STABILITY IN TAX

Think Ahead

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STABILITY IN TAX

The world changes, and with it so must tax systems. But unplanned, uncontrolled or uncommunicated change can do more harm than good. This report analyses how best to approach that change, and the steps policymakers should take to best address the wider needs of society through the tax system.

This paper was first published in 2015. It has been re-released to support the 2020 report *Foundations for a sound tax system: simplicity, certainty and stability*. References to web resources have been checked and updated where necessary, but the body text has not been edited.

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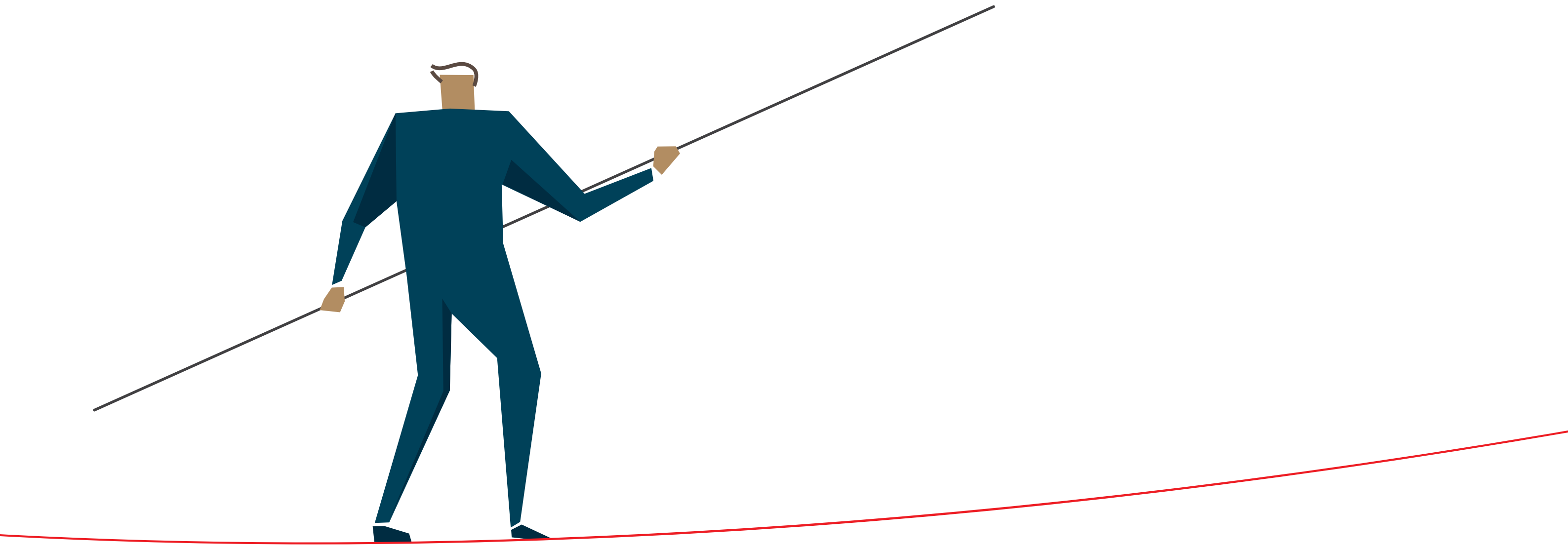
Introduction

Stability is one of the three fundamentals for policymakers to consider when trying to design and implement a good tax system, alongside simplicity and certainty. Together, these fundamentals make up the three overarching principles that policymakers should have in mind every time they consider a change to the tax system, and they are the three key benchmarks that taxpayers can use to assess the effectiveness of government in maintaining and improving that system.

It has been said that nothing is certain except death and taxes. Taxes are widely regarded as a constant of life in any structured society. The realisation that so fundamental a structure as the tax system (the rates, the bases and even the administration of taxes) is not, in fact, very 'constant' has the potential to unnerve the populace, fomenting unrest and even revolution if a change is too radical.

