Tax Research UK

Tax Briefing

Why HM Revenue & Customs have got the Tax Gap wrong

Summary

This briefing considers criticisms made of the work of Tax Research UK in estimating the nature and extent of the UK tax gap.

The UK tax gap has three components: tax recognised by taxpayers to be due but paid late or not at all; tax illegally evaded by those who should pay it and tax avoided as a result of the exploitation of loopholes in tax law not anticipated by the UK tax authorities.

It has been claimed by HM Revenue & Customs that these sums when combined total not more than £40 billion per annum and this sum was defended in a parliamentary debate by Exchequer Secretary David Gauke MP on June 16 2010.

Tax Research UK has estimated the tax gap to be at least £120 billion at any point in time at present and has used this estimate as the basis for a claim that addressing this issue could, by itself, do much to close the current UK government financial deficit[i].

Given the disparity in these estimates it seems clear one estimate has to be more accurate than the other, always noting that absolute accuracy in these matters is impossible: by definition taxpayers choose not to disclose the contribution they seek to make to the tax gap. This paper argues that the Tax Research UK estimate is, on the basis of reasoned analysis and research, highly likely to be considerably more accurate than the estimate made by HM Revenue & Customs.

Firstly, the Tax Research UK estimate for tax paid late or not at all is not an estimate: it is a statement of fact made by HM Revenue & Customs in evidence to the Parliamentary Accounts Committee in 2009. It could only be wrong if tax paid late is not a part of the tax gap. HM Revenue & Customs documentation showing that tax paid late is part of the tax gap is included in this report. The HM Revenue & Customs say this gap is, despite that, just £1.8 billion. The Ministerial claim is that this figure should only be considered to be £3 billion. Curiously they do not agree. Both seem to be considerably wide of the mark.

Second, with regard to personal tax avoidance this briefing shows that the claim by HM Revenue & Customs that there is just £1.1 billion of tax avoidance spread over income tax, national insurance

Tax Research LLP
The Old Orchard
Bexwell Road
Downham Market
Norfolk PE38 9LJ
United Kingdom

Phone	01366 383 500
Mobile	0777 552 1797
Email	richard.murphy@taxresearch.org.uk
Web	www.taxresearch.org.uk/blog
Skype	richardmurphy1572
Registered number	OC316294

and capital gains tax combined is very obviously wrong. Indeed, in his budget speech in 2010 George Osborne straightforwardly contradicted that HM Revenue & Customs claim when saying that tax avoidance with regard to capital gains tax alone exceeded £1 billion, happening in the process to exactly confirm the estimate of avoidance with regard to that particular tax made by Tax Research UK. The Exchequer Secretary also contradicted HM Revenue & Customs' claims in his speech on 16 June: it is very clear neither minister has any faith in the HM Revenue & Customs estimate whilst that of Tax Research UK appears to accord with the Chancellor's estimate. As such the Tax Research UK figure is considered confirmed until evidence to the contrary is presented.

It is however accepted in this briefing that current evidence does suggest more work is needed to support the Tax Research UK figure for tax avoidance by companies of £12 billion. This is not to say that estimate is wrong; it does say more evidence is now available which strongly suggest that the figure for such tax avoidance cannot be as low as that claimed by HM Revenue & Customs, amounting to a sum of just £3.4 billion because the new evidence now available suggests that the tax gap for corporation tax would appear to exceed £7 billion at present. More research on this will be published in the autumn of 2010.

Tellingly, the difference arising between the new evidence and the 2008 TUC estimate prepared by Tax Research UK appears to relate to small companies and not big companies. With regard to large companies the TUC estimate that those companies pay tax at an effective rate approximately 8% less than might reasonably be anticipated has been confirmed by new HMRC data. What is surprising is that this tax gap does not extrapolate to small companies: they are paying tax at almost the full expected tax rate according to HMRC data, virtually eliminating the policy driven differential between large and small company tax rates. It is in this area that more work is now needed because if this is true then further planned changes in corporation tax rates for large companies announced in the first coalition government budget will mean large companies will soon be enjoying the lowest effective tax rates in the UK, and will be paying tax at lower rates than smaller businesses. This is an issue of real importance to the UK and its tax gap, if true.

Finally, the report considers the claim by HM Revenue & Customs that tax evasion does not exceed £33.5 billion a year or about 6.5% of the total tax base. Tax Research UK suggests that, based on the average VAT gap of about 13.7% the tax gap due to evasion is not less than £70 billion per annum. This report robustly defends the use of Tax Research UK's methodology. It also points out that academic estimates of the shadow economy in the UK fall in a range from about 12.5% to about 16% - in the middle of which the Tax Research UK estimate for tax evasion (fuelled by the shadow economy) falls. The HM Revenue & Customs claim is, in this case, outside all expected outcomes for such an estimate and is therefore highly likely to be incorrect.

Based on this evidence the Tax Research UK claim that the tax gap is likely to be in the order of £120 billion at any point in time is considered justified. As such the policy recommendations based on this estimate are also considered justified.

That said, this conclusion does not end this debate. As this briefing notes, such a conclusion does instead give rise to the following questions:

1. Why isn't this tax gap being acknowledged by HM Revenue & Customs and Ministers?
2. Why did HMRC so very obviously understate their estimates so significantly?
3. What is now going to be done to ensure accurate estimates of the tax gap are prepared?
4. Given the problems that clearly exist in relying upon HM Revenue & Customs and HM Treasury to estimate the tax gap can we have an Office for Tax Responsibility to ensure that proper tax estimates are prepared and that credible plans to close the tax gap are put in place?
5. When will adequate resources to tackle the tax gap be allocated to HMRC? This would include cancelling the current HM Revenue & Customs office closure programme and reinstating sacked staff whose services are essential if the tax gap is to be closed.
6. Why wasn't closing the tax gap the focus of government attention in its plans to cut the deficit, and given the size of potential revenue available from doing so, how can cuts in public services be justified unless this issue has been tackled first?

The tax gap debate is by no means over.

The Tax Gap and Tax Research UK

Tax Research has undertaken extensive work on the tax gap in the UK[ii]. Indeed, few have done more work on this issue, and the work of Richard Murphy, the director of Tax Research UK, for the TUC has been recognised by HM Treasury as being pivotal in the development of debate on this issue in the UK[iii].

That work initially concentrated solely on the corporate tax gap – the apparent payments not made to HM Revenue & Customs by the largest corporations in the UK. Work on this issue was first published in 2006[iv].

This work was updated and enhanced considerably in 2008 with the publication of The Missing Billions in 2008 which extended the estimate of losses to cover both individuals as well as companies[v]. The estimate of tax avoidance by companies in this report was £12bn per annum and by individuals some £13bn per annum.

