



National Audit Office

HM REVENUE & CUSTOMS

Tackling the hidden economy

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Tackling the hidden economy

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SUMMARY

1 The hidden economy is usually taken to mean any undeclared economic activity. Definitions vary, but it can range from casual moonlighting, work paid cash in hand, fraudulently claiming welfare benefits, through to tax evasion and organised crime. We reported in January 2008 on the Department for Work and Pensions' progress in tackling benefit fraud. This report focuses on HM Revenue & Customs' (the Department) work in tackling the hidden economy, covering four groups:

- businesses that should be registered to pay tax, such as VAT, but are not;
- people who work in the hidden economy and pay no tax at all on their earnings (ghosts);
- people who pay tax on some earnings but fail to declare other additional sources of income (moonlighters); and,
- employers who may facilitate ghosts and moonlighters, and also evade employers' National Insurance contributions.

It excludes the Department's work in relation to under declarations of income by registered taxpayers as these risks are dealt with by the Department's mainstream compliance teams. We use the term "hidden economy" to refer to the above four groups throughout this report.

- 2 The report examines:
- the Department's approach to tackling the hidden economy (Part 1);
 - how the Department encourages people and businesses into the formal economy (Part 2);
 - how the Department detects people and businesses in the hidden economy (Part 3);
 - the sanctions the Department imposes (Part 4); and
 - how the Department manages the risks to tax from the hidden economy (Part 5).
- 3 Appendix 1 provides details of our methodology.

The risks from the hidden economy

4 In common with other tax authorities, HM Revenue & Customs has sought to estimate the amount of tax lost from the hidden economy, but so far no one has been able to produce robust estimates. In 2002 the Department published estimates of VAT losses of between £400 million and £500 million from between 125,000 and 180,000 businesses that should have been VAT registered but were not. Since that time the Department has continued to work on ways of estimating the amount of tax lost. For other taxes, the Department estimated in 2005 that using certain assumptions there were some two million ghosts and moonlighters with losses of at least £1.5 billion. The Department is using new computer software to help assess the risks from the hidden economy by comparing tax records with a number of external data sources. It expects regular comparisons between these records to provide it with better information on the extent of the hidden economy and trends within it. In 2008 the European Commission intends to undertake a study to identify the best methodology for providing comparable estimates of the amount of undeclared work across the EU.

5 The Department currently assesses the risks from the hidden economy by drawing on various sources of information including the experience of its hidden economy teams, assessing whether the risks identified by other tax authorities could also apply to the UK, making greater use of data matching techniques, considering whether information from academic research provides insights into the sectors it could tackle and reports by the public to its hotline of those suspected of operating in the hidden economy. For example the Department's experience shows that self-employed people are the most likely group to be operating in the hidden economy, especially where cash is commonly used for payment. The results of the hotline also show new risks to tax revenue emerging from those trading on the internet and from buy-to-let landlords failing to declare their income and capital gains.

Encouraging people and businesses into the formal economy

6 The Department achieved an overall return of around 4.5:1 on the £41 million a year it spent on all of its hidden economy work in 2006-07. As part of the Department's wider tax compliance approach, it has been developing specific risk-led campaigns using new targeted ways of encouraging people into the formal economy. These campaigns have led to much higher returns which provide lessons for the future. Advertising campaigns have resulted in some 8,300 additional people registering to pay tax who may otherwise have joined or remained in the hidden economy. The Department estimates that they will pay tax of around £38 million over three years providing a return of 19:1 on the expenditure of £2 million. Building on this success, the Department could make more use of advertising to inform people of the benefits of working in the formal economy and make clearer what is likely to happen to them if they come forward voluntarily. Some are concerned whether they can afford to pay the tax owed not realising that the Department will allow time to pay. The European Commission has identified opportunities for Member States to make more use of advertising campaigns to highlight to the public the risks of employing people in the hidden economy. In Canada, the tax authority has run a national advertising campaign to inform the public of the risks in dealing with home repair contractors operating in the hidden economy and the Department has undertaken some similar campaigns.

7 The Department has successfully used voluntary disclosure arrangements to encourage people to declare tax owed. In 2006 and 2007 the Department won landmark rulings against a variety of major financial institutions that required them to disclose the details of offshore bank accounts held by UK residents. As a result the Department received details of around 400,000 bank accounts from which it estimated that up to 100,000 people should have included income and/or the resulting interest from those accounts on their tax returns but had not. It recently introduced the Offshore Disclosure arrangements to encourage these people to come forward voluntarily, disclose and pay all tax owed. By the 22 June 2007 closing date of the scheme, the Department had received 64,000 notifications and around 45,000 people came forward to disclose under the arrangements bringing in around £400 million at a cost of £6 million or a return of 67:1.

Detection and sanctions

8 Since 2003-04 the number of cases detected by the Department's hidden economy teams each year has fluctuated between a high of 32,700¹ and a low of 28,300 in 2006-07. The number of cases was 12 per cent lower in 2006-07 than in 2003-04, mainly because the Department's teams appear to have concentrated on identifying and targeting higher value cases. Over the four year period to 2006-07, the amount of tax detected has increased by 13 per cent in real terms to £145 million. To increase detections, the Department set up the Tax Evasion hotline in 2005 to allow members of the public to report suspicions of tax evasion. It received over 100,000 calls in the first year but progress on investigating these cases has been slower than expected with around 2,000 investigations completed in 2006-07 compared with 5,500 planned. The total tax assessed in 2006-07 has also been much lower than expected at £2.6 million compared to original estimates of £32.5 million. The Department's original assumptions have proved to be incorrect with additional effort needed to handle three times more calls than expected and evaluate the information received. More of the information than expected has been of insufficient quality to help with detecting someone working in the hidden economy. To deal with cases more quickly, the Department is now using automated methods to compare the information received with tax records and other external data sources as a way of determining whether tax may be owed.

9 The Department has also been making more use of data matching techniques to detect people in the hidden economy. In a pilot project, the Department used specialist computer software to analyse various internal and external information sources which initially identified over 300,000 potential cases. The Department is testing the accuracy of the information and refining its approach, and plans to conduct further work in 2008-09 on up to 20,000 cases, with a potential value of £26 million in additional yield. This work is experimental and is at an early stage of development. The lessons from this work will help the Department identify cases with more certainty in the future. There may be other opportunities to data match tax records against other large external data sources holding information for example on landlords and the self-employed in the home repair and maintenance sector.

10 Where people are detected in the hidden economy, the Department can impose a civil penalty of up to 100 per cent of the tax owed but in most cases it is much lower. It is examining whether to impose the

maximum penalties in more serious cases. The number of hidden economy cases prosecuted increased to around 70 cases in 2006-07, which cost on average £30,000, exceeding the average amount of tax detected at £11,260. The Department did not receive much publicity on these cases thereby reducing their wider deterrent effect. It closed 284 cases in 2006-07 because there was either insufficient evidence to refer the case for prosecution, little tax at risk or further investigation of the case would not be in the public interest. Overall the turnover in completing cases appears to be slowing down. The Department completed investigations on 353 cases during 2006-07. The number of new cases opened during the year (290) was less than this level, while 335 cases were carried forward to 2007-08.

Conclusions and recommendations

11 In the absence of robust estimates of the size of the hidden economy, it is difficult to assess the overall effect of the Department's activities on reducing the amount of tax being lost. Nevertheless it has made improvements in response to previous reports by the NAO and the Committee of Public Accounts and developed its methods. As a result the Department appears to be more effective, having achieved some success with new advertising and disclosure campaigns to encourage people to regularise their tax affairs, and the number of hidden economy cases prosecuted has increased. The Department's work also compares well in many areas with other tax authorities.

12 The Department achieved a return of around 4.5:1 on the £41 million a year it spent on all of its hidden economy work in 2006-07, and this should increase as more recent initiatives achieve their full effect. Nevertheless, the risk of being detected and the consequent penalties for non-compliance are relatively low, and there are opportunities to tackle the hidden economy more effectively. The relatively high returns achieved from the Offshore Disclosure arrangements indicate that the Department should combine more extensive data matching with a programme of targeted advertising campaigns in risk areas such as the home repair, maintenance and improvement sector to encourage people into the formal economy. It could also seek to change public attitudes to help reduce demand for hidden economy work and its social acceptability by building on its previous campaigns that highlighted risks to the public of employing those operating in the hidden economy. There are also opportunities to mount a more effective deterrence, by making fuller use of the penalties available, and securing more publicity for successful prosecutions.

¹ The number of cases detected in 2005-06.

13 Our analysis suggests that the Department has been successful in using new methods to encourage large numbers of people into the formal economy relatively quickly, while still penalising them for their dishonesty. Such methods have enabled the Department to make higher returns than from its civil and criminal investigations. As the Department identifies opportunities to make further use of these new methods it will need to reappraise how it deploys its resources to best effect between this type of work and more formal investigations. In so doing it will need to have regard to maintaining a balanced programme of prevention, detection and deterrence and be mindful of the wider public interest in prosecuting significant dishonest conduct.

14 In this context we recommend that the Department should take the following steps:

- a** In common with other tax authorities the Department does not have robust estimates of the tax lost from the hidden economy. It has been developing its understanding of the risks to tax for different sectors and groups but it should bring the information together in a structured way to produce a firmer estimate of tax lost, identify the areas of highest risk and gaps in coverage where further analysis is needed. A firmer estimate of the tax lost would help the Department judge the scale of the challenge, how it is changing over time and whether it is doing enough to tackle the problem.
- b** The Department has obtained good returns from the Offshore Disclosure arrangements. It should devise similar schemes in other sectors to secure widespread voluntary disclosure. Such schemes would involve obtaining information through data matching or other sources on groups of potentially non-compliant people or businesses and using that information to contact those who should consider taking advantage of the schemes. Sectors where the Department could test this approach are home repair, maintenance and improvement and landlords where the risks of people/businesses operating in the hidden economy are high.
- c** The Department has had some success in using publicity to encourage people into the formal economy. There are opportunities to make more extensive use of publicity to raise awareness of the benefits of joining the formal economy and how to do this, and to change public attitudes about the social acceptability of employing people who work in the hidden economy. The Department should:
- Periodically remind people of their responsibilities to register as self-employed, building on the success of recent campaigns.

- Advertise the advantages of joining the formal economy such as pointing out to those in the hidden economy that it would increase their credibility as business people and open up business opportunities.
 - Advertise more widely the help it provides to people on putting their tax affairs in order including that it will accept payments by instalments.
 - Use publicity to encourage high take-up of further voluntary disclosure schemes.
 - Make more widely known the action it will take where it detects people in the hidden economy. Some people in the hidden economy believe that the Department will seek a prosecution in every case, which discourages them from coming forward.
 - Publicise more widely the outcome of prosecution cases to increase their deterrent effect.
 - Launch further campaigns to change attitudes about employing people in the hidden economy particularly in the home repair and maintenance sector where it could build on its previous campaign.
- d** The Department obtains higher returns from detecting certain types of cases such as businesses not registered for VAT, employer compliance cases and small businesses. It should concentrate more detection work on cases where the overall return is higher.
- e** The Department's hidden economy teams do not always provide feedback on the usefulness of the information provided by other teams within the Department and public sector bodies which refer suspicious cases for further investigation. The Department should provide feedback to help these teams understand the type of information that is useful in detecting cases.
- f** In some of the cases detected by the Department, businesses have kept poor financial records making it difficult to assess the correct amount of tax due. The Department should:
- Send warning letters more routinely to those detected who have not kept adequate financial records, particularly where they present a significant risk to tax.
 - Provide them with information on where they can obtain help, and the penalties they could face. This help could include providing suitable software free of charge.
 - Use planned reviews of the records businesses keep to follow up on cases where it has found businesses have kept poor records in the past.

PART ONE

The Department's approach to tackling the hidden economy

1.1 This part of the report looks at the size and nature of the hidden economy, who is in the hidden economy and HM Revenue & Customs' approach to tackling the hidden economy.

Tax losses from the hidden economy

1.2 The hidden economy is usually taken to mean any undeclared economic activity. It covers tax evasion of all kinds, ranging from casual moonlighting and work paid cash-in-hand through to organised crime. Some of the hidden economy is truly 'hidden'; for example firms that are not registered with any government agency. Much of it though consists of undeclared profits from known businesses. The hidden economy affects everyone. Honest businesses suffer from unfair competition from those in the hidden economy. People working in the hidden economy do not benefit from the protection of employment legislation such as the minimum wage, health and safety standards in the workplace or the working time directive. Customers of people working in the hidden economy do not get guarantees for work carried out or legal recourse for poor quality work. The Government loses out as people and businesses in the hidden economy do not pay tax on their income and may be claiming benefits to which they are not entitled.

1.3 The National Audit Office recently reported on *Progress in tackling benefit fraud* (HC 102, Session 2007-08). This report focuses on HM Revenue & Customs' work in relation to the following four groups:

- businesses that should be registered to pay tax, such as VAT, but are not;
- people who work in the hidden economy and pay no tax on their earnings (ghosts);

- people who pay tax on certain earnings but fail to declare other additional sources of income (moonlighters); and
- employers who may encourage or facilitate ghosts and moonlighters, and also evade employers' National Insurance contributions.

1.4 It excludes the Department's work in relation to under declarations by registered taxpayers on known income sources (e.g. through cash-in-hand work) as these risks are dealt with by the Department's mainstream compliance teams on the various taxes. We use the term "hidden economy" to refer to the above four groups throughout this report.

1.5 In common with other tax authorities HM Revenue & Customs has sought to estimate the amount of tax lost from the hidden economy but, so far, no one has been able to produce robust estimates. In 2002 the Department estimated that it lost between £400 million and £500 million in VAT from between 125,000 and 180,000 businesses that should be VAT registered but were not. Since that time the Department has continued to work on ways of estimating the amount of tax lost. For other taxes, the Department estimated in 2005 that using certain assumptions there were some two million ghosts and moonlighters with losses of at least £1.5 billion.² It emphasises that the estimate is unreliable as it is based on patchy data and is subject to a high margin of error. Paragraphs 5.2 to 5.4 cover the Department's assessment of the risks to tax from the hidden economy and how these compare with other tax authorities.