Of course, most change has nowhere near so dramatic an impact, but tax, like the weather, undoubtedly affects every member of a society. Unlike the weather, tax is something that every government can change, but the urge to tinker should be resisted. Ill-considered use of a power is no better than a deliberate abuse. Change should be made only for the better and after careful consideration.

Stability is a close cousin of certainty. If taxpayers are making a decision today which will affect them into the future, they will benefit from being able to predict the impacts of that decision. 'Certainty' is about knowing what the answer to a given question ought to be; stability is about whether the current answer will still be correct in one, two or ten years' time. The distinction is between clear rules (which may change every year) and familiar rules (which may always be unclear at the margins). Stability extends to the rates at which calculated values are taxed and the administrative practices surrounding that process in a way that certainty does not.



STABILITY IS A CLOSE COUSIN OF CERTAINTY. IF TAXPAYERS ARE MAKING A DECISION TODAY WHICH WILL AFFECT THEM INTO THE FUTURE, THEY WILL BENEFIT FROM BEING ABLE TO PREDICT THE IMPACTS OF THAT DECISION.

Why stability?

For individuals and businesses alike, stability is fundamental to effective planning and efficient compliance. For most individuals in systems that operate withholding systems for employment taxes, the impact of tax on the individual is purely financial, as all the actual administration is undertaken for them by others, but even here for many households the ability to budget sensibly will be reliant on predicting actual aftertax incomes. While a small change in rates may be expected and will be absorbed, a sudden larger swing may cause difficulties or unintended consequences.

For business, the issue is rather more urgent. The ability to forecast cash-flows accurately is essential to the financial viability of any business in both the long and short terms. Businesses planning any kind of long-term investment will be less likely to commit to a particular course of action if the financial outcome is uncertain. Governments must bear in mind that trust in the long-term stability of a regime can only be earned over time, and will be destroyed if regular unheralded changes to the system are made – even where such changes might objectively be considered to 'improve' the system.

Because of the number of different taxes businesses have to pay, and the number of times each year when these may be payable, a small change in even a single tax can have significant administrative impact. Every change imposes an administrative cost on those who have to comply with it, and it is probably true to say that business would prefer a '90% perfect' system that remained stable for 10 years to a system that was '91% perfect' in year one, and then subjected to unanticipated changes every year to implement incremental improvements bringing it up to '92% perfect' by year 10. The costs and uncertainties imposed by the constantly shifting regulatory regime would outweigh any objective benefits of the system perceived in isolation at any one year.

Large-scale infrastructure and development projects are an area where a commitment to long-term stability by government can have wider benefits that far outweigh any directly linked tax impacts. The optimal model is not necessarily one where the tax-paying developers or their backers extract agreement to lower taxes; all that is needed is for government to remove the spectre of unheralded change. The function of tax is to try to improve society, and if uncertainty about tax is going to stand in the way of projects that would otherwise benefit society then it has failed in its objective.

Business does not necessarily need concessions from the existing regime in order to encourage investment, but confidence that government will not change the rules halfway through a 5-, 10- or 15-year project so as to change the deal unilaterally in its own favour will be a significant positive influence.

Tax rate stability

It is generally the case that a tax system will rely upon one or two major taxes for the bulk of its revenue. Across most OECD nations general consumption taxes, such as a value-added tax (VAT) or a goods and services tax (GST), vie with personal income taxes to generate the bulk of revenue, with corporate income taxes making up the largest part of the rump. Developing economies and those reliant in greater part on natural resources may generate a greater proportion from business taxes, but only in the most extreme examples do these outweigh other taxes.

Nevertheless, the tax burden on business is structurally important as it directly affects the multiplier effect of business, which itself drives GDP and the broader economic wealth of the nation. Without business to employ individuals, sell goods and/or add value in the manufacturing chain, other tax revenues would stall alongside the wider economy.

Where significant proportions of the government's revenue come from just one or two key measures, the related rates of tax need be moved only minimally in order to generate a significant revenue impact. The number of changes can be kept to a minimum, and the burden of that change spread across a comparatively wide base. Attempting to raise significant amounts of revenue from smaller populations will be disruptive, as the resultant distortion in the system will inevitably encourage those otherwise subject to it to try to manoeuvre themselves outside the scope of the relevant imposition. From a behavioural perspective, a broadly shared burden will be less divisive, as the shared experience will limit divisions.

