now file online, which is 73 million returns in total. Moreover the fraction of income tax self assessment returns filed online was well below the 50% envisaged by 2005 back in 2000 by the Cabinet Office Minister Jack Cunningham¹⁹ and then affirmed in the Inland Revenue's Public Service Agreement 2001-2004.²⁰ Furthermore according to NAO (2007) taxpayers are still least likely to use HMRC's online services for information about how to complete their self assessment form compared to other sources of information available.

In 2005 the Government asked Lord Carter to consider ways of increasing the uptake of electronic filing and in March 2006 he published his *Review of HMRC Online Services*. In order to increase the numbers of self assessment tax returns filed online, Carter (2006) recommended that the filing periods for self assessment be reduced such that the deadline for papers returns moved from 31st January to 30th September and the deadline for electronic returns moved from the 31st January to 30th November by 2007-08. This would give a significant incentive for taxpayer to file their returns online.

These proposals proved controversial amongst accountants and tax advisers and in July 2006 the Government announced that it would implement a modified version of Carter's

¹⁹ Modernising Government White Paper (2000) available at <http://www.archive.official-documents.co.uk/document/cm43/4310/4310-sm.htm>

²⁰ Inland Revenue Public Service Agreement 2001-2004: "Ensure by 2005 that 100% of services are offered electronically, wherever possible through a common Government portal, and a take-up rate for these services of at least 50%."

proposals such that electronic returns could still be filed up to 31st January but paper returns would only be accepted before 31st October.

Now that this issue has been resolved it is appropriate that attention should turn to the other recommendations the Review put forward.

Lord Carter pointed towards the US Internal Revenue Service (IRS), which as noted above enjoys much higher rates of online filing than HMRC, as potentially showing the way forward for the UK in the longer term:

HMRC currently offers free online forms for all its online services. Most other countries take the same approach but the IRS has chosen to stay out of the software market and has negotiated with the software industry for the industry to offer free software to certain groups. In the future, as online filing becomes the norm, we think that HMRC, working with the industry, should consider this approach and whether it might be better to leave software provision to the industry and focus HMRC resources on the infrastructure for exchanging electronic data with customers, agents and other intermediaries.

The relationship between the IRS and the software industry was of particular interest:

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'.

It should be also added that the cost to the IRS of processing such returns is considerably less than the cost incurred by HMRC. In their evidence to the Public Accounts Committee, HMRC said that excluding overheads it costs £13 to process an

electronic return compared to £22 to process a paper return. The IRS says 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.

We will have to wait to see the extent to which Lord Carter's recommendations on filing periods due to be implemented in 2007-08 improve the current situation and HMRC are confident they will.²¹ Yet a recent survey by the Working Together E-group, led by the representative bodies of the tax profession, of their members concluded that whilst there was enthusiasm for e-services, there was widespread doubt over HMRC's ability to deliver them²². Moreover last year a poll by YouGov highlighted that only 23 per cent of those questioned trusted the Government to protect their personal details online, against 70% of those questioned who trusted banks²³. Both these surveys demonstrate the significant hurdles HMRC will have to overcome.

2. Outcomes of the Policy Roundtable

In March 2007, the Group hosted a policy roundtable to discuss the future of electronic filing of tax returns in the UK and what lessons the UK and US could learn from each other's experiences in this area.

From the UK both the Institute of Chartered Accountants in England and Wales (ICAEW) and the Chartered Institute of Taxation (CIOT) took part. There was a widespread feeling amongst those present from the UK that Lord Carters' Review had led to significant improvements in the dialogue on this issue between HMRC, taxpayers and those representing their views. The ICAEW in particular felt that the Review had established a new principle that HMRC would only introduce new e-service initiatives when the required functionality was in place and not before. Having said this, there were some

²¹ See for example Public Accounts Committee - *Filing of income tax self assessment* returns: "The Department considers that differential filing [recommended by Carter (2005)] would increase the take up of online filing to 57% in the first year."

²² The Working Together E-group – "E-Filing of Personal Tax Returns Survey" (20 December 2006), available at <http://www.icaew.co.uk/index.cfm?route=144116>

²³ See YouGov/Computer Associates - "Organisations offering online services must do more to protect personal details" (April 4, 2006) available at <http://www.ca.com/uk/press/apr06/040406.htm>

dissenting voices during the roundtable who still felt that the push towards electronic filing was being driven by Government's needs at the taxpayers' and employers' expense.

Representatives of the US Free File Alliance, whose work was highlighted by Carter (2006), and the Washington DC based Information Technology and Innovation Foundation (ITIF), travelled from the US to give presentations. The IRS submitted evidence in written form.

The Free File 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 population²⁴. 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 must have a choice of at least two 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 dollars 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.

As Carter (2006) pointed out, from the perspective of the software companies who join the Alliance it 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 prosper and innovate.

The Alliance pointed towards a number of these innovations as evidence of the benefits of this arrangement. For example rather than completing a form, when using this software taxpayers fill out an electronic questionnaire which then populates the relevant forms on the taxpayer's behalf. Moreover at the taxpayer's request the software can even pre-populate large sections of this questionnaire by uploading information on their financial affairs from their employer's payroll provider. There is great potential to simplify

²⁴ This figure is slightly below that quoted in Carter (2006).

the process of filing tax returns for the taxpayers in the UK; NAO(2007) estimated that around £300 million is underpaid by taxpayers arise from errors on the taxpayer's behalf.

