The Taxing Wealth Report 2024

Every politician's guide to "How to pay for it"[1]

Background to Taxing Wealth Report 2024: Methodology and decision criteria

Brief summary

This note suggests that the Taxing Wealth Report 2024 is based on four related conceptual ideas that raise issues that need to be addressed if additional tax revenues are to be raised in the UK in a way that is fair to all taxpayers. These are:

1. The creation of horizontal tax equity, which requires that all incomes of similar amount be taxed the same sum irrespective of where that income comes from.
2. The creation of vertical tax equity, which requires that as a person's income increases the amount of tax paid on it will always increase irrespective of its source, with a progressive tax system resulting as a consequence.
3. The identification and elimination of tax gaps, which are the differences between the tax revenues that a jurisdiction should be able to collect and the tax revenues it actually recovers during the course of a period.
4. The identification and elimination of tax spillovers, which are the negative consequences of the interactions between different tax systems or different parts of the same tax system that can often (sometimes unintentionally) reduce tax revenues and the size of a tax base.

[1] This note forms a part of 'The Taxing Wealth Report 2024' published by Finance for the Future LLP, which is UK LLP number OC329502, registered at 33 Kingsley Walk, Ely, Cambridgeshire, CB6 3BZ. See https://www.financeforthefuture.com/taxing-wealth/. This note was written by Richard Murphy FAcSS FCA FAIA (Hon), Professor of Accounting Practice, Sheffield University Management School, who is a director of Finance for the Future LLP.

Tax spillover assessments identify the causes of tax gaps and so, in turn, the reasons why horizontal and vertical tax equity do not exist within a tax system.

Whilst addressing these issues the note makes clear that the Taxing Wealth Report 2024 uses microeconomic theory to justify:

a. The recognition of all sources of increase in the financial well-being of a person as being of equal value to that person and that all such sources should, as a result, be subject to equal rates of taxation. This recognition does, as a result, remove the distinction that is commonplace in tax between earned and unearned income and income, capital gains and capital receipts, all of which are considered as equal for these purposes.
b. The idea that progressive taxation is equitable because of the reducing marginal utility of each additional sum received by a person as a contribution to their financial well-being during the course of a period.

Background

The changes proposed in the Taxing Wealth Report 2024 are justified against a number of criteria, as follows:

- Horizontal tax equity, which requires that all incomes of similar amount be taxed the same sum irrespective of where that income comes from.
- Vertical tax equity, which requires that as a person's income increases the amount of tax paid on it will always increase irrespective of its source, with a progressive tax system resulting as a consequence.
- Reducing tax spillover effects[2] to close the tax gap[3] and reduce tax avoidance and evasion, meaning by implication at the rate of tax compliance[4] in the UK is increased.
- Raising additional tax revenue.

In this note the reasons for adopting these criteria are explained.

Horizontal tax equity

[2] Tax spillovers are the consequences of the interactions between different tax systems or different parts of the same tax system that can often (sometimes unintentionally) reduce tax revenues and the size of a tax base.
[3] The tax gap is the difference between the tax revenues that a jurisdiction might be able to collect and the tax revenues it actually recovers during the course of a period.
[4] Tax compliance is seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

The principle of horizontal tax equity requires that all increases in the financial well-being accruing to people in equivalent circumstances within a population be taxed in equal amount whatever the origin of that increase in financial well-being might be.

To put this in context, it should not matter whether this increase in financial well-being arises from employment, self-employment, a rent, a return on savings in whatever form paid, a capital gain or, maybe, a gift. Each of these activities increases the financial well-being of the recipient and in that case if a tax system is to be equitable there should be no discrimination in the amount of tax paid by persons in equivalent circumstances if they are to enjoy an increase in their financial well-being for any of these reasons.

Note, however, that this principle does not say that all income should be taxed in equal amount. Horizontal tax equity does not justify a flat tax, which is a tax of equal amount on any increase in financial well-being that a person might enjoy irrespective of each such person's differing financial circumstances. Instead, horizontal tax equity quite specifically allows that the different circumstances of taxpayers can be taken into consideration when determining tax due, so long as the same consideration of circumstances is made for each person in an equivalent situation.

Importantly, horizontal tax equity applies to all sources of increase in a person's financial well-being, and not just to their income. In other words, it is indifferent to whether that increase in financial well-being arises as a consequence of income earned (whatever its source) or increases in wealth (again, irrespective of the origin of that increase) or gifts.

