

In the shade: the UK's missing economy

Richard Murphy
May 2014

AABA



Contents

In the shade: the ten minute summary	2
1. Background to this report	5
2. The tax gap	5
3. The value of unrecorded sales in the UK	6
4. What's the tax lost on £100 billion of missing sales?	7
5. How can so much money go astray?	9
6. Other evidence on the UK shadow economy	14
7. Conclusions and recommendations	14
8. About the author	20

The small print

© Richard Murphy April 2014

The right of Richard Murphy to be identified as the author of this work has been asserted by him in accordance with the Copyright, Designs and Patents Act, 1988.

Published by Tax Research LLP, The Old Orchard, Bexwell Road, Downham Market, Norfolk, PE38 9LJ on behalf of Tax Research LLP, the Tax Justice Network and the Association for Accountancy and Business Affairs.

Grateful thanks are offered for financial assistance provided to Richard Murphy to assist production of this report by Oxfam GB and the Joseph Rowntree Charitable Trust. The recommendations in this report do not necessarily represent the views of Oxfam and the Joseph Rowntree Charitable Trust. Richard Murphy is solely responsible for the content of this report.

Any part of this report may be reproduced without the permission of the publishers where doing so is not for commercial purposes or is for the advancement of education.

In the shade: the UK's missing economy

The ten-minute summary

The research referred to in this report suggests that:

1. The UK probably lost £40 billion in tax in the year 2011/12 as a result of the unrecorded sales of UK businesses.
2. Based on HM Treasury Budget forecasts, this loss is likely to have increased to at least £47 billion in the current, 2014/15, tax year.
3. The estimate is based upon HMRC data for annual VAT losses and is consistent with EU data on the same subject and peer-reviewed data on the size of the UK shadow economy.
4. This estimate means that approximately £1 in every £10 of sales in the UK economy may not be recorded for tax purposes.
5. HMRC appear to only recognise about £10.5 billion of this loss in 2011/12 in its own tax gap estimates. This report does, therefore, suggest that in that year there were £29.5 billion of losses that HMRC did not recognise.
6. Of this sum this report suggests that maybe £7 to £8 billion of lost tax relates to the unrecorded income of the UK's self-employed people.
7. This leaves about £22 billion of loss that is attributable to UK limited companies.
8. Of this sum it is estimated that at least half – or about £11 billion – may be due to the unrecorded income of the approximately 1.1 million companies that admit to HMRC that they trade in the UK at an average loss of about £10,000 each.
9. The remaining sum, or about another £11 billion, is suggested to be due to the activities of the U.K.'s 'shadow companies'.
10. This report suggests that there may be at least 400,000 companies that trade in the UK that do not report that fact to HMRC. In addition, these companies either do not file accounts or annual return forms as required by law with the UK Registrar of Companies, or if they do, they file dormant company accounts that do not reflect the fact that they are really trading.
11. The tax lost each to these shadow companies might, on average, be about £27,500, but that reflects VAT lost, corporation tax not paid and income tax and national insurance not declared on cash wages paid to staff. Each such company may, on average, have sales income of less than £75,000 a year, or a figure just below the annual VAT registration limit. The range of such incomes will, however, vary enormously, but evidence noted suggests that this level of turnover is entirely within the expected range of the incomes of smaller UK companies.
12. Research supporting this report suggests that there is strong evidence that a large number of shadow companies exist in the UK:
 - a. More than 300,000 companies are, on average, struck off the Register of Companies each year and few of these have submitted the accounts that are due to be filed by them before being struck off. The number of

- investigations by either Companies House or HMRC into these companies that are struck off appears to be very low;
- b. More than 400,000 companies a year do, on average, fail to file annual return forms with the Registrar of Companies, including those struck off;
 - c. 340,000 sets of accounts due to the Registrar of Companies were probably not filed in 2012-13, including those due by companies struck off;
 - d. HMRC currently fail to request corporation tax returns from at least 650,000 companies each year that might be trading. Their checking on those companies that say they are not trading appears to be minimal;
 - e. Of the companies asked to submit corporation tax returns in 2011/12 more than 270,000 did not do so. Whilst these companies were penalised for not doing so almost none of those fines were paid;
 - f. Evidence from both the USA and from HMRC suggests that false declaration by smaller companies appears to be commonplace in at least 40% of all tax returns submitted. Based on this ratio, around 360,000 may not be declaring income they have actually earned each year;
 - g. Because only about 470 investigations of small company corporation tax returns were undertaken by HM Revenue & Customs in 2011-12, an effective rate of less than one for every 5,700 companies, the chance of a small company being discovered to have under-declared its income is remote;
 - h. Of the number of companies filing tax returns more than 500,000 said they did not trade and it seems few of these had their tax affairs investigated by HMRC;
 - i. Even using the most generous of calculations just 41% of all companies actually declared that they were trading in 2011-12 and fewer paid any corporation tax. It stretches credibility that 59% of all UK companies were really in existence to do nothing.
13. These numbers appear to converge on an estimate (and it can be no more than that) of about 400,000 companies a year having ample opportunity to trade in the UK and yet not declaring that fact and, most importantly, get away with it because of weak enforcement of regulations.

