The Taxing Wealth Report 2024

Every politician's guide to "How to pay for it"[1]

Reforming tax administration:

Preparing proper tax gap estimates

Brief Summary

This note suggests that:

- The UK should prepare proper estimates of the tax gaps[2] within its tax system.
- Because the UK's HM Revenue & Customs does not prepare comprehensive tax gaps at present a wide variety of tax losses go unreported including:
    - The loss from tax bases, like wealth, that are not taxed;
    - The cost of exemptions, allowances and reliefs within the tax system;
    - The cost of the abuse of those exemptions, allowances and reliefs;
    - The cost of tax avoidance, because HM Revenue & Customs use a very narrow definition for the identification of this abuse.
- It is likely that the UK's tax gap is considerably larger than that reported by HM Revenue & Customs.
- If a broader five-tier gap analysis that included consideration of untaxed tax bases and the cost of tax exemptions, reliefs and allowances was to be undertaken annually:
    - Debate on the UK's tax system would be considerably better informed;
    - HMRC would manage its resources more effectively;
    - Rates of tax abuse might be reduced;
    - Rates of taxpayer compliance might rise;

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[1] This note forms a part of 'The Taxing Wealth Report 2024' published by Finance for the Future LLP, which is UK LLP number OC329502, registered at 33 Kingsley Walk, Ely, Cambridgeshire, CB6 3BZ. See https://www.financeforthefuture.com/taxing-wealth/. This note was written by Richard Murphy FAcSS FCA FAIA (Hon), Professor of Accounting Practice, Sheffield University Management School, who is a director of Finance for the Future LLP.

[2] Tax gaps are the differences between the tax revenues that a jurisdiction should be able to collect and the tax revenues it actually recovers during the course of a period.

- Taxpayer morale would increase over time. • The cost of undertaking this exercise is small compared to the benefits that might be gained. • Because there is no direct relationship between better estimation of the tax gap and enhanced tax yield no estimate of that benefit to be gained is made. • Because many tax gaps are created by measures benefitting the wealthy and those with high incomes this change might have particular impact on them. • This measure is intended to reduce the chance of illicit accumulation of wealth within the UK.

The proposal	To prepare proper estimates of the UK tax gap since those currently available: • fail to take into consideration most tax avoidance activity; • the cost of both unnecessary and inappropriate tax reliefs, and • the failure to tax all available tax bases.
Reason for the proposal	1. To improve the horizontal equity of taxation by ensuring that all taxes that should be in use to produce that desired outcome are in operation and to check that each of them is being managed appropriately so that all tax due is collected, which is a condition of achieving this goal. 2. To increase the prospect of vertical equity of taxation in the UK which is heavily dependent upon the creation of improved horizontal tax equity, which goal is currently undermined by the ineffectiveness of the UK's tax gap estimation that fail at present to indicate the steps required to create both horizontal and vertical tax equity. 3. To reduce the tax spillover[3] effects that are exploited by many of the activities currently not addressed by UK tax gap estimates.

[3] Tax spillovers are the negative consequences of the interactions between different tax systems or different parts of the same tax system that can often (sometimes unintentionally) reduce tax revenues and the size of a tax base.

	4. To reduce the rate of tax avoidance and tax evasion in the UK. 5. To consequently improve the rate of tax compliance in the UK. 6. To raise additional tax revenues.
Estimated tax that might be raised as a result of the recommendation made	The behavioural response to this recommendation cannot be known because there is unlikely to be a direct link between the measurement of tax gaps and changed taxpayer behaviour. The gain comes from: • Better use of HM Revenue & Customs' resources. • Closure of tax gaps. • The creation of improved taxpayer morale as a result of the closure of loopholes resulting in a more level tax playing field, increasing the inclination on the part of taxpayers to be tax compliant[4].
Ease of implementation	Relatively straightforward, although the collection of some data will take time to arrange. The process would be improved if undertaken by an Office for Tax Responsibility (see separate recommendation).
Likely difficulties that might result from implementation	Few, although political accountability for failure to address the resulting tax gap estimates might be embarrassing if not undertaken.
Likely time required to implement the change	This could be a rolling process of change meaning that full implementation could be rolled out over a number of years to some advantage as cumulative lessons learned are acted upon.
Consultation period	Short.

[4] Tax compliance is 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.

required.	