This logic is based upon standard microeconomic theory. Based upon that theory, which in this case appears to accord closely to observed reality, there is no reason to think that a person should, or does, value their increase in financial well-being differently as a consequence of it source. What matters to them is the fact that their well-being has been enhanced. As a consequence, tax differentials that discriminate between the origins of increase in financial well-being are contrary to the principles of horizontal tax equity.

This concept of indifference as to source is also implicit in modern accounting theory and in the accounting standards used to record the income of companies both in the UK and internationally. The primary method of computing the income of any entity using these standards is to compare the net worth of a company at the end of a period (£A) with the net worth of that same company at the beginning of the period (£B) having allowed for sums withdrawn from the entity during the period by its owners, whether by way of dividend, share buyback or other means (£C), and the issue of new shares or other equity (£D).
In other words, profit or income (£Y) is calculated as:

£Y = £A - £B + £C - £D

This may come as a surprise to those who presume that the income of an entity during a period is the figure included as net profit after tax in the profit and loss account or income statement of the entity in question (£E). This is not the case. The movement in the value of the balance sheet at the end of a period (£A) is, instead, reconciled with the value at the beginning of the period (£B) by publication of three separate statements:

- The income statement (or profit and loss account, as some might know it), which estimates the net sum earned from trading, having allowed for tax during the course of the period (£E).

- The statement of comprehensive income for the period, which recognises the change in the market value of the assets and liabilities of the enterprise during the course of the period when stated at fair market value at both the opening and closing dates, some of which movements may be taxable. (£F)

- A statement of the change in equity arising during the course of the year, which explains the sums withdrawn from the entity during the period by its owners, whether by way of dividend, share buyback or other means (£C), and the issue of new shares or other equity (£D).

As a result, and given that the changes in equity have already been included in the calculation noted above, earnings (£Y) can also be stated as:

£Y = £E + £F

To translate this to the context of this note, the earnings a person has during a period broadly equate to the earnings a trading entity records in its income statement (£E). It is this figure that most think represents their total income in the year. This idea is also implicit in most tax systems, largely because almost all of our taxes were created before modern theories of income and accounting were created.

This idea of income is, however, wrong. Within the context of taxation, the only relevant criteria of capital that can be used for measurement purposes is a financial one since tax can only be paid using money and can only be charged on tax bases that can be measured in monetary terms. In that case a person's total income in a period must be their increase in net worth having allowed for what they have consumed and should therefore also include the change in the fair value of the assets that they own and sums that they owe during the course of period, as is reflected in modern accounting (£F). In that case horizontal tax equity needs to be based upon this concept.

Vertical tax equity

Vertical tax equity assumes that horizontal tax equity exists. In other words, it assumes that all people of similar circumstance make the same tax payment on each additional sum that increases their financial well-being irrespective of its source.

What vertical tax equity then suggests to be appropriate is that any additional sum payable in tax resulting from an increase in financial well-being should increase in proportion to the total increase in the financial well-being of the recipient of that additional payment in a period irrespective of the source of that increase in financial well-being.

This suggestion has its origin in microeconomic theory. That theory suggests that as a person's financial well-being increases each additional incremental increase in that well-being will have a reduced overall impact on the enhancement of their overall well-being. In other words, the marginal value of increasing financial well-being declines as financial well-being does itself increase.

That this logic is likely to be true is apparent. For a person on very low income any additional sum made available to them will usually have a significant impact upon their perception of their financial well-being. The same sum when received by a person with considerable financial well-being is likely to be of much lower significance, to the point where that person might not even notice it at all. That said, any suggestion that this change in the marginal well-being of a person arising from additional financial well-being can be measured precisely across the range of increased well-being that a person might enjoy is inappropriate, as such measurements are always subjective and so will vary between people. However, in aggregate the observation that such differences in reaction do exist clearly holds true and is observable in human behaviour. As such, it is entirely reasonable to base policy upon it.

Tax, fiscal policy and vertical tax equity

When establishing its overall fiscal policy a government needs to determine what part of its expenditure will be paid for with newly created money, which part will require taxation to be raised to control inflation and what part will be funded using borrowing facilities. This note only concerns itself with the taxation element of this decision, which is usually by far the largest component in this equation, but it is important to note that decisions that a government makes on tax do not exist in isolation and represent only a part of a government's overall fiscal strategy.