² For these other taxes the Department estimates that the losses from ghosts and moonlighters range from £1.5 billion to £6.1 billion with a point estimate of £2.5 billion. The Department's estimate is set out in the paper *Estimation of tax gap for direct taxes*, KAI Analysis 8 - Compliance Strategy of 1 April 2005 published with Budget 2008 papers.

Who operates in the hidden economy and why

1.6 A recent survey by the European Commission shows that there is a large market for undeclared work throughout the EU, especially for household services.³ Across 27 EU countries the Commission found that around 5 per cent of people had undertaken undeclared work in the last year. The results for each country ranged from 1 per cent to 18 per cent. The UK was below the average. The Commission recognises that the method used tends to under-report the extent of undeclared work. The results also show that undeclared work is mostly undertaken by young people who are unemployed or self-employed. Professional people with above average incomes are more likely than others to purchase goods and services from the hidden economy.⁴ Other research shows that most people are likely to have some involvement with the hidden economy at some stage by employing someone in the hidden economy to undertake work, such as gardening or home maintenance. More than one half of the people surveyed by the Commission stated that they would have purchased services from the formal economy if they had not had the opportunity to employ someone working in the hidden economy.

1.7 In 2003 the Department interviewed 100 people who worked in the hidden economy to understand the reasons why they did so and what would change their attitudes. In 2007 our consultants interviewed 30 people who had, or are working in the hidden economy and reviewed international experiences.⁵ The results of this work show that people often seek to justify working illegally in the hidden economy on the grounds that they:

- use their income from the hidden economy to pay for essentials such as mortgage payments, food, gas and electricity. Others have lost their job or been made redundant and are working in the hidden economy for a short while until they find permanent employment. These people mostly work in the hidden economy for friends or former colleagues.
- moonlight to try out another job before deciding whether to take this up as their main source of income. This is because they do not know whether they have the skills or contacts to make a success of their new line of business or they need to confirm

that there is a large enough market for their goods or services. Some however consider their work in the hidden economy as more of a hobby and their earnings too small to be of interest to the Department.

- do not feel a strong obligation to pay taxes because they do not understand or are opposed to what their taxes are used for. *“You’re taxed on everything aren’t you? You’re taxed on your wages, your beer, clothes, everything. I ain’t got a clue what they do with the money... If you’re a taxpayer they really should let you know what your taxes go towards, and you hear all this, you hear bits and whatever, but there’s a lot of things I don’t know, I’d like to know.”*
- know that they should pay tax on their income but are distracted by personal issues. For example some people are busy making arrangements for their divorce and obtaining access rights to their children.
- believe they have not been treated fairly by Government, especially in comparison to others. Some compare how they are treated with migrant workers in their community who may have been provided with social housing. In their view by working in the hidden economy they are claiming back a share of what the Government has given to others.
- consider that the tax system does not incentivise them enough to work in the formal economy. They tend to be in low paid work and rely on overtime to supplement their income.
- believe that in certain sectors such as construction and buy-to-let many people operate in the hidden economy. They know of others who do not declare their income to the Department and realise that these people have never been detected. This gives them the confidence to also operate in the hidden economy as they want to earn a similar income. *“I think maybe I was in the type of industry that always does that anyway. But I was thinking that if everybody else does it, why don’t you do it? And I was seeing that everybody was doing it, and if I didn’t do it I’d be the only one left out.”*
- believe that those in a position of power are abusing their position. They see no reason why they should not work in the hidden economy.

³ See COM (2007) 628 final, Section C.

⁴ *Undeclared Work in the European Union: Special Eurobarometer 284 Wave 67.3* – October 2007. The survey involved interviews with 26,755 EU citizens aged 15 and over living in 27 EU Member States.

⁵ Ipsos MORI carried out 30 in-depth interviews with people working in, or who have previously worked in, the hidden economy. RAND Europe compared tax authorities’ approaches to tackling the hidden economy (Appendix 2).

The Department's approach to tackling the hidden economy

1.8 The Department has around 1,270 staff tackling the hidden economy at a direct cost of some £41 million a year (Appendix 3). Its objective is to improve the extent to which people and businesses pay the amount of tax due by:

- providing education and help to make it as easy as possible for taxpayers to comply.
- helping people and businesses who are in the hidden economy to move into the formal economy and supporting their continued compliance.
- detecting people and businesses in the hidden economy, and imposing sanctions by recovering arrears of tax, interest and penalties and referring for prosecution the most serious cases.
- changing public attitudes so that people do not purchase goods and services from those in the hidden economy.

1.9 As part of the Department's strategic approach to increase people and businesses compliance with their tax obligations, it is developing better ways of identifying those who are non compliant and the type of response needed to change their behaviour such as by using campaigns to target specific segments of the population. For the hidden economy, this has included a focus on people holding offshore accounts who do not pay tax on the interest; businesses involved in e-commerce activities⁶; landlords who do not declare rental income or capital gains, and sectors as diverse as barristers and fishermen who have not registered for tax.

1.10 Responsibilities for tackling the hidden economy extend beyond the Department. It chairs the Interdepartmental Informal Economy Steering Group which seeks to share information, carry out research, discuss issues of common interest and encourage joint working between departments. The members include the Department for Work and Pensions, DEFRA, the Department for Business, Enterprise and Regulatory Reform, the Home Office, HM Treasury and the Gangmasters Licensing Authority (Appendix 3). The Department also works closely with teams from the Department for Work and Pensions to share information, intelligence and carry out joint investigations.

1.11 Through the Intra-European Organisation of Tax Administration, the Department has been proactive by becoming involved with workshops on sharing best practices on tackling the hidden economy. We have also compared the Department's approach to tackling the hidden economy with tax authorities in the United States, Canada, Sweden, Belgium and Australia.⁷ This shows that overall the UK compares well in many areas. A summary of the results from the comparison is at Appendix 2. The findings show that across tax authorities there is no common definition of the hidden economy. Some include within their definition all forms of income that is undeclared while others include only cash transactions that are undeclared. Tax authorities also use different terms such as "underground", "grey", "black", "shadow" and "cash" to describe income that is undeclared for tax purposes. We found that tax authorities have identified similar high risk sectors to the UK, mainly sectors of the economy where cash is commonly used (see Part 5).

⁶ Our report on *VAT on e-commerce* (HC 1051, Session 2005-2006) examined how the Department tackles the failure of e-commerce businesses to register for VAT where we found that the main risk lies with businesses trading solely on the internet and e-marketplace traders (where a number of traders offer goods and services on a website at a fixed price and/or by inviting bids) rather than businesses which have introduced online operations alongside their existing business.

⁷ See *Comparing Tax Authorities Approaches to Tackling the Hidden Economy* by RAND Europe. A copy of the report is on our website www.nao.org.uk.

PART TWO

Encouraging people and businesses into the formal economy

2.1 This part of the report looks at how the Department developed a series of initiatives and campaigns to encourage people and businesses into the formal economy. It examines the help it provides to new taxpayers and its various schemes to secure voluntary disclosure and payment of tax arrears.

The help the Department provides to new taxpayers

2.2 The Department aims to make it as easy as possible for taxpayers to comply by providing: simple processes for registering; accessible and easy to understand guidance; and forms that are straightforward to complete. It provides a wide range of help for all taxpayers through its website, in printed guidance, by telephone and face to face, at a cost of around £90 million a year.⁸

2.3 Our report on *Helping newly registered businesses meet their tax obligations*⁹ found that the proportion of new businesses filing their returns on time is generally lower than for the business population as a whole. We concluded that the Department could reduce the burdens on businesses by unifying the common elements of registering for different taxes and by expanding the facility to register online, and that the Department needs a better understanding of the type of help that improves compliance and its cost effectiveness. In response the Department undertook to streamline the registration process for businesses and expected the registration burden for businesses to reduce over the next few years. The Department has subsequently made it easier for businesses to register by using a single form to register for income tax and National Insurance contributions with space to indicate whether they will also be an employer or need to register for VAT.

2.4 Our report on *Helping individuals understand and complete their tax forms*¹⁰ found that the Department could make it easier for taxpayers to find the forms and guidance they need, by better advertising of website and telephone contact details on forms and improving navigation of the website. The Department intends to improve its website to make it more accessible and easier to navigate.

2.5 Some of those in the hidden economy interviewed by our consultants¹¹ do not view the Department positively and would not approach them for help. They think the Department should build better links with community-based organisations who could provide information on tax matters to local businesses. These people thought that community-based organisations were more approachable and could do more to encourage taxpayers to obtain information about their tax obligations. The Department is currently working with community-based organisations to improve the guidance available and on other projects at a cost of £2 million a year over the next three years.

2.6 Some of those in the hidden economy are concerned about their ability to keep adequate financial records to calculate the tax owed. The Department provides written guidance and training on the records businesses need to keep for tax purposes. The Australian Taxation Office has gone a step further by providing free record keeping software, a record keeping assessment computer tool to help small businesses understand the business records they need to keep and evaluate how well the business is doing, and fact sheets for specific sectors on basic record keeping requirements.

8 *HM Revenue & Customs: Helping individuals understand and complete their tax forms*, HC 452, Session 2006-2007 paragraphs 1.3 and 1.4.

9 *HM Revenue & Customs: Helping newly registered businesses meet their tax obligations*, HC 98, Session 2006-2007.

10 *HM Revenue & Customs: Helping individuals understand and complete their tax forms*, HC 452, Session 2006-2007.

11 Ipsos MORI carried out 30 in-depth interviews with people working in or who have previously worked in the hidden economy.

Advertising campaigns

2.7 The Department recently ran a series of advertising campaigns at a cost of £2 million specifically to raise awareness amongst the self-employed to register for tax through the helpline for the Newly Self-Employed – **0845 915 4515**. It ran three advertising campaigns during the period June 2005 to March 2007. One of the main messages was “It is a simple process to register and we are there to help, ring our helpline”. The advertising campaigns focused on particular groups who may have failed to register for tax such as e-traders and landlords.

2.8 The initial campaign costing £1.5 million resulted in:

- An estimated additional 5,000 people calling the helpline to register. These are people who may have otherwise joined or remained in the hidden economy. The Department estimates that it will collect £23 million in tax over three years from these people based on typical late registration cases.
- A further 3,300 people called the helpline to request the *Thinking of working for yourself?* guide and if these people register the Department would collect an estimated £15 million in tax over three years.

The Department ran two small follow up campaigns but these did not result in a significant increase in registrations of self-employed people who might normally consider working in the hidden economy.

2.9 Our consultants’ interviews¹² with those in the hidden economy indicate that they would consider moving into the formal economy if they knew more about the advantages of doing so. In their view the Department should advertise the benefits to them from complying, such as increasing their credibility as business people and opening up business opportunities for them. They also thought that when drawing people’s attention to their tax obligations the Department could also point out that they could be eligible for welfare benefits or gain other financial advantages. Some thought that more people would be encouraged to work in the formal economy if the Government emphasised that it is there to help and support them. The European Commission has identified opportunities for Member States to make more use of advertising campaigns to inform citizens about the benefits of paying taxes and making social security contributions and to highlight the risks of employing people in the hidden economy.

“I think they should lose this image of the tax man’s out to get youthat’s what I would suggest, and be more communicative ... every year I get my tax assessment, and it’s just a form to fill in ... There’s nothing there saying well if you did this, this might give you an opportunity to save thisit’s a bit of an incentive.”

2.10 Research by the Australian Taxation Office in 2004 found that many people were tolerant of the hidden economy. The general public were more concerned with a minority who “abused the system to the detriment of society in general” such as those who were also wrongly claiming welfare benefits. The Australian Taxation Office has been working to change public attitudes by informing them of the consequences of purchasing goods and services from the hidden economy. The results of a survey by the Australian Taxation Office in 2007 showed that nearly three quarters of Australians thought that it is unfair to use cash to evade taxes. In 2007 HM Revenue & Customs adopted a similar approach highlighting the risks of employing people in the hidden economy. The Swedish tax authority carries out regular surveys of the general public to assess their attitudes to tax fraud and the hidden economy. It found that young people often did not consider taxes important and the tax authorities used advertising campaigns to show what would happen if nobody paid their taxes. The Danish tax authority has used similar campaigns that have helped to change attitudes among young people.

Voluntary disclosure arrangements

2.11 Where a self-employed person realises that they should have registered for tax but have not they can approach the Department to register late but they incur a penalty of £100. The Department also expects them to pay any tax owed. In 2006-07 some 5,200 self-employed people came forward voluntarily to register late for tax, incurring a penalty and resulting in payments totalling £16 million. The Department has also worked on four schemes to encourage people and businesses in the hidden economy to disclose their income and join the formal economy. These are:

- the Tax and Benefits Confidential helpline (an ongoing scheme);
- the VAT short term incentive scheme (scheme closed);
- the Offshore Disclosure arrangements (scheme closed); and
- the Hartlepool project, where the Department worked with a number of other organisations (scheme closed).

¹² Ipsos MORI carried out 30 in-depth interviews with people working in or who have previously worked in the hidden economy.

The Tax and Benefits Confidential helpline

2.12 In June 2000 the Department set up the Tax and Benefits Confidential helpline to provide callers with confidential information about their tax obligations, benefit entitlements and details of the payments needed to put their tax affairs and benefits in order. Operators have discretion to waive up to £2,000 in tax and National Insurance contributions owing. The helpline – **0845 608 6000** – is open 8:30am to 5:30pm Monday to Friday. Contact details are not included in BT telephone directories. Details of the helpline are on the Department's website – www.hmrc.gov.uk/taxbenconf/index.htm and include clear instructions about what people need to do. The Department believes that the confidential helpline role has largely been superseded by its Newly Self-Employed helpline (paragraph 2.7 above) and by a helpline for welfare benefits set up by the Department for Work and Pensions in November 2007. Although the Tax and Benefits Confidential helpline took 43,000 calls in 2006-07, the majority of these calls were for general information already available from other helplines. Only 65 taxpayers registered using the scheme in 2006-07. The Department is reviewing whether the Tax and Benefits Confidential helpline should continue.