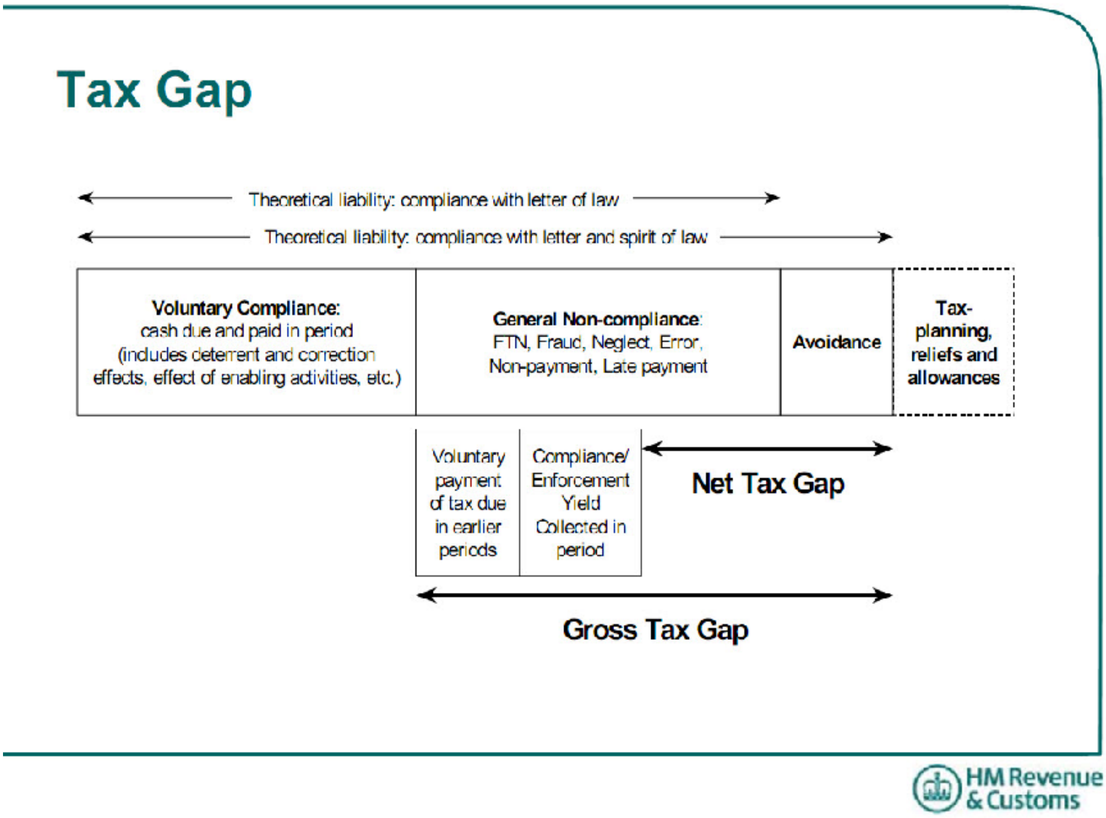
In March 2010 the scope of the work was extended again to cover, in addition to tax avoidance, tax lost as a result of non-payment and serious late payment of tax and from tax evasion, both being addressed in a report produced for PCS, the union representing the majority of HM Revenue & Customs staff. Tax lost to nonpayment was estimated to be £28bn based on HM Revenue & Customs disclosures to a House of Commons Select Committee whilst evasion was estimated at £70 billion.

In the meantime the pressure arising as a result of this work had led to the publication by HMRC of various estimates of the tax gap culminating in what HMRC describes as the publication of "more accurate estimates for many components of the tax gap, including Corporation Tax for large business, and an estimate of the overall tax gap"[vi]. A summary of those estimates is noted in Appendix 1 to this report. The estimate suggests that the total tax gap amounts to £40 billion.

Other estimates by Tax Research LLP over time have estimated the cause of some elements in the tax gap. For example, in February 2009 an estimate of the direct cost of tax havens to the UK was published, estimating that cost to be £18.5 billion per annum[vii], a sum somewhat higher than the estimate of the same figure by HM Revenue & Customs[viii]. These causal issues are not considered further in this paper.

What is the Tax Gap?

Tax Research agrees with the following definition of the Tax Gap produced by the Large Business Services of HM Revenue & Customs in 2005[ix]



This paper considers, as does HM Revenue & Customs, that tax avoidance is part of the tax gap. This perception is based on the fact that voluntary tax compliance and fair tax planning are both part of tax compliance which is defined as seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

The tax gap is defined as, consistent with the above diagram, having three major components:

1. Tax lost to tax avoidance, which is defined here as seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud) but contrary to the spirit of the law;

2. Tax lost to tax evasion, which is the illegal nonpayment 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;
3. Nonpayment of tax declared to be due, i.e. late payment or bad debt suffered by HM Revenue & Customs.

The first of these is also defined as avoidance by HM Revenue & Customs in their diagram, the second and third are defined by them as general non-compliance.

Comparing the HMRC and Tax Research UK estimates of the Tax Gap

The HM Revenue & Customs and Tax Research UK estimates of the tax gap are significantly different. The following table compares the two, the HMRC estimates being based on best possible interpretation of the data they have published reproduced in appendix 1 (this being required because the table in question does not add up, however many times you try):

	HM Revenue & Customs view £'bn	**Tax Research UK view £'bn**	**Difference £'bn**
Tax evasion (balancing figure in case of HMRC)	33.5	70.0	36.5
Unpaid tax	1.8	28.0	26.2
Tax avoidance	4.7	25.0	20.3
Total	**40.0**	**123.0**	**83.0**

Is the HM Revenue & Customs estimate of the Tax Gap credible?

Recent discussion in parliament, and subsequent evidence from the budget statement of George Osborne has led to considerable doubt about the credibility of the HM Revenue & Customs estimate of the tax gap arising. It is argued here that the Tax Research UK estimate is considerably more credible based on evidence available, despite claims made by a Minister inn defence of the HM Revenue & Customs estimate.

The Minister tackles Tax Research LLP

On June 16 a debate took place in Westminster Hall on tax avoidance. Answering for the government Exchequer Secretary David Gauke MP addressed the work of Tax Research UK on this issue. His full comments concerning Tax Research LLP are reproduced as Appendix 2 to this report. It will be noted he challenged the Tax Research UK estimates of tax evasion, unpaid tax and tax avoidance.

The Minister's errors of fact

The Minister did, unfortunately get a great many of his facts wrong on this and other issues.

Some errors he made were simple misstatements of fact. For example, he claimed that Tax Research LLP and the Tax Justice Network are essentially the same organisation. It is an odd claim to have made: the only involvement the Tax Justice Network has had in the work noted here was to support PCS' publication of their March 2010 report, which was, however entirely funded by PCS. It had no involvement in the TUC work and likewise none in earlier Tax Research UK reports. The Minister made a claim that had no substance: much of his commentary that followed was in the same vein.