This being noted, when a government decided on what taxes might be levied to fulfil its overall goal of revenue generation, it is normal for it to take into consideration its broader, social, economic and industrial objectives, including those with regard to:

- Redistribution of income and wealth.
- Re-pricing market failure with regard to products like carbon, tobacco and alcohol.
- Reorganising the economy through the use of fiscal incentives, and charges to encourage preferred activity (such as those related to a green transition) and discourage those which a government considers to be legal but nonetheless undesirable (such as gambling, speculation and carbon intensive activity).

Most governments claim to have a policy with regard to redistribution of both income and wealth, although as findings elsewhere in this report demonstrate, that goal is only weakly represented in overall UK taxation policy. If it were to be enhanced through a policy of vertical tax equity the government would have to firstly create as much horizontal tax equity as it can plausibly achieve. It would then use that achievement as a platform for the creation of progressive taxation across all aspects of taxation, taking into consideration the impact of all taxes on financial well-being.

Doing so would reflect the fact that, based on the already noted logic of the diminishing marginal utility of each incremental increase in financial well-being, there is also a diminishing marginal cost in terms of utility foregone to a person to settle their taxation liabilities as their financial well-being increases. A policy of vertical tax equity seeks to impose taxation charges that will, on average, impose equal perceived marginal costs to taxpayers when settling their taxation liabilities, whatever their sources of financial wellbeing. This necessarily requires that those with the highest level of financial well-being during a period make the greatest tax contribution during the course of that same period. That should not be seen as an accident of tax policy, but its required design outcome of seeking to achieve vertical tax equity.

Closing tax gaps

The tax gap has been defined in slightly varying ways by differing tax authorities and academics[5]. For example, the US Internal Revenue Service (IRS) defines the tax gap as 'the difference between the tax that taxpayers should pay and what they actually pay on a timely

[5] This section is based on work by the author published at https://academic.oup.com/book/39754/chapter/339816709

basis.' The definition in question is useful because it includes a dimension that most omit, which is that of time. However, the definition remains incomplete for a reason that the IMF notes, which is that the appraisal is usually undertaken within 'the current policy framework' of the jurisdiction being appraised. In that case the tax gap appraised by most tax authorities might be defined as 'the difference as measured within the current policy framework between the tax that taxpayers should pay and what they actually pay on a timely basis.'

It is important to note that this report does not accept this definition of the tax gap. That is because it does not accept that the current tax policy framework should be excluded from consideration when appraising tax gaps. That is in turn because a great many of the advantages that those with wealth enjoy within the UK (and other) tax systems arise because of the failure of current tax systems to either tax that wealth or because those systems provide opportunity for reducing taxes paid in entirely legal ways but which, nonetheless, undermine horizontal and vertical tax equity. To exclude these issues from review within tax gap analyses does in that case make no sense.

The standard definition of tax gaps noted above leads to tax gap analyses that usually refer to three identifiable tax gaps. However, for the purposes of this report five are considered. These are:

1. The tax base gap, which refers to the cost of tax bases not taxed by choice e.g. wealth.
2. The tax rate (or policy) gap, which refers to the costs (both positive and negative) of granting higher and lower rates of tax that vary from the norm or standard rate, as well as the cost of all allowances and reliefs granted to taxpayers, for whatever the reason.
3. The cost of tax evasion.
4. The cost of tax avoidance.
5. The cost of bad debt i.e. declared sums owing but not actually paid.

The last three tax gaps are those measured by most current tax gap appraisals. The first two are the additional tax gaps that this report suggests should be appraised if a tax gap appraisal is to suggest how horizontal and vertical tax equity can be created.

Recognition of this broader range of gaps than is usually calculated is important for a number of reasons and would, it is suggested, add to the quality of tax debate, whether at the macro- or micro-economic levels.

For example, a calculation of the first two noted tax gaps would encourage discussion on issues such as inequality, management of the environment, and investment incentives. The important point is that this makes clear that tax is not just about raising revenue: it is also about redistribution, repricing market failure and the delivery of fiscal policy.

Importantly, a comprehensive tax gap analysis would also change the focus of discussion on the third, fourth and fifth tax gaps that relate to tax evasion, avoidance and tax paid late or not at all. Estimates of each of these gaps are useful, but there are practical problems in distinguishing each of these gaps. For example, the boundary between tax evasion and avoidance is notoriously fluid. As importantly, informed discussion on these gaps would not just focus on their quantum, important as it is, but the cause for their having arisen. This would require that tax spillovers be taken into account in any such discussion. This is why tax spillover analysis (noted below) is now so important.