Key features of the scheme are that the Department will help the caller with:

- registering for tax.
- understanding their responsibilities for paying National Insurance contributions.
- working out how much tax and National Insurance contributions they owe.
- working out their entitlement to Working Family Tax Credits or other benefits.
- determining whether they have been claiming benefits to which they are not entitled and how to contact the Department for Works and Pensions.

Where the caller wants to regularise their tax affairs the Department sends them a letter setting out their circumstances and the tax and National Insurance contributions they need to pay. The letter will tell them to contact their local tax office. So long as the caller has provided all relevant information the local tax office will not change the tax position set out in the letter.

The VAT short term incentive scheme

2.13 From April to September 2003, the Department ran a short term one-off incentive scheme for businesses that should have registered for VAT but had not. The Department forecasted that 6,300 businesses would take advantage of the scheme and raise £11 million in additional VAT and interest. Penalties would be waived as

long as the businesses continued to comply for 12 months. The scheme cost the Department £500,000 in advertising costs and an estimated £2.7 million in penalties foregone from businesses which would have registered late voluntarily. When the scheme closed the Department had received just under 3,000 registrations which raised £11.4 million in tax and interest or an average of £3,800 per case. Around 55 per cent of those businesses that took advantage of the scheme subsequently failed to submit a VAT return on time causing the Department to impose £2.5 million in penalties. The Department has not monitored the continued compliance of these businesses. The scheme provided the Department with useful lessons on the features that could be incorporated in future disclosure schemes such as establishing the principle that all arrears of tax and interest should be repaid.

Key features of the scheme were:

- The Department would not impose a late registration penalty on businesses that came forward as long as they filed VAT returns and paid over the VAT due on time for 12 months;
- Businesses would work with the Department to establish the correct amount of VAT owed; and
- Businesses would pay all arrears in full including interest.

The Offshore Disclosure arrangements

2.14 A key plank of the Department's compliance approach is to develop responses to the threats it has identified to tax revenue by using data from various sources. The recent Offshore Disclosure arrangements are a good example of how the Department is using this approach in practice. It is legal for UK taxpayers to hold funds in offshore accounts, but where they are domiciled in the UK they should declare interest earned on those funds for tax purposes. The Committee of Public Accounts in their report on *Tackling Fraud Against the Inland Revenue* (1st report, Session 2003-04) noted that the Department faced a growing threat from fraud involving offshore accounts. It recommended that the Department should work with the banking and credit card industry and professional representative bodies to ensure the reporting requirements of suspicious transactions under the Money Laundering Regulations were fully understood and acted upon. It also recommended that if difficulties remained the Department would need other ways to obtain the information it requires, such as a statutory duty for financial institutions to disclose the identify of offshore account holders. The Department accepted that further measures might be needed.

2.15 Following landmark rulings against a variety of major financial institutions, the Department obtained details of around 400,000 UK resident offshore bank accounts. The Department estimated that up to 100,000 people should have included income and/or the resulting interest from these accounts on their tax returns but had not. In April 2007 the Department introduced the Offshore Disclosure arrangements to encourage these people to come forward voluntarily, disclose and pay their outstanding tax. People have always been able to make a disclosure to the Department but the Offshore Disclosure arrangements drew attention to an area where the Department had particular concerns.

Key features of the arrangements were that:

- It was open to those who held an offshore account linked to a loss of UK tax and/or duties. Disclosures that did not involve an offshore account that were made to a HMRC office under the same terms also received the same treatment.
- The taxpayer needed to notify the Department by 22 June 2007 of their intention to make a disclosure under the arrangements.
- The disclosure must include all UK tax owed – not just the tax owed on the offshore account.
- The Department would impose a set penalty of 10 per cent on the tax arrears. There would be no penalty where the undeclared income/gains were less than £2,500. The Department would seek a minimum penalty of 30 per cent and up to 100 per cent of the tax owed for those with unpaid tax who did not take advantage of the arrangements.
- The taxpayer must disclose and pay the tax, interest and penalties by 26 November 2007.
- The Department will inform the taxpayer whether their disclosure has been accepted by 30 April 2008 at the latest.
- The Department has reserved the right to consider cases for criminal investigation.

2.16 The Department included details of the arrangements on its website. The arrangements focused on those offshore account holders on whom the Department had obtained information, with the banks and the Department writing to inform them about the disclosure scheme. By the 22 June closing date, the Department received 64,000 notifications. Around 45,000 people came forward to disclose under the arrangements bringing in around £400 million at a cost of £6 million to the Department: a return:cost ratio of 67:1. The arrangements represent a new and less resource intensive way of working for the Department, which seeks to change the

behaviour of large groups of taxpayers. The Department is already contacting those people who it believes may owe tax but who chose not to come forward. It could seek to impose penalties of up to 100 per cent of the tax owed in these cases. In the most serious cases, the Department intends to refer the evidence to the Revenue and Customs Prosecutions Office for a decision to be made whether to prosecute those people. The Department is currently in discussion with the wider banking industry to obtain further offshore account information, where appropriate. This information should give rise to further significant additional tax yield.

2.17 The Belgian tax authority ran a similar scheme in 2004 raising £340 million in additional tax. The tax authority limited the penalties to six per cent for those who transferred their deposits back to Belgium for three years and nine per cent in other cases. The tax authority ran another scheme in 2005 but with higher penalties. It expected to raise £276 million in additional tax but only raised £48 million. The Australian Taxation Office has recently run a similar scheme modelled on the UK's experience.

The Hartlepool project

2.18 From April 2005 to March 2006 a number of public sector organisations including HM Revenue & Customs, One NorthEast (the local regional development agency), Business Link, the Department for Work and Pensions and Hartlepool Borough Council worked together on a pilot project “to promote enterprise creation by targeting individuals who are currently operating in the hidden economy and encouraging them to legitimise and then develop their businesses”. The project planned to provide, through intermediaries, confidential advice to people on the help that was available to them and on the amount of tax they owe. Only one person asked for help in assessing how much tax they owed but decided not to make a disclosure to HM Revenue & Customs.

Key features of the scheme were:

- An intermediary gathered information from the person on the basis of questions provided by the participating organisations including HM Revenue & Customs and the Department for Work and Pensions.
- The information was then submitted to the departments without revealing the person's identity.
- The offer to the applicant included details on their entitlement to benefits and tax credits. It also included the amount of tax owed and the payment options available.

2.19 The evaluation of the project found that:

- The main success was bringing the various agencies together working to common objectives. A one stop shop made the support available to businesses easier to understand.
- The availability of a confidential assessment for businesses in the hidden economy was largely unknown within the Hartlepool area because it was not advertised.
- It was designed to tackle an area of significant non-compliance;
- The Department had a list of those suspected of not paying their tax. It contacted these people setting out its suspicions and drawing their attention to the disclosure scheme; and
- The penalty was fixed at a lower level than would normally be the case to encourage people to take advantage of the scheme. This was backed up by public statements saying that those who did not come forward would be investigated and heavily penalised if the Department found they owed tax on their offshore account.

The returns and costs of the various schemes

2.20 Our analysis of the returns and costs of the various schemes shows that the Department has made the highest returns from the Offshore Disclosure arrangements (Figure 1). The lessons from this scheme which could be applied more widely are that:

The potential returns from disclosure schemes in other areas of non-compliance will vary according to the tax at risk in individual cases, and people's ability and motivation to pay any tax owed.

1 Return:cost ratios of the various schemes

Scheme	Number using the scheme	Cost to the Department ¹ £ million	Average cost of each case £	Estimated additional tax raised £ million	Return:cost £
Offshore Disclosure arrangements	64,000	6.0	94	400	67:1
Advertising campaign	8,300	2.0	240	38 ²	19:1
VAT short term incentive scheme	3,000	0.5	166	11.4	23:1
Tax and Benefits Confidential helpline ³	65	0.2	2,700	Not Available	Not Available

The Hartlepool project incurred little expenditure by the Department and did not result in any additional tax.

Source: National Audit Office analysis of HMRC data

NOTES

- 1 Includes salary-related costs of staff and other direct costs associated with the scheme over the life of the schemes. No estimate of processing costs is included.
- 2 The yield includes tax from the first return and additional tax over the two subsequent tax years.
- 3 2006-07 data. The Tax and Benefits Confidential helpline dealt with 43,000 calls.

PART THREE

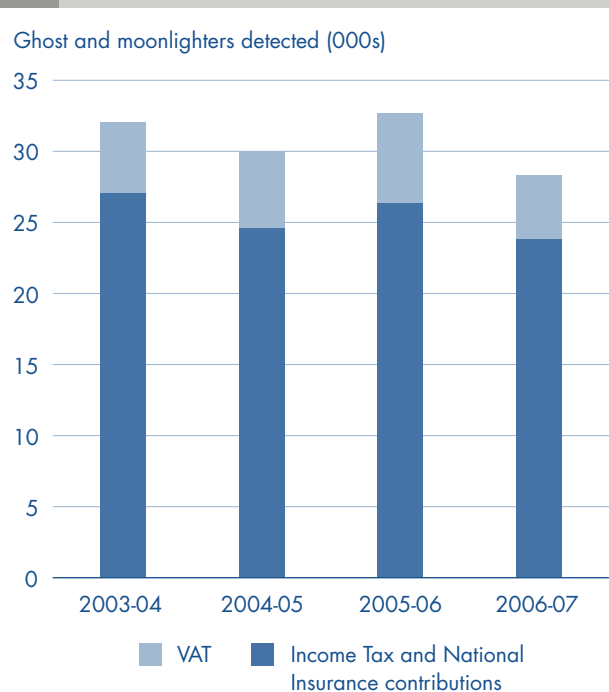
Detecting people and businesses in the hidden economy

3.1 This part of the report looks at the Department's performance in detecting hidden economy cases and the methods it uses. Most cases are investigated within specialist hidden economy teams, but teams that undertake other types of tax enquiry work may also uncover hidden economy cases.

The Department's performance in detecting cases

3.2 The Department uses a variety of methods and techniques to identify potential non-compliance and determine which cases to pursue. Detected cases are those selected by the Department for further action. Since 2003-04 the number of cases detected each year¹³ by the Department's hidden economy teams has fluctuated between a high of 32,700 and a low of 28,300. The number of cases was 12 per cent lower in 2006-07 than in 2003-04 (**Figure 2**). This reduction was partly because the teams appear to have concentrated on identifying and targeting higher value cases. It spent £22.0 million¹⁴ in 2006-07, or £770 on average in detecting and following up each case. In addition to the cases detected by the hidden economy teams, the Department estimates that other teams investigated around 7,800 hidden economy cases in 2006-07. Data for earlier years is not available.

2 Trend in the number of cases detected 2003-04 to 2006-07



Source: National Audit Office analysis of HMRC data

NOTES

1 The data only include cases detected by the Department's hidden economy teams. Hidden economy cases detected by other teams such as employer compliance teams and sector specialist teams are not included.

2 The data includes cases where a tax return has been received. It excludes cases where self-employed people have registered late voluntarily but have been referred to the teams.

13 A detected case is where the Department has identified people or businesses that are not registered for tax and have subsequently filed a tax return following action by the Department. A business may be counted as detected separately under Income Tax and VAT.

14 Costs include salary-related costs and other direct costs only.

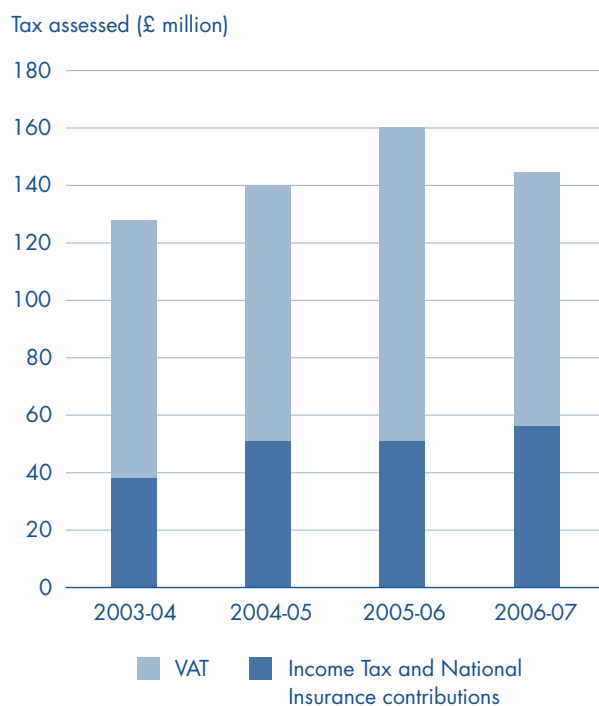
3.3 A European Commission survey of people in 27 EU countries found that over one half of respondents (55 per cent) thought that the risk of being detected by the authorities for undertaking undeclared work was small. The UK was better at 46 per cent. The survey also found that people who have participated in the hidden economy thought the risk of detection was smaller than those who had not. The European Commission points out that peoples' perception about the risk of detection does not necessarily relate to the actual risk in each country.

3.4 Over the 4 years to 2006-07 the amount of tax detected by the Department's hidden economy teams increased by 13 per cent in real terms to £145 million (Figure 3).

- On Income Tax and National Insurance contributions the average amount raised from the initial detection of a case increased by 60 per cent in real terms to nearly £1,670. The increase could reflect the Department's increased expertise in identifying tax liabilities and their efforts to target higher value cases; or it might also reflect an increase in the scale of the hidden economy. In 2006-07 nearly £700 per case was also raised as the Department provided support to businesses detected during the previous two years and recorded the amount of additional tax it collected.
- On VAT, the average amount remained constant at around £18,000 per case in real terms.

Other teams within the Department also detect hidden economy cases but data on the amount of tax they detect in these cases is not readily available.