Based on these findings the report recommends that:

- The attitude towards the enforcement of tax and company law regulation in the UK, especially amongst politicians, many of whom see it as an example of 'red tape' needs to change because tax cheating is undermining the viability of many small businesses in this country;
- HMRC should be provided with all the resources it requires to tackle all tax evasion, which would include a considerably expanded tax investigation programme. This can only be achieved by investing more resources into the department and ending the programme of cuts and staff reductions that have been imposed upon it for a number of years;

- Companies House needs additional resources to enforce the requirements of company law, which can be easily funded by increasing the current £13 a year charge for having a company to a more realistic £30;
- Banks and other financial services providers (including accountants and lawyers) who have a duty in money laundering law to identify the ownership of the companies for whom they act should be required to report to HMRC and Companies House annually the identity of all the companies that they know have bank accounts or other indications of trade, with full bank account details being supplied. They should, at the same time be required to confirm the beneficial ownership of all companies for which they act, which they must know for money-laundering purposes, and provide the company's usual trading address at which it can be contacted. With this information HMRC and Companies House will then know which companies really trade in this country, and so will be able to demand tax, accounts and other data from them as required by law;
- HMRC should be legally required to demand a corporation tax return from all companies where they have been advised that it may be trading;
- HMRC should be given powers to approach banks and other financial service providers known to have had contact with a company if that company does not submit a corporation tax return within three months of the time allowed by law to require the provision of information, such as bank statements, that would let HMRC prepare estimated tax demands to be paid by the company in the absence of accounts and corporation tax returns;
- The tax liabilities of any company that has failed to submit tax returns to HMRC should be made the personal liabilities of the directors of the company and all its owners who have more than 25 per cent of the share capital as well as the company itself. In this way the limited liability of companies would not permit deliberate tax abuse, as it does at present, because those responsible for that abuse would become personally liable to make payment of any sums they have defrauded;
- The proposed public register of the beneficial ownership of companies in the UK should be verified for accuracy by Companies House using the data supplied to it by banks and other financial services providers to ensure that accurate information is published on that register.
- Companies House should not be allowed to strike off a company until that company has supplied accounts covering all its periods of trading;
- HMRC should be required to object to the striking off of any company whilst tax returns and tax liabilities owing by it remain outstanding;
- HMRC and Companies House should be provided with the resources they need, including increased staffing, to enforce these laws since the cost of enforcement will be vastly less than the potential sums raised.

In the shade: the UK's missing economy

1. Background to this report

This report summarises the findings of research undertaken by Richard Murphy that has been published by Tax Research UK. That research was undertaken using financial assistance provided to Richard Murphy by Oxfam GB and the Joseph Rowntree Charitable Trust, to whom grateful thanks are offered. The recommendations in this report do not necessarily represent the views of Oxfam GB and the Joseph Rowntree Charitable Trust. Richard Murphy is solely responsible for the content of the research undertaken which is available at <http://www.taxresearch.org.uk/documents/intheshade.pdf>.

The research that was undertaken investigated two issues. The first was one part of the UK tax gap. That part was the element that relates to unrecorded trading within the UK economy. The second issue was how failure in UK company regulation has almost certainly contributed to the size of that tax gap resulting from unrecorded trading.

2. The tax gap

Tax gaps exist in all economies. In the UK the tax gap represents the difference between the amount of money that would be raised by the government if the tax system worked as both Parliament and our tax authority, HM Revenue & Customs (HMRC) think it should and the amount of money that is actually paid in tax during a year.

Broadly speaking, the tax gap is made up of three parts. The first part is tax that people know they should pay, but don't. This is, in effect, bad debt that the government cannot recover from the people who owe it.

The second part is down to tax avoidance. Tax avoidance happens when people exploit loopholes in the law to avoid paying the tax that the government thinks they owe. Most recent cases involving large companies and well-known celebrities are about tax avoidance. No one has broken the law, but along the way tax lawyers and accountants have certainly tried to bend it.

The third component of the tax gap is by far the biggest, and is tax evasion. Tax evasion always involves breaking the law. Most commonly it means that people do not declare either all or part of the income that they have earned to our tax authority. Sometimes it means that they also claim expenses to offset against the income to which they are not entitled.

The most common form of tax evasion is people not declaring their trading income. It is that part of the tax gap to which this report refers. Other types of tax evasion include not declaring investment income, hiding income offshore, making claims for expenses that are not allowable, criminal attacks to exploit the tax system and straightforward errors and

mistakes within tax declarations that are not, however, criminally intended. It is important to note therefore that any estimate provided in this report is not an estimate for all UK tax evasion although it is a fair estimate of the tax loss arising as a result of what might be called the UK 'shadow economy' - that is, economic activity that is deliberately not recorded by those undertaking it to avoid the impact of regulation, including tax law.

Tax gaps are important. At a time when much is made of the need for the government to move towards a balanced budget any measure to close a tax gap means that expenditure on other government services need not be cut, and this issue does, therefore, have potential massive social impact in the UK. In that context, estimating the scale of the tax gap that exists in the UK is important, as is understanding the cause for that tax gap arising. In addition, being aware that there are policies available that could help address these issues is vital. This report suggests that the tax gap is a much bigger problem that HMRC admit, but is also not an insoluble problem.

The report also suggests that the choice of methodology used to assess the tax gap and the measures used to tackle it are political: the amount of tax gap that is tolerated is always a matter of choice but without reliable data and policy options being available those choices cannot be properly made. The research to which this report refers seeks to provide data that will improve the choices available on both these issues.

As a result, however, this report suggests that HMRC are not producing reliable data on the size of the UK tax gap. It also suggests that government cuts to the number of staff at HMRC and at Companies House (which is responsible for collecting data on the activities of UK companies) have severely reduced our capacity to know which companies are actually trading in this country, and so collect tax from them.