Tax spillovers

A tax spillover is a loss arising within and between tax systems, whether domestic or international, as a result of one part of a tax system undermining the effectiveness of another part of the same tax system, or that of another state. The tax avoidance industry exploits the opportunities that tax spillovers create. Unless tax spillovers are properly understood that industry cannot, as a consequence, be appropriately challenged, with its activities being brought to a close.

As importantly, nor can, the changes required to deliver horizontal and vertical tax equity be properly identified. This is an issue of particular significance when considering the first and second tiers of the tax gap. These relate to tax bases not subject to tax and the availability of allowances and reliefs as a matter of taxation policy that do, however, undermine both the integrity of the tax system as a whole and the horizontal and vertical equity of it.

Whilst the impact of not taxing an available base, such as wealth, is relatively easy to identify issues relating to the tax policy or tax rate gap, as the second tier of loss is called, are much harder to appraise, not least, because of the confusion that they cause. For example, a person or company making use of an opportunity that is explicitly provided to them in law that results in their payment of less tax than might otherwise be expected is often said to be tax avoiding. However, that is not true. If they are quite explicitly working within the letter and spirit of the law to claim an allowance or relief, or to take advantage of a tax rate that has been made available in law, then they cannot be avoiding an obligation, and as such are not tax avoiding. The blame for the loss that has arisen as a result of the taxpayer's activity falls fairly and squarely upon the government that made the opportunity of which they have taken advantage available. The taxpayer cannot be blamed for taking advantage of an opportunity that the government should not have made available to them. Tier two of the tax gap measures this government created cost, which might explain why it is so rarely estimated.

Another importance of tax spillover methodology is that it makes clear that tax gaps are related to each other: in other words, a tax loss arising in one tax might also indicate a loss in another tax. This will most particularly have an impact on the estimation of losses arising from tax evasion because what this suggests is that they cannot be calculated by tax in isolation, as is commonplace at present. For example, to use accounting logic, if the reporting of turnover is suppressed to evade declaration of a value added tax liability then it follows that, firstly, the suppressed income cannot be reintroduced into other tax declarations (such as those for corporation tax, personal income tax and social security charges) without the VAT under-declaration being apparent and secondly, that under-declarations of those other taxes must follow. This understanding is key to correct estimation of tier three of the tax gap.

Tax avoidance, as properly defined, is the focus of tier four of the tax gap. Tax avoidance involves an activity deliberately undertaken by a taxpayer in a way that they know might not be tax compliant. In this context, tax compliance means seeking to pay the right amount of tax (but no more) in the right place at the right time, where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

A taxpayer who is undertaking tax avoidance activity, meaning that they are necessarily taking the risk of not being tax compliant, is taking a calculated risk that the way in which they declare a tax liability might be wrong but that the balance of probabilities suggests to them that this is a risk worth taking because the prospect of penalty in the form of additional liability is limited, even if the error might become apparent. Tax spillover analysis can suggest the likelihood of this activity taking place. For example, if there is a lax tax or company and trust administration in a jurisdiction the chance that any tax avoidance will be identified and challenged is low if such entities are made use of in the tax avoidance arrangement, as is very often the case. This can then give rise to a probabilistic estimation of this tax gap.

The fifth tier of the tax gap is usually, and superficially, about unpaid tax but it should become much more broadly based if it is to be really useful. That is because whilst some non-payment of tax is due to genuine insolvency for reasons that have arisen beyond the taxpayer's control, some might also result from the design of the tax system itself, and from the level of administrative resources provided to it. In other words, unpaid tax can be seen as a metaphor for a broader issue of concern, which is the risk of spillover within both national and international tax systems arising from poor systemic tax design, whether that be because of the creation of undetected or unaddressed arbitrage risk within tax legislation and between tax legislation and that regulating accounting, company or contract law; or because of risk resulting from the arbitrage of the tax system when tax rate differentials within and between states encourage that abuse. The suggestion is that this risk is measurable and expands the base for this tier of the tax gap beyond a simple consideration of unpaid tax.

This five-tier approach is different from that adopted by most countries addressing tax gap issues at present. The difference is essentially one of scope and ambition. HMRC typifies current thinking on this issue when it says that 'thinking about the tax gap helps the department to understand how non-compliance occurs and how the causes can be addressed'. What appraisal of the tax gap, assisted by tax spillover analysis can do is something substantially more significant, which is to set out an agenda for reform of a tax system so that it can address issues arising from:

- Horizontal tax inequality.
- Vertical tax inequality.
- Faults in the design of a tax system.
- The failure to supply resources to a tax system in adequate amount to permit the collection of tax owing.
- Tax avoidance and tax evasion.