3 Trend in the additional tax, penalties and interest identified from detections in real terms at 2006-07 prices



Source: National Audit Office analysis of HMRC data

NOTES

- 1 The data include only additional tax, penalties and interest identified by the Department's hidden economy teams. Hidden economy cases detected by other teams such as criminal investigation, employer compliance teams and sector specialist teams are not included.
- 2 The data includes cases where a tax return has been received. It excludes cases where self-employed people have registered late voluntarily but have been referred to the teams.
- 3 Hidden economy cases produce three types of financial benefit: backdated tax, including interest and penalties (direct yield); improved future compliance with tax obligations (compliance yield) and deterrence of other potential ghosts and moonlighters. The above table includes direct and compliance yield but excludes deterrence yield.

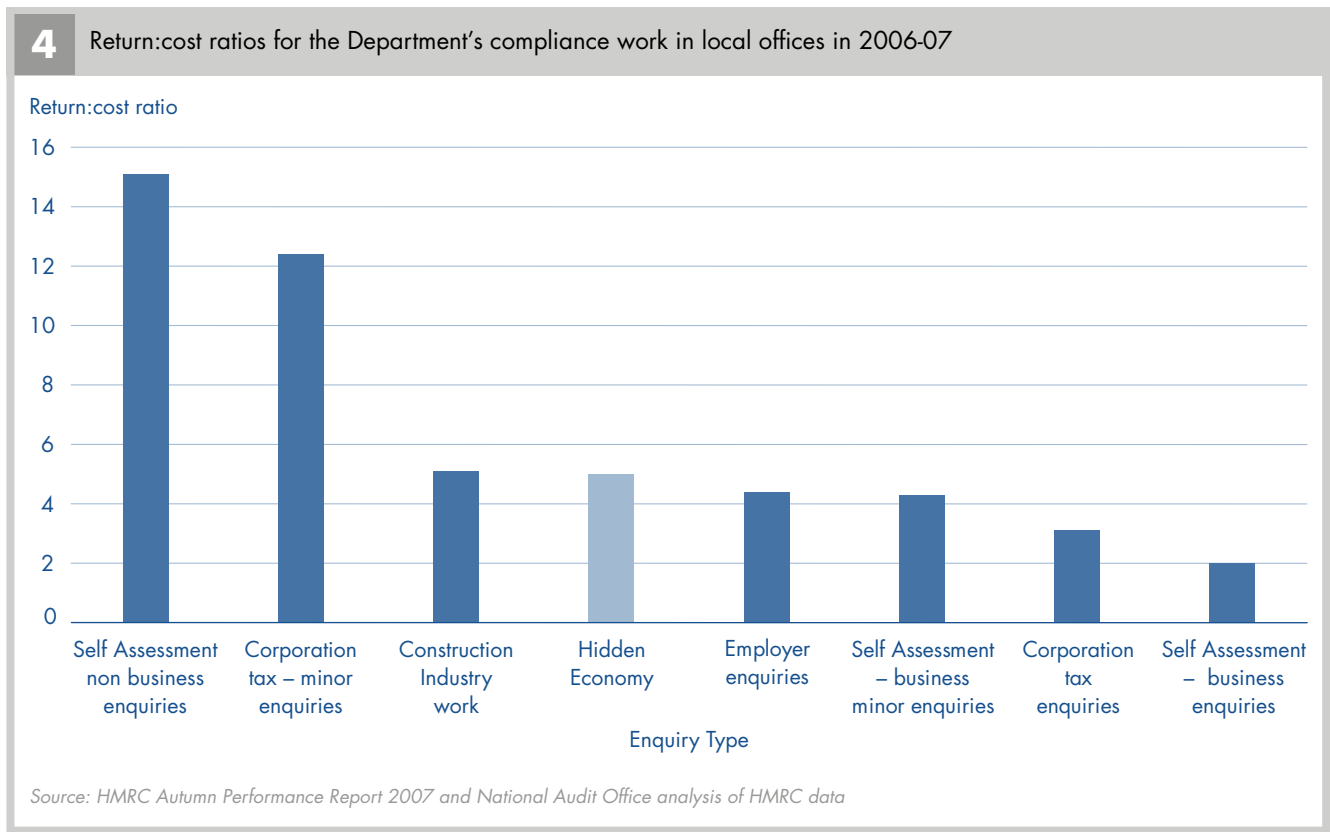
Returns and costs from the Department's detection work

3.5 We calculate that the Department's return on its detection and investigation of hidden economy cases in 2006-07 was £5 for every £1 invested.¹⁵ The return from hidden economy work is in the middle of the range of the returns from the Department's other enquiry work by local offices (**Figure 4**). The highest returns from hidden economy work are from investigating businesses which should be registered for VAT but were not (**Figure 5**).¹⁶ We were unable to analyse the distribution of the amount of tax involved to identify which type of cases or sector provided the Department with the highest returns because data were not held in a way that allowed this.

The methods the Department uses to detect cases

3.6 The Department uses information from a wide variety of sources to detect people in the hidden economy including from members of the public, other parts of the Department and other organisations. This section examines the Department's use of:

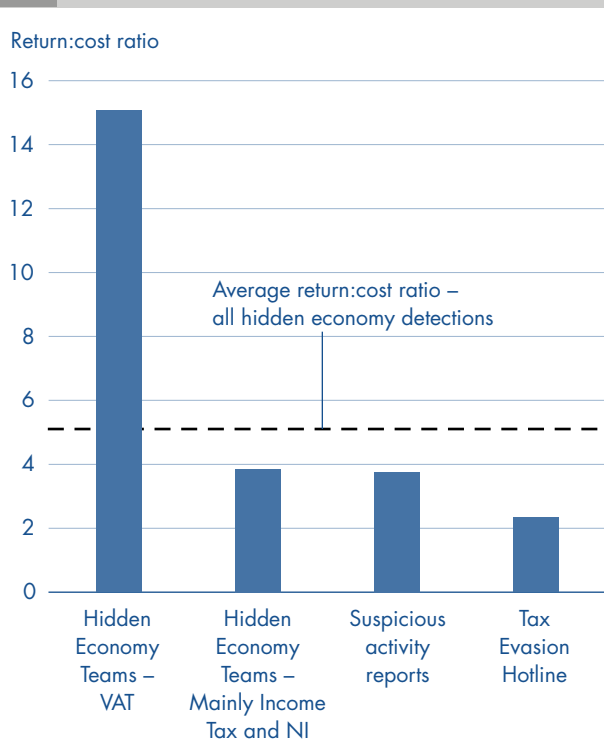
- information from the tax evasion hotline to which members of the public may report suspicions of tax evasion;
- cases referred to the hidden economy teams internally and by other government departments; and
- data matching to detect people in the hidden economy.



¹⁵ Costs include salary related costs and other direct costs only. Tax raised includes direct yield (backdated tax, penalties and interest) and compliance yield from monitoring former ghosts and moonlighters post registration. No allowance has been made for deterrence effects on other taxpayers.

¹⁶ The return:cost ratio for VAT includes the estimated future revenue benefit for the following 12 month period. Unlike the yield for other taxes, the calculation of the future revenue benefit does not rely on examining subsequent returns. The different basis of the calculation means that the returns on VAT and direct taxes are not fully comparable.

5 Return:cost ratios of the Department's detection methods in 2006-07



Source: National Audit Office analysis of HMRC data

NOTE

The return:cost ratio for VAT includes the estimated future revenue benefit for the following 12 month period. Unlike the yield for other taxes, the calculation of the future revenue benefit does not rely on examining subsequent returns. The different basis of the calculation means that the return:cost ratios for VAT and direct taxes are not fully comparable.

The Tax Evasion hotline

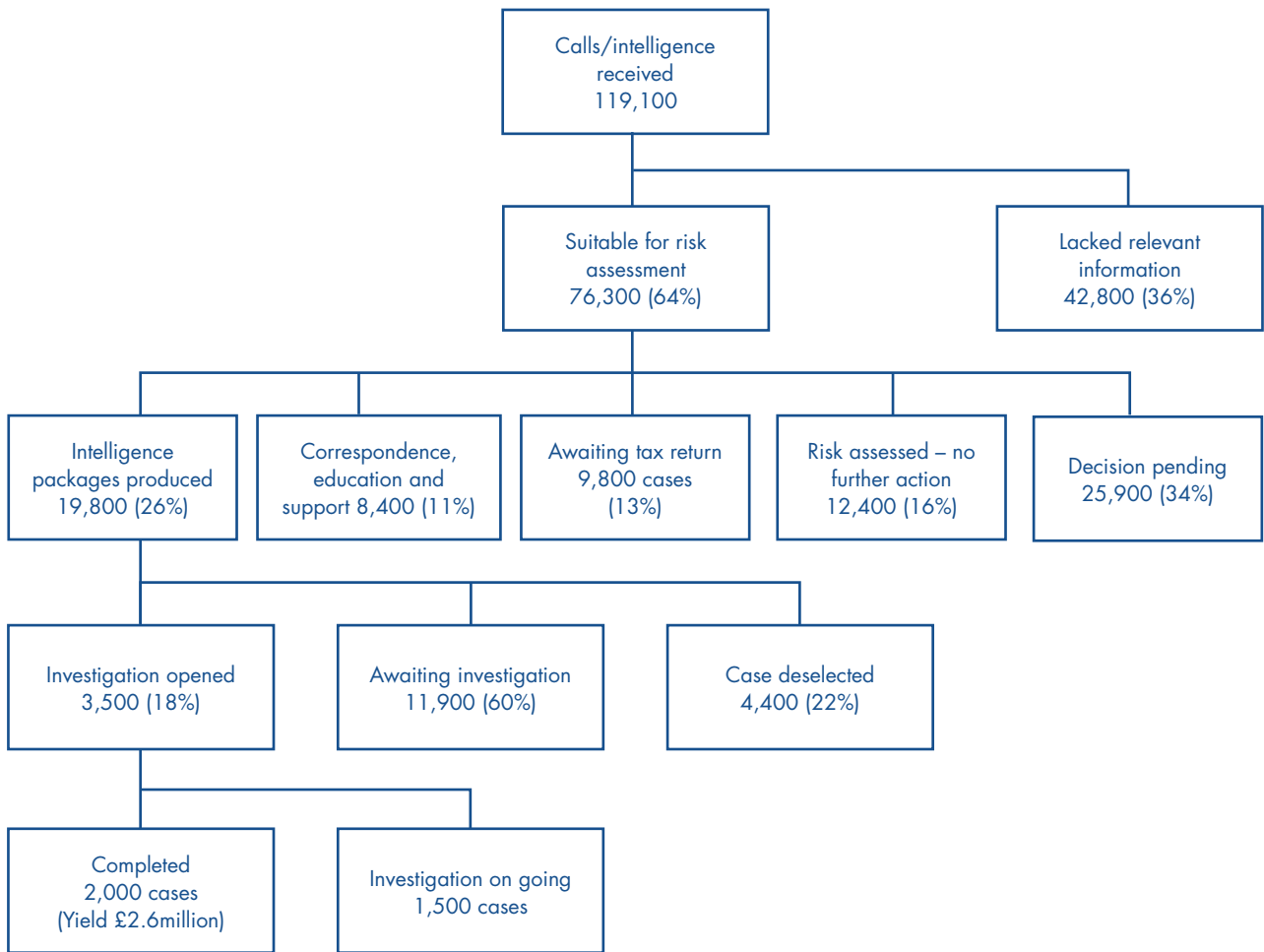
3.7 Before 2004 the Department had a Business Anti-Fraud hotline to which employers could report suspicions about competitors who were failing to meet their PAYE obligations. Although the Department did not widely advertise the hotline it received around 1,500 calls a year. In our report on *Fraud against the Inland Revenue* (HC 429, Session 2002-03) we concluded that the value of the hotline would be increased if the remit were widened to include all fraud against the Inland Revenue and its existence publicised. In Budget 2004, the Department was

provided with additional funds to set up a confidential Tax Evasion hotline – **0800 788 887** – allowing members of the public to report suspicions on the evasion of income tax, corporation tax, capital gains tax, inheritance tax, VAT and National Insurance contributions. The hotline was set up in November 2005 to take calls Monday to Friday 8am to 8pm and Saturday and Sunday 8am to 4pm. People can also report details of their suspicions through the Department's website by completing an online form. The Department spends around £700,000 a year on staffing the hotline and around £3 million a year on investigating cases.

3.8 Between February and April 2006 the Department used a combination of TV, press and radio campaigns and other advertising methods to encourage members of the public to telephone the hotline with their suspicions on self-employed people operating in the hidden economy. The campaigns focused on particular groups that are more likely to be operating in the hidden economy such as hairdressers, trades involved in the home, repair and maintenance sector, taxi drivers and motor vehicle repairers. A more limited radio campaign was launched in February 2007 concentrating on employers not paying over tax deducted from salary, and e-traders and landlords not paying tax on their income. In total the Department has spent £4.5 million on advertising the hotline. The Department received around 120,000 calls and other contacts such as by email in 2006-07. The number of calls has averaged 7,000 a month since then. On average each call costs the Department around £6 to handle.

3.9 A third of the calls received in 2006-07 lacked relevant information and could not be actioned. Of the 76,300 calls which were subject to risk assessment, no further action is to be taken on 12,400 and 8,400 people had been dealt with by offering them education and support. The Department was awaiting the receipt of tax returns from 9,800 cases as no tax was yet due. As at 31 March 2007 no decision had been made on 25,900 cases. Of the 19,800 cases where the Department has produced intelligence packages, 3,500 cases had been opened of which almost 2,000 had been completed generating additional tax of £2.6 million (**Figure 6 overleaf**).

6 Progress as at 31 March 2007 on hotline calls received during 2006-07



Source: National Audit Office analysis of HMRC data

CASE EXAMPLE

Hotline

Following information provided by a member of the public to the Tax Evasion hotline, the Department wrote to a person who had never paid tax but whom it suspected was working as a car mechanic. The person admitted that they had been trading as a business but had not registered with the Department to pay tax. The Department calculated that the person owed £56,000 in tax, interest and penalties. A separate investigation found that the person also owed £70,000 in VAT.