Second, note that the Minister said of Tax Research UK's estimate of tax avoidance:

> *That estimate includes the use of legitimate reliefs promoted by the Government to encourage certain activities, such as capital allowances to encourage investment and research and development tax credits to encourage innovation. Tax avoidance is generally regarded as the use of legal structures and allowances to reduce tax bills in manners not intended by Parliament when enacting the legislation. It is simply nonsense to categorise as tax avoidance the use of allowances for purposes intended by Parliament.*

The fact that the estimate was in fact that of the TUC might be overlooked: the fact that of the £25 billion estimate made by Tax Research UK some £13 billion related to personal tax avoidance, and none of that did in an way relate to mates such as claiming capital allowances is much harder to ignore.

The Minister's own position in this issue is even harder to understand when earlier in the same debate he had said:

> *Tax avoidance is estimated to contribute around 17.5%-around £7 billion-of the total tax gap. It is worth making that point at the beginning because, although those contributing to this debate today have not fallen into this trap, there is sometimes a conflation between the tax gap, which is a considerable figure, and tax avoidance, which is still a considerable figure but is only part of the £40 billion figure. None the less, £7 billion is a substantial sum, and this Government are determined to reduce it as far as possible.*

Rather oddly, the figure for £7 billion cannot be tied back to any combination of figures in the HM Revenue & Customs estimate reproduced in Appendix 1. That though might be left aside: the point is that the Minister says tax avoidance – the legal use of tax allowances in ways not planned by the government is part of the Tax Gap. That is exactly what Tax Research UK says as well. The dismissal of the Tax Research UK estimate without any further evidence when the figure he quotes has no known source seems in the circumstance to be an error.

The third error of fact within the Minister's statement relates to unpaid tax and is dealt with in detail in the next section of this paper.

The Minister's error with regard to unpaid tax

Addressing Tax Research UK's estimate of £28 billion of unpaid tax owing to HM Revenue & Customs the Minister said on 16 June:

> *That is a snapshot figure of all tax owed to HMRC on 31 March 2009, which does not represent the actual losses to the Exchequer from non-payment. Almost all tax owed to*

> *HMRC is eventually paid, sometimes within days of becoming due. A proportion of debts outstanding are in staged repayment plans, such as those covered by the business payment support service. Only the tax debt written off as uncollectable by HMRC is an actual loss to the Exchequer from debt. That is therefore the amount that HMRC uses in its estimate of the tax gap, which in the 2007-08 tax gap figures was not £28 billion but £3 billion.*

Unfortunately for the Minister his claim was factually incorrect. Tax Research UK did not estimate the sum in question: it was a figure reported as overdue and outstanding by HM Revenue & Customs to the Public Accounts Committee and included by that committee in a report dated 30 November 2009 entitled "HM Revenue and Customs: Improving the Processing and Collection of Tax: Income Tax, Corporation Tax, Stamp Duty Land Tax and Tax Credits"[x] in which it is noted that:

> *In 2008–09, total taxes and duties collected and receivable were £436 billion, some £22 billion lower than in 2007–08. The £436 billion included £28 billion in tax debtors. The Department has made a provision for bad and doubtful debts of £11.2 billion, 40% of the total, and £3.3 billion more than in the previous year.*

However that must be put in the context of the evidence the committee received, as reproduced in their report. Evidence given by Ms Strathie, Permanent Secretary and Chief Executive of HM Revenue & Customs, to the PAC included the following statement:

> *Much of our debt is not paid on the right day and within that total tax take of almost £436 billion there is £100 billion which is paid late.*

How, however, she know this is not clear. As the PAC noted:

> *Weaknesses in the Department's existing systems prevent it from analysing debts by age and value and from calculating a taxpayer's total debts across all taxes. The Department has deferred its plan to invest in a new debt management system because of other priorities.*

True debt seems, therefore unlikely to be known: what is clear is that £28 billion was the figure of tax paid late in March 2009 and using the definition of HM Revenue & Customs established in 2005 of the tax gap this sum is fairly to be considered as part of that tax gap in its totality.

The only real surprise is that the sum is so small: representing just 23 days of tax paid late. Given the weaknesses in the systems that the PAC noted the possibility of it being higher is considerable. The chance that it is £3 billion seems highly unlikely. In any event, if it were £3 billion the HM Revenue & Customs estimate of £1.8bn published in December 2009 cannot be reconciled with that sum and must therefore be considered unreliable, or simply wrong.

The Minister's errors with regard to tax avoidance

Graphic evidence in support of the TUC claim that the total tax gap with regard to tax avoidance may be very accurate was provided by the budget. In his budget speech on 22nd June the Chancellor said[xi]:

> *Some of the richest people in this country have been able to pay less tax than the people who clean for them.*

That is not fair – and it stems from the avoidance activity that has exploited the wider gap between the rate of capital gains tax and the top rates of income tax.

These practices are costing other taxpayers over £1 billion every year.

This estimate of tax avoidance by the Chancellor from the Despatch Box needs comparison with the HMRC estimate of December 2009 and that if the TUC, prepared for them by Richard Murphy of Tax Research UK.

The HMRC estimate of December 2009 says that total tax avoidance for income tax, national insurance and capital gains tax amounts to £1.1 billion a year. Since £1.1 billion amounts to more than £1 billion it seems that the Chancellor might be saying, if the HMRC figure is correct, that all tax avoidance for all these three taxes, of which the smallest by a massive margin is capital gains tax (it representing £2.5bn of tax collected in 2009-10 as opposed to £229bn for the other two taxes) might relate to Capital Gains Tax alone. None, it would seem, could have related to income tax or national insurance at all if the December 2009 HMRC estimate is correct. That, of course, is very obviously unlikely.

The Missing Billions made that fact clear. In that report it was suggested by Richard Murphy that Capital Gains Tax avoidance could take place in two ways. The first was shifting income into gains and the second arose by shifting income from higher rate taxpayers to lower rate tax payers so that the overall rate of tax within married couples and civil partnerships was reduced – both being practices the Chancellor alluded to in his speech. The Missing Billions estimated the former cost £0.5bn and the latter cost £0.6bn. In other words, it estimated a total of £1.1 billion of tax avoidance arising from this tax – or a figure of more than £1 billion a year, exactly as the Chancellor has confirmed has occurred.

There appear two possible explanations for these disparities: the first is the Chancellor has been relying too heavily on the TUC's work although his Minister and HM Revenue & Customs claim it is wrong, in which case he needs to offer explanation to parliament. The alternative is that the TUC estimate is right and accords with official estimates but the data published by HMRC in December 2009 is very seriously wrong.

This, however, has further consequences. If the TUC estimates are right (as seems very likely – or the Chancellor would not have produced remarkably similar estimates in his budget speech) then it is very obvious that tax avoidance is also much higher than HMRC has admitted – as his minster had already implied by saying it was at least £7bn when HM Revenue & Customs state it to be only £4.7bn.