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At a macro level, the economic shock imparted by sudden shifts in rates can be bad for business and consumer confidence alike. If the overall burden on a country's economy is measured as a share of GDP it is quite clear that there has been a steady rise in the proportion of productive surplus appropriated directly to the state over time across the vast majority of developed countries. (See, for example, the OECD's Revenue Statistics 2014 table, covering 1965 to 2012.[1]

While in most cases step-changes in rates are prompted by war and the consequent additional strain on the national purse, it is also a common feature of the statistics that the burden rarely returns to the pre-war level on the outbreak of peace; rather, governments find things on which to spend the money that will viewed as a benefit to society. Nonetheless, that increase in burden is incremental.[2]

Tax base stability

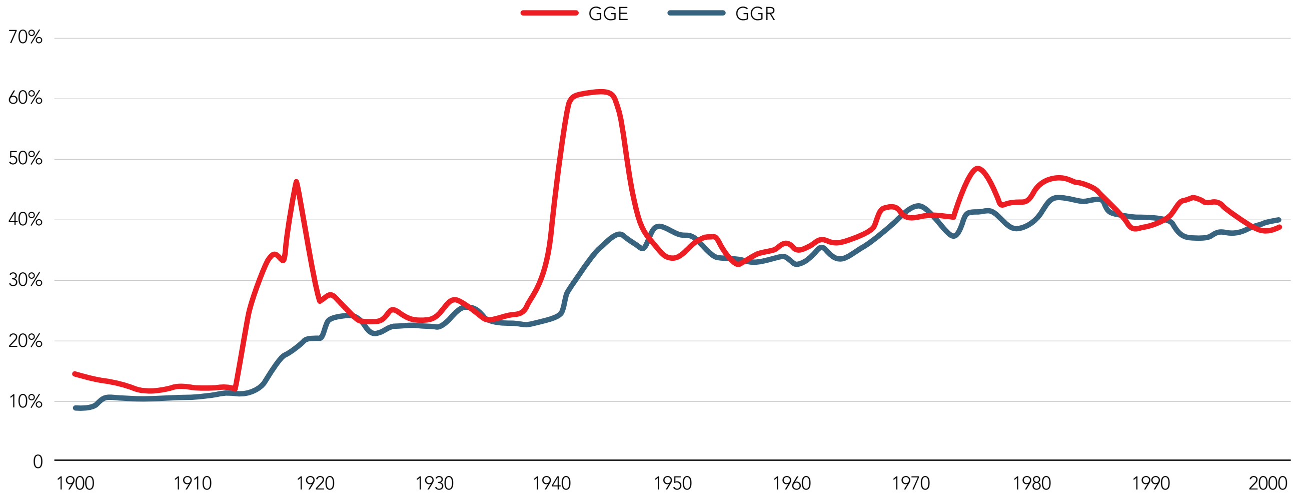
Turning to individual taxes, it is clear that maintaining steady tax rates and bases will allow taxpayers to plan for the future without having to factor in tax change as an influence. There is an economic cost to every change, and revising the rules and procedures that taxpayers are expected to follow will impose a cost of compliance. The more frequent the change, the greater that cost, and policymakers should carefully weigh the balance between the effects of many successive changes and those of one 'big bang' shift in the operation of the system.

For smaller business in particular, which are as a rule more focused on making money and lack the capacity to adapt to new regulations, large but infrequent changes are generally preferable to a steady drip of tiny alterations. Where changes increase tax liabilities, businesses can suspect they are being 'caught out' if small unpublicised changes slip past their vision. The impact of tax incentives will be wasted if businesses are simply too fatigued by a never-ending stream of mostly inconsequential changes to notice them.

Revisions to administrative processes should be properly and holistically evaluated. A change such as the UK shift to fully online computerised reporting of Pay As you Earn (PAYE) employee tax withholding obligations as payments are made, discussed in more detail below, has clear potential wider benefits, provided it is implemented in a considered fashion and without being compromised to meet other policy objectives. Use of XBRL technology (eXtensible Business Reporting Language) and conventions for business tax returns and their accompanying information can also have wider benefits, but again the process and standards applied must be designed to ensure maximum coherence and consistency with other initiatives.