3. The value of unrecorded sales in the UK

The research that backs up this report has estimated the amount of tax lost to the UK government as a result of unrecorded trade taking place in the UK. It did this by extrapolating data published by HMRC that relates to what is called the VAT gap. The VAT tax gap is the only one prepared by HMRC that starts with an estimate of the amount of tax that should be paid in the economy based on a statistical breakdown of the component elements of our gross domestic product, and then compares this to the amount of VAT actually paid. This is as a result called a 'top down' estimate of tax lost. Such estimates are always likely to estimate the real scale of the tax lost in an economy precisely because they start by looking at the economy as a whole. HMRC does however, and unfortunately, only use this approach for VAT. For all other taxes, however, it uses what is called a 'bottom up' approach to estimating the tax gap. This 'bottom up' method looks at the tax returns that HMRC receives each year, estimates the errors in them, and then presumes that this error rate reflects that for the economy as a whole. There is, however, a fundamental flaw in this approach, which is that tax evaders do not, in many cases, submit tax returns and as such they fall outside this estimation process. This results in a serious underestimation of the tax gap.

In 2011/12, which is the most recent year for which information is available, HMRC estimate that the resulting VAT loss arising in the UK economy amounted to £11.4 billion (or about 10.4% of total potential VAT paid). However, of this sum they estimated that £1.8 billion was due to bad debt and maybe £0.8 million resulted from deliberate fraud leaving a VAT gap resulting from unrecorded trade of about £8.8 billion.

Usefully, alongside the HMRC estimate of the UK tax gap is an EU estimate calculated on a broadly similar basis. This estimate has, in recent years, been significantly higher for the UK than that presented by HMRC, averaging around 12.5% of total likely VAT owing. Having adjusted both these percentage estimates for HMRC's identified losses to fraud and bad debt, an average UK VAT percentage tax gap rate of 9.7% of total likely potential VAT liabilities has been estimated by the research supporting this report. This implies that almost exactly £1 pound in every £10 of VAT due to be paid on trade undertaken in the UK is not actually received by the government.

However, the situation is more complicated than simply saying that the unrecorded sales giving rise to this loss represent the whole of the UK shadow economy because, as a matter of fact, the EU estimates that VAT is only charged on 53% of all sales that are made in the UK. This is not due to fraud, but because government policy has determined that many items are either not subject to VAT at all (they are considered to be exempt for the purposes of this tax) or are subject to what is called zero rate VAT, which includes items like most food, children's clothes, new houses, and so on. Any extrapolation of the VAT lost has, therefore, to take into account the fact that there are many sales to which VAT may not apply but which may, nonetheless, be subject to tax evasion because income tax, national insurance, corporation tax or other charges may still be due upon them.

Taking these two factors into account, the research for this report shows that total unrecorded sales in the UK economy are likely to be about 92% of the total theoretical VAT liability owing in the UK. In 2011/12 the total theoretical VAT liability amounted to £109.8 billion, suggesting that the unrecorded sales in the UK economy in that year were likely to have been about £100.1 billion. They will, of course, have increased since then, a point that is noted further below.

4. What's the tax lost on £100 billion of missing sales?

There is at this point an important point to make: if VAT is evaded on trading, which is the inevitable conclusion that must be drawn from the fact that HMRC say that £8.8 billion of VAT is lost to them for this reason each year, then the sales on which that VAT should have been charged will also not be recorded in any books or records that are used as the basis for preparing the accounts that should be supplied to either HMRC or Companies House.

There is a simple explanation for this. If the sale was recorded, but the VAT was not, this would be glaringly obvious to any tax inspector who looked at those books. This is well known to almost everyone who is committing this type of fraud, meaning that the VAT

evader will almost certainly not record the sale to which the VAT that they have evaded relates. The inevitable consequence of this is that by not recording the sale on which VAT has been evaded the fraudulent trader also evades all the other taxes due on that sales income as well as the VAT itself. This is, of course, logical: if people choose to evade tax they don't pick and choose which tax to evade; they inevitably evade them all.

The consequence of this inference, which HMRC avoids in their own work on the tax gap, is that if there are likely to be £100 billion worth of sales not recorded in the UK, as the VAT gap inevitably implies, then all the direct taxes due on that income, such as income tax on salaries, national insurance on salaries, corporation tax on profits, and so on, will also not be paid. Properly estimating the amount of unrecorded sales based on VAT tax gap data does, therefore, provide an opportunity for estimating, on a top-down basis, the total likely loss to the UK government as a consequence of the unrecorded PAYE liabilities and corporation tax liabilities due on this income.

Once lost income of this scale is being considered then the research that supports this report suggests that initially the most reliable basis for estimation of tax lost is to look at macro economic information i.e. to look at the national accounts as a basis for estimating the likely tax foregone as a result of the tax gap. Overall, in the UK in 2011/12 about 36% of total national income was paid in tax. This figure provides a starting point for estimating the total tax lost on £100 billion worth of missing sales income.

Other evidence does, however, have to be taken into account. So, for example, as the research that supports this report notes, when looking at the likely potential losses resulting from such unrecorded sales at a micro economic level i.e. when considering the actual losses that might arise in varying individual circumstances as a result of unrecorded sales, the percentage lost income varies between about 25% and maybe 54% of total potential record sales when taking into account VAT, corporation tax, income tax and national insurance at varying rates depending upon the situation considered. The higher estimates result from presuming that the lost income is likely to be subject to higher rate income taxation in many cases, not least because it is inevitable that some part of this lost revenue will, inevitably, be cash skimmed off the top of accounts that are already being disclosed for tax purposes, and on which some income tax at basic, and even higher, rates might already have been paid by the owners who are enjoying the benefit of the income that the businesses they control has generated. There is strong academic evidence to suggest that this 'top skimming' is a significant element in the shadow economy¹.