In the absence of evidence to the contrary the derailed and specific calculations of tax avoidance, all prepared on similar bases to that confirmed to be correct for Capital Gains Tax by the Chancellor, are presumed to be true. These suggest a tax gap on taxes charged ion individuals and trusts of at least £13 billion a year and suggest HM Revenue & Customs have seriously underestimated this gap.

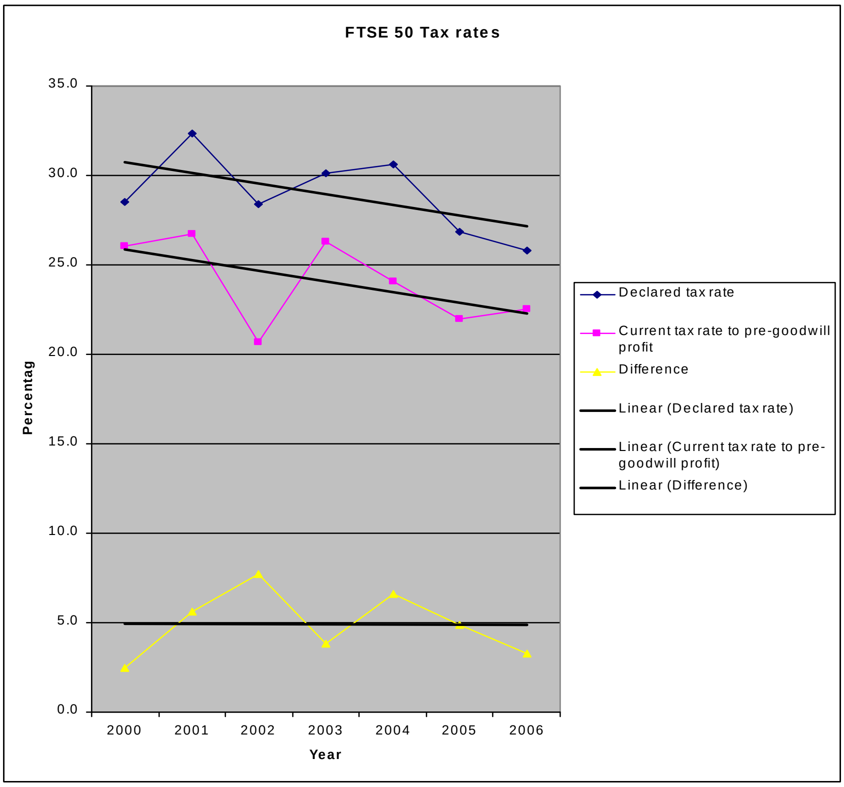
The corporate tax avoidance gap

The issue with regard to corporate tax avoidance is less clear than the issue with regard to personal tax avoidance where it is very obvious that the HM Revenue & Customs' estimate is considerably inaccurate.

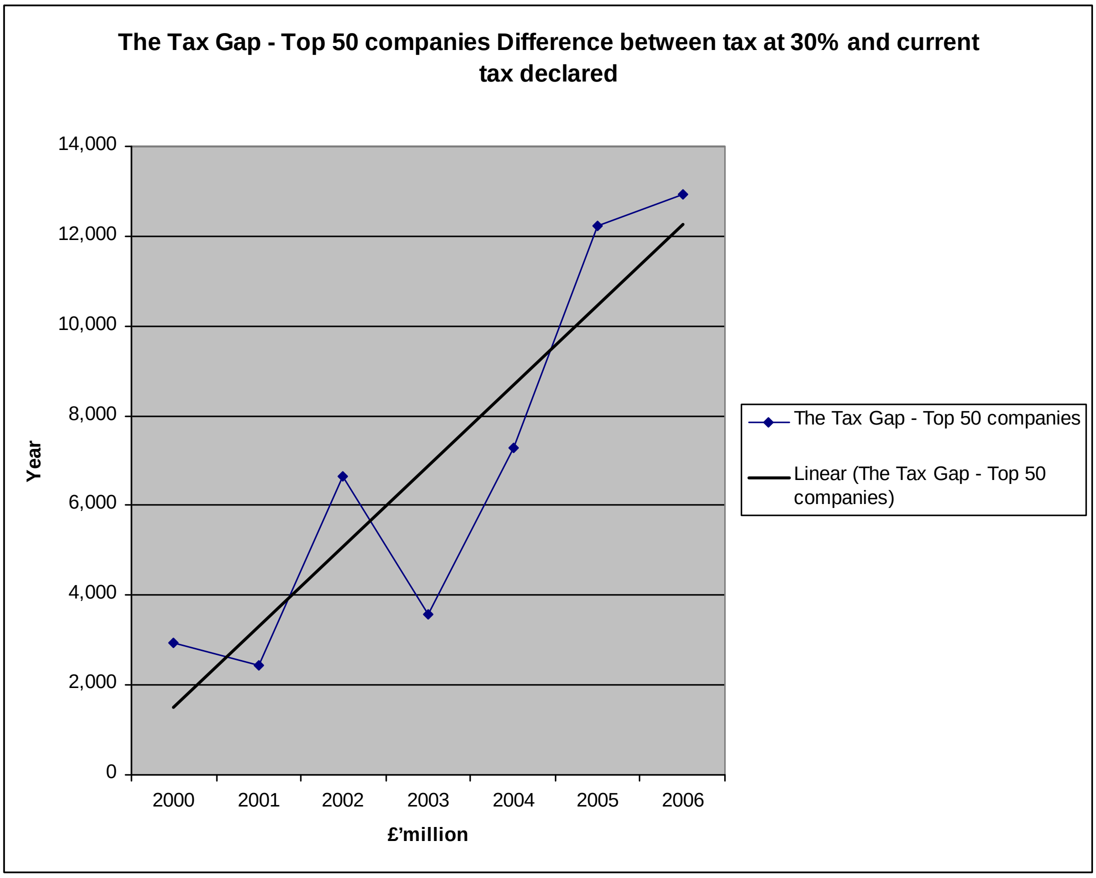
Thankfully and appropriately HMRC suggest that tax avoidance is more prevalent in the corporate sector, with large companies avoiding at least £3.1 billion in tax and small companies at least £0.3 billion in corporation tax. The TUC estimate is, however, that they avoid £12 billion in all, a figure more than three times the HM Revenue & Customs estimate.

The TUC estimate, prepared by Tax Research UK, is based on the fact that there is an expectation gap in corporation tax. Corporation tax has the appearance, especially with regard to the highest earning companies in the UK, of being the flattest tax in the UK. From 1999 to 2007 the tax rate for these companies was 30%. In 2008 it was reduced to 28%. The TUC tax gap logic is that something approaching this tax rate should therefore appear to be paid by large companies over time. This assumption is, incidentally, also implicit in the corporate accounting required for this tax under the rules of the International Accounting Standards Board. They require that what is called "deferred tax accounting" take place because if tax allowances mean a tax benefit is received early for any reason by a company it is probable, in the International Accounting Standards Board's view, that it will reverse over time and so the tax rate should even out when an extended time period is considered. The logic used does, therefore accord with that of at least some in the accounting profession.