Perhaps a more fundamental question, and one which is perhaps not asked as often as it should be, is 'why change at all?' Much change in the tax system is politically driven, but while the underlying merits of a given policy intention will be a matter of opinion and debate, what

FIGURE 1: Government spending and revenues as a percentage of GDP since 1900



Source: Institute for Fiscal Studies, Briefing Note No. 25.[2]

1 <https://www.oecd.org/ctp/tax-policy/revenue-statistics-ratio-change-all-years.htm>, accessed 20 July 2020.

2 The US government publishes historical data on tax revenues online http://www.usgovernmentrevenue.com/revenue_history ; while the Institute for Fiscal Studies publishes the UK data, see Figure 1.1 at page 2 of its Briefing Note No. 25 <http://www.ifs.org.uk/bns/bn25.pdf>, accessed 20 July 2020.

matters more is not the intention but the actual impacts of implementation. Whatever it was that the changes were meant to achieve, it is what they actually do (whether positive or negative) that will ultimately matter to all those affected by them.

The mechanics of implementation and its interaction with the rest of the system, and any other changes planned for the future, should always be considered as early as possible, and revisited at every stage in development and implementation. If the chosen mechanism is inappropriate, or its consequences too destructive, alternatives should be considered including abandonment of the measure.

Impact assessments are increasingly used by legislators to try to model the outcomes of changes, but it is vital that such assessments are realistic. They must be more than simply a box-ticking exercise, and must be updated to reflect any changes in the proposals.

Difficult though the exercise may be, policymakers must devote attention to trying to understand what the implications of their proposals will be in the context of the real world, not what they would like them to be in a stylised and simplified model. Very often, the theoretically perfect tool for a given job will not actually work in practice, and change in that direction will be counterproductive.

Take, for example, the system of Working Tax Credits operated in the UK to relieve the burden on those with low incomes. The intention is that those with low taxable incomes can, subject to an assessment of household circumstances, claim an award to offset, or even reverse, their income tax burden. Theoretically, the model has much to recommend it, allowing as it does for fine tuning of individuals' incomes at one end of the income scale while having no undesired impacts on those with higher incomes.

Modelled on a spreadsheet, it appears the perfect complement to a broader landscape of otherwise regressive direct and indirect taxes. In fact, it is the very subtlety and responsiveness of the mechanism that is its weakness. In order to reflect the correct position for a given year, the system needs to be fed regular and accurate updates from those using it.

The target demographic are, by definition, those who may have more chaotic lives, and would in any event struggle with the need to assess and update income and household details frequently, even if they did not have more pressing issues to deal with. Starved of the necessary information, the system has fallen out of favour as it results in far too many under- and overpayments to those who fall within its reach.

The problem lies not in the system, nor necessarily in those trying to use it, but rather in the interaction between the two. The tax credit system has been designed to operate with the precision and delicacy of a surgeon's scalpel when something more rough and ready might have proved more appropriate.

Tax administration stability

As technologies change so the administration of tax systems will change. Improvements in technology can offer significant enhancements to both the efficiency and effectiveness of tax collection. Yet rushed or poorly thoughtthrough change can compromise those beneficial impacts. Particular care should be taken with systems such as withholding mechanisms for employment taxes or consumption tax returns and processes, which have a significant effect on the businesses implementing them.

The good management of any change in the system is essential in the process of improving tax systems. UK governments implemented a number of fundamental upgrades to the process of calculating and reporting PAYE withholding tax liabilities on income between 2007 and 2013.

The first stage was replacement of the tax authority's own fragmented legacy system for calculating and reconciling income tax liabilities withheld from salaries. Although the process did result in genuine benefits, difficulties in communicating transitional changes resulted in widespread criticism of the tax administration.