Background

The tax gap has been described as the amount of tax that a jurisdiction does not collect as a consequence of the tax system of that place not being appropriately complied with by those owing tax in that place. As a result, they do not pay tax in accordance with its laws and regulations of that place as they are interpreted by its tax authority[5].

This description does, for example, provide a basis for the estimates of the tax gap prepared on an annual basis by HM Revenue & Customs[6] in the UK. That description does, however, ignore the fact that substantial parts of the potential tax revenues owed in a country are not collected by governments as a result of their decisions not to tax some tax bases (such as wealth), or because of the tax allowances, reliefs and exemptions that they

[5] For a more detailed explanation of this issue see the authors description of the tax gap at https://academic.oup.com/book/39754/chapter/339816709. An alternative academic explanation of some of the issues addressed here is to be found at https://eprints.whiterose.ac.uk/153627/10/modern_monetary_theory_and_the_changing_role_of_tax_in_society.pdf

[6] https://www.gov.uk/government/statistics/measuring-tax-gaps

make available within their tax laws and regulations, many of which in turn provide opportunities for tax arbitrage[7], avoidance[8], abuse[9] and even evasion[10].

If these issues are taken into account the tax gap can be redefined as the difference between the tax revenues that a jurisdiction might be able to collect and the tax revenues it actually recovers during the course of a period. This represents a significantly different approach to this issue from that taken by HM Revenue & Customs. This alternative, preferred, approach noted here produces a considerably more comprehensive analysis of the tax gap than is possible using the methodology adopted by HM Revenue & Customs. Their approach is suited for use by a tax authority of government that thinks that the sole purpose for tax is to raise revenue. The basis of estimation of the tax gap suggested here is

[7] Tax arbitrage refers to the process of selecting the regulation, law or legal system that will be applied to a transaction, or more likely a series of related transactions, with the usual intention of securing a profit, although this might be by way of reduced cost than by increased revenue.

Situations where such choices might be made relate, for example, to the use of differing accounting standards, or with regard to different regulatory environments e.g., by recording transactions in a tax haven or secrecy jurisdiction rather than the location where the transaction might be more obviously located.

A great deal of tax avoidance involves forms of arbitrage and regulatory arbitrage is at the heart of tax spillovers.

[8] Tax avoidance is the term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud). The practice may be summarised as 'seeking to get around the law'.

Tax avoidance usually entails setting up artificial transactions or entities to re-characterise the nature, recipient or timing of payments with the intention of saving tax. Motive is generally considered important in the identification of tax avoidance activity.

Where the entity is located or the transaction routed through another country, it is international avoidance.

Special, complex schemes are often created purely for this purpose. Since avoidance often entails concealment of information and it is hard to prove intention or deliberate deception, the dividing line between avoidance and evasion is often unclear, and depends on the standards of responsibility of the professionals and specialist tax advisers.

An avoidance scheme which is found to be invalid entails repayment of the taxes due plus penalties for lateness.

Some claim that this term refers to any activity that reduces the amount of a person's income subject to tax, for example, claiming of allowances and reliefs clearly provided for in national tax law. This is not the case. If the law provides that no tax is due on a transaction then no tax can have been avoided by undertaking it. This practice is now generally described as tax compliant. Tax avoidance instead refers to the practice of seeking to not pay tax contrary to the spirit of the law. Some also call this aggressive tax avoidance.

[9] Sometimes called aggressive tax avoidance: see the previous footnote.

[10] Tax evasion is the illegal non-payment or under-payment of taxes, usually resulting from the making of a false declaration or no declaration to tax authorities; it entails criminal or civil legal penalties.

more useful to those governments seeking to use tax as a tool for a wide range of fiscal, social and economic policy purposes, as actually happens in practice in the management of a modern economy.

The five-part approach to the tax gap

There are five tax gaps that can be measured using the second approach noted above:

- Tax base gaps.
- Tax spend gaps.
- Tax evasion.
- Tax avoidance.
- Tax known to be owing but not settled i.e. unpaid tax.

The approach used by HM Revenue & Customs only measures the last three of these gaps. That is why it is of limited use.

Tax base gaps represent the cost of tax bases that a jurisdiction decides for its own reasons not to tax. Wealth is a common tax base that is either not taxed or is severely undertaxed, as is noted throughout the report of which this note forms a part, but there are other examples.