It is also worth reflecting upon the fact that with a number of private companies and not-for-profit organisations, like the Free File Alliance, providing this service to taxpayers, it ensures that any technical difficulties that might arise are localised and taxpayers can continue to file their returns online even if some service providers run into difficulties.

Although this year HMRC's online service coped with the demands placed upon it, and it is rightly proud of this fact, there have been instances, particularly during the early years of Self Assessment Online, when this was not the case and taxpayers were unable to file their returns online with confidence.

For example 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 filed. The filing period was extended by a further two weeks past the original deadline.

As was commented upon at the time, these technological difficulties and security breaches can discourage taxpayers from filing their returns online. They reduce taxpayers' confidence in the system and so may discourage uptake.

Robert Atkinson, President of the ITIF, briefed the Group on his recent paper: *"Turbo Government": A Bold New Vision for E-government* (2006). According to Atkinson there are three phrases of E-government:

- I. A passive presence on the Web based on information, but not citizen interaction
- II. Web applications that allowed individuals to interact with government, such as paying parking tickets and renewing drivers' licenses
- III. Functionally oriented, citizen-centred government Web presences which break down bureaucratic barriers

Most public sector organisations in the US have reached this second phase but have made slow progress towards this third. In the US the Government has found it difficult to build applications linking together numerous departments and non-departmental public bodies and even more difficult linking applications that cut across levels of Government.

For Atkinson then the relationship between the IRS and the tax software industry is an exemplar of how the US public sector can move onto his third stage of E-Government. By engaging with private sector expertise, not as contractors but partners in the provision of electronic tax filing, together they have created a service that is functionally oriented around the citizen's needs whilst at the same time delivering the public sector's goals and objectives.

Part III: Conclusions

The cost of administering PAYE-NIC falls disproportionately on small employers causing a harmful distortion in the competition between small and large firms. This is both unfair and has been shown to be bad for the UK economy. Moreover 5.7 million taxpayers are paying the wrong amount of tax and there is evidence to suggest that PAYE is failing to keep pace with changes in the labour market. In NAO (2006), Sir John Bourn, Comptroller and Auditor General warned: “Within its new framework for managing PAYE, HMRC also needs to have appropriate arrangements for monitoring emerging trends in the labour market to allow it to develop an appropriately planned response to future changes in the taxpayer population.”

One solution discussed here, originally proposed in Inland Revenue (1998) would be to remove the burden of tax administration from small employers and ask their employees to take on some responsibility for ensuring they pay the correct tax liability. This would significantly increase the numbers of tax returns received by HMRC and create new administrative and compliance burdens in the process.

Yet there evidence that this move towards the individual taking greater responsibility for their tax affairs is already underway. IFAP (2006) notes that: “Since the first report was produced [in 1994] there has been a shift in responsibility for the management of personal tax away from the HMRC to the individual. This shift has moved beyond self assessment which has been steadily bringing more and more individuals into its net and now includes tax credits which require the individual to apply for a tax rebate or an additional allowance to reduce their tax liability.”²⁵

Moreover one issue that arose during the policy roundtable on electronic filing was that in the US, where many more individuals do file tax returns, it was felt that this process played an important role as a yearly financial audit for the family or individual. In fact the IFAP claim that 82% of UK adults will waste £7.9 billion in unnecessary tax in 2007. If

²⁵ IFAP produces annual research into how much we waste as a nation and per person by paying unnecessary tax. The body was set up to promote the work of independent financial advisers.

this figure is correct, then perhaps it offers a moral case for why individuals ought to become more involved in their tax affairs.²⁶

One of the many recommendations to put forward in Carter (2006) to increase online filing was that the UK should look towards the success that has been achieved in the US in this area. The US revenue authority, the IRS, has chosen to stay out of the software market and has negotiated with the software industry for the industry to offer free software to certain low income groups through the Free File Alliance. This approach has been labelled the third phase of E-government, whereby Government partners with not-for-profit organisations and private sector enterprises to produce citizen orientated e-services.

The Free File Alliance believes that this arrangement provides the necessary market space in which the private sector can prosper and innovate to reduce the burden the individual faces when preparing and filing their tax return. Moreover it has proven popular amongst taxpayers, with many more of them choosing to file their tax returns electronically than do so in the UK and at substantially reduced costs to the IRS than HMRC currently bear.

When weighing up the merits of increasing the numbers of individuals expected to file tax returns, there is a great deal to be learnt from the success in the US of the IRS's partnership with the tax software industry which has reduced compliance costs for the individual and administrative cost to the Revenue.

²⁶ See IFAP press release, URL: [http://www.unbiased.co.uk/taketaxaction/press-releases/uk-s-tax-waste-mountain-grows-to-7-9-billion-\(consumer-media\)/](http://www.unbiased.co.uk/taketaxaction/press-releases/uk-s-tax-waste-mountain-grows-to-7-9-billion-(consumer-media)/)

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