The second stage, moving all reporting of salary and related tax payments to an online process known as Real Time Information (RTI), was influenced by other political considerations, and as a result the tax authority was faced with implementing in a matter of months a huge change programme which most observers argued should have been introduced under an agreed timetable over a period of several years.

While the mechanics of the final system may eventually be capable of delivering the intended benefits, the lack of time to test, learn and educate inevitably compromised the process of adoption, resulting in unnecessary misunderstandings and disagreements between taxpayers and their advisers on the one hand and the tax authority on the other. A more measured approach to the rollout would have given both taxpayers and the authority the opportunity to iron out difficulties in a more constructive fashion. Arbitrary dates and deadlines are the enemy of efficient implementation.

Another factor which government ignores at its peril is the staffing of the administrative authority. Tax is, ultimately, for the benefit of individual human beings, and it is administered by individuals. Consistent and calculated investment in the professional staff responsible for operating the system on a daily basis will help create a core of dedicated long-term public servants. Without appropriate recognition of the vital role they play in maintaining the fabric of society, motivated individuals will simply regard a tax department as a stepping stone to more rewarding work in the private sector. Investment in the training and retention of staff at every level should be a priority. Without the institutional memory of long-term staff the same mistakes will be made, on a daily basis at the basic administrative level, and on an annual, or even longer-term basis, with correspondingly undesirable impacts at higher levels.

The way forward

So how can we try to enhance the stability of a tax system? There must be a concern that in a fast-changing economic landscape a static tax system will become a liability – at best stifling economic activity and at worst allowing for abuse.

Mechanisms for change are an essential feature of any healthy system, but those mechanisms should not themselves be abused. Much has been made of the perils of short termism in financial markets and corporate decision making, but the very same accusation can be levelled at governments around the world in relation to their management of their tax systems. Can the problems revealed in the wake of the global financial crisis teach tax policymakers anything?

One glaring issue is, of course, that while corporate decision makers may have an indeterminate term of office, politicians are in almost every case limited by fixed terms of appointment. They will be torn between trying to achieve all that their ideals would call for and, at the same time, ensuring that they or their fellow thinkers remain re-electable.

Not every political system changes rapidly, and in some cases there has been a deliberate decision to adopt consensus decision making. Over a period of many years, the governments of the Netherlands followed a policy of moderation and restraint. The outcome of that policy, achieved by compromise and restraint, has been a stable and predictable tax system welcomed both by domestic business and foreign investors. While the consensus model of decision making may have deprived politicians of some of their discretion in shaping tax policy, the broader benefits of the more stable system could well be argued to come closer to meeting the objective of using the tax system to benefit people. A measured and well-signposted programme of predictable change represents the optimal pragmatic compromise for all concerned.

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What does good change look like?

Change for the sake of change would be a bad thing in a tax system, but change in pursuit of perfection is a different matter. There is, of course, a distinction between the improvement of the tax system, and improvement of society in general.

The question should always be asked as to whether the tax system is the best way to raise particular funds or achieve particular social objectives, and whether, if it is, the specific measures proposed are the best way of using the system. All too often, though, the politician’s fallacy comes into play: ‘something must be done; this is something, so we must do it’.

The question of whether the probable degradation of the tax system will be outweighed by the broader benefits to society, or whether a better mechanism may exist, appears all too often to be ignored.

Lessons from business?

A parallel with the global financial crisis is the concern that those charged with designing changes to tax systems may, like the management of some businesses, be inclined too much to self-interest rather than the benefit of the 'owners' of the tax system. In many cases the owners of the system (members of society) are both the 'customers' and 'suppliers' as well as the ultimate beneficial owners.

Perhaps tax systems should have the equivalents of the non-executive directors appointed to company boards. Some kind of independent oversight of tax policy and the effectiveness and efficiency of the system in each jurisdiction would reassure taxpayers and investors alike that the non-partisan aspects of the tax system are not being compromised for short-term political ends.

Likewise, the growth of international trade and the reliance of conventional business taxation on legal form has led to the creation of a de facto international tax system, but only as a consequence of the accumulation of treaties and conventions. Examples of truly international taxation systems are rare. Perhaps the closest example is the European VAT, but many commentators argue that this is an example of how not to implement a multi-jurisdictional tax.[3]

Even in this case, the administration of the tax is mostly undertaken at national level. Although provisions are based upon agreed EU legislation, and disputes adjudicated ultimately at EU level, there is no unified body charged with implementing or administering the legislation.

