The Taxing Wealth Report 2024

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

Reforming tax administration:

Undertaking annual tax spillover assessments

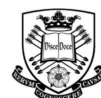
Brief summary

This note suggests that:

- The UK should undertake annual tax spillover assessments.
- Tax spillover assessments identify the ways in which one part of a tax system undermines another part of that same tax system, or that of another country, meaning that the expected amount of tax is not paid as a result.
- Tax spillover assessments do, as a result, complement proper tax gap assessments by highlighting why it is likely that anticipated tax revenues are not paid.
- Tax spillover assessments should, by their nature, set out an agenda of legislative reforms to the tax system that will result in it working to best effect.
- If a government sets out to generate a fixed sum in revenue and tax spillover assessments can identify the best way for it to do this at lowest cost then:
    - Cost of tax administration should be minimised
    - Tax avoidance should be reduced
    - Overall tax yields should rise if tax rates are not cut
    - Tax rates could be cut
    - Overall horizontal and vertical tax equity should increase

[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.

The Taxing Wealth Report 2024 is a joint project between:

Finance for the Future and  Sheffield University Management School

- Taxpayer morale should rise because honest taxpayers will know that the opportunities for tax abuse will have been reduced.
- Tax spillover assessments would be best undertaken by an independent Office for Tax Responsibility and not HM Revenue & Customs, who cannot be objective on this issue.
- The cost of undertaking tax spillover assessments will be modest.

The proposal	To require the preparation of tax spillover assessments on an annual basis. A tax spillover is the impact that one part of a tax system has on another part of a tax system, whether in the same tax jurisdiction or in another one.
Reason for the proposal	1. To improve the horizontal equity of taxation by ensuring that the tax spillovers that prevent this outcome are identified with a plan of action for their removal being recommended. 2. To improve the vertical equity of taxation by ensuring that the tax spillovers that prevent this outcome are identified with a plan of action for their removal being recommended. 3. To reduce the tax spillover effects that are exploited by many of the activities currently not addressed by UK tax gap estimates. 4. To reduce the rate of tax avoidance and tax evasion in the UK. 5. To consequently improve the rate of tax compliance in the UK. 6. To raise additional tax revenues.
Estimated tax that might be raised as a result of the recommendation made	The behavioural response to this recommendation cannot be known because there is unlikely to be a direct causal link that can be proved between the measurement of tax spillovers and changed taxpayer behaviour.

	The gains come from: • Identifying the weaknesses within the UK's tax system. • Identifying mechanisms to address these weaknesses. • Better use of HM Revenue & Customs' resources. • Closure of tax gaps. • The creation of improved taxpayer morale as a result of the closure of loopholes resulting in a more level tax playing field, increasing the inclination on the part of taxpayers to be tax compliant.
Ease of implementation	Relatively straightforward. The process would be improved if undertaken by an Office for Tax Responsibility (see separate recommendation).
Likely difficulties that might result from implementation	Few, although political accountability for failure to address the resulting identified tax spillovers might be politically difficult.
Likely time required to implement the change	Tax spillovers could be introduced as a rolling process of change meaning that full implementation could be spread over a number of years to some advantage as cumulative lessons learned are acted upon.
Consultation period required.	Short.

Background

A tax spillover is the impact that one part of a tax system has on another part of a tax system, whether in the same tax jurisdiction or in another one.

For example, if the corporation tax rate in a country is below its normal income tax rate them there is an artificial incentive to form a company and so save tax.

Alternatively, if a country does not charge taxes on income there is an incentive for income to be shifted to that jurisdiction to avoid taxes that might be due in a country that does have taxes on income.

Importantly, tax spillovers arise as a result of tax policy failures. They might be exploited by taxpayers, but the opportunity to abuse is created by the failure to create an integrated and cohesive tax system. Tax spillover assessments measure those risks and simultaneously suggest how they might be addressed.

Who wins and who loses from a tax spillover?

The usual loser from a tax spillover is the country that does not collect the tax that it might reasonably expect to be paid to it as a result of the laws that it has in operation.

This situation can arise because that country's own laws undermine its own tax system, which is a surprisingly common phenomenon. On occasion this can be accidental. Tax systems are usually large and complex and such conflicts can happen inadvertently. On other occasions this is deliberate, often because of short-sighted policy by a government wanting a particular outcome or incentive to apply at a point of time without really considering the overall consequences of doing so.

Alternatively, the spillover can arise because of a country's tax system being undermined by the actions of another jurisdiction. Tax havens deliberately undertake this type of activity, seeing to undermine the tax systems of other jurisdictions as a result of the policies that they adopt. This activity is commonly called tax competition.