3.10 The Department had originally planned to complete investigations on nearly 5,500 cases between April 2006 and March 2007 but completed around 2,000 (Figure 7).¹⁷ It also expects the number of completed investigations in 2007-08 to be much lower than estimated at the beginning of the hotline project. This is mainly because its assumptions about the progress of cases have not been achieved in practice. The Department’s original assumptions on resources have also proved to be incorrect with additional effort needed to handle three times more calls than expected and to evaluate the information received.

¹⁷ The Department originally planned to advertise the hotline one year earlier but had to wait for Ministers to approve the campaign. The data has been adjusted by one year to allow for the later start date.

7 Hotline cases completed in 2006-2007

	Estimated numbers of cases	Cases achieved	Estimated average amount of tax £	Average achieved £	Estimated tax assessed £ million	Total tax achieved £ million
Registration of ghosts and moonlighters	2,100	1,823	790	890	1.7	1.6
Employer compliance reviews	2,600	14	10,540	23,170	27.2	0.3
Small business investigations	800	146	4,630	4,730	3.6	0.7
All cases	5,500	1,983	5,940	1,330	32.5	2.6

Source: National Audit Office analysis of HMRC data

NOTE

Figures have been rounded.

3.11 While the average tax yield for individual cases completed during 2006-07 has been much higher than estimated, the total tax assessed has been much lower, at £2.6 million compared to the £32.5 million expected. This is because most of the information received by the Department has been on ghosts and moonlighters where cases completed have averaged £890 in additional tax. The Department originally expected to receive more information about small businesses and employer compliance cases which were expected to involve significant revenue. There were fewer investigations than expected as a result - although such cases had higher average yield at £4,700 for small businesses and £23,000 for employer compliance cases. In addition the Department envisaged a quicker turn around of cases from the original call to the case take-up than it has been possible to achieve to date due to the quality of information provided. The continued slow progress in dealing with cases means that the Department is likely to raise up to £7 million in additional tax in 2007-08 compared to its original estimate of £77 million. The Department expects the amount of tax raised to increase with the greater use of automated methods (paragraph 3.17) and through the use of education initiatives rather than formal inquiries. To help deal with cases more quickly, the Department is now using automated methods to compare the information received with tax records and other external data sources as a way of determining whether tax may be owed. Up to November 2007, 5,300 hotline calls had been reviewed in this way.

Referrals to the hidden economy teams

3.12 The Department shares information and intelligence internally and with a number of different public sector organisations including the Home Office, the Department for Work and Pensions, the Gangmasters Licensing Authority and the Serious Organised Crime Agency. For example the Department has been active in a number of cross-department activities including:

- its specialist labour provider teams working closely with other enforcement agencies to deal with abuses including unregistered gangmasters.
- working alongside a UK police operation on a campaign to tackle abuses in the adult entertainment industry.
- working with police and immigration authorities on a national campaign in the nail bars industry which has identified unregistered businesses.
- Operation Jumbo which brought together information from across the Department and other agencies to identify previously unknown businesses linked to Heathrow Airport.

It is difficult to evaluate how well the arrangements for sharing information work because there is very little data readily available on the outcome of cases from these sources. However, we examined the Department's use of suspicious activity reports of money laundering made by financial institutions and others to the Serious Organised Crime Agency and internal referrals made by the national minimum wage team.

3.13 The Committee of Public Accounts in their report on *Tackling fraud against the Inland Revenue* (HC 62, Session 2003-04) recommended that the Department should make greater use of suspicious activity reports to detect fraud. Under the Money Laundering Regulations organisations are required to make suspicious activity reports to the Serious Organised Crime Agency where they know or suspect that a transaction involves money laundering. The Department was provided with additional funds in 2004 to use these reports to detect people who may have a source of income they are not declaring.

3.14 In the period April 2004 to the end of March 2007, the Department completed 7,150 investigations involving over £27 million in tax or around £3,800 in each case (Figure 8). This was substantially fewer cases than the Department expected as a court ruling in 2006 reduced the amount of information available to the Department from solicitors and accountants. This is because solicitors and accountants are under a duty to keep the affairs of their clients confidential, and the circumstances in which they are able to disclose client communications are limited. The Department had anticipated significant numbers of cases from these sources. In addition it has also found that it is taking longer than expected to follow up on cases because initially it waited until people filed their tax return for the period to which the suspicious activity report relates which can be up to 22 months after the report is received. The Department now raises such issues with the taxpayer in advance of them filing their tax return. Based on the current levels of success, the Department expects over the next two years to raise a further £51 million from investigating cases involving suspicious financial activities.

3.15 The Department enforces the national minimum wage on behalf of the Department for Business, Enterprise and Regulatory Reform which is responsible for the policy. It has a team of 130 staff responsible for investigating employers who are identified as being at risk of not paying the national minimum wage. In the course of their work the team comes across employers who may be paying employees' cash in hand. Of the 4,200 national minimum wage investigations carried out in 2006-07, 580 cases or 14 per cent of cases were referred to hidden economy teams. The national minimum wage team does not however receive feedback on what has happened to these cases or whether the information was useful in following up cases.

The Department's use of data matching

3.16 The Committee of Public Accounts report on Tackling VAT fraud (HC 512, Session 2003-04) recommended that better use of data matching between the former HM Customs and Excise and former Inland Revenue was needed to detect traders who were evading VAT by operating in the hidden economy. In response the former Departments carried out pilot projects in 2003 and 2004 to data match businesses' VAT records with direct taxes to identify those who should be paying a tax. The former Departments found the process difficult as it used different reference numbers for each business for each of the taxes.

8 Investigations completed into suspicious activity reports by end of March 2007

	Estimated numbers of cases	Cases achieved	Estimated average amount of tax £	Average achieved £	Estimated tax assessed £ million	Total tax achieved £ million
Registrations of ghosts and moonlighters	9,980	5,503	940	1,510	9.4	8.3
Employer compliance reviews	0	10	Not applicable	40,190	0.0	0.4
Small business investigations	9,980	1,641	6,480	11,180	64.6	18.4
All cases	19,960	7,154	3,710	3,780	74.0	27.1

Source: National Audit Office analysis of HMRC data

NOTE

Figures have been rounded.

3.17 Following the creation of HM Revenue & Customs in April 2005 it has been working on projects to link data on taxpayers across its internal computer systems and is carrying out a wider programme of matching data on taxpayers. This has included making more use of data matching techniques to detect people and businesses in the hidden economy. In a pilot project, the Department has used specialist computer software to analyse various internal and external information sources to help identify potential ghosts and moonlighters. The first stage of the exercise identified around 300,000 potential ghosts and moonlighters for further investigation. The Department is carrying out tests on 500 of these records to assess the accuracy of the information and is using the results to help improve the way the software identifies cases in the future. This work is experimental and is at early stage of development and subject to further testing. In the next stage the Department plans in 2008-09 to look at up to 20,000 cases, with a potential value of £26 million in additional yield. The results from these cases will help the Department improve further the way it identifies potential cases.

3.18 In time the Department intends to provide an organisation wide data matching service to detect people and businesses not complying with their tax obligations. The service will be similar to one developed by the Department for Work and Pensions which carries out regular bulk data matching exercises to detect errors and fraud in benefits. HM Revenue & Customs is looking to improve the accuracy of its data matching as its experience grows, and will seek further opportunities to match data with other organisations to detect people in the hidden economy. We consider that the Department could make more extensive use of information already available on businesses that pay business rates on their premises, and local authority licences for doormen, street traders and taxis which could be compared with tax records to identify ghosts and moonlighters. The Department could also make more use of vehicle licensing data held by the Driver and Vehicle Licensing Authority for example to identify the owners of high value cars and commercial vehicles who may not be declaring their income. Data matching exercises could involve using personal data for a large number of people and businesses, and the Department would need to ensure appropriate controls to safeguard such details.

3.19 We found that all tax authorities use data matching to some extent. The Australian and Canadian tax authorities have been increasing their use of data held by other government agencies and the private sector to detect people in the hidden economy. Most tax authorities target sectors where the risks of people working in the hidden economy are highest.

PART FOUR

Sanctions

4.1 This part of the report looks at the Department's use of sanctions. It examines the circumstances in which the Department imposes civil penalties and its use of criminal investigation including cases referred to the Revenue and Customs Prosecutions Office for decisions on whether to pursue a prosecution in the criminal courts. It also examines whether sanctions are viewed as an effective deterrent by those in the hidden economy.

Civil penalties

4.2 In cases where dishonesty is involved, the Department can impose a penalty of up to 100 per cent of the tax owed but this power is rarely used to its full extent. The Department can reduce the penalty where the offence is not serious and where the person makes a complete and voluntary disclosure of the amount owed and cooperates with the Department's enquiries.¹⁸ It also charges interest on late payments. The Department may decide not to charge interest or impose a penalty where only a small amount of tax is involved or the person does not have the funds.

4.3 In 2006-07, the Department imposed penalties and levied surcharges amounting to around £5 million or 3 per cent of the total of £161 million¹⁹ tax identified, reflecting both the high proportion of cases (estimated at over half of cases) where no sanction was imposed and the low level of penalties imposed in practice. The Department charged interest of around £4.3 million or nearly 3 per cent of the total tax detected.

4.4 Following the Review of Powers, Deterrents and Safeguards²⁰, the Finance Act 2007 introduced a single penalty regime for Income Tax (including Pay As You Earn and National Insurance contributions), Corporation Tax and VAT. For tax periods commencing on or after 1 April 2008, the penalties will be based on the amount of tax understated, the nature of the behaviour that gives rise to the understatement and the extent of disclosure by the taxpayer. For the most serious cases there is a penalty of up to 100 per cent for deliberate understatement with concealment. The Department is consulting²¹ on its proposal to abolish the fixed penalty of £100 for late registration for National Insurance (Class 2), as it now believes that this does not encourage people to come forward.

4.5 The Department can impose a penalty of up to £3,000 where a business has failed to keep adequate business records. It only applies the penalty in the most serious cases such as where a person has deliberately destroyed records or where there are repeated failures. When the Department first finds that a business has failed to keep proper records, it should issue a written warning, explaining that a penalty could be imposed in future. In 9 of the 37 civil cases we examined the person had failed to keep proper records but a warning letter had only been issued in one case. The Department intends to undertake more reviews to check that businesses are keeping proper records.

¹⁸ For VAT the late registration penalty is between 5 per cent and 15 per cent of the VAT owed.

¹⁹ This includes £145 million tax, interest and penalties detected by hidden economy teams (paragraph 3.4) and £16 million recovered from voluntary declarations (paragraph 2.11).

²⁰ See <http://www.hmrc.gov.uk/about/powers-appeal.htm>.

²¹ *Modernising Powers, Deterrents and Safeguards: A new approach to compliance checks.*

4.6 The Department does not have readily available data on the total number of hidden economy cases completed in any year or the time taken to complete cases because the information is held on a large number of different computer databases. We therefore analysed the time the Department took to complete the 37 civil cases we examined. On average they took around 10 months with 9 cases taking over a year. The Department completed VAT cases in less than 5 months on average compared with nearly a year for cases involving direct taxes mainly because it is more straightforward to calculate the amount of tax owed in VAT cases, and because the VAT cases tend to involve businesses with better record keeping. The cases taking the longest to complete involved both direct taxes and VAT. The Department usually completes these types of cases sequentially as the profit on which direct taxes are assessed cannot be determined until VAT payments are agreed. Cases can also take a long time to complete where the person does not respond to the Department's information requests and needs chasing up.

Criminal investigation and prosecution

4.7 Up to April 2005 the Department was responsible for investigating and prosecuting cases. Since then the Revenue and Customs Prosecutions Office has been set up, under the superintendence of the Attorney General, as an independent prosecutor to prosecute cases referred to it by HM Revenue & Customs and the Serious Organised Crime Agency within England and Wales. In Scotland, cases are reported for consideration of prosecution to the Crown Office and Procurator Fiscal Service. When cases are referred to the Revenue and Customs Prosecutions Office, it considers whether the case should be prosecuted, who should be charged and with what offence(s). Revenue and Customs Prosecutions Office lawyers can also provide guidance and advice to the Department's criminal investigators during the investigation and prosecution process.

4.8 In 2003 the Committee of Public Accounts²² commented that the new offence of evading income tax (which was relevant in tackling fraud in the hidden economy) had been used only to a limited extent and recommended increasing the level of prosecutions. At that time, the Inland Revenue was prosecuting around 60 tax fraud cases of all types and HM Customs and Excise around 90 cases in total each year.²³ Few of these prosecutions were for hidden economy activities.

4.9 The Department now considers criminal investigation of hidden economy cases, where the amount of tax involved may exceed £10,000 and there are other features present such as it is a second offence (**Figure 9**). Cases which proceed to a prosecution are usually dealt with by the Crown Court which can take more time. Previously the Department would consider investigating cases where the tax involved exceeded £1,500, which could be dealt with more quickly by the Magistrates' Courts. The number of cases prosecuted using the new offence has increased to 69 in 2006-07. We calculated that the Department refers for prosecution around 2 cases per thousand detected in the hidden economy. In comparison prosecutions were 60 cases per thousand for benefit fraud cases.

9 Criminal investigation case examples

A joint investigation with the Department for Work and Pensions found that a parish councillor had evaded £26,500 in tax from his plumbing business, and had claimed £38,000 in benefits by claiming to be unfit for work. He was sentenced to 15 months imprisonment in March 2006 but had no assets to pay the tax owed.

A chiropodist had worked since 1997 as self employed but had not registered for tax. He was arrested at his place of work in September 2006 and interviewed under caution. The Department calculated that he owed some £30,000 in tax. He was sentenced in July 2007 to 8 months imprisonment (suspended for 2 years), 250 hours community service and is required to pay back £25,441 in instalments.