This consistent payment pattern close to the anticipated tax rate was not, however, what Tax Research UK found for the TUC. They found that far from there being a steady pattern of tax paid there was a steady fall in the effective tax rate of the largest fifty companies in the UK over the period from 2000 to 2006[xii]. This graph illustrates the findings:



As important as this finding of correlated steady falls in the tax rate was, the following graph adds extra piquancy, demonstrating the increasing value gap of the difference between the expected and actual tax rates implicit in the TUC report:



Enormous amounts of tax were apparently not being paid by these companies and after allowing for the fact that some of their activities were overseas and therefore not subject to UK tax rates and that the companies sampled represented a significant but minority part of the total tax base for UK corporation tax a tax gap of £12 billion of tax was estimated.

This has been subject to subsequent challenge, including the charge that the impact was, as the Minister claimed, due to the claiming of allowances justified in law. This issue could not be addressed at the time: the data to do so was not available. To some extent it is not now, but some better data is now published by HM Revenue & Customs, maybe as a direct response to this work[xiii].

The data in question does show profits before and after capital allowances, and compares tax paid by companies in the UK, categorised by broad industry codes. This allows some further analysis to take place. The following table results for the tax year 2007 – 08 (the last data available):

Industry	Number of cases with trading profits and other income	Income chargeable to tax £'m total	Average Income Chargeable £	Tax rate %	Tax payable £'m total
Energy, water supply	4,009	23,638	5,896,233	29.8%	7,051
Hotels and catering	35,500	2,332	65,690	25.8%	601
Transport and communication	37,652	4,016	106,661	25.5%	1,024
Metal goods and engineering	49,379	8,187	165,799	25.0%	2,044
Other services	89,850	6,004	66,822	24.1%	1,449
Distribution and repairs	127,833	22,254	174,087	24.1%	5,367
Construction	112,204	11,091	98,847	23.6%	2,622
Agriculture, forestry, fishing	16,212	979	60,387	23.5%	230
Banking, finance and insurance	40,989	61,003	1,488,277	21.5%	13,104
Business services	537,545	55,126	102,551	18.8%	10,388
Other manufacturing	42,924	14,470	337,107	14.2%	2,048
Overseas activities	233	59	253,219	11.9%	7
Extraction, metal mfg,chemicals	11,840	8,458	714,358	11.2%	951
Not classified	113,496	8,288	73,025	10.2%	845
All industries	1219666	225905	225905	21.1%	47731
Small companies	904807	83820	92639	19.2%	16135
Large companies	314859	142085	451265	22.2%	31596

The data has been sorted in the descending order of the average tax rate paid by companies in each sector. The sample base is all UK companies paying corporation tax (curiously, and perhaps enormously tellingly for the estimates of tax evasion – just 50.3% of UK registered companies appear to pay corporation tax as a result – which will be an issue for further investigation in the future)[xiv].

Note that income chargeable to tax is after capital allowances: they cannot distort this data. Despite this no sector paid tax at 30%. That is almost certainly because some companies in all sectors qualified for the small companies rate of corporation tax. This was 20% on profits of less than £300,000 in the year in question. A transitional rate applied on profits from £300,000 to £1.5 million increasing the rate from 20% to 30% over that band of profit.

This small companies' rate is important in this analysis and is the reason for the analysis in the last two lines of the table. Small companies were assumed to be those in the above table where average profits were less than £150,000. These companies paid an average tax rate of 19.2%. This is remarkably similar to the anticipated tax rate of 20%.

Large companies on the other hand paid an average tax rate of 22.2%. Some sectors likely to be dominated by very large companies, such as banking, paid tax at a rate lower than this – at just 21.5%. And this, it must be stressed, as after allowing for their capital allowances. They are no longer an excuse for these aberrant tax rates, but this does – and this must be stressed – mean that some tax avoidance cannot be picked up in these figures, which is why they may well still seriously understate the tax gap with regard to tax avoidance.

Of course it would be unreasonable to think the sample of large companies should pay tax at 30% as there are some small companies included in all the categories in question. But it is very hard to explain why some large companies, such as those engaged in overseas activities and the extractive industries pay tax at such low rates on their UK profits whilst some UK based businesses, which small companies in construction are all likely to be, pay corporation tax at 23.4% on average. There is, based in this evidence, a tax gap in the corporate sector, and it is certainly not explained by capital allowances, as the Minister claimed. The gap also relates to those companies paying no tax at all – not included in this analysis.

Whether the gap is as a result £12 billion is, on this data selection (which represents a different approach to that used in the TUC report) open to question – a question that must be addressed by more work. But, if the largest companies in this survey (those where average profits exceed £300,000) had paid tax at 28% on average (which given all allowances have already been taken into account may reasonable) then the tax due by them would have been £7 billion higher than that shown to have actually been paid.

This figure may indicate the TUC estimate to be high: equally it may not. As noted, this is a very tentative suggestion based on a very simple and short analysis of the data. But it does strongly suggest that the HM Revenue & Customs estimate of corporate tax avoidance is a serious underestimate of the actual figure, and it does also leave many important unanswered questions, by far the most relevant of which is why large companies pay tax at, on average, almost 8% less than the rate expected (confirming, coincidentally, almost exactly the TUC finding on this issue) when small companies pay their tax at rates above those expected in a great many cases.

The suggestion that the issue of tax avoidance is resolved in the corporate sector by data currently published by HM Revenue & Customs is therefore wholly inappropriate: the gap is real, much bigger than they estimate and indicative of the need to tackle major policy issues if anything like an appropriate tax system for the corporate sector in the UK is to be created.

The Minister's error with regard to tax evasion

On the question of tax evasion David Gauke MP said during the debate on June 16:

> *For example, Tax Research LLP estimates total revenue lost due to tax evasion at £70 billion. That figure is obtained by applying the percentage tax gap from VAT to direct taxes. There are two main problems with that. First, different tax regimes have different tax gaps. According to independent research by the OECD, for example, the operational experience shows that tax regimes such as pay-as-you-earn that withhold tax at source have far smaller tax gaps than other types. To apply the VAT gap percentage to taxes collected by PAYE or otherwise at source greatly overstates the tax gap, because the VAT tax gap is considerably higher.*
>
> *Secondly, an element of double counting is involved, although, to be fair, that might not be apparent from the numbers used by Tax Research. The VAT gap already includes amounts due to tax avoidance and tax debt. Applying that percentage to direct taxes and then adding additional amounts for both avoidance and tax debt, as does Tax Research, results in the double counting of losses from the avoidance of direct taxes and non-payment.*

The second point is obviously true: of course Tax Research UK has less data available to it than HMRC. The fact that HM Revenue & Customs is not publishing data on a timely, sufficient or clear enough basis to properly assess tax collection in the UK is an issue noted, but not addressed here. The issue here relates to the tax gap and in this context the first claim is the one of concern.