Tax competition is deliberately designed to create tax spillover effects by incentivising the transfer of income, gains and wealth from the jurisdictions where they arise and should be taxed to tax haven locations where they are undertaxed as a consequence. The tax haven wins from this activity as a result of hosting the activities of the lawyers, bankers and accountants who undertake this tax competition activity and who contribute to the local economy as a result. The clients of those lawyers, bankers and accountants obviously hope to gain an advantage as a consequence.

Overall, the greatest cost of this activity is to society at large. If a government requires a certain level of tax to achieve its goals and some exploit tax spillovers to reduce the sums that they should reasonably owe then others, who are more law abiding, pay more tax as a consequence. This creates injustice in society through the failure to deliver both horizontal and vertical tax equity.

All tax spillovers, however created, undermine fair competition and the level playing field on which it is essential that all business operate if markets are to operate in the best interests of society as a whole. Unfair competitive advantages can be created as a consequence of tax spillovers and this can result in the misallocation of scarce capital within society, with consequent cost to the overall income of all jurisdictions as a result of the inappropriate reallocation of some income to those who have exploited tax spillovers.

For all these reasons tax spillovers need to be identified, risk appraised and eliminated to the greatest degree possible. Tax spillover assessments are the mechanism to achieve this objective.

What does a tax spillover assessment involve?

When the concept of tax spillover was first created by the International Monetary Fund[2] in 2014 the approach used was quantitative, econometric and focussed on the impact of tax competition on the corporation tax receipts of developing countries.

The concept of tax spillover has since been developed by Prof Andrew Baker and Prof Richard Murphy (the author of this note), most especially in a 2019 academic paper[3] and in subsequent work for the Global Initiative for Financial Transparency[4], which has had the backing and support of the IMF[5] and World Bank.

As proposed by Baker and Murphy, tax spillover analysis should not be an exclusively quantitative exercise, but should involve a substantial qualitative process, involving reporting and assessing a wide range of tax practices and processes. Such an exercise should be informed by the aim of reducing the harm states do to their own fiscal autonomy and that of other states.

To be comprehensive spillover assessment should consider spillovers between and within tax systems covering the following areas, at a minimum:

- Income tax
- Corporation tax
- Capital gains tax
- Social security or national insurance

[2] IMF (2014) Spillovers in international corporate taxation, IMF Policy Paper, available from: https://www.imf.org/external/np/pp/eng/2014/050914.pdf
[3] https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.12655#gpol12655-bib-0026
[4] https://fiscaltransparency.net/making-tax-work/ and https://fiscaltransparency.net/tax-transparency-principles/
[5] https://blog-pfm.imf.org/en/pfmblog/2021/08/making-tax-work-pathways-to-enhancing-tax-transparency-and-performance#more

- Tax politics
- Tax administration
- Company and trust administration, and
- International tax agreements.

They could in time be extended to:

- Indirect taxes, such as value added tax
- The benefits system
- Wealth taxes
- Land taxes.

Tax politics refers to the attitude of a government towards tax (which varies significantly between states) and its approach to funding a tax authority, tax equity and the integration of tax into broader policy making.

Why tax spillover assessments are needed

A tax authority needs to undertake tax spillover assessments to assist its appraisal of:

- the efficiency of its administration
- its focus on closing the tax gap
- its effectiveness in promoting tax reform
- its ability to promote horizontal and vertical tax equity. and
- its use of data in an equitable fashion.

An appraisal of the interaction of the tax and company and trust administrations within a jurisdiction is also vital: these administrations are a vital sources of data that must be effective if tax spillovers are to be avoided and tax abuse prevented.

Spillover assessment is therefore domestic as well as international and should revolve around three forms of assessment:

- domestic spillovers
- international risks generated by a jurisdiction, and
- international vulnerabilities of a jurisdiction.

Conducting a tax spillover assessment

Professional assessors conducting spillover analysis should collect impressions about current tax practice through wide ranging stakeholder consultations, including interviews and surveys, in a process similar to the corporate governance ROSCs (Reports on Observance of Standards and Codes) conducted by World Bank Staff.

These field notes should translate into a more qualitative style country reports assessing and reporting on tax practices and the spillover risks in the jurisdiction.

Vitally, they should contain targeted policy recommendations.

The appraisal process recommended by Baker and Murphy is ideal for this purpose and is a focus of their approach. Many of the recommendations made in the broader report of which this note forms a part are based on a trial tax spillover assessment for the UK[6].

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