Having taken these factors into account it seems likely that the overall tax loss this unrecorded income is likely to give rise to may be higher on average than a pro-rata part of tax paid on GDP as a whole, simply because it is likely to represent the top part of many people's income, in which case higher rates of tax are, eventually, due. As a consequence it is assumed that the loss arising is 40% of the total unrecorded sales income. This means that in the tax year 2011/12 some £40 billion was probably lost to the UK government as a result of the tax gap arising on unrecorded sales income in the UK.

The situation has deteriorate since 2011/12. By 2014/15 three factors increased the scale of this loss. The first is, of course, inflation. The second is growth in GDP, which is now being predicted by the government and the Office for Budget Responsibility (OBR). The last is the fact that the OBR has issued forecasts in December 2013 suggesting that the VAT gap is now rising. Taking all these factors into account it is likely that the revenue lost to the government from unrecorded sales income will in 2014/15 amount to in excess of £47 billion.

5. How can so much money go astray?

Many people have considerable difficulty in imagining how £47 billion can go missing in the UK economy, or how £100 billion (or more, as is likely now) of sales can take place without being recorded. To put it in context, £47 billion is the size of the combined housing, environment and transport budgets for the UK in the 2014/15 tax year, or almost exactly half the total education budget.

The difficulty of imagining (or admitting to) such a large loss might be what prevents HMRC from accepting the possibility that it exists. Instead, in 2011/12, the last year for which they have published data, they admit to losing about £10.5 billion in tax as a result of activity in the UK shadow economy. However, they also admit to £8.8 billion of VAT gap after excluding criminal activity and bad debt, having also admitted that tax avoidance is largely absent with regard to this tax. What this does, however, mean is that on the basis of the research that supports this report, at least £29.5 billion of tax lost in 2012/12 has to be accounted for.

There are four potential ways in which this tax loss could arise. The first is that self-employed people could be under-declaring their income. Secondly, some self-employed people might not be declaring that they have any trading income at all. Thirdly, very obviously some companies trading in the UK could also be under-declaring their income and, lastly, there may be UK limited companies that are operating entirely in the shadow economy, their activities entirely unknown to HM Revenue and Customs.

Our research draws on a number of sources to suggest how the losses should be allocated between these various categories. Most importantly, we note that research in the USA has shown that up to 52% of the income of self-employed people might be omitted from tax returns whilst overall 43% of business income may be unreported. Furthermore, in the UK HMRC has found that of the tax returns that they receive from self-employed people more than 40%, on average over time, include under-declared income. In fact, there is consistent and strong evidence from within HMRC's tax gap research to show systematic under declaration of income by those companies and self-employed people who do make declaration of their income for tax.

Considering each of these four likely explanations for lost tax revenue arising as a result of unrecorded trading income is important. In the case of the UK's self-employed people, under-declaration of earnings might explain why, as their numbers have expanded, the

average earnings of those in self-employment have fallen, so that according to research we undertook in 2013, based upon data from HMRC and the Office for National Statistics, the average earnings of self-employed people in the UK who declare income of less than £100,000 a year was just £10,400 in 2010/11, the most recent year for which data was available. If this income was, on average, understated by about 40%, as US data might suggest likely, then an average mis-declaration of £7,000 of sales a year might be taking place amongst the self-employed. This would give rise to an additional tax liability of at least £2,000 each, suggesting that the total tax not paid by this group might be about £7 to £8 billion (using ONS data on self employed persons with significant income). None of this, however, is likely to be VAT since most of these businesses will be operating below the VAT registration threshold. Since it is likely that most of the lost tax to which the HMRC tax evasion gap refers is VAT this lost income resulting from mis-declaration by the self-employed is unlikely to be part of their estimated tax evasion gap.

That there are self employed people who do not declare their income at all to HMRC is indisputable. The fact that HMRC and the Office for National Statistics cannot agree how many self-employed people there are in the UK, with HMRC estimating the number in excess of 5.1 million people and the ONS estimating no more than 3.9 million in 2010/11, simply highlights the problem in collecting reliable data in this area and the scale of possible misrepresentation that could be taking place. HMRC allow for £3.2 billion of loss resulting from what is likely to be the undeclared income of unrecorded self employed people in their most recent tax gap data. In overall terms this seems a plausible estimate of the tax lost from the activities of those who never declare themselves as self employed according to the research that supports this report and as such no further part of the missing £29.5 billion is likely to be explained by this cause.

This then means that about £22bn of missing tax revenue in 2011-12 needs to be explained by the activities of the corporate sector, over and above the loss arising from VAT that largely explains most of HMRC's tax gap data for evasion. As noted above, this loss must be in two parts. The first is income not declared by companies who submit corporation tax returns to HMRC and an additional sum by those who operate as what this report calls 'shadow companies'.

There can be no doubt that many of the smaller companies that file tax returns understate their income. The US Treasury estimates on under-reported income, already noted, suggest that the average under-declaration rate by US companies with asset worth of less than US\$10 million may be as high as 29% of the true sum owing. This is less than the rate for self-employed persons but still significant. HMRC themselves admit that over a six year period 31% of small company corporation tax returns under-declared income owingⁱⁱ. It is important to note that the figures are not strictly comparable but the coincidences with the patterns found regarding self-employment are striking even if the overall rate of under-declaration appears to be lower.