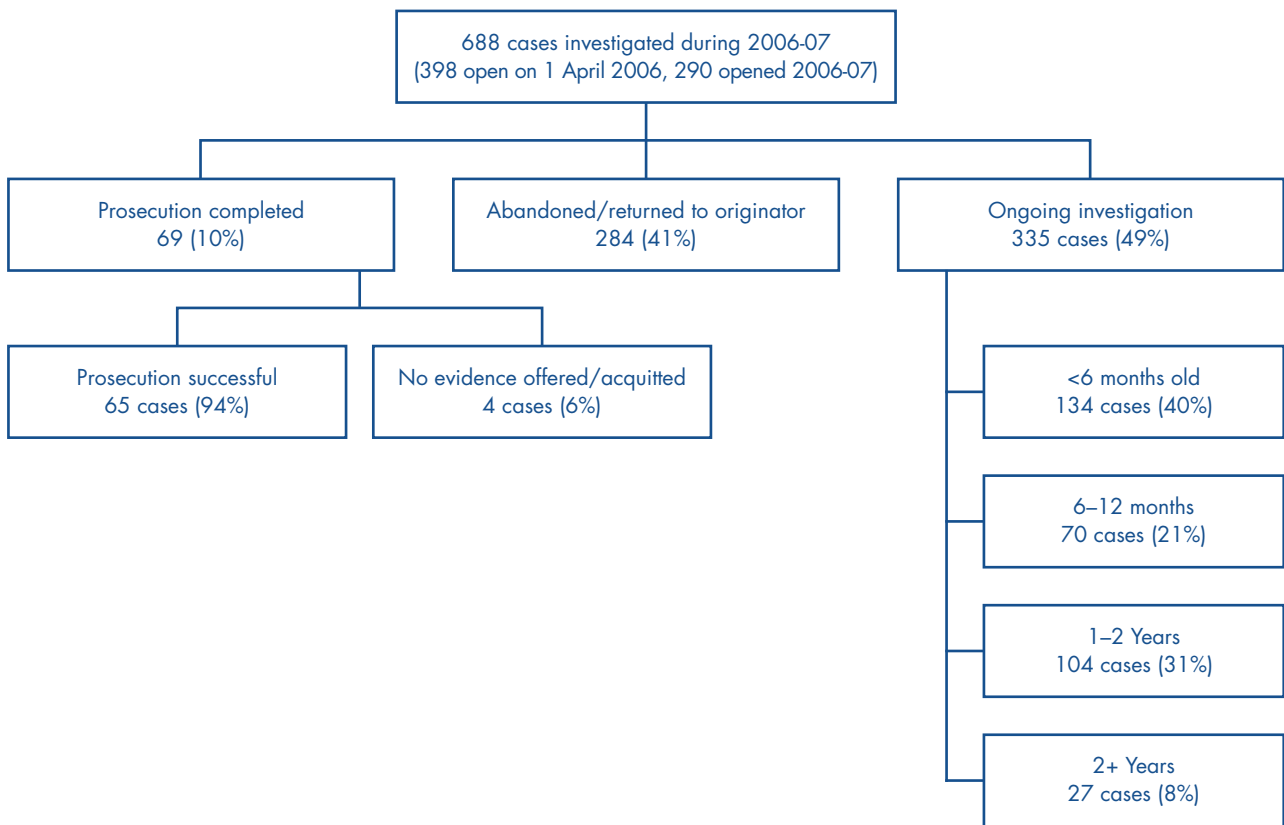
²² *Tackling Fraud Against the Inland Revenue*, Committee of Public Accounts, First Report 2003-04, 13 January 2004, HC 62 2003-2004, PAC Conclusions (ii) and (iii).

²³ *HM Customs & Excise: Tackling VAT fraud*, HC 357 2003-2004, paragraph 2.22.

4.10 The cost of investigating cases is high for the Department at over £30,000 for each case prosecuted, compared with average tax involved of £11,260. The benefit of prosecutions cannot be judged solely in terms of the costs of investigations and the tax at risk. A major dimension is punishing those involved in dishonesty and achieving a wider deterrent effect. Achieving a wider deterrent effect depends in large part on raising public awareness of the risks of detection and the consequences of being caught. The Department works proactively to obtain media coverage in some cases when a conviction has been obtained by briefing local media and a press notice. This generates interest in the local media but less so nationally.

4.11 In 2006-07, there were 69 prosecutions of hidden economy cases. The Department also closed 284 cases where there was either insufficient evidence to refer a case for prosecution, little tax at risk or further investigation of the case would not be in the public interest. Nevertheless it opened four times as many criminal investigations as the number of cases prosecuted in 2006-07. The Department expects that as the expertise of the criminal investigation case workers grows it will increase the number of more complex cases being undertaken and reduce the lower value cases. Overall the turnover in completing cases appears to be slowing down. The Department completed investigations on 353 cases during 2006-07. The number of new cases opened during the year (290) was less than this level, while 335 cases were carried forward to 2007-08 (**Figure 10**).

10 Criminal investigations and prosecutions in 2006-07



Source: National Audit Office analysis of HMRC data

4.12 The Department expects simple criminal cases such as hidden economy cases to be completed within one year. Of the 335 cases where the investigations were still ongoing at the end of 2006-07, nearly a third had been open for over one year and a further 27 cases (8 per cent) had been ongoing for more than 2 years. Our analysis of criminal investigation cases found that various factors can influence the time taken including delays within the Department in taking action at various stages of the investigation and the time it takes the Department to obtain sufficient evidence to refer cases to the Revenue and Customs Prosecutions Office (for example seeking court orders to obtain bank account records). The time taken to complete the prosecution is affected by the availability of court time to hear the case. In its report on *Tackling VAT Fraud* (36th Report, Session 2003-04), the Committee of Public Accounts recommended that court time should be made available promptly so that cases are brought to trial more quickly. The Committee noted that it could take up to a year for court time and lawyers to become available to try a complex VAT fraud case. In response, the Department said that it was conscious of the need to bring prosecutions to court promptly and continued to work closely with the then Department for Constitutional Affairs to remove the obstacles that prevent this. In January 2008, the Revenue and Customs Prosecutions Office agreed a protocol with Her Majesty's Court Service which designates a number of Crown Courts to deal with all its cases including revenue cases involving the hidden economy, with the aim of improving case management and enhancing judicial expertise in dealing with such cases. No such protocol exists in Scotland.

The effectiveness of sanctions

4.13 The Committee of Public Accounts in their report on *Tackling Fraud against the Inland Revenue* recommended that the Department should examine opportunities to secure higher levels of compliance by improving arrangements for payment by instalment and interest on arrears of tax. In response the Department stated that it already had arrangements to make things easier for those who have tax arrears and who want to regularise their tax affairs. Where people cannot pay what they owe immediately the Department is prepared to talk to

them about payment by instalment. Our interviews with those in the hidden economy show that some are more concerned about the amount of tax they would have to repay, and their inability to pay it immediately, rather than the sanctions the Department imposes.

4.14 The Department does not monitor how many hidden economy cases are granted time to pay. Our analysis of 53 civil and criminal cases included only one example, a PAYE case, where time to pay had been granted. The Department encourages those detected to make substantial payments on account in order to reduce interest charges and reduce the likely level of penalties by demonstrating their willingness to cooperate.

4.15 Our consultants' interviews with people in the hidden economy indicated some were not concerned about the sanctions the Department would impose. They thought the Department would take little action against them because they were "small fry". Others would like to legitimise their activities but believed they would be prosecuted. The European Commission has suggested that Member States should do more to publicise to the general public the sanctions they will impose to act as a deterrent. A review by the Department for Work and Pensions in 2004 of its sanctions concluded that prosecution was the most appropriate and effective deterrent for the most serious and persistent offenders. It also found that customers should be made more aware of the sanctions that would be imposed. HM Revenue & Customs' website and other tax information have clear information on the penalties imposed for late VAT registration but not for other taxes.

4.16 Some of those in the hidden economy interviewed by our consultants did not think that the sanctions imposed by the Department were appropriate. They felt they had no choice but to work in the hidden economy to pay for essential items. The risk of detection and possible sanctions did not influence their attitudes. Some suggested that community sentences would be more appropriate, as people would have less time for paid work which would affect them financially. They also saw community work as a social punishment with a stigma attached to it which may dissuade some from working in the hidden economy.

PART FIVE

Managing the risks from the hidden economy

5.1 This part of the report looks at how the Department manages the risks from the hidden economy. It examines the Department's assessment of the risks and how it tackles two particular areas of risk: landlords in the hidden economy and those working in the hidden economy in the home repair and maintenance sector.

The Department's assessment of the risks

5.2 The Department currently assesses the risks to tax from the hidden economy by drawing on experience of its hidden economy teams, using information provided to the hotline, assessing whether the risks identified by other tax authorities could also apply in the UK, making greater use of data matching techniques and considering whether information from academic research provides insights into the sectors it should be tackling. From this work the Department has identified some sectors where the risks to tax from the hidden economy are likely to be high. For example the Department's experience shows that self-employed people are the most likely group to be operating in the hidden economy, especially where cash is commonly used for payment. The results from the hotline also show that new risks to tax revenue are emerging from those trading on the internet and from buy-to-let landlords failing to declare their income and capital gains. The very nature of the hidden economy means that the Department lacks a good understanding of the risks and the scale of those risks across all sectors of the economy.

5.3 The Department is however currently developing its approach to assessing the risks using the results from the transforming compliance risk management pilot project to identify areas of the hidden economy on which to focus (paragraph 3.17). It expects that regular comparison of tax

records against external information sources will provide an improved picture on the extent of the hidden economy and trends within it. The Department has tried to estimate the amount of tax lost from the hidden economy but has to date only been able to make broad estimates (paragraph 1.5). In 2006 the Department employed the University of Bristol to produce firmer estimates on the amount of tax lost from the hidden economy. They carried out a pilot project interviewing 150 people to assess the feasibility of carrying out a questionnaire survey of the UK population as a way of estimating the size of the hidden economy. The Department considers that the proposed methodology was unlikely to produce worthwhile results because a significant number of people would refuse to take part.

5.4 Academics have used various methods to estimate the size of the hidden economy but these have resulted in a wide range of estimates depending on the assumptions made. In our work comparing how tax authorities tackle the hidden economy we found that none of them has yet found a reliable method to estimate the size of the hidden economy. The European Commission intends to undertake a study in 2008 to identify the best methodology for providing comparable estimates of the amount of undeclared work across the EU.²⁴ The Australian Taxation Office is carrying out several projects targeting those parts of the hidden economy which the general public consider to be least acceptable to identify tax evaders. It is using data matching techniques to identify people in cash-based businesses who lead a wealthy lifestyle such as those owning luxury cars and boats which appear unsupported by the income declared on their tax returns. The Australian Taxation Office is also targeting people who have failed to meet a number of other obligations such as health and safety requirements, or claiming welfare benefits, when they have undeclared earnings.

²⁴ The European Commission defines undeclared work as any paid activities that are lawful as regards their nature but not declared to public authorities, taking into account differences in the regulatory system of Member States. Since 1993 the European Commission has sought to widen the concept of work, and encouraged Member States to facilitate "the re-entry into the formal labour market of many citizens who have to work at the margins". In 2003 the European Commission called on Member States to adopt a comprehensive strategy to lessen the advantages of undeclared work by stepping up enforcement measures and sanctions and adapting existing legislation, particularly by reducing burdens and obstacles to joining the formal economy including by providing appropriate incentives in the tax and benefit system.

Tackling landlords in the hidden economy

5.5 The buy-to-let property market has been increasing – the Council of Mortgage Lenders estimates that the number of buy-to-let mortgages increased from 28,700 at the end of 1998 to 849,900 at the end of 2006. The Department is concerned that some of the estimated 1.2 million landlords in the UK may not be including rental income from their properties on tax returns and/or are not declaring the capital gain when they sell a property. The tax rules can be complex with different rates and allowances depending on whether a property is rented as a residential letting, a holiday let or rooms are let out in a person's home.

5.6 A survey by the Department in 2007 of 112 landlords found that the majority claimed they did not set out to make money from property having “fallen into it” through circumstances such as inheriting a property. For some it did not occur to them that they might owe tax on their income. Some were indignant that they should be paying tax, particularly where they have an overseas property. Where someone has a number of properties the Department found that their awareness of the need to pay tax was higher.

“I’ve never bothered to even think about paying tax, and I’ve never looked on it as a money making machine. It was just there and empty and then somebody wanted it. So it wasn’t bought as buy-to-let”

5.7 In February 2007 the Department launched a trade and national advertising campaign advising landlords of the need to declare their income and pay tax on any profit. The campaign points out that landlords who let multiple properties could be running a rental business and should be registered as self-employed. The campaign also points landlords to information on the Department's website that enables them to determine whether they may have a tax liability. The Department's website also has links to further information on other taxes landlords may need to pay. It has also used advertising to encourage members of the public to report cases to the hotline where landlords may not be paying tax on their rental income

or declaring the capital gain on the sale of property. The Department is using information from a number of external sources including letting agencies and local authorities' payments of housing benefit to landlords to detect those who are not declaring their rental income/capital gains (**Figure 11**). In addition the Department is using WebRobot (an advanced search engine which can search the World Wide Web to identify websites and businesses that match particular profiles) to identify rental properties for comparison with its tax records to see whether landlords have declared the rental income.

5.8 There are a number of sources of information the Department could use on a regular basis, subject to the appropriate gateways and information powers, to identify landlords who may not be including rental income or capital gains on their tax returns:

- Since April 2006 landlords are required to be licensed by their local authority where their houses are in multiple occupation. From May 2006 all landlords letting residential property in Scotland are also required to register with the local authority.
- From April 2007, all deposits (for rent up to £25,000 a year) taken by landlords and letting agents in England and Wales, must be protected by a tenancy deposit protection scheme. The Government has awarded contracts to three companies to run the schemes. The Department is examining whether it can data match with their records.
- Through mortgage lenders the Department could obtain the details on buy-to-let landlords.

