

## OTS Complexity project<sup>1</sup>

### Focus: Avoiding complexity; the OTS's lessons learned and some principles

#### 1. What's wrong with complexity?

This is in many ways the starting point for the OTS as an entity: something of a principle that complexity is bad. Some issues:

- Compliance burdens: a more complex tax system is more expensive for taxpayers and they are less likely to get their tax right first time.
- Choices have costs: if the tax system offers choice (as it often does – even if only in terms of use a relief or not) there is cognitive effort required for a taxpayer to make a decision and they are less likely to make the right decision. The OTS has shown that there are 1,156 tax reliefs<sup>2</sup>: how can any single taxpayer know them all and so decide which one(s) to go for?
- Psychological costs: difficult to measure, but the effect is apparent. Taxpayers find tax stressful, which can make them put off doing it. Complexity contributes to this and can result in late returns/penalties, compounding the effect. Forms with too many questions – even if the questions are easy – become disproportionately harder for taxpayers who have a cut-off point at which they often won't even attempt a form.<sup>3</sup> There is research that suggests complexity leads to reduced trust in the system and reduced compliance.
- HMRC has a customer-centric strategy: so complexity adds to HMRC's costs of administration as taxpayers are likely to need more assistance or correction.
- Taxpayers spend a lot of time<sup>4</sup> on tax compliance and filling out forms: what if they (or their advisers) could spend that time doing something else? What is the damage to the economy?
- There is also an argument that complexity contributes to tax avoidance – in that complex legislation can leave loopholes that can be exploited.

It could be argued that some complexity is good for the economy. Taxpayers often expect the system to be 'fair' and a more complex system allows better design/targeting of provisions and reliefs. Business incentives/support can be given on a targeted basis. More subtly, complexity can help governments raise more money without people realising fully what is happening. But simplicity and fairness pull against each other with a key challenge being that designing too many fairness 'tweaks' into a tax risks it becoming over complex, unmanageable and hence unfair.

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<sup>1</sup> All OTS reports are available on our website: only some links to smaller papers are given here.

<sup>2</sup> In 2015 – there are no doubt more now. See

<https://taxsimplificationblog.wordpress.com/2015/03/27/finance-act-2015-new-tax-reliefs/>

<sup>3</sup> This of course assumes that the taxpayer has got past the 'brown envelope barrier' and actually opened the communication from the taxman!

<sup>4</sup> And also money if they pay an agent.

## 2. What is complexity?

It is in many ways easiest to start from the other end: what is simplicity? In the 18<sup>th</sup> century, Adam Smith set out four principles of a good tax system which can be summarised as:

- Certainty of how the tax due is determined;
- The burden should be proportionate to the ability to pay;
- Convenience; and
- Efficiency of collection.

These longstanding principles are still relevant today<sup>5</sup> but need to be expanded/refined to reflect today's environment. This also brings out aspects of particular relevance to the OTS.

- **Simplicity** – it is not possible to achieve certainty unless the taxes are simple and capable of being understood and dealt with by those liable to pay. A taxpayer should be able to know the tax they are due to pay before they pay it, without this being excessively difficult.
- **Stability** – constant change adds to complexity and damages confidence in the tax system; without stability, certainty will be undermined as further changes may be needed to achieve taxation objectives.
- **Efficiency**: A simple tax system will have low unavoidable compliance costs (e.g. cost of a postage stamp when filing or paying<sup>6</sup>) and zero avoidable compliance costs (e.g. not having to pay an adviser to help as the taxpayer can deal with the requirements).

The OTS has also looked at ideas on necessary and unnecessary complexity:

- **Necessary complexity** is the bare minimum amount of complexity required to properly administer the tax according to policy objectives, recognising that there will always be some complexity in tax.<sup>7</sup>
- **Unnecessary complexity** is, in effect, bells and whistles. That can mean any of: outdated provisions; requiring information not needed to calculate tax; duplicate provisions to deliver the same policy intention; not abolishing obsolete rules; using the tax system to micro-manage the economy; or when there is a feature of the tax system which creates unnecessary problems.<sup>8</sup> But many such examples will stem from policy choices – so it is in many ways a case of recognising the complexity that such choices bring.