The scale of activity of companies tends to be much bigger than that for self-employed people, even if the number of companies is significantly smaller. For example, the inflation

adjusted average corporation tax payment of smaller companies (broadly, those with profits of less than £350,000) was in excess of £13,500 in 2011/12, a sum bigger than the average declared earnings of self-employed persons. This implies that each has profits that on average amount to in excess of £65,000 a year. According to VAT statistics it is also clear that about 95 per cent of all trading turnover in the UK is undertaken by limited companies.ⁱⁱⁱ In that case it is reasonable to think that it is in this sector that much of the missing trade noted in this report must be taking place. In that case the inevitable problem is in determining what part of this loss is down to companies who actually submit returns and what part is due by those who do not?

HMRC think that overall about 31% of small company tax declarations include errors, with the overall error rate split approximately equally between those with errors of less than £1,000 and those with errors exceeding that amount (with no upper limit specified). This would certainly imply a much lower tax gap than IRS data would suggest and potentially a relatively modest overall loss. However, the IRS evidence on mis-declaration is more broadly based than HMRC's and, it should be noted, the HMRC sample base from which it draws its conclusions is small, potentially covering fewer than 500 company investigations a year. What HMRC also appear not to consider it more likely that small company tax evasion results in losses of VAT and PAYE rather than corporation tax. VAT is lost on the unrecorded sales whilst it is not corporation tax that is lost when small company owners tax evade by not declaring sales income. It is instead income tax and national insurance that is lost because that is the tax due when money is taken out of a small company and, of course, the money that is tax evaded through the use of small companies is taken by their owners for their own personal use. To look for the resulting tax loss in corporation tax data is, therefore, always going to be a forlorn search.

Even so, if it is assumed that 30% of all the companies reporting trading income to HMRC (i.e. approximately 330,000 companies) reported income that was lower than really earned (as HMRC data suggests likely) and that on average this under-declaration was of at least 30% (as US data suggests likely) then £1.3 billion of corporation tax would have been evaded by these companies. This is a sum within the range of HMRC's own estimate on this issue in its 2013 tax gap estimates (page7).

However, this loss ignores the VAT and PAYE losses and if corporation tax is being lost then the evidence from the VAT gap is that both of these other taxes will also be subject to more considerable losses. In the UK about 35% of all corporation tax is paid by small companies. There is, unfortunately, no way of knowing precisely what this might imply for lost PAYE (income tax and national insurance) or VAT paid, but a rational approach to estimation has to be adopted. In the tax year 2011/12, to which these estimates apply, corporation tax revenues were £44 billion, VAT £98 billion and PAYE about £233 billion^{iv}. If it was assumed that the same ratio between these revenues applies when estimating the overall loss to tax evasion in small companies only partly declaring their income then the VAT loss would be £2.9 billion and the PAYE loss would be £6.9 billion. This would give rise to an overall loss due to companies not declaring all of their income of £11.1 billion a year – or almost exactly half the overall loss that this report is still seeking to allocate. This would imply an average

tax loss per company declaring trading income of £10,000, given that approximately 1.1 million companies submit tax returns each year saying they are trading. Overall, and given that this is an average that embraces companies that will be turning over sums of up to £1 million or more a year, this seems plausible.

This implies that 'shadow companies', which are those that do not declare that they trade to HMRC and, in all likelihood Companies House, must account for the remaining £11 billion of missing tax revenue, which works out at an average of about £27,500 per company. This might seem high, but there several factors to consider.

Our research, involving extensive analysis of data from HMRC, Companies House, the Department for Business, Innovation and Skills and the Office for National Statistics, supports our conclusion that there may be 400,000 'shadow companies' operating in the UK each year. Key findings from our research include the following:

- a. More than 300,000 companies are, on average, struck off the Register of Companies each year and few of these have submitted the accounts that are due to be filed by them before being struck off. The number of investigations into these companies that are struck off appears to be low;
- b. More than 400,000 companies a year might, on average, fail to file annual return forms with the Registrar of Companies, including those struck off;
- c. 340,000 sets of accounts due to the Registrar of Companies were probably not filed in 2012-13, including those due by companies struck off;
- d. HMRC currently fail to request corporation tax returns from at least 650,000 companies each year that might be trading. Checks on companies claiming to be not trading appear to be minimal;
- e. Of the companies asked to submit corporation tax returns in 2011/12 more than 270,000 did not do so;
- f. Of the number of companies filing tax returns more than 500,000 said they did not trade and it seems few of these had their tax affairs investigated by HMRC;
- g. Evidence from both the USA and from HMRC suggests that false declaration by smaller companies appears to be commonplace in at least 40% of all tax returns submitted. Based on this ratio it is possible that of the number of the companies not being asked to submit tax returns or not submitting them despite being requested to do so, some 360,000 may not be declaring income each year;
- h. About 470 investigations of small company corporation tax returns were undertaken by HM Revenue & Customs in 2011-12, an effective rate of less than one for every 5,700 companies. The likelihood of a small company being discovered to have under-declared its income is remote.

Taking all data into account, and allowing for the number of new companies formed each year who do not therefore need to file accounts or annual returns until the following year, this research suggests that of the UK's 3 million companies just about half submit corporation tax returns, only 1.1 million admit to trading income and less than one million actually pay tax. This means that just 41% of all companies actually declared that they were

trading in 2011-12 and fewer paid any corporation tax. On any basis it seems hard to believe that 59% of all UK companies were really in existence to do nothing when there is almost never anything but economic justification for ever forming a company.