11 Case Example of landlords and undeclared rental income

A retired person inherited a property in May 2000 which was divided into flats that were rented out from 2001 until 2004 when they were sold. Using information obtained from property letting agencies in 2005, the Department identified that the person was receiving an income for the property but had not declared it. In January 2006, the Department interviewed the person under caution. The landlord settled the case by paying £28,000 in Capital Gains Tax and £1,500 in Income Tax.

Tackling those working in the hidden economy in the home repair, maintenance and improvement sector

5.9 The home repair, maintenance and improvement sector includes a large variety of activities, such as home extension and conversion work, central heating and insulation, kitchen and bathroom fitting, door and window work, electrical and decorative work. There are no estimates on the amount of tax lost or the number of people working in the hidden economy in this sector. The Department for Business Enterprise & Regulatory Reform has undertaken work to estimate the total number of people employed and the value of the work undertaken in the construction industry using Office for National Statistics data and its own survey of businesses. In doing so it has estimated that in 2006 there could be 600,000 people undertaking home repair, maintenance and improvement work who are either operating legally below the VAT registration threshold or are operating in the hidden economy. Households paid around £8.4 billion on work undertaken by these people representing over one half of all expenditure on private housing repair and maintenance.

5.10 A report by the Federation of Master Builders in 2003 found that there are strong incentives for both businesses and households to become involved in the hidden economy and evade tax: businesses are paid in cash and households receive a discount on the cost of the work. The Federation of Masters Builders suggested that the Government should tackle the hidden economy in this sector by reducing VAT to 5 per cent on home repair, maintenance and improvement work. Since 1999 the European Commission has allowed Member States to reduce the rate of VAT on specified labour intensive services and several Member States have reduced the rate of VAT on building renovation and maintenance work. The Commission has noted that there is limited evidence to show the effects on the level of undeclared work in these countries.

5.11 A survey of 12,000 homeowners carried out by AA Legal Services in 2007 found that around 78 per cent had used someone to carry out work on their house in the last 12 months. Of these most paid in cash with almost one in five experiencing problems, leading to further cost. AA Legal Services advised homeowners to avoid using people who offer to reduce the price of a job for payment in cash and do not provide a receipt.

5.12 The Department targeted part of its advertising on the home, repair and maintenance sector to encourage businesses to register for tax and the general public to report cases to the hotline where they suspect people are operating in the hidden economy. In 2006-07 around 40 per cent of the calls to the hotline were about businesses suspected of operating in the hidden economy in this sector. The Department could also look at data matching its records against those of other public sector organisations that may use these types of contractors such as local authorities, health authorities and the property maintenance records of the Ministry of Defence. In Canada, the tax authority has run a national awareness advertising campaign – *Get it in Writing* – to inform the public of the risks involved in dealing with home repair and maintenance contractors operating in the hidden economy. The Tax Authority has worked in partnership with the Canadian Home Builders' Association to assist them in advertising and promoting this message to consumers.

APPENDIX ONE

Scope and methodology

Scope

1 The study focused on losses of Income Tax, National Insurance contributions and VAT from:

- businesses that should be registered to pay tax, such as VAT, but are not;
- people who work in the hidden economy and pay no tax at all on their earnings (ghosts);
- people who pay tax on certain earnings but fail to declare other additional income (moonlighters); and
- employers who may encourage or facilitate ghosts and moonlighters, and also evade employers' contributions.

2 The study did not cover under declarations of income, such as cash takings, by the self-employed who are registered with the Department. Our reports on the *Filing of Income Tax Self Assessment returns* (HC 74, Session 2005-06) and the *Collection of Income Tax, National Insurance and Capital Gains Tax through Self Assessment* (Standard Report on Accounts 2006-07) examines how the Department checks the accuracy and completeness of tax returns.

Methodology

3 The report examines whether the Department could do more within existing resources to reduce the tax lost from unregistered businesses, moonlighters and ghosts in the hidden economy. We have considered whether the Department:

- does enough to encourage people and businesses to enter the formal economy;
- detects cases and imposes sanctions successfully, and
- understands the scale and nature of the tax at risk from unregistered businesses, moonlighters and ghosts.

Encouraging people and businesses into the formal economy

4 We reviewed the Department's approach to encouraging people and businesses into the formal economy. We examined the Department's:

- advertising campaigns to encourage the self-employed to register and the public to report cases where they suspect businesses are operating in the hidden economy. We reviewed the Department's evaluation of the campaigns. We examined the type of cases reported to the hotline, the Department's progress in dealing with them and results including "success rates" and tax yield;
- previous incentive schemes encourage those in the hidden economy to regularise their tax affairs and the lessons learned from them. We also followed up on the Committee of Public Accounts recommendations on the use of incentive schemes.

Detecting cases and imposing sanctions

5 We reviewed the Department's approach to detecting and imposing sanctions including the:

- methods for detecting cases in the hidden economy and their effectiveness. We followed up on the Committee of Public Accounts recommendation that the Department should make greater use of data matching. In carrying out the work we drew on the experiences of other tax authorities;
- prioritisation of cases for investigation and case handling systems for tracking them;
- the actions taken on less serious cases; and
- the sanctions imposed on those detected in the hidden economy and the Department's success in recovering the tax lost. We compared with other public sector organisations the type of sanctions imposed.

6 We analysed trends in the Department's data. We analysed trends in the Department's data on the number of cases detected, amount of tax involved by each tax and the sanctions imposed. We tried to examine the distribution of cases detected in 2006-07 to establish the financial spread and types of cases (people/employers/businesses) and possible opportunities to improve performance by targeting more high value cases.

7 We examined a sample of 53 hidden economy cases carried out under civil and criminal procedures.

The case studies were selected manually by National Audit Office staff from lists of completed investigations in the Department's East, London & Anglia, North West & Midlands and South regions. The cases illustrated the differing circumstances and methods involved at each stage of the case, and included:

- 30 Income Tax ghosts or moonlighters
- 11 cases involving both direct and indirect tax
- 9 VAT only ghosts
- 3 employer compliance cases (PAYE)

The tax involved in the cases ranged from £0 (8 cases) to £3.5 million with an average of £20,500 (excluding the largest case).

Managing the risks to tax from the hidden economy

8 We reviewed the Department's approach to assessing risks. We employed Risk Solutions to review the Department's approach to assessing the risks from ghosts, moonlighters and unregistered businesses. They also examined the Department's assessment of the size and threat to tax from ghosts, moonlighters and unregistered businesses.

9 We produced case studies. We examined how the Department is tackling the hidden economy in the home repair and maintenance and buy-to-let landlord sectors. There were two aspects to this work:

- a The first involved illustrating for each initiative the scale of activity such as numbers employed/businesses involved, any indications of the size of the hidden economy including the reasons the Department selected these areas, the work the Department does to tackle these areas, the results and the challenges it faces.
- b The second involved identifying particular issues faced by people including their perspectives and motivations for remaining in or leaving the hidden economy. We drew on the results of work the Department has produced on around 100 case studies of people in the hidden economy. This was supplemented with the results of interviews by our consultants Ipsos MORI of those who have left, or are currently operating in, the hidden economy. The consultants conducted 30 in-depth interviews in total.

Overarching methodologies

10 We reviewed existing research into the hidden economy. We employed Professor Colin Williams of the University of Sheffield who is an academic expert on the hidden economy to produce a paper synthesising the main lessons from the research carried out internationally, by UK academics and other organisations such as the Joseph Rowntree Foundation on tackling the hidden economy.

11 We carried out financial analysis. We analysed the costs and outcomes of the Department's work to tackle ghosts, moonlighters and unregistered businesses at each stage – prevention, detection and investigation – by calculating the return the Department makes on each £1 invested.

Departmental staff in hidden economy teams and other activities in 2006-07 were costed using average salary for each grade adjusted to reflect salary related costs and identified other direct costs by interview of the Department's staff (see Appendix 3). The resources used in hidden economy work in previous years could not be identified due to major changes in the Department's organisation following the amalgamation of Inland Revenue and HM Customs and Excise in 2005.

Working with the Department's Knowledge, Analysis and Intelligence division we identified tax assessments raised by hidden economy teams and estimated the likely cash received using data for comparable activities. We also attributed any tax received from former ghosts and moonlighters for up to two years following registration for Income Tax. Similar data was not available on VAT due to changes in computer records; however this yield was estimated from the annual VAT liability assessed by case officer.

12 We undertook an international benchmark. We employed RAND Europe to research the approaches used by other tax authorities to tackling the hidden economy. This enabled us to put the Department's performance in a comparative context and provided lessons on tackling the hidden economy. RAND Europe examined the approach to tackling the hidden economy by tax authorities in five countries including the United States, Canada, Australia, Belgium and Sweden. We also contacted the European Commission to discuss its role in encouraging and supporting Member States activities in tackling the hidden economy. RAND Europe's work is independent research that has been drawn on for this study, which does not necessarily confer endorsement by HM Revenue & Customs. A summary of RAND Europe's report is at Appendix Two. The full report is available on the National Audit Office website (www.nao.org.uk/publications/nao_reports) alongside this report.

13 We set up an Advisory Group for the study: The Group provided advice and feedback to the study team on our study plans and emerging findings and conclusions. The Group consisted of:

- Aaron Barbour, Community Links
- Derek Elliot, The Audit Commission
- Jonathan Fisher QC, ICAEW Fraud Advisory Panel
- Andrew Fyfe, City of London Police, Economic Crime Department
- Jim Gee, Director of Fraud Services, KPMG
- Judith Hicks, Department for Work and Pensions
- Søren Pedersen, Danish Tax Authority (SKAT)
- Professor Colin Williams, University of Sheffield

APPENDIX TWO

A summary of the report by RAND Europe on *Comparing how some tax authorities tackle the hidden economy*

The background to the work

1 The National Audit Office commissioned RAND Europe²⁵ to carry out a study placing the performance of HM Revenue & Customs in tackling the hidden economy in an international context. The study also sought to identify good practices used by other tax authorities that could be adopted by the UK. A copy of the report is on the National Audit Office's website (www.nao.org.uk). The report covers:

- Estimating the size of the hidden economy;
- Tax authorities' strategies and how they are organised to tackle the hidden economy;
- Encouraging people into the formal economy;
- Detecting people in the hidden economy; and
- The sanctions imposed by tax authorities.

2 RAND Europe compared the approaches of five tax authorities – Australia, Belgium, Canada, Sweden, and the United States. These countries are similar to the UK in wealth per capita and demographics. Each of the tax authorities has identified the hidden economy as an important area to tackle and has a range of measures to deal with the problem. The structure of the tax systems in these countries and their tax rates are however different. Some such as Belgium and Sweden have higher rates of tax than countries such as the United States and Australia (**Figure 12**). In carrying out the work RAND Europe also drew on work by the European Commission on undeclared work. The study used a template agreed with the National Audit Office to gather information from a review of publicly available documents and from contact with officials in each tax authority and other organisations.

12 Each country has different rates of tax

	Total tax receipts as percentage of GDP in 2003	Personal income tax (% of tax receipts) in 2003	Corporate income tax (% of tax receipts) in 2003	Taxes on goods and services (% of tax receipts) in 2003	Other (% of tax receipts) in 2003
Sweden	50.6	31.3	5.0	26.3	8.9
Belgium	45.4	31.4	7.4	24.6	7.5
OECD average	36.3	24.9	9.3	32.1	10.4
United Kingdom	35.6	28.7	7.8	32.7	13.0
Canada	33.8	34.6	10.4	26.1	14.0
Australia	31.6	38.5	16.7	29.7	15.1
United States	25.6	35.3	8.1	18.2	13.5

Source: Taxation 2003, OECD (2007)

²⁵ RAND Europe is an independent not-for-profit policy research organisation that aims to serve the public interest by improving policymaking and informing public debate. Its clients are European governments, institutions, and firms with a need for rigorous, impartial, multidisciplinary analysis.

Estimating the size of the hidden economy

Definitions

3 The hidden economy affects everyone. Honest businesses suffer from unfair competition from those in the hidden economy. People working in the hidden economy do not benefit from the protection of employment legislation. Customers of people working in the hidden economy do not get guarantees for work carried out or have legal recourse for poor quality work. From governments' point of view, the hidden economy can lead to:

- Tax losses;
- benefit fraud where unemployed people are engaged in undeclared work while claiming benefit; and
- avoidance of employment legislation, such as minimum wage agreements or certain health and safety and other standards in the workplace.

4 Tax authorities tackle the hidden economy to reduce the amount of tax revenue lost and to be fair to taxpayers who are complying with their obligations. They use various definitions to cover the hidden economy. For example some include within their definition all forms of income that is undeclared, while others include only undeclared cash transactions. Tax authorities also use different terms such as "underground", "hidden", "black", "shadow" or "cash" economy to describe income that is undeclared for tax purposes.

Estimation methods

5 To estimate the size of the hidden economy, some academic studies analyse macro-economic indicators such as income and expenditure data. Other research

uses the results from surveys and reviews of tax records. Each method produces different results on the size of the hidden economy usually in terms of a percentage of GDP rather than an estimate of the amount of tax lost. The results from surveys and reviews of tax records tend to produce lower estimates than methods using macroeconomic data. This is because tax records provide only a partial view of the size of the hidden economy (a review of tax records will exclude from the calculations those people and businesses who do not file a tax return) and respondents to surveys are likely to understate their involvement in the hidden economy. Commentators suggest that analysing macro-economic data tends to overstate the size of the hidden economy. In the academic literature, there is a growing consensus that using direct methods (surveys and tax records) to estimate the size of the hidden economy are preferable to indirect methods (macro-economic data).²⁶

6 Whichever method is used the results from the research examined tends to show that the same countries have a relatively large or small hidden economy. The results of recent research indicates that the UK has a smaller hidden economy than most other countries (Figure 13). They also show that the size of the hidden economy has changed little in some but is increasing in others. The size of the hidden economy is influenced by a number of factors. For example, higher taxation countries appear to have a larger hidden economy. The complexity of the tax system and the rigidity of labour market regulations can also have an impact on the size of the hidden economy.²⁷ Specific factors in each country such as the role of social networks can affect the size of the hidden economy. This means that the range of measures used by tax authorities to tackle the hidden economy cannot be viewed in isolation from other factors that could also affect the size of the hidden economy.