While the overall legislative framework imposes some restrictions on the freedom of EU member states to alter the VAT, the existing latitude has resulted in a wide range of approaches to administration, with return forms, thresholds and administration and collection processes varying significantly across the EU.

Consistency in approach in respect of such cross-border or internationally applicable taxes would, of course, have advantages for both taxpayers and the authorities. The scope for disputes and arbitrage will be reduced where both sides to a transaction can reliably predict its outcome wherever it is taking place.

A steady drive toward the alignment and coordination of tax systems would bear its own stability dividend as domestic authorities would converge upon common models. Inevitably, different systems will need to reflect the underlying attributes of the territories and societies to which they apply. While a UK tax practitioner could easily follow the sense of Ugandan tax legislation (they have common roots), the application of the same law in two radically different economies would pose fundamentally different challenges for policymakers in the two countries.

Rates of tax are rarely cited by big business as a reason they like or dislike particular tax systems – it is changes in the rules that most concern them. Nonetheless, it is probably worth noting that changes in rates, whether up or down, are unlikely to endear policymakers to big business either: research has indicated that most tax managers in multinationals are measured not on their achievement of reductions in effective tax rates but on their maintenance of a compliant filing record and avoidance of nasty surprises for the board.

Companies would rather know that their liability will be 30% all along than face a sudden hike to 25% after forecasting investment and returns on an expected rate of 20%. When asked to name a feature that could improve the attractiveness of a tax system, nearly half the respondents to a survey of 940 European multinational companies cited more certainty about the future of the tax system as their favoured option (with 36% citing simplification as the most favoured improvement; only 20% wanted to improve their national tax authority itself). The results suggest that policymakers need to think more carefully about the underlying system rather than worrying about how it is administered.[4]

One thing that governments can be sure of: while tax may rarely be the sole reason for a decision on investment going one way or the other, it will always be a factor in the considered decisions of a successful long-term business. Even if not explicitly addressed in the decision-making process, concerns about the stability or predictability of the tax system will be reflected in the overall political risk weighting given to a new investment. The greater the risk, the higher the predicted rate of return needed on the underlying business opportunity for the board to invest. Policymakers should remember that a marginal decision on a major industrial project may well be affected by a single intemperate gesture in the management of personal or sales taxes.

3 For instance, see Ine Lejeune's 'The EU VAT Experience: What Are the Lessons?' for a detailed discussion, especially the table at page 281 <http://www.taxhistory.org/www/freefiles.nsf/Files/LEJEUNE-21.pdf/$file/LEJEUNE-21.pdf>, accessed 20 July 2020.

4 <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/tax/deloitte-uk-tax-european-tax-survey-2013.pdf>, accessed 20 July 2020.

Conclusion

Governments should bear in mind also that the world changes fast, faster than most legislatures can update tax legislation (especially where entrenched interests might oppose change). Rather than constantly trying to hit a moving target, there may be wisdom in accepting imperfections in the short term, while taking a measured approach to implementing genuine structural improvements that meet the principles of simplicity and certainty in a transparent and accountable fashion. Pragmatically, some degree of imperfection must be tolerated. The law of diminishing marginal returns applies to improvements to tax systems as it does any other pursuit.

The importance of the tax system to individuals and society is so great that it should not be treated as a short-term political football, but seen instead as the bedrock of constitutional funding, and recognised as an integral and pervasive element of every business and individual's environment. A good tax system will benefit both a government and its populace; a poor one will discomfit individuals and discourage business, with impacts far beyond the tax system itself.

A GOOD TAX SYSTEM WILL BENEFIT BOTH A GOVERNMENT AND ITS POPULACE; A POOR ONE WILL DISCOMFIT INDIVIDUALS AND DISCOURAGE BUSINESS, WITH IMPACTS FAR BEYOND THE TAX SYSTEM ITSELF.

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