This evidence does not dispute the fact that there are a great many so-called 'dormant' companies in the UK. These are companies that, for various reasons, their owners wish to keep on the Register of Companies, but it seems highly improbable that more than half of UK companies fall into this category, not least when it is easy for a company to trade and yet remain undetected while doing so. That 400,000 of these supposedly dormant companies might be trading, whilst not declaring the fact, is supported by a raft of evidence, including that noted above, and even so there would remain an almost implausibly large number of dormant companies in the UK, totaling well in excess of 1 million at any point in time.

To allocate the remaining £11 billion of the unexplained tax gap resulting from unrecorded sales income to these 400,000 shadow companies that do not declare that they trade would suggest that at least £27,500 of tax is lost to each of them, on average. This is the highest estimated loss attributable to any of the various types of trading entity that might contribute to this tax gap, but it remains plausible.

Firstly, as with companies that declare only part of the income, most of the loss is a combination of VAT, income tax and national insurance and not corporation tax. In combination, as the research supporting this report shows, these can in combination amount to more than 50 per cent of evaded income, even if that might not be the case if they are accounted for legally.

Secondly, this means that the amount of gross income on which evasion is occurring may be little more than £60,000 in each company, which is a far from improbable level of trading for many such companies. HMRC VAT data makes clear that of the companies that are VAT registered (which is by no means all of them, of course) more than 650,000 trade with income up to the VAT threshold of £79,000 (2013/14) and another 350,000 or more, on average trade between that level and £150,000 of turnover. In other words, turnover of about £60,000 might be exactly within the average range expected of companies operating in the UK economy.

Thirdly, this does not mean VAT is not involved: averages are just that and some companies may have very high turnovers indeed, meaning that significant VAT losses can be attributed to them.

Fourthly, it must be appreciated that such losses need not necessarily be down to the activities of a single person in each case, although they could be. The evasion may well also relate to the payment of cash in hand wages, which is why it is highly likely that considerable PAYE fraud is a part of this process.

The root explanation for the remaining part of the missing billions resulting from the unrecorded trade that VAT tax gap probably lies here.

6. Other evidence on the UK shadow economy

There is one final point to consider before conclusions are drawn. This is that the suggested 10% unrecorded level of income happens to agree almost exactly with research undertaken over an extended period on the size of the UK shadow economy by academic teams usually including Austrian academic Prof Friedrich Schneider. So, for example, in a 2013 report for the Institute of Economic Affairs, Prof Schneider and Prof Colin Williams of Sheffield University estimate that the UK shadow economy was approximately 10 per cent of GDP, compared to about 14 per cent in Nordic countries and about 20–30 per cent in many southern European countries^v. Other estimates by Schneider have estimated higher figures: he is often quoted giving rates of around 12.5% for the UK, e.g. in World Bank peer reviewed reports. This latest 10% figure Schneider and Williams say, suggests that the total unrecorded part of the UK economy might amount to £150 billion a year because not all activity is, of course, represented by trading income. The estimate of loss that they make, using an entirely different methodology to that used here, is however almost exactly consistent with that which this report and the supporting research suggests to be occurring. This report suggests how part of that unrecorded income might arise.

Of course, we recognise that plausible speculation on the cause of a tax gap which itself is estimated on the basis of data in turn calculated from GDP data that is also based on a wide range of assumptions does not provide absolute proof of correctness. However, all economic analysis involves the sort of estimation on which this report is based.

Our research uses a plausible 'top down' method to estimate the tax gap for taxes other than VAT and in the process estimates the loss arising to the UK from trading entities deliberately failing to declare all their income to HMRC. This is data that HMRC has consistently failed to report despite the IMF saying in 2013 that its work in this area was 'fair' at best whilst also suggesting that its work in some other areas of tax gap estimation was good, or better.

7. Conclusions and recommendations

Precisely because the tax gap loss referred to in this report is so much bigger than the HMRC estimate – with it now probably costing the UK government at least £47 billion a year compared to the £10.5 billion that HMRC admit to – it is vital that this report suggests ways in which this problem can be tackled. A loss of this amount is sufficient to fund a number of significant government departments. This tax gap is also enough to ensure that even if only capable of being remedied in part – as is, of course, inevitably the case – it could change the whole direction of UK government economic policy by removing the need for a great many of the cuts that are now causing enormous social and economic difficulties for people and communities across the UK.

The first, and most obvious issue that must be addressed is the current deficiency in HMRC's work in estimating tax gaps. As the IMF has noted, HMRC is relatively good at finding some types of error within the tax returns it receives. However, HMRC is less good at estimating errors made outside the declared tax system. HMRC should acknowledge this and follow the IMF's recommendation that it improve its work in this area. This report, and the methodology we use for our research, suggest at least one way in which this might be done.

Second, and most obviously, HMRC needs more resources than it currently has available to it to tackle the problem of locating and then taxing the vast sums involved. Over the last decade HMRC has seen its resources steadily depleted: its staffing level has fallen from approximately 100,000 to about 55,000 people – the last several thousand of whom are currently in the process of losing their jobs as HMRC enquiry centres and local tax offices – which many consider to be the 'eyes and ears' of the service – are being closed down. This policy is being pursued to supposedly save cost when it is very likely that in practice the cost in terms of lost revenue could outweigh any potential saving many times over. The entire operations of HMRC should now be subject to a critical and independent review to assess its resource needs, including the resources needed to tackle the tax gap.

The most obvious point that has to be made in saying this is that HMRC has to be seen by the government and HM Treasury for what it is – a revenue generating department with an obligation to maximise its income – rather than as a cost centre tasked with the job of minimising its costs, which is how it is managed at present.