In this context reference should be made to HM Revenue & Customs' document published in December 2009 which deals with the method of calculating the VAT gap. This says:

> *The aim is to measure the total level of VAT losses by comparing the net theoretical tax yield with actual VAT receipts. The difference between these amounts is known as the VAT gap.*

Nowhere in the methodology does it say that tax paid late is included in this VAT Gap. In fact, the December 2009 HMRC report says that tax debt has only been a material issue in one year – which was 2008-09. Since Tax Research LLP based their estimate for evasion on weighted VAT tax gap ratios published by HM Revenue & Customs over a period seven years this cannot have had material impact on their findings and no likelihood of double count of the VAT gap is therefore likely in respect of unpaid tax. This claim by the Minister is, therefore, considered to either be wrong or wholly immaterial to assessment of tax evasion.

Second, the minster says tax avoidance is included in the figure for the VAT gap. This has to be accepted as a possibility. However, as appendix 1 makes clear, no attention is drawn by HM Revenue & Customs to this possibility in their published data and as such it is reasonable, again, to presume that the impact is immaterial. Evidence from the professional tax press is that VAT planning is of much more limited extent than that relating to direct taxes. As such it is unlikely to have serious impact on the amount of tax recovered or form a significant part of any VAT gap. No doubt this is why a figure for it has not been estimated or published for use by third parties wishing to analyse the tax gap.

The key questions is, then, whether it is reasonable to extrapolate what is likely to be a tax evasion rate of 13.7% for VAT, calculated over seven years, over all direct taxes. The Minister says that is not the case, stating as noted above that such a ratio could not apply to payment systems such as PAYE where error rates are low.

Unfortunately the Minister makes a fundamental error in stating this to be the case. Of course it is true that once wages are declared by a company it is likely that PAYE will reduce the risk of error in declaration and computation occurring. That ignores that fact that tax evasion means that paid are simply never declared and as such go nowhere near the PAYE system and therefore are subject to a 100% tax calculation error rate irrespective of the efficiency of PAYE with regard to declared wages. The question is therefore whether the existence of a VAT gap suggests it is likely that an income tax gap on wages is likely to follow as a consequence (and a corporation tax gap on profits, etc.,) and not what the Minister claims.

Explaining how the VAT gap gives clear indication of the scale of this issue takes some effort but is worth doing. It is important in the context to understand the points in the revenue cycle at which major taxes hit revenue generating operations such as companies (and government departments, charities, self employed people and so on). This diagram of an income statement / profit and loss account might help explain that:

Income / expense category	Tax charged
Income / sales	VAT charged to customers
Overheads	PAYE (made up of income tax and national insurance) on wages VAT reclaimed on expenses incurred
Profit	Corporation tax if a company / self employed income tax if not incorporated

It is important to note that revenue flows down the system i.e. sales have to be made to enable cash to be generated to ensure wages (and the tax on them) can paid and in turn profit can be earned, again giving rise to tax due.

The VAT gap suggests that 13.7% of expected VAT is not paid to HMRC. Since VAT is eventually a tax on consumption this suggest in turn that 13.7% of turnover that should have been subject to AVT has not been reported for tax purposes.

In that case it is the contention of Tax research LLP that the sales giving rise to that VAT liability are also not declared to HMRC when accounts are prepared (if at all) indicating profits earned. There is good reason for saying this: the most basic test a VAT inspector undertakes when looking at a company's records is to ensure that the sale recorded in the accounts are the same as the sales recorded on the business' VAT returns. In other words, given that this is widely known VAT evasion always gives rise to income suppression in accounts. Of course, in many cases it gives rise to no accounts being prepared or declared for tax purposes at all.

The latter case is, perhaps the best place to start the next stage of this explanation. It is very obvious that if someone runs a business where, to avoid VAT they take all their sales income in cash and put none of it on a VAT return or in a set of accounts that they will not then declare any tax due on wage payments they make. These wage payments will instead be settled illicitly out of that illicit cash. They will therefore be part of the tax evasion gap.

Alternatively, if the illicit cash is not used to pay wages (and maybe other costs) then it will flow straight through to the bottom line i.e. it will be profit in the hands of the person who has committed the VAT fraud. This should also be subject to income tax (or, maybe corporation tax – but this is unlikely).

In other words, if there is VAT fraud at the top of the profit and loss account it has to flow down through that profit and loss account and in the process give rise to fraud with regard to income tax on wages and national insurance or tax evasion on profits with regard to income tax or corporation tax as well. This is the inevitable consequence of suppressing the income that was illicitly received to ensure VAT fraud took place.

It is important to note that the same pattern recurs if a business records part of its income and suppresses part of its top line sales records to ensure VAT fraud is not discovered. In that case either wages are paid in cash, and PAYE is not operated, or if wages are properly recorded in full then profit is seriously under-recorded and the direct tax fraud takes place there. But missing trader fraud apart (and that is now small – but does give rise to direct tax evasion on the proceeds of the crime, a fact that should not be ignored) in every case atop line VAT fraud gives rise to a direct tax fraud as well. The Minister is wrong to deny this.

And of course the Minister cannot suggest that the problem only exists in VAT registered businesses: why those business should suppress income to save tax but those that are not VAT registered do not is an argument no one should seek to make. Nor should they argue that the shadow economy does not extend to the state sector where it takes a different form in bribes and other payments made to officials, a problem little acknowledged but which is universal, and which also contributes to the tax gap

To put it another way then, the figure for VAT fraud does inevitably act as a proxy measure for the size of the "shadow" economy. In Tax Research UK's work on the tax gap it is assumed that this ratio is 13.7% - the average for the VAT gap over 7 years, and have been cautious in extrapolation. The suggestion is, as a result, that this proportion of the total gross direct tax that should have been collected is lost as a result of the impact of the shadow economy (distinct from tax avoidance and late and non-payment of taxes declared to be due but not settled on time) just as this proportion of the total gross VAT that should have been collected is lost. As is shown above, one conclusion flows from the other, inevitably.

The question to then ask is whether this is plausible. Work in estimating the shadow economy is always laden with the problem that people do, by definition, not wish to report their own tax fraud. However, an IMF estimate (admittedly relating to 1988 – 2000) suggests gat the shadow economy in OECD states might be in the band 14 to 15% of GDP. The Revenue has acknowledged this in their own internal (but now published) memos on this issue[xv]. Other literature in academic journals confirms that this might be the lower end of the expected range, but that the UK might also be at that lower end[1]. However, what this confirms is that an estimate that the shadow economy might represent 13.7% of all economic activity within the UK is, on the basis of external studies, entirely reasonable. It follows that an estimate of this figure for the purposes of tax evasion is also reasonable.