This should put tax gap analysis at the core of the whole process of macro-prudential regulation used by a state to assess the systemic tax risks that it faces both within and beyond its jurisdiction.

Preventing tax spillovers

The subject of tax spillovers has already been noted since it is an issue intimately related to interpretation of tax gaps, but a further explanation of this issue is still appropriate.

The concept of a tax spillover was first noted in academic literature by the International Monetary Fund (IMF) in 2014, when it published a report looking at the potential economic impact of corporation tax policy in some developed countries on the corporation tax collected by developing countries. This issue was the major focus of much tax justice debate at the time, where losses due to international tax competition were of primary concern.

Unfortunately, the IMF methodology was deeply econometric, and whilst there is nothing wrong with this in principle, in this particular case the data was what is described as 'noisy', meaning that far too many possible explanations for the observed variations in tax paid were available, the consequence being that very few useful conclusions could be drawn.

This does not, however, undermine the usefulness of the concept of tax spillovers. This concept has been developed since 2014, mainly within the NGO community and also in academia by Professors Andrew Baker and Richard Murphy of Sheffield University (the latter also being an author of this paper). Baker and Murphy define tax spillovers as the impact that one part of a tax system has on the effective operation of another part of that same tax system or a part of the tax system of another jurisdiction.

The idea is relatively easy to understand. As is readily observable in a tax system like that of the UK, which has been the subject of piecemeal development over time, many parts of that system as a whole undermine other parts of it. This can either be because of the offer of an incentive in one part that undermines the objective of another element or, it can be because tax rates on offer in one tax can directly undermine the demand for tax owed under the regulations relating to another tax, with the taxpayer having some degree of choice about which they might pay.

In addition, the concept of tax spillovers has been extended by Baker and Murphy to appraise the difficulties created by the administration of tax; the availability of data to the tax authority from other parts of the economy; the attitude of governments towards tax and the degree of international tax cooperation the government of a jurisdiction is willing to participate in.

It could be expected that the resulting appraisal of tax risk would, given the multifaceted nature of this examination, be something hard to appraise. Baker and Murphy have addressed this issue, suggesting that in practice the appraisal system can be reduced to the preparation of a grid looking not unlike a chessboard, if eight variables happen to be included in the appraisal, as they suggested in their work. This would then permit each element of the tax system being appraised to be compared with each other element of the tax system subject to appraisal:

Country X	Issue impacting upon										
	Tax spillovers	Income tax	Corporation tax	Capital gain tax	Social security	Tax competition	Tax Politics	Company and trust administration	International agreements	Total	Sub totals
Issue being considered	Income tax										
	Corporation tax										
	Capital gain tax										
	Social security										
	Tax Politics										
	Tax administration										
	Company and trust administration										
	International agreements										
	Total										

The basis of appraisal can include objective elements, such as tax rate differentials, but quite importantly it also includes the possibility of the subjective judgement of those who are familiar with a tax system and the way in which it is used as well as abused in practice,

Ideally, a number of people or organisations with relevant tax expertise would undertake such an appraisal with the scores of being aggregated. The resulting marks are intentionally, straightforward, and so indicative. They are only available from within a range from 1 to 5, with no consideration been given to the use of decimal points at present.

A score of one means that the element of the text system being appraised reinforces the element of the tax system with which it is being compared. In contrast, a score of five indicates that the elements of the tax system being appraised does seriously undermine the other elements of the tax system with which it has been compared. A score of three is neutral whilst those of two and four suggests that some element of reinforcing or undermining (respectively) of other parts of the tax system is taking place, but not to such an extent that a score of one or five is required.

The advantages of this system of tax system appraisal are:

1. It allows for both objective and normative opinion to be taken into account.
2. It is relatively quick and cost effective to undertake.
3. It can produce a ranking by adding the scores, as the grid noted above shows.
4. By colour coding the marks (green for 1 through to red for 5) a visual risk indicator can be prepared.
5. Vitally, the system automatically indicates the areas where most attention might be needed.

An example of such an appraisal for the UK tax system with fill supporting notes has been produced[6] as has a full explanation of the methodology[7 and 8].

[6] https://onlinelibrary.wiley.com/action/downloadSupplement?doi=10.1111%2F1758-5899.12655&file=gpol12655-sup-0002-Appendix.docx
[7] https://onlinelibrary.wiley.com/action/downloadSupplement?doi=10.1111%2F1758-5899.12655&file=gpol12655-sup-0001-Appendix.docx
[8] https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.12655