Next, the whole political rhetoric regarding the tax gap needs to change. For many politicians the issue of tax evasion by small businesses is a taboo subject because they are too frightened of alienating this sector when in fact if they really believe that the small business community is vital to the economic health of the UK then they would go out of their way to beat tax evasion. There are three reasons for saying this.

Firstly, the presence of tax cheats in this sector undermines the viability of companies that could otherwise prosper and grow to create new employment, new products, and prosperity in communities across this country. Because their profitability is limited by being forced to compete with companies who are cheating on their taxes, including charging VAT, they cannot make the money that would fuel the investment that would create this growth.

Secondly, many politicians seem to consider compliance by small companies with the law that regulates them as burdensome 'red tape' rather than essential protection for those who trade with these companies, including protection for society at large to ensure that the tax due by these companies is paid. Limited liability is a privilege, not a right, and those who want to use it should be required to account for it, and politicians should stand-up to enforce that obligation as they do when it comes to other law breaking.

Thirdly, ensuring that tax declarations are properly made is vital if we are to really understand the earnings of the self-employed. As the number of self-employed people in the UK grows steadily, with many seemingly starting such businesses because there is no

alternative work available to them, it is vital that we understand how much is earned by those in self-employment if serious poverty traps are to be avoided. Rhetoric about self-employment that simply applauds 'plucky new entrepreneurs' might be wholly inappropriate if data on the low levels of earning by those in self-employment is confirmed by honest tax returns.

If these issues within government, HMRC and politics can be addressed there still remain further steps that can be taken to ensure that there is the best chance of UK small businesses being persuaded to declare their income appropriately. As data from both HMRC and the USA shows, the probability that a source of income is declared correctly on a person's tax return increases considerably if information on that source is provided automatically by a third party to the tax authority with the taxpayer whose income has been disclosed in this way knowing that this has happened. It is an unfortunate, and widely recognised fact that if taxpayers are aware that tax authorities do not know about a source of income, or believe that those authorities have little prospect of finding anything meaningful out about it, then the chance that the income in question will either not be declared, or will be seriously under-declared, on a tax return increases dramatically.

It is for precisely this reason that the whole debate about tax and transparency that has dominated so much of the international agenda of the G8 and G20 over the last two years came about. When dealing with tax haven abuse, in particular, the focus of countries like the UK has been to demand that these places (including the Cayman Islands, Jersey, Guernsey and the Isle of Man) should be obliged by law to provide information to HMRC on the identities of those UK people who have accounts in those places, whether they are in their own names or in the names of companies or trusts that those UK resident people control. The data that these places have now, under international pressure, agreed to supply to the UK includes information on the names of the companies or trusts controlled by UK resident people, the name of the bank where these people or their companies or trusts hold accounts, the account numbers in question and in many cases the account balance plus some information on the income earned. Automatic information exchange exerts a strong deterrence pressure on people who might otherwise be tempted to use offshore vehicles to evade tax.

The absurd outcome of these new agreements with tax havens is, however, that very soon HMRC will be automatically supplied with significant amounts of information on the companies owned by British people in tax havens but will not be supplied with similar information on an automatic basis if those companies are instead located in the UK. This is particularly paradoxical because UK banks are also now required to collect information on the beneficial ownership of every company for which they provide banking services and, if that company is owned or controlled by people from some other states, such as the USA, they must supply that information to HMRC for onward supply to those other countries and yet we are not demanding that they do the same for all UK companies, whoever they are owned by, to make sure that those companies pay all the tax they owe in this country.

What this report suggests is that we should adopt the idea of automatic information exchange, which has now become commonplace in international tax to the extent that it is now considered an international norm by the Organisation for Economic Cooperation and Development, and make it part of UK domestic law. This would mean that any UK bank providing services to UK company would have to automatically, at least once a year, supply information to HMRC and to Companies House on the name of the companies to which they supplied services, the address at which they corresponded with it, the names and addresses of the people who they considered as a result of their money-laundering reviews control the company, the numbers of its bank accounts and a broad indication of the sums deposited each year.

There will be a number of immediate advantages as a consequence of the supply of this information. First of all, HMRC would know, with a high degree of accuracy, which UK-based companies have bank accounts, at least if those accounts were located in the UK. This would provide HMRC with an accurate picture of which companies were likely to be trading because it is very difficult to trade without a bank account. As a consequence they could, and should be legally required to, send corporation tax return demands to each and every one of these companies, each year. This would remove a great deal of the randomness about the process of requesting corporation tax returns which currently exists, where, if a company chooses to say that it is not trading HMRC may well decide not to request a tax return from it for up to 5 years.

Secondly, whereas at present HMRC almost invariably contacts the company through its registered office address, which can be that of an accountant, lawyer, or even an accommodation agency, it will instead have available to it a real trading address. This increases its chance of undertaking effective correspondence.

Importantly, if a company is known to have a bank account then Companies House should not be allowed to strike it off until such time as it has filed all its accounts that cover the periods during which it might have traded, and HMRC should be given the power to demand copies of bank statements from the bank that supplied services to the company if the company itself fails to submit corporation tax returns and accounts within three months of the date when they were due. At that point HMRC should be provided with the power to raise an estimated tax assessment using that data, and to make this tax liability the personal responsibility of the directors of the company so that tax cannot be evaded simply because they refuse to make payment through the limited company for which they have been responsible.

If this combination of powers was to be put in place then much of the problem caused by the UK's shadow companies, and the enormous sum lost to them, would be addressed. Of course, in the case of genuine insolvency that personal liability could be avoided by a properly conducted liquidation.

This still does, however, leave the problem of under declared income by the self-employed and those companies that do currently submit corporation tax returns and the difficulty of

identifying those self-employed people who choose not to declare any of their income, all of which are significant. There are, again, ways to address these issues.

