



National Audit Office

## HM REVENUE & CUSTOMS

# Tackling the hidden economy

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 341 Session 2007-2008 | 3 April 2008



# 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 32,700<sup>1</sup> 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.

<sup>1</sup> 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.