In that case to assume that the VAT gap ratio applies to direct taxes as well is not only logical, it is the only rational assumption to make. To assume a substantially lower figure – of about 6% as HM Revenue & Customs have done – is outside the plausible expected range of outcomes and is therefore highly unlikely to be a correct figure for tax evasion.

Conclusions

As a result of these findings the following are likely:

1. The total tax gap with regard to unpaid and late paid tax is likely to be at least £28 billion;

[1] Seer for example, this paper which suggested 12.7%. http://www.dur.ac.uk/john.ashworth/EPCS/Papers/Schneider.pdf

2. The tax gap with regard to tax avoidance by individuals is likely to be at least £13 billion;
3. The tax gap with regard to tax avoidance by companies is likely to significantly exceed the HM Revenue & Customs estimate of £3.4 billion but may be less than the TUC estimate of £12 billion, although much more work is required on this issue;
4. The tax gap with regard to tax evasion is likely to be at least £70 billion per annum;
5. The total tax gap at a point in time at present is therefore likely to be £120 billion a year. As predicted in the report written by Tax Research UK for PCS in March 2010.

In other words, it is maintained that the Tax Research UK estimates of the tax gap are substantially more accurate than those of HM Revenue & Customs – as evidenced by recent comments from the Despatch Box by the Chancellor of the Exchequer.

That then leads to the following questions:

1. Why isn't this tax gap being acknowledged by HM Revenue & Customs and Ministers?
2. Why did HMRC so very obviously understate their estimates so significantly?
3. What is now going to be done to ensure accurate estimates of the tax gap are prepared?
4. Given the problems that clearly exist in relying upon HM Revenue & Customs and HM Treasury to estimate the tax gap can we have an Office for Tax Responsibility to ensure that proper tax estimates are prepared and that credible plans to close the tax gap are put in place?
5. When will adequate resources to tackle the tax gap be allocated to HMRC? This would include cancelling the current HM Revenue & Customs office closure programme and reinstating sacked staff whose services are essential if the tax gap is to be closed.
6. Why wasn't closing the tax gap the focus of government attention in its plans to cut the deficit, and given the size of potential revenue available from doing so, how can cuts in public services be justified?

It might, finally, be worth repeating the recommendations made in the PCS report issued in March 2010, since the all remain wholly pertinent in the light of these findings:

Recommendation 1: The basis for estimating tax avoidance should be revised to use a definition widely recognised in society and which correctly reflects areas of continuing policy concern as well as those abuses making use solely of artificial arrangements.

Recommendation 2: HM Revenue & Customs should be required to prepare estimates of evasion of direct taxes on a "top down" basis, as they do for indirect taxes.

Recommendation 3: H M Revenue & Customs should recognise that their existing bottom up methodology for calculating the tax gap for direct taxes will inevitably seriously under-estimate the size of that estimate.

Recommendation 4: HM Revenue & Customs should recommence publication of the many statistics on taxation produced by the former Inland Revenue which have ceased to be available since its demise, the lack of which make objective appraisal of the performance of the tax system hard to achieve.

Recommendation 5: HM Revenue & Customs should engage more staff to tackle tax avoidance and tax evasion.

Recommendation 6: HM Revenue & Customs must on occasion select cases for investigation without consideration of potential tax yield, and make clear that this happens to protect revenues from those on lower levels of earnings.

Recommendation 7: More staff should be engaged to scrutinise tax repayments before they take place.

Recommendation 8: More staff should be engaged to recover tax debt owing, and limits on sums to be pursued for collection should be lowered considerably.

Recommendation 9: The cost of additional staffing to HM Revenue & Customs shall until such time as unemployment falls below 1 million be based on the marginal likely cost to the government as a whole of engaging them.

Recommendation 10: The local office closure programme being pursued by HM Revenue & Customs should not just be stopped, it should be reversed. Tax must be seen to be collected in the community.

It is our firm belief that adopting these policies would highlight the true extent of the UK Tax Gap, provide the data needed to appraise progress in tackling it, and be cost effective methods of achieving that goal.

Appendix 1

HM Revenue & Customs estimate of the Tax Gap published December 2009

Table 1.1: Tax Gaps for HMRC administered taxes – revenue losses 2007-08 (£bn)

		Estimates (£ billion)			
Tax	**Component**[1]	**Point**[2]	**Lower**	**Upper**	**% Tax gap**
Indirect taxes[3]					
Value Added Tax (VAT)		11.5	N/A	N/A	12%
Spirits duty		0.1	0.0	0.2	5%
Cigarette duty		1.0	0.4	1.6	11%
Hand rolled tobacco duty		0.5	0.4	0.6	53%
Great Britain Diesel duty		0.5	0.0	0.9	4%
Great Britain Petrol duty[4]		0.0	0.0	0.0	0%
Northern Ireland Diesel duty[5]		0.1	0.1	0.2	34%
Northern Ireland Petrol duty[4]		0.0	0.0	0.0	15%
Other (Illustrative indicator)[6]		0.9	N/A	N/A	
Total indirect taxes		15	N/A	N/A	10%
Direct Taxes					
Income tax, National Insurance Contributions (NICS), Capital Gains Tax	Inaccurate self-assessment returns from individuals	7.2	3.3	13.4	
	Non-declaration of unearned[7] income and capital gains by individuals who do not receive returns	0.3	N/A	N/A	
	Hidden economy (income from un-declared employment and self-employment)[8]	2.8	1.3	6.9	
	Inaccurate returns from small and medium sized employers (PAYE)[8,9]	0.4	0.2	0.5	
	Avoidance[10]	1.1	0.8	1.6	
	Non-payment	1.4	1.4	1.4	
	Other (Illustrative indicator)[11]	2.7	N/A	N/A	
	Total Income Tax, NICS, Capital Gains Tax	**15.8**	**N/A**	**N/A**	**6%**
Corporation Tax	Inaccurate returns from Small and Medium sized businesses[12]	3.6	1.2	8.1	
	Avoidance by Very Large businesses[13]	3.1	N/A	N/A	
	Other tax gap for Very Large businesses[13]	0.2	N/A	N/A	
	Avoidance by Large and SME businesses[10,12]	0.3	0.2	0.4	
	Non-payment	0.4	0.4	0.4	
	Other (Illustrative indicator)[14]	1.3	N/A	N/A	
	Total Corporation Tax	**8.9**	**N/A**	**N/A**	**16%**
Cross-tax avoidance	Cross tax and stamp duty land tax avoidance[10]	0.2	0.1	0.3	
Other (Illustrative indicator)[15]		1.6	N/A	N/A	
Total direct taxes		25	N/A	N/A	8%
Total HMRC Tax Gap		**40**	**N/A**	**N/A**	**8%**

Appendix 2

Comments made by David Gauke MP, Financial Secretary to the Treasury, on Wednesday 16 June 2010 as reported in Hansard

http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm100616/halltext/100616h0009.htm

"The hon. Member for Southport mentioned the £120 billion estimate, although he did not necessarily say that he thought it was right. It is mentioned frequently among hon. Members and in the media. That figure was produced by the Tax Justice Network, or Tax Research LLP, which is essentially the same organisation. It is a striking figure, and is often repeated. It is very different from the £40 billion estimated by HMRC. The £120 billion figure has clearly focused attention on the matter, and that is no bad thing, but scepticism about it is widespread; indeed, I expressed some scepticism myself from the Opposition Benches a year or so ago. Given the disparity between the £120 billion and HMRC's numbers, I have asked officials to review it.

It must be accepted that in preparing estimates, organisations external to Government have access to much less data than HMRC. The types of methodology available to them are therefore restricted. It is reasonable to assume that HMRC is clearly in a better position to make an assessment, but there is no reason why outside bodies should not contribute to the debate. However, having considered the methodology used to produce the figure of £120 billion, I must tell the House that even a brief analysis reveals that it is deeply and systematically flawed.

For example, Tax Research LLP estimates total revenue lost due to tax evasion at £70 billion. That figure is obtained by applying the percentage tax gap from VAT to direct taxes. There are two main problems with that. First, different tax regimes have different tax gaps. According to independent research by the OECD, for example, the operational experience shows that tax regimes such as pay-as-you-earn that withhold tax at source have far smaller tax gaps than other types. To apply the VAT gap percentage to taxes collected by PAYE or otherwise at source greatly overstates the tax gap, because the VAT tax gap is considerably higher.

Secondly, an element of double counting is involved, although, to be fair, that might not be apparent from the numbers used by Tax Research. The VAT gap already includes amounts due to tax avoidance and tax debt. Applying that percentage to direct taxes and then adding additional amounts for both avoidance and tax debt, as does Tax Research, results in the double counting of losses from the avoidance of direct taxes and non-payment.

The Tax Research estimate of tax debt is £28 billion. That is a snapshot figure of all tax owed to HMRC on 31 March 2009, which does not represent the actual losses to the Exchequer from non-payment. Almost all tax owed to HMRC is eventually paid, sometimes within days of becoming due. A proportion of debts outstanding are in staged repayment plans, such as those covered by the business payment support service. Only the tax debt written off as uncollectable by HMRC is an actual loss to the Exchequer from debt. That is therefore the amount that HMRC uses in its estimate of the tax gap, which in the 2007-08 tax gap figures was not £28 billion but £3 billion. Of course, we must take steps to reduce that figure further, and I am keen to encourage measures to do so, but we should get the number right.

The final and most significant point concerns tax loss due to tax avoidance, which Tax Research estimates at £25 billion. That estimate includes the use of legitimate reliefs promoted by the Government to encourage certain activities, such as capital allowances to encourage investment and research and development tax credits to encourage innovation. Tax avoidance is generally regarded as the use of legal structures and allowances to reduce tax bills in manners not intended by Parliament when enacting the legislation. It is simply nonsense to categorise as tax avoidance the use of allowances for purposes intended by Parliament.

If I have been unfair in setting out those points, I am sure that Tax Research will correct me, but that appears to be the methodology used. Furthermore, the Tax Research estimate does not provide HMRC with any credit for the significant amount of tax that it recovers by challenging avoidance schemes. The figure of £25 billion therefore seems somewhat wide of the mark.

I thank my hon. Friend the Member for Southport for this debate. This Government take tax avoidance seriously. We must take every possible step to minimise tax avoidance. We cannot afford to let it undermine our efforts to reduce the deficit, and it is not fair that by deliberately creating schemes that avoid tax, some people pay less while the vast majority of the hard-working public pay their fair share. Action against tax avoidance will be a priority, alongside improving the tax law-making process, introducing robust legislation and targeting HMRC counteraction and investigation.”

Appendix 3

Select bibliography, all by Richard Murphy unless noted

Mind the Tax Gap A report showing the amount of tax not paid by major UK corporations and offering explanation as to why this happens. Published 2006 and covering the period 2000 - 2004. Available at http://www.taxjustice.net/cms/upload/pdf/Mind_the_Tax_Gap_-_final_-_15_Jan_2006.pdf

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Tax Justice and Jobs: The business case for investing in staff at HM Revenue & Customs Report for PCS, the union representing the majority of staff at HM Revenue & Customs, including estimates of tax evasion, avoidance and unpaid tax in the UK, published March 2010. Available at http://www.pcs.org.uk/download.cfm?docid=11BBD8A3-BDB1-4319-B1E0A20CA10825E8

The direct tax cost of tax havens to the UK Discussion of the cost of tax havens to the UK. Available at http://www.taxresearch.org.uk/Documents/TaxHavenCostTRLLP.pdf

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1. Draft Paper on 'Developing Methodologies for Measuring Direct Tax Losses' dated March 2008 (PDF 411K) http://www.hmrc.gov.uk/freedom/methodologies.pdf
2. Paper on Measurement of Direct Tax Gaps (PDF 44K) http://www.hmrc.gov.uk/freedom/measurement-diirect-tax-gaps.pdf
3. Submission to Chancellor on 13 February 2008 (PDF 29K) http://www.hmrc.gov.uk/freedom/submission-chancellor130208.pdf
4. Submission to FST on 28 February 2008 (PDF 36K) http://www.hmrc.gov.uk/freedom/submission-fst280208.pdf
5. An official statistical release, Measuring Tax Gaps 2009 (PDF 617K) http://www.hmrc.gov.uk/stats/measuring-tax-gaps.pdf
6. A Pre-Budget Report (PBR) document Protecting Tax Revenues: Protecting Tax Revenues 2009 (PDF 3K) http://www.hmrc.gov.uk/pbr2009/protect-tax-revenue-5450.pdf

Appendix 4

Endnotes

[i] See http://www.financeforthefuture.com/TaxBriefing.pdf

[ii] See bibliography

[iii] See HMRC 6 in bibliography para 7

[iv] See Mind the Tax Gap in Bibliography

[v] See bibliography for details.

[vi] http://www.hmrc.gov.uk/freedom/tax-gap-estimates.htm accessed 26-6-10

[vii] See bibliography

[viii] http://www.hmrc.gov.uk/freedom/update-offshore-tax-gap061106.pdf

[ix] No online reference now available – supplied by HM Revenue & Customs to Tax Research LLP in 2005.

[x] http://www.publications.parliament.uk/pa/cm200910/cmselect/cmpubacc/97/97.pdf

[xi] http://www.hm-treasury.gov.uk/junebudget_speech.htm

[xii] The work is currently being extended to 2009 and will be published in autumn 2010

[xiii] See http://www.hmrc.gov.uk/stats/corporate_tax/11-3-corporation-tax.pdf

[xiv] According to Companies House there were 2,423,000 companies registered during the period. http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2008_2009.pdf

[xv] See bibliography regarding memos published February 2008