13 The size of the UK's hidden economy appears relatively lower than other countries examined

	Belgium	Sweden	Canada	Australia	United Kingdom	United States
Size of hidden economy as percentage of GDP 2001-02	22.0	19.1	15.8	14.1	12.5	8.7

Source: Schneider, F. (2002)¹

NOTE

1 Schneider, F. (2002), "The Size and Measurement of the Hidden Economy in 110 Countries Around the World", presented at an Workshop of Australian National Tax Centre, ANU, Canberra, Australia, July 17, 2002.

26 Schneider F. (2006), *Shadow Economies of 145 Countries all over the World: Estimation Results for the Period 1999-2003*, Research Paper.

27 Research papers point to the positive correlation of factors such as the tax burden, excessive regulation, corruption and the hidden economy, see e.g. Bovi, M. (2002), *The Nature of the Underground Economy: Some Evidence from OECD Countries*, ISAE.

7 Estimates of the tax lost to the hidden economy could potentially help tax authorities with understanding the scale of the challenge. They can also help tax authorities assess trends and the possible effects of their efforts. The very nature of the hidden economy has meant that none of the tax authorities have been able to estimate on a regular basis the amount of tax lost. Some have tried and are continuing with their efforts. In 2006 HM Revenue & Customs employed the University of Bristol to produce estimates of the amount of tax lost to the hidden economy. They carried out a pilot project to assess the feasibility of carrying out a questionnaire survey of the UK population as a way of estimating the amount of tax lost to the hidden economy. HM Revenue & Customs concluded that the proposed methodology was unlikely to produce worthwhile results because a significant number of people would refuse to take part. It is now looking at new IT solutions to assist in the measurement of the hidden economy. The United States is planning to estimate the tax gap, a broad indicator of tax evasion, on a more regular basis (a four yearly measurement supplemented by annual reviews of a small sample of tax records). Sweden has undertaken ad hoc studies on the basis of macro-economic data and reviews of tax records. The Belgian tax authority has used survey data in the past and has relied on the results of a number of academic studies. The European Commission intends to undertake a study in 2008 to identify the best methodology for providing comparable estimates of the amount of undeclared work across the European Union.

8 Some tax authorities such as Australia and Canada do not consider that estimating the amount of tax lost to the hidden economy is worthwhile²⁸ because of the many different approaches and methodologies which result in a wide range of estimates. They are also concerned about the cost of preparing estimates from which there would be little discernible benefit.

Strategies and objectives for tackling the hidden economy

9 Tax authorities have broadly similar objectives and strategies for tackling the hidden economy. For example important objectives are to protect the revenue base and increase voluntary compliance. They emphasise the importance of tackling the hidden economy in their national strategies as part of meeting their objectives because of the amount of tax that could be potentially at risk. Their approach includes a range of measures to encourage people into the formal economy, detect those in the hidden economy, and deter individuals from entering the hidden economy (Figure 14).

10 In tackling the hidden economy, tax authorities focus on particular sectors or groups based on perceived risks to tax revenue. They have identified broadly similar sectors. For example tax authorities consider as high risk, sectors where cash transactions are commonly used for payment. They are also mindful of emerging new risks such as internet trading which provides new opportunities for businesses to operate in the hidden economy without detection.

11 Tax authorities have organised their staff resources in different ways to tackle the hidden economy. Some use general tax compliance staff to tackle the hidden economy as part of their wider activities of tackling non-compliance. In others, there are dedicated staff for tackling the hidden economy who may be used in combination with other tax compliance staff.

14 Tax authorities use similar measures to tackle the hidden economy

Prevention	Detection	Deterrence
Research into motivations	Risk assessments	Prosecutions
Media campaigns	Information from the public	Administrative penalties
Disclosure schemes	Data matching Tax audits	

Source: RAND Europe

28 The Australian Bureau of Statistics has produced some estimates on the size of the hidden economy in Australia in 2001.

Encouraging people into the formal economy

12 Tax authorities are focusing more on encouraging people into the formal economy as a way of improving voluntary compliance in addition to the traditional detection and deterrence approaches. For example tax authorities are using information campaigns to inform people of their responsibilities and to change attitudes. They have also used short term voluntary disclosure schemes to encourage individuals to declare income from the hidden economy. The UK's use of these schemes has attracted interest from others. HM Revenue & Customs' recent Offshore Disclosure arrangements has several characteristics that independent evaluations²⁹ identify as good practice, namely that the scheme respects the tax rates of the UK, is limited in scope and duration, and uses direct targeting such as writing to those individuals suspected of holding income and/or capital outside of the tax system.

Detection methods

13 Compared to other countries, HM Revenue & Customs is at the forefront in using a telephone hotline to obtain information from the public on those suspected of operating in the hidden economy.³⁰ Only Australia uses a similar hotline. In Canada, the Revenue Agency plans to set up a central hotline. Tax authorities are increasingly using data matching techniques to detect those in the hidden economy. Data matching appears successful where tax records are matched with external sources of information to identify taxpayers with income streams that have not been declared.

Sanctions

14 In most cases, tax authorities impose a financial penalty on those they detect in the hidden economy. The penalty may or may not be applied on top of the amount of tax owed. The amount of the penalty imposed varies widely between tax authorities. Tax authorities only prosecute individuals/ businesses in a relatively small number of cases because of the costs involved. They tend to prosecute the more serious cases and where a wider deterrent message is needed. From the available information it is not possible to determine the cost effectiveness of sanctions including the extent of the deterrent effect.

Overall conclusions

15 Assessing the comparative effectiveness of tax authorities' efforts to tackle the hidden economy is difficult because:

- The very nature of the hidden economy has meant that none of them has successfully estimated on a regular basis the amount of tax lost to the hidden economy. Some are continuing with work to produce robust estimates on the overall tax losses from the hidden economy. Without such estimates it is not possible to assess whether the amount of tax lost is increasing or decreasing over time and which would provide some measure of the effect tax authorities are having on the problem. Academic studies suggest that the size of the hidden economy (expressed as a percentage of GDP) is lower in the UK than in many other countries.
- The total amount of tax lost could be affected by factors outside of the control of tax authorities. For example high rates of tax, the complexity of the tax system, economic conditions and cultural factors can have an impact on the willingness of people and businesses to participate in the hidden economy.
- There is little published information available on the cost-effectiveness of the measures used by tax authorities to tackle the hidden economy. This is an area where tax authorities could usefully share more information on what measures work and why.

16 Despite these limitations, our work has identified a range of good practices used by tax authorities in tackling the hidden economy. Overall we consider that the UK compares well with others. It is at the forefront in using telephone hotlines to enable the public to report their suspicions of people working in the hidden economy and in the use of voluntary disclosure schemes where there has been success in collecting large amounts of tax owed. In many areas, the UK has practices that are comparable to others. There is a trend internationally to do more data matching exercises that draw on large external databases to compare against tax records on a regular basis as a way of detecting those in the hidden economy. Some tax authorities use surveys regularly to gauge peoples' attitudes to the hidden economy. Where the results indicate that sectors of the community consider it acceptable to participate in the hidden economy, the tax authority uses information campaigns to change attitudes. The tax authority then follows up with further surveys to assess whether attitudes have changed as a result.

²⁹ See for instance, Pacolet, J., Coudron, V. and Van De Putte, I. (2004), *Zonder Pardon: Spaarfiscaliteit, Vermogensbelasting, Fiscale Amnestie*, HIVA: Antwerp.
³⁰ The UK hotline also deals with tax evasion cases.

17 On prevention, good practices include:

- Tracking the motivations of those in the hidden economy through surveys to feed into the overall risk assessment for compliance activities (Australia and Sweden);
- Targeted educational campaigns at specific sectors (e.g. home repair and maintenance or small businesses) and cooperating with trade associations to tackle industries with a high incidence of non-compliance (Australia, Belgium and Sweden);
- Offering voluntary disclosure schemes (UK, Belgium and Australia);
- Surveys tracking the attitudes of those in the hidden economy to assess the impact of media campaigns (Australia and Sweden);
- Community visits, workshops and specific internet sites to encourage people into the formal economy (Australia and Canada); and
- Schemes to displace the hidden economy such as the use of work vouchers in Belgium. These are policy initiatives requiring decisions by Government.

18 On detection, good practices include:

- Using telephone hotlines to enable the public to report their suspicions of people working in the hidden economy (UK);
- The regular use of data matching to target specific sectors and activities in the hidden economy particularly where there is a high incidence of non-compliance (Canada and Sweden); and
- The wider use of external data in data matching to increase the rate of detection (Australia, Canada, US).

19 On sanctions, good practices include:

- The systematic use of sanctions and adjusting penalties for inflation to increase deterrence;³¹ and
- Tracking the perceptions of people on sanctions to assess the deterrent effect (Sweden).

31 These factors are not necessarily applied in the countries studied but are mentioned in evaluations in the United States, Belgium, and Sweden as important areas for improvement in the sanctions regime, see e.g. GAO (2007) *Tax Compliance: Inflation Has Significantly Decreased the Real Value of Some Penalties*, Report to the Committee on Finance, U.S. Senate, GAO-07-1062.

APPENDIX THREE

Responsibilities within HM Revenue & Customs and other government departments and agencies in tackling the hidden economy

15 The Department's business units responsible for tackling the hidden economy

Business unit	Responsibilities	Number of staff	Direct Cost ¹ £m
Local Compliance	<p>In November 2006 Local Compliance set up 20 dedicated hidden economy teams located around the country. These teams are responsible for investigating suspected ghosts, moonlighters evading Income Tax, National Insurance contributions and VAT. Local Compliance also have separate employer compliance teams that are responsible for ensuring employers operate the PAYE system properly but also detect employers who pay staff without operating a PAYE scheme, and Small Business Teams who carry out some of the investigations of moonlighters as well as other compliance work.</p> <p>Prior to November 2006, Local Compliance had:</p> <ul style="list-style-type: none"> ■ Right Track Teams originally set up by the former Inland Revenue to detect ghosts and moonlighters evading direct taxes. ■ Joint Shadow Economy Teams with staff from the Department for Work and Pensions. The role of the teams was to detect those operating in the hidden economy where more than one Department had an interest. ■ Shadow Economy Teams who concentrated on detecting businesses that should be registered for VAT. These teams were set up in April 2003 by the former HM Customs and Excise. 	900	27.4
Risk and Intelligence	They provide information to Local Compliance on areas to tackle in the hidden economy, and prepare standard intelligence packages on individual suspects for them to investigate.	180	5.4
Criminal Investigation	They investigate cases with a view to prosecution.	50	2.6
Customer contact	They operate the Self-Employed Helpline and a Hotline for the public to report cases of suspected tax evasion. From April 2008 they will monitor the compliance of those formerly in the hidden economy and provide them with education and help where needed.	140	5.7
Total		1,270	41.1

Source: National Audit Office analysis of HM Revenue & Customs information

NOTE

¹ Costs include salary related costs plus directly attributable costs (e.g. advertising).

16 The work of other members of the Inter-Departmental Informal Economy Steering Group

Organisation	Responsibilities	Examples of working together
Department for Work and Pensions	The Department administers pensions, benefit payments and welfare to work and other programmes. It investigates cases where people are claiming welfare benefits but are suspected of working in the hidden economy for cash-in-hand payments.	<p>The Departmental staff work in “virtual” teams with HM Revenue & Customs staff to share information and intelligence on those working in the hidden economy. They also undertake joint investigations.</p> <p>The Department for Work and Pensions carries out regular bulk data matching exercises of those claiming benefits to HM Revenue & Customs tax records and other organisations’ records to confirm their employment status and their eligibility for benefits.</p>
Home Office/ Border and Immigration Agency	One of the Home Office’s objectives is to ensure and enforce compliance with UK immigration laws, removing the most harmful people first and denying the privileges of the UK to those here illegally. It published <i>Enforcing the rules: A strategy to ensure and enforce compliance with our immigration laws</i> (March 2007) which sets out how government agencies can work cooperatively to tackle the problem. The strategy’s central tenet is to progressively deny work, benefits and services to people in the country illegally.	<p>The Home Office is seeking to create immigration crime partnerships across the country and collect, analyse and disseminate immigration crime information and intelligence more effectively.</p> <p>In 2005 the Home Office launched a Joint Workplace Enforcement Pilot to explore the scope for closer coordinated working between government departments to tackle the exploitation of illegal migrant workers.</p>
Defra	The Department is responsible for policy on the agricultural, horticultural and fishing industries where significant numbers of temporary workers are employed. The Department is also responsible for enforcing the agricultural minimum wage.	It has carried out research into the agricultural, horticultural and fishing industries and participated in cross-agency work to tackle the hidden economy.
Department for Business, Enterprise and Regulatory Reform (DBERR)	The Department is responsible for creating the conditions for business success. The Department has policy responsibility for the National Minimum Wage.	The Department funds HM Revenue & Customs teams that enforce the National Minimum Wage.
Gangmasters Licensing Authority	It was set up to curb the exploitation of workers in the agriculture, horticulture, shellfish gathering and associated processing and packaging industries. It is now illegal to supply workers to the agriculture and food processing and packaging sectors without an Authority licence.	<p>When the Authority receives an application, it asks HM Revenue & Customs to confirm the applicant’s business details, whether there are any investigations into them or whether there have been any civil penalties imposed or criminal action taken against them in the last three years.</p> <p>The Authority provides intelligence to HM Revenue & Customs. They can also carry out joint investigations.</p>

Source: Inter-Departmental Steering Group on the Informal Economy

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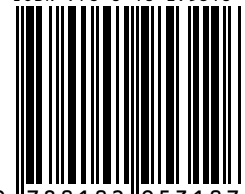
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