## 3. What is simplification?

Complexity is the opposite of simplicity. It can emerge from the tax system for any number of reasons. Overall, it's what makes it more difficult to know how much tax a taxpayer should be

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<sup>5</sup> The devolved taxes in Scotland are founded on the Adam Smith principles: <https://www.revenue.scot/about-us/scottish-approach-tax>

<sup>6</sup> With of e filing even that cost disappears, though possibly balanced by the time cost of accessing the system.

<sup>7</sup> Examples would be personal allowances for income tax (which still have to be managed) or laying down rules for calculating profits subject to corporation tax.

<sup>8</sup> Examples could be differential personal allowances (including their withdrawal), having a system of capital allowances instead of depreciation and aspects of the RTI 'on or before' rule.

paying, it increases compliance costs and makes it more difficult for the taxpayer to take ownership of and control their tax affairs. Consequently, the OTS sees simplification as making it **easier** to deal with a taxpayer's tax affairs. It is important to stress that we look at this from the point of view of all those involved with the system: taxpayers (individual and business), agents **and HMRC**.

We draw a distinction between technical and administrative complexity as follows:

- Technical: mainly concerned with policy and legislative flaws and inconsistencies
- Administrative: concerned with the operational process, including forms and filing procedures.

Our experience is that administrative simplifications can bring greater benefits than technical changes, not least because administrative change is generally easier to effect.

#### 4. Tax gap and smaller businesses

Small businesses invariably see the tax system as complex, probably because they have to deal with multiple taxes, have few in-house resources and so pay for external help, bringing home to them the cost of the system. Complexity/simplification could be said to have some impact on the tax gap.

- The current tax gap is some £36bn on HMRC's calculations<sup>9</sup>;
- Half of this gap is small businesses: those with the highest compliance costs;
- 20% of the tax gap is estimated to be error or failure to take reasonable care.

The data doesn't include the results of errors in HMRC's favour, including failure to take up reliefs.<sup>10</sup> A simpler system that is easier to comply with has potential to reduce the gap.<sup>11</sup>

#### 5. Causes of complexity

The tax system was once solely about raising money to fund the monarch's expenditure (traditionally wars) and was relatively simple. One key reason for increased complexity is that nowadays the tax system is made to do a variety of tasks – probably three broad things<sup>12</sup>:

- Funding government expenditure, which is vastly wider than it once was with social security and healthcare being key components;
- Satisfying particular political objectives, i.e. putting into place specific government promises or plans which might be redistribution<sup>13</sup> or might be special rules for favoured groups or causes, or parts of the economy; and
- Social policy objectives – encouraging or discouraging particular actions or investments<sup>14</sup>

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<sup>9</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/561312/HMRC-measuring-tax-gaps-2016.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/561312/HMRC-measuring-tax-gaps-2016.pdf)

<sup>10</sup> For example, in the OTS's small business review often found that small businesses were intimidated by HMRC, so didn't claim all the reliefs or expenses they were entitled to. The reliefs and pensioners reviews both pointed out that only around a third of those entitled to the Blind Persons' Allowance claimed it – some at least because of difficulties in so doing. If the tax system was simpler the reliefs could be claimed, so potentially costing HMT money. A current example is the planned change to savings tax – which potentially answers our highlighting the problems caused by the 10% savings rate.

<sup>11</sup> HMRC's Making Tax Digital programme is of course very much focussed on closing this part of the tax gap through digitising and streamlining reporting.

<sup>12</sup> Some suggest a fourth: to give tax experts something to do....

<sup>13</sup> In other words taxing the rich more heavily than those that are less well-off to pass wealth around.

In one of our earliest reports – on small business<sup>15</sup> – those we talked to helped us formulate the main causes of complexity. The top six were (the first three are in order, the rest equally placed):

- Change
- Income tax/NIC interactions
- HMRC administration
- Capital allowances/depreciation
- Employment status
- VAT boundary issues (i.e. rate determination) especially in international situations

The most important point is the first one on the list: change causes complexity. A stable tax system (see the earlier point), even if it is complex, gives people more time to get to grips with it and the effort they put in is more worthwhile. Over time it becomes simpler through familiarity. The impact for the OTS is that we have always assessed our recommendations to make sure the simplifications they will deliver will be ‘worth it’. The point for policymakers is that even measures that aim to simplify the system need to be thought through in terms of how the change can be effected in as simple a way as possible.<sup>16</sup>

Beyond the simple matter of change, policy creation can lead to complexity in:

- The policy goals of a tax;
- Other policy areas (e.g. social welfare benefits);
- How policy goals are translated into legislation; and
- How the measure is put into practice

Our work on complexity has included developing a complexity index. This recognises the above points and considers ten factors, categorised under the two main areas, to give ratings for the complexity of areas of the system.<sup>17</sup>

### *Underlying complexity*

Policy complexity:

1. Number of exemptions plus number of reliefs
2. Number of Finance Acts with changes since 2010

Legislative complexity

3. Gunning-fog readability index
4. Number of pages of legislation

Operational complexity

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<sup>14</sup> The classic examples being the ‘sin taxes’ – increased duties on things seen as less desirable such as tobacco. More recently, enhanced capital allowances (ECAs) have been offered – usually at 100% – for things such as environmentally friendly plant and machinery which also falls into the category of ‘remedying market failures’. But OTS evidence (see the Competitiveness report) has questioned how effective ECAs have been: do they simply reward investment that would be made anyway or even lead to increased prices?

<sup>15</sup> See <https://www.gov.uk/government/publications/small-business-tax-review>

<sup>16</sup> Good communication is often a key part of the answer.

<sup>17</sup> For a full discussion of the factors and why they have been used, refer to the paper on the Complexity Index (<https://www.gov.uk/government/publications/office-of-tax-simplification-complexity-index>) but it will be seen that they link back to the sorts of issues discussed in this paper.

5. Complexity of HMRC guidance
6. Complexity of information required to make a return

### *Impact of complexity*

7. Numbers of taxpayers affected
8. Aggregate compliance burden
9. Average ability of taxpayers
10. Revenue at risk due to error, failure to take reasonable care and avoidance

## **7. Avoiding complexity: some principles**

We therefore arrive at a set of four principles which we would urge politicians and policymakers to consider, if they want to avoid adding unnecessarily to complexity. These overriding principles each have a number of sub-points:

### ***First: think through the policy to make sure the policy aims will be met by the tax measure being proposed:***

- Should the measure be a **tax measure in the first place**? There seems to be a default option of reaching for the tax system to achieve something – but could the objective be achieved more efficiently through other routes such as a **grant or regulation**?<sup>18</sup> Using behavioural insights – the ‘nudge’ principle – is these days another option.
- **Is the change really needed**? Will the benefit outweigh the disruption and transitional issues? Try to avoid tinkering<sup>19</sup>.
- **Balance fairness and complexity**: fairness and simplicity are essentially opposing forces. Is it really fair if people are less likely to understand it or be able to comply? Challenge tweaks to a provision aimed at increasing fairness: is it really going to be worth it in terms of the additional complexity caused?<sup>20</sup>
- **Don’t create incentives to avoid**: high marginal rates can increase complexity and then encourage planning, which may then have to be controlled.<sup>21</sup>
- Consider **administration** from the start: what is the likely impact on taxpayers, advisers – and HMRC?

### ***Second: focus the measure carefully:***

<sup>18</sup> The OTS twice recommended replacing the Blind Persons’ Allowance (BPA) with direct grants to those eligible – which would ensure all blind people would benefit instead of the 35% or so who current claim BPA.

<sup>19</sup> The most-frequently cited example to the OTS was the Annual Investment Allowance: what should be a relatively straightforward allowance has been complicated by constant changes in the amount. Long-term certainty and stability would encourage investment and it is pleasing this was effected by s8 F(2)A2015..

<sup>20</sup> A classic example was the higher personal allowance given to those aged 75+ compared with the allowance for those aged 65+. The general increase in personal allowances has now (2016/17) eliminated this differential (and the higher allowances generally), but was it ever really worth the complexity caused? The clawback of the additional personal allowance when incomes rose above a certain level caused immense confusion and work and still applies to the married allowances available to those born before 6 April 1935. Was it properly assessed against the administrative burdens caused?

<sup>21</sup> Examples are the 60% rate created by the withdrawal of personal allowances above £100,000; the High Income Child Benefit Charge which applies to those with income above £50,000; and the whole area of rates arbitrage between income tax and CGT rates.

- **Consult:** talk to the people who will use or be affected by the legislation; try and see it from their point of view so as to help assess practical issues.<sup>22</sup>
- Leading on from consultation, resist pleas by **special interest groups** for exceptions that cannot be proven to be really necessary.
- Consider the **ability** of the target group to understand the measure (e.g. pensioners) or claim it (e.g. small business).
- Think about the **wider impact:** is there a knock-on into other areas? Does this solve one problem only to create a bigger one?
- **Anti-avoidance:** anti avoidance provisions are needed of course, but the risk is that the traditional route of more detailed rules just create more loopholes, leading to further layers of legislation. Would it be better to use broad principles, including relying on the GAAR? Or rely on better enforcement of existing rules?<sup>23</sup>

### ***Third: design the measure to meet the aim***

- Revisit **administration;** consider it in greater depth: what procedures will be necessary? What forms will have to be completed?<sup>24</sup> What guidance will be needed – and what are the implications for HMRC’s helplines?
- Setting **boundaries and fault lines** so that it is difficult to place oneself one side without incurring the relevant economic cost;<sup>25</sup> align with **common sense** boundaries that work in today’s environment<sup>26</sup>.
- Is there **existing legislation** that can be used? Better to use or build on what is there rather than start again.
- Use existing **categories and definitions**<sup>27</sup>; align with common sense
- How **precise** does the provision have to be? Would it be better to write a **general entitlement** for a relief rather than precise rules to cater for every situation?<sup>28</sup> There is a risk that generality means HMRC discretion and so inconsistency. If the conclusion is that the

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<sup>22</sup> There is a risk that consultation leads to more complexity if all the requests from consultees are accommodated. The statutory residence test undoubtedly became more complex in trying to answer all the points raised during consultation.

<sup>23</sup> The provisions on disguised remuneration are usually cited to the OTS as a classic example of this phenomenon.

<sup>24</sup> Working out the precise forms that will have to be completed by claimants from the start can be salutary. The development of the new tax-free childcare support is a good example of how administration of the new relief has been built into the work from the start, with ‘customer journeys’ carefully considered.

<sup>25</sup> In other words don’t set up a situation where it is too easy to sidestep the provision or gain its benefit by changing something. The classic example would be the 0% corporation tax rate, introduced in Budget 2002, which encouraged small sole traders to incorporate.

<sup>26</sup> The OTS’s Employment Status report shows that the rules on determining employment/self-employment are not keeping up with current working patterns; see also our recent Focus paper on the ‘Gig’ economy.

<sup>27</sup> The OTS definitions project showed there are 1000+ definitions in the three acts surveyed, including repeated or subtly varying definitions of such terms of ‘group [of companies]’ (40+). Some differences will be needed for what are distinct situations but why so many? Why do terms such ‘connected persons’ (in Capital Gains tax) get repeatedly defined? See <https://www.gov.uk/government/publications/definitions-in-tax-legislation-and-their-contribution-to-complexity>.

<sup>28</sup> The OTS has also floated the idea of ‘layered legislation’ where the initial stage – in a sense the ‘one pager’ – sets out the main rules and principles; more details are given in stage 2; stage 3 is then full detail for those who really need it.

new rule needs to be spelt out very precisely, does that suggest that it is a bad rule and should be rethought?<sup>29</sup>

- **Stand back:** does the new measure really do the job or has it become too involved?

#### **Fourth: maintain the measure properly**

- Keep rules **up to date** with the changing environment: amounts/thresholds may become obsolete with inflation and become irrelevant or a source of complexity that outweighs the value of the relief.<sup>30</sup>
- Taking that a little further, there should be a process to **assess/challenge provisions for continuing relevance:** the OTS reliefs project found many unused/obsolete reliefs. We have argued for **sunset clauses**<sup>31</sup> or a requirement for **post-implementation reviews** to force a reappraisal of the effectiveness of the rules.<sup>32</sup> Is the area still **'fit for purpose'**?

It will be observed that these four broad principles parallel the principles underpinning the last government's approach to tax policymaking: 'Tax Policy Making: a new approach'<sup>33</sup>. The OTS's view is that adherence to those principles will help prevent too much unnecessary complexity: our amplification of the principles above should help in practice.

## **8. Concluding thoughts: is it possible to have a simple tax system?**

The OTS is often challenged on what a simple tax system would look like. Our starting point would be in terms of guiding principles such as:

- Focussed on raising money and not distracted by other economic or political objectives except where absolutely necessary;
- Understood by those who have to deal with it; and
- The lowest cost of compliance possible.

If we want to get to a simple tax system, the starting point has to be a variant on the old joke: we'd be better starting from anywhere but where we are now. A flat tax system is in principle attractive and would certainly be simple: but can we practically change from where we are now with the

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<sup>29</sup> There is a marked contrast between the approach taken in many European jurisdictions, influenced by civil law rather than common law. The UK's VAT law was deliberately 'sketched out' for case law to decide the details. Of course this creates its own problems – uncertainty over boundary issues which is another cause of complexity. But as the OTS Competitiveness report recommended, guidance, rulings and good publicity can deal efficiently with the problems.

<sup>30</sup> Examples are the £8,500 'higher paid' threshold which had become irrelevant (now being formally abolished...almost) and the £8,000 removals allowance which no longer covers the intended average moving costs. In both cases – especially the £8,500 limit – many people told us that it was simply not worth monitoring the exemption: "it's more trouble than it's worth".

<sup>31</sup> For example, see our recommendation for a 5-year Disincorporation relief which was adopted (though the relief is not as full as we had recommended): we practise what we preach!

<sup>32</sup> The NAO report on 'The Effective Management of Tax Reliefs' developed this theme and argued that reliefs should be properly evaluated and, inter alia, monitored for avoidance risks. See <http://www.nao.org.uk/wp-content/uploads/2014/11/Effective-management-of-tax-reliefs.pdf>

<sup>33</sup> See [http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/tax\\_policy\\_making\\_response.pdf](http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/tax_policy_making_response.pdf)

myriad of reliefs and exemptions that people are used to?<sup>34</sup> Getting to a simple tax system would require major structural changes which would be politically (and administratively) difficult.<sup>35</sup> In the same way, stopping changing the system – given that change is to most the biggest source of complexity – is not going to happen. But what should happen is that changes are challenged with the sort of principles set out in this paper: it is much easier to avoid complexity in the first place rather than try and eliminate it once it is baked into the tax code.

Increasing the threshold at which income tax is paid (through personal allowance) takes more earners out of the tax system and is therefore simpler for them. But they usually remain in the NICs system, so retaining a measure of complexity and confusion which full integration of tax and NICs would obviate. The low earner also usually finds more complexity in tax credits/benefits than taxation.

A key route in practice to a simpler tax system is increased digitisation. The OTS illustrates this by the example of a PC: few people know what goes on inside but good interfaces mean it can be a simple machine to use. So it is with taxation: hence the point above about considering compliance aspects early in the process. The power of digitisation can mask complexity<sup>36</sup> but at the same time simplification can make digitisation easy to achieve.<sup>37</sup> The OTS has long been keen on the idea of pre-populating tax returns and the measures announced in Budget 2015 point the way towards making the tax system seem much simpler by linking the information the centre has on taxpayers' affairs and reflecting that back for checking rather than expecting full re-entry.<sup>38 39</sup>

We reluctantly have to conclude that we cannot have a simple tax system – life (especially business life) is complex and the tax system has to reflect some of that complexity. But that should not stop us aiming for a **simpler** tax system. The tax system should be simple for those with simple tax affairs; some complexity is, in principle permissible for those with complex affairs!

*The Office of Tax Simplification*

*June 2015, updated February 2017*

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<sup>34</sup> We are often told that countries such as Estonia have a simple system...but they started from a largely blank sheet of paper.

<sup>35</sup> Bringing income tax and NICs together is the obvious one and something that the OTS has repeatedly recommended. Our recent reports demonstrate the difficulties involved, but set out a programme of reform over a period. On a smaller scale, abolishing inheritance tax and replacing with CGT on death has been noted.

<sup>36</sup> The OTS recommended such things as composite coding notices to show people how their allowances are allocated, something that is now being deployed, and the programme of reforms that is leading to the effective abolition of P11Ds.

<sup>37</sup> This is very much the area of HMRC's Making Tax Digital programme of course.

<sup>38</sup> The Singaporean duty refund system cited in the Competitiveness report is an example. Digitisation can also help the tax authority control the system: we also noted the Chilean automatic online reporting of invoices ('fiscal tills').

<sup>39</sup> There is of course a risk that a digitised system will mean that more people have to do something than is the case with the non-digitised system. But that wider, small burden may well equate to a lower overall effort – and also have a positive impact on the perception of the tax system as more people are actively involved with it and are forced to think about it a little.