Tax spend gaps represent the cost of the exemptions, allowances and reliefs granted within tax bases that are otherwise subject to tax. It is thought that there are more than 1,000 such exemptions, allowances and reliefs in the UK at present. They are likely to have a total value exceeding £400 billion per annum, meaning that their effective management is key to the proper administration of the UK tax system and yet the cost of many of them is unknown, and their usefulness is rarely, if ever, appraised in most cases.

The tax evasion gap is the tax cost of the illegal non-declaration of income that should be taxed by a taxpayer, or the tax cost of their illegal claim for a tax exemption, allowance or relief to which they are not entitled.

The tax avoidance gap is the tax cost arising from a taxpayer arranging their affairs in such a way that they pay less tax as a result of their manipulation of the tax laws of a jurisdiction in a way that the tax authority of that jurisdiction thinks is contrary to the spirit of the laws in place.

The unpaid tax gap is the tax cost of sums known to be owing to the tax authority that is not paid e.g. due to the insolvency of a taxpayer before payment can be collected.

Why existing tax gap estimates made by HM Revenue & Customs are inadequate

Existing tax gap estimates in the UK are prepared by HM Revenue & Customs. They are inadequate because:

1. HMRC does not estimate the UK tax base gap. As such HMRC do not address this key issue within the UK tax system, which is precisely why the under-taxation of wealth is not known about. That is a major omission on their part.

2. HMRC does not either regularly measure or appraise the effectiveness of all tax exemptions, reliefs, and allowances, or their abuse, within its estimate of the tax gap, and as such fails to appraise this key issue within the UK tax system.

   It also fails to note or provide estimates of the considerable cost arising from the abuse of these tax exemptions, beliefs, and allowances, the arbitraging of which represents a significant focus of most tax avoidance activity within the UK, none of which cost is included in the text gap estimates, meaning that those estimates seriously understate the scale of tax abuse in the UK.

3. With the exception of HM Revenue & Customs' estimate of the VAT gap, tax gap estimates prepared by them are undertaken on what is called a 'bottom-up' methodology. When this approach is used the tax returns that are submitted to HMRC are used as the basis for the analysis of the tax gap. There are significant problems with this approach including:

   a. The majority of taxpayers in the UK are not required to submit tax returns, meaning that the sample base for estimation of the tax gap is inherently statistically flawed.
   b. Very large numbers of UK limited liability companies (maybe 50%) either are not required to submit a corporation tax return each year, or do not do so as a matter of fact. Given that large amounts of tax abuse of all forms are likely to be undertaken through limited liability companies, this means that the basis for estimation of tax gaps with regard to the activities of these organisations is likely to be significantly and inherently flawed as a consequence.
   c. Relatively little of the UK tax base is subject to independent verification of data as a consequence of the provision of information from third parties to HMRC. Obvious exceptions to this observation include wages that are subject to PAYE, interest paid by banks and some recent changes to notifications with regard to land transactions. In the absence of this third-party data, the reliance upon self-declaration of taxpayers is not an adequate basis for estimating the tax gap when it is known[11], for example, that more than 40% of self-employed people understate their earnings on their tax returns, and the same ratio is likely in all areas where self-declaration is the basis for assessment of taxation liabilities.

   It follows that if HMRC's tax gap estimates are to be properly appraised as to their reliability then they must be compared to 'top-down' estimates of the tax gap. This was recommended by the IMF[12] in 2013 when they were invited to consider the validity of HMRC's approach.

[11] Based on HMRC tax gap estimates
[12] https://www.imf.org/external/pubs/ft/scr/2013/cr13314.pdf page 46

Top-down estimation of tax gaps uses data based on national income (gross domestic product) statistics to estimate the total value of the tax bases giving rise to taxation liabilities. These estimates are then used to estimate tax owing, which sums are then compared with actual taxes recovered to present an alternative view of tax gaps. Without the adoption of this additional approach, and given the other weaknesses in the data sources already noted, the reliability of current tax gap estimates in the UK has to be considered to be low[13] [14].