First of all, if automatic information exchanges is to become the norm for companies as this report proposes, then there is no reason why the idea should not be extended to the self-employed. Banks should be required to identify the accounts of those customers that they either know are used for the purposes of self-employment, or which they suspect might be used for that purpose and report that information to HMRC at least annually. This is not an unduly difficult task. People in regular employment tend to be paid broadly consistent sums at broadly consistent intervals. The self-employed tend to be paid erratically, and in uneven amounts. Whilst of course, any such reporting without the cooperation of the bank account holder could be subject to error, if a bank was required to write to each of its customers stating their intention to disclose that they believed that their bank was being used for the purpose of recording self-employed income each year then firstly those customers would be put on notice to make declaration if that was appropriate and secondly the customer would have a right to appeal to both the bank and HMRC stating why the apparent evidence of their banking behaviour was inconsistent with their having self-employed income. The point is, of significance: once again the aim is to make sure that the self-employed person is put under pressure to report by putting them in a position of knowing that HMRC might suspect them of having self-employed income. The matching obligation on the part of HMRC would be to issue a tax return to any person the bank advised might have self employed income so that the issue could be resolved, if appropriate.

Lastly, there remains the matter of under declared income by companies. There is one straightforward protection available in these cases that should always be used. The tax potentially evaded in any such situation should always be considered the personal responsibility of the director or directors who have enjoyed the benefit of the missing turnover. Since, by definition, any such missing income will have left the company's accounts for the benefit of another person this is entirely reasonable, but if it was enforced then the privilege of limited liability could not be used to evade personal responsibility for any tax owing, and that is vital if the law is to be enforced.

None of this will, however, happen unless resources are available. Those resources are needed at Companies House, where additional checking of late returns from companies will be required as well as increased capacity to chase and prosecute those directors who are responsible for not filing the annual returns and accounts currently not submitted. Given that some 400,000 or more companies fail in this way each year this is no small task, but the funding required could be easily raised. At present the annual fee for maintaining a company is as low as £13. If this was increased to a more reasonable £30 then an additional £50 million might be available to police the system. That would almost double the resources available at Companies House^{vi} without in any way imposing any real burden on business.

The cost of the additional resources required HRC would be simply recovered: if £47 billion is being lost and it costs approximately £4 billion a year to run the tax aspects of HMRC's work

then the chance of a very strong net return on investment of at least £1 billion to pursue missing income would be very large indeed.

This then brings this report back full circle to the point near the beginning where it was said that the scale of the tax gap that is tolerated in any economy is, in large part, a political choice. There is such a choice to be made in the UK between closing the tax gap or continuing to impose austerity. Permitting the tax gap from unrecorded income to continue undermines fair trade in this country, destroys competition, prevents many businesses from realising their true potential, harms employment prospects, denies entrepreneurial companies the resources they need to invest in innovation and undermines the trust of the general public in the business community. All of these cause immense harm. Closing the tax gap would end that harm. It would also prevent some though not all, of the austerity measures that are causing great distress in communities throughout the UK.

About the author

Richard Murphy (56) is a chartered accountant and economist. A graduate in economics and accountancy from Southampton University he was articled to Peat Marwick Mitchell & Co in London. He subsequently founded a firm of accountants in London. In parallel with his practice career Richard was chairman, chief executive or finance director of more than ten SMEs.

Since 2003 Richard has been increasingly involved in economic and taxation policy issues. He was a founder of the Tax Justice Network and is currently director of Tax Research LLP. He also runs an accountancy practice.

Richard Murphy has been responsible for introducing many new issues into debate on tax policy. In particular he created the entirely new accounting concept of country-by-country reporting that has now been partially adopted by the European Union and will be for international taxation by Organisation for Economic Co-operation and Development, the latter at the behest of the G8 and G20.

Richard is also widely considered to have created the UK debate on the tax gap which began with the publication in 2008 of his report entitled 'The Missing Billions' by the TUC. Richard researched the current EU estimate of the European tax gap.

As principal researcher of the Tax Justice Network from its inception until 2009 Richard helped put the tax haven issue on the international agenda. He created the Financial Secrecy Index for that organisation and in the process defined the term 'secrecy jurisdiction', which is the main technical term now used to describe what are colloquially known as tax havens.

Richard has been a visiting fellow at Portsmouth University Business School, the Centre for Global Political Economy at the University of Sussex and at the Tax Research Institute, University of Nottingham.

He is a co-author of 'Tax Havens: How Globalization Really Works', Cornell University Press, 2009 and author of 'The Courageous State', Searching Finance, 2011 and 'Over Here and Under Taxed', Vintage Books, 2013.

In October 2012 the Association of International Accountants gave Richard their award for an Outstanding Contribution to the Accountancy Profession.

In December 2013 Richard was ranked as the seventh most influential person in international taxation in International Tax Review's Global Tax 50 of the most significant participants in worldwide tax.

Endnotes

ⁱ See, for example

<http://www.iea.org.uk/sites/default/files/publications/files/IEA%20Shadow%20Economy%20web%20rev%207.6.13.pdf> and literature referred to therein

ⁱⁱ <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf> page 54

ⁱⁱⁱ VAT Fact Sheet 2012-13 table 2.9

^{iv}

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/304364/20140410_Mar_v0.1.pdf

^v

<http://www.iea.org.uk/sites/default/files/publications/files/IEA%20Shadow%20Economy%20web%20rev%207.6.13.pdf>

^{vi}

http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012_2013.pdf