National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs, HM Treasury

The management of tax expenditures

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Key facts

£155bn	5%	£11bn
sum of the estimated costs of 'tax expenditures' in 2018-19 (tax reliefs supporting government objectives)	real increase in summed estimated cost of tax expenditures, 2014-15 to 2018-19	estimated 2018-19 cost of tax expenditures with published evaluations since 2015

362	number of tax expenditures (tax reliefs supporting government economic and social objectives)
111	number of tax expenditures that HM Revenue & Customs has costed
23	number of tax expenditures with a forecast cost of more than £1 billion in 2018-19
63	tax reliefs HM Treasury assessed for value for money as part of a monitoring exercise by 2019
15	number of tax expenditures with published evaluations since 2015

Summary

Introduction

1 The UK tax system had 1,190 tax reliefs as at October 2019. A tax relief reduces the tax an individual or business owes. There are two broad categories of tax reliefs: structural tax reliefs that are largely integral parts of the tax system and define the scope and structure of tax (such as the personal tax allowance); and non-structural tax reliefs where government opts not to collect tax to pursue social or economic objectives. Non-structural tax reliefs are often referred to as 'tax expenditures' and we use this description in this report. Examples include tax credits for companies' research and development (R&D) costs and income tax relief on pension contributions. Some tax expenditures simply reflect a policy choice by ministers to support particular groups or sectors (for example the housing market), while others are designed to incentivise behaviour. Some tax reliefs can be difficult to classify because they have more than one objective and include elements of both tax expenditures and structural reliefs.

2 Tax expenditures are an important part of public policy design. They cover most areas of government activity, including welfare, housing, business, food, education, health and transport. They can also make the tax system more complicated and less transparent, and they could pose risks to public finances because their costs can rise beyond expectations. Tax expenditures differ from public spending in that they reduce the amount of tax collected, rather than consume resources after tax is collected. However, they are similar in that both affect the public purse and can be used to pursue discrete policy objectives.

3 The UK had 362 tax expenditures in October 2019, with HM Revenue & Customs (HMRC) reporting the cost of 111. These tax expenditures had a combined estimated cost of £155 billion in 2018-19. Aggregating the cost of tax expenditures gives a sense of their scale, but it does not reflect the amount of tax that would be generated if tax expenditures were removed because some taxpayers would change their behaviour and there may be wider economic impacts.

4 Ministers propose policy changes to introduce or amend tax expenditures as part of the Budget. Parliament undertakes scrutiny of tax policy including tax expenditures as part of the Budget process and through the work of the Treasury Select Committee. HM Treasury and HMRC (the exchequer departments) are responsible for all aspects of the effective working of the UK tax system including tax expenditures. HM Treasury is responsible for strategic oversight of the tax system and HMRC is responsible for administering the system. The Accounting Officers of HM Treasury and HMRC are accountable to the Committee of Public Accounts for the economy, efficiency and effectiveness of the resources they use to discharge their responsibilities, including the work they carry out to manage tax expenditures.

5 Along with the Committee of Public Accounts, we have repeatedly raised concerns about the departments' management of tax reliefs. In our 2014 report, *The effective management of tax reliefs,* we found that neither department had frameworks or principles to guide their administration of tax reliefs. In 2016, we reported that while HMRC had developed internal guidelines for managing reliefs, staff did not understand they were compulsory. In 2018, the Committee of Public Accounts concluded that HMRC did not know whether a large number of tax reliefs were delivering value for money. HMRC and HM Treasury have responded to our recommendations by increasing their oversight of tax expenditures and actively considering their value for money. In 2019, HMRC informed the Committee that, whilst both HM Treasury and HMRC are responsible for advising ministers, the prime responsibility for advising ministers on the value for money of tax reliefs lies with HM Treasury.

6 In July 2019, the Office for Budget Responsibility (OBR) identified the costs of tax reliefs as one of four new fiscal risks to the public finances. The OBR was concerned that: the government did not know the full cost of tax reliefs; that tax reliefs lacked transparency and scrutiny; and added complexity to the tax system.

Scope of this report

7 This report examines the effectiveness of HM Treasury's and HMRC's use of their resources in the management of tax expenditures. Government spending is governed by HM Treasury's *Managing Public Money* but there is no equivalent guidance for tax expenditures. The rules governing the tax system are set out in legislation which Parliament scrutinises through the Finance Bill process. The exchequer departments provide information needed to support decision-making. How the exchequer departments monitor and evaluate tax expenditures informs government's understanding of the value for money of tax expenditures. In this report we examine how HM Treasury and HMRC manage tax expenditures overall and examine their oversight and administration across the lifecycle of tax expenditures, specifically:

- the number and cost of tax expenditures (Part One);
- design and monitoring of tax expenditures (Part Two); and
- the evaluation and review of tax expenditures (Part Three).

8 Under section 6 of the National Audit Act 1983, the Comptroller and Auditor General (C&AG) examines the economy, efficiency and effectiveness of the way that government departments use their resources in discharging their functions, including the management of tax expenditures. Our assessment is informed by deeper dives into how the departments used their resources to administer and oversee nine established tax expenditures and design three that were new or recently amended (**Figure 1** on pages 7 and 8). We have not set out to conclude on the value for money of specific tax expenditures. Our audit approach is set out in Appendix One and our evidence base in Appendix Two.

Figure 1

Case study tax expenditures covered in this report

We looked at tax expenditures which supported a range of objectives and had differing ages and cost

Description	Objective	When introduced	Cost 2018-19[1] (£m)
1 Zero rating of VAT on the construction and sale of new dwellings (residential and charitable buildings).	Support housing construction	Long-standing (40+ years)	*14,800*
2 Relief from inheritance tax on agricultural property.	Support continuity of farming business		*315*
Research and Development (R&D) reliefs:	Support research and development activity	Established (6 to 39 years)	
3 Small- and medium-sized enterprises			*2,515*
4 R&D expenditure credit[2] R&D reliefs provide an extra deduction from companies' taxable income for R&D expenditure. Loss-making companies can receive a tax credit.			*2,340*
5 Entrepreneurs' relief – reduces capital gains tax to 10% for sales of certain assets (for example, selling a business or shares in a business).	Encourage enterprise		*2,200*
6 Patent box – reduces the corporation tax rate to 10% for profits from patented inventions.	Support commercialisation of innovation, and attract and retain intellectual property		*1,150*
7 Film tax relief – film production companies can claim additional corporation tax relief for film production expenditure in the UK.[3] Loss-making companies can receