The tax gap at the core of the current financial crisis and how to close it

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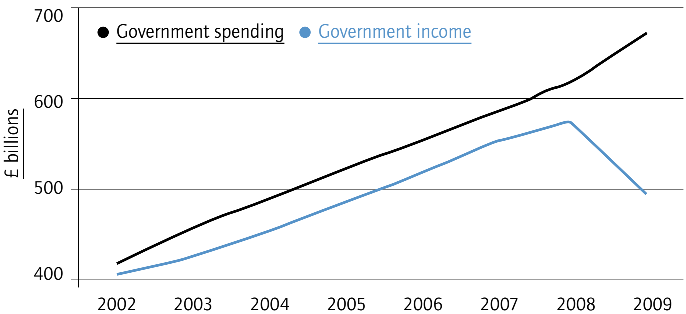
Governments must take energetic steps to prevent the current huge losses of tax revenue to tax evasion and avoidance made possible by fiscal competition between countries. Four sets of measures are proposed: country-by-country reporting for multinationals; general anti-avoidance principles; automatic information exchange between tax authorities; and setting minimum tax rates for the well-off.

A lack of tax revenue did not cause the current financial crisis. The lack of tax revenue caused by the current financial crisis is, however, the problem facing almost all governments, worldwide.

The problem can be exemplified using figures for the UK. Budgeted UK government tax revenue and spending from 2002 to 2009 is shown in Figure 1.

Figure 1 **Budgeted UK government income and spending 2002-2009**



Source: HM Treasury web sites for the budget for each year noted: http://www.hm-treasury.gov.uk/bud_bud09_index.htm

What becomes readily apparent is that the current crisis in government financing is not a spending related issue: it is a revenue related issue. It is the collapse in income that is at the core of our current fiscal crisis. If we wish to continue to enjoy the benefits of government spending, the means has to be found to restore government income when a 'tax gap' of £175 billion has opened up in the UK, and of similar proportion to GDP in other countries.

That 'tax gap' has four major components:

1. Income lost as a result of a downturn in economic activity: this is not the concern of this paper;
2. Tax lost to tax avoidance which is seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud) but contrary to the spirit of the law;
3. Tax lost to tax evasion which is the illegal non payment or under-payment of taxes, usually by making a false declaration or no declaration to tax authorities, resulting in legal penalties if the perpetrator is caught;
4. Non payment of tax declared to be due, i.e. bad debt.

The second to fourth items on this list are the issues considered here. Estimates of the size of these tax gaps are rare, and subject to considerable dispute. Again taking the UK as an example, the likely gap is in the range £70 billion to £120 billion, that is between 40% and 68% of the current annual tax deficit. While the situation will vary between countries, there is no reason to believe that similar orders of magnitude, indeed quite possibly much higher relative figures, do not apply in other countries. Tackling this issue is, therefore, of paramount importance.

There are a range of policy initiatives any government can and should take to tackle the tax gap at this time. These initiatives split into two parts. First, tax evasion and the non-payment of tax due must be tackled. This should be done by increasing the number of staff engaged by tax authorities to tackle these issues; this makes particular sense during a period of high unemployment. However, this logical course of action is contrary to policy of many cash-strapped governments. In the UK a significant number of tax offices are to be closed and staff made redundant, leading to low morale amongst remaining staff, chaos in tax administration and rising debt arrears. There is significant danger in this at a time when public services are under threat. Failure to collect tax due undermines the relationship between state and citizen at a time when it will be under stress. Investment in tax collection and tackling tax evasion is vital at this time.

Secondly, challenging tax avoidance is vital. This activity, unrecorded by government in the main because by definition it is legal, shifts the burden of tax payment in society, most especially from capital (and large companies that engage it) onto labour and from the wealthy and self-employed onto employed labour. The resulting perceptions of injustice are politically significant at this time.

A wide range of measures are available to tackle tax avoidance, of which the following are a selection:

Create country by country reporting for multinational corporations

Country by country reporting is a new form of accounting for multinational corporations promoted by civil society organisations. Discussion of country-by-country reporting is well advanced and it has been or is currently subject to active discussion by, amongst others, the International Accounting Standards Board, the Organisation for Economic Cooperation and Development and the European Parliament.

Country-by-country reporting differs from existing accounting in that it would require disclosure, without exception, of the following information by multinational corporations in their accounts:

— The name of each country in which it operates;
— The names of all its companies trading in each country in which it operates;
— Its profit and loss account for each country in which it operates, including details on third-party and intra-group sales, labour costs and head count, profit made and tax paid;
— A limited balance sheet for each country.

This proposal would reveal the use of tax havens by multinational companies and highlight those who are seeking to hide their profits from the view of the public, their shareholders and tax authorities alike. It is the strongest currently known tool available to assist tracking down of corporate funds hidden in tax havens.

General Anti-Avoidance Principles

General Anti-Avoidance Principles are exactly what they sound like. They are laws that say that if a person puts a step or steps into a transaction or series of transactions for the main or sole purpose of reducing their tax liability, then that step is ignored in calculating their tax. Such laws exist and work in Australia, South Africa and even Jersey. Their power is in banning a means of tax abuse before a tax lawyer or accountant has thought it up. They have a strong deterrent effect and this is why they are important.

Automatic information exchange between tax authorities

In a global world it is easy for a tax payer from one state to hide their income in another jurisdiction, especially if the latter is a secrecy jurisdiction. Secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so.

Current measures to tackle this are based on what is called information exchange on request. It has a low deterrent effect because the level of information one tax authority must supply to another before a request for data can be made is considerable: very few requests are made as a result.

The European Union Savings Tax Directive is the best example of an embryonic system for automatic information exchange where tax authorities send data to each other automatically to ensure that income hidden in tax havens is revealed. However, it is limited in geographic scope, is restricted only to interest income received by individuals, and includes loopholes that limit its effectiveness. Using it as a precedent, we recommend the automatic supply of information by the tax jurisdiction where a person who is resident in another tax jurisdiction has an interest in a financial structure – whether it be a bank account, company, partnership, trust or foundation – to that jurisdiction where they are recorded as resident for anti-money laundering legislation purposes. By law this data already has to exist, and this proposal would add essential transparency to the tax system that will shatter banking, corporate and trust secrecy.

Setting minimum tax rates for the well off

Few countries succeed in creating progressive taxation systems, largely because of the wide range of allowances and reliefs available to the well off, meaning that in many countries their tax deductions are worth more than average income. The easiest way to tackle this is to set minimum rates of tax that must be paid once high levels of income are reached. This can be done in two ways: either a minimum rate of tax is set when, for example, income reaches the equivalent of

€100,000, meaning that, whatever allowances or reliefs are provided for in the tax system, a person's tax bill cannot fall below this rate when compared to their gross income. Alternatively, and possibly more simply, a ceiling on allowances and reliefs can be set above which no one can claim more. The opportunity for tax avoidance is therefore reduced considerably.

Further reading

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