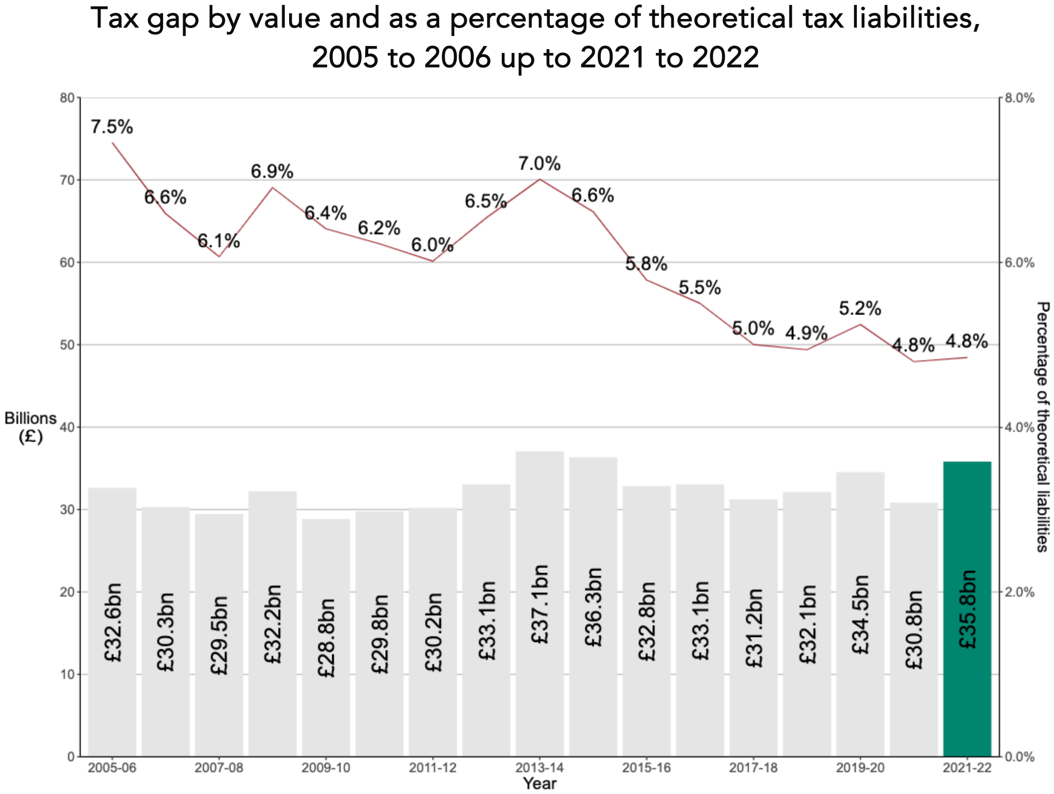
4. Some of the definitions used by HM Revenue & Customs in the preparation of tax gaps need to be revised. In particular, the presumption that tax avoidance is only activity that arises as a consequence of a marketed tax schemes[15] requiring notification to HM Revenue & Customs needs to be dropped when measures to prevent use of such schemes have largely been successful. The resulting apparent decline in tax gaps might appeal to the senior management of HMRC, but it does not reflect the full scale of tax avoidance activity being undertaken in the UK economy, and a much broader definition of tax avoidance needs to be used in tax gap estimation in future, taking care to ensure that there is no overlap with tax spend gap analysis.

5. All the above being noted, it is also appropriate to suggest that the time has come to take estimation of the UK tax out of the hands of HMRC. It is quite inappropriate that the authority responsible for collecting tax is the same agency as that appraising its efficiency in doing so. The unlikely fact that the tax gap has been recorded as an almost consistent number little different from £35 billion per annum over many years suggests that the time has come for a third-party to undertake this work. As noted above, this might in part be because of the failure to update definitions with regard to tax avoidance, which has assisted the declining percentage tax gap whilst the estimated sum lost remains near constant:

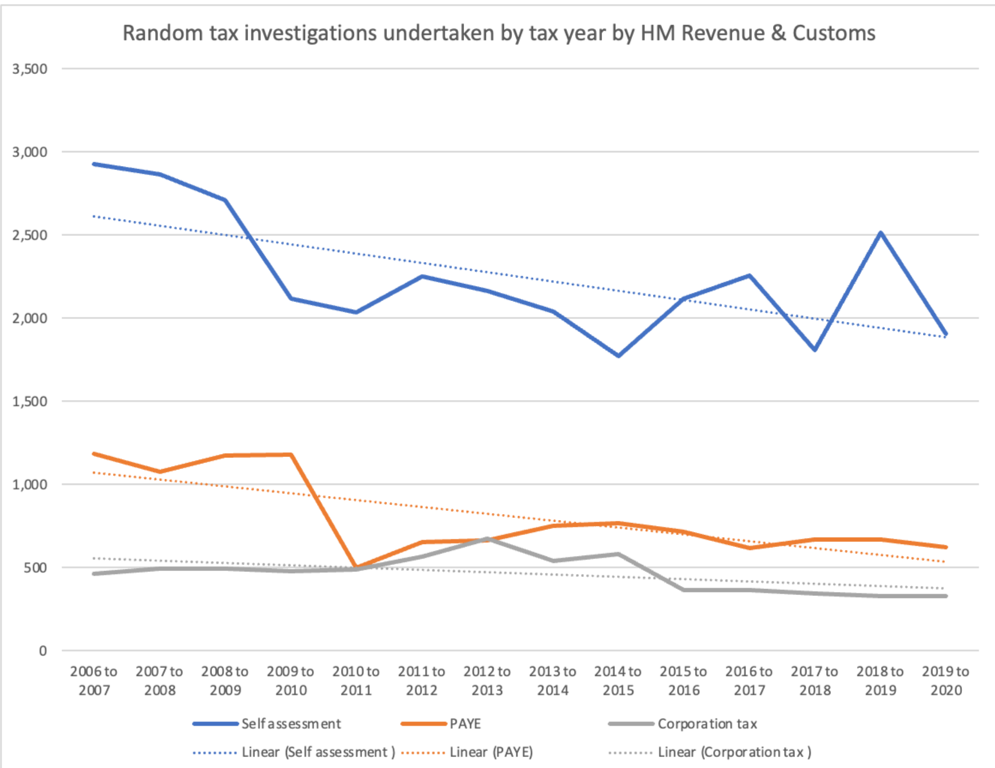
[13] HMRC address this issue but don not adequately justify their approach at https://www.gov.uk/government/statistics/measuring-tax-gaps/methodological-annex

[14] It is notable that HM Revenue & Customs consider that VAT is the only tax gap estimate is the only one they prepare with low uncertainty attached to it, and is also the only significant top down estimate that they prepare. See section B at https://www.gov.uk/government/statistics/measuring-tax-gaps/methodological-annex

[15] See section K at https://www.gov.uk/government/statistics/measuring-tax-gaps/methodological-annex



6. The other issue to note with regard to this is that the effort invested in the tax investigations that underpin tax gap has declined over the years during which this work has been undertaken, as indicated by the number of random investigations per annum undertaken by HMRC in three major areas of tax, which investigations heavily inform the bottom-up tax gap estimates:



Source: author calculations based on data from HMRC[16].

As is apparent, there is a serious downward trend in the number of tax investigations undertaken when the number of taxpayers has remained almost constant over this period (rising by just 1.2 per cent) although the UK population rose by 10.0 pe cent in the same period, which is in itself a cause for tax gap curiosity. The case for restoring the rate of tax investigations would appear to be compelling in that case.

As is suggested in another note that contributes to the Taxing Wealth Report 2024, of which this proposal forms a part, it is considered appropriate that an Office for Tax Responsibility that acts independently of HM Revenue & Customs with the power to audit its activities should now assume responsibility for tax gap calculations to address these concerns.

Addressing these concerns

The concerns noted should be addressed by addressing the various issues noted above to change the basis of estimation of the annual tax gap in the UK.

In future it is suggested that a five-tier tax gap be undertaken for the UK annually.

It is suggested that this work be undertaken by an Office for Tax Responsibility. A separate note on the broader role that this Office for Tax Responsibility might undertake is included in the Taxing Wealth Report 2024.

It is suggested that this Office for Tax Responsibility (ideally, but in its absence, HM Revenue & Customs) should complement the annual tax gap report with a annual tax spillover assessment that appraises tax risk within the UK tax system so that a systematic approach to its elimination can be adopted. This matter is referred to in more detail in another note that will form part of the Taxing Wealth Report 2024.

The suggested benefits that would arise are:

1. That there would be a better understanding of the UK tax system as a consequence of the availability of a five-tier tax gap appraisal.

2. That tax decision-making would be improved in quality.

3. The resources of HM Revenue & Customs would be better directed towards those areas in greatest need of attention if tax compliance is to be achieved.

4. As a consequence, tax revenues should improve.

5. It is likely that tax morale amongst tax compliant taxpayers would improve,

[16] https://www.gov.uk/government/statistics/measuring-tax-gaps/methodological-annex section H.

increasing tax yield.

6. With better informed tax decision making it is likely that both horizontal and vertical tax equity within the tax system will be enhanced.

Being realistic, this is a process that would take place over time, but given the relatively small investment required to improve the quality of UK tax gap estimates the rate of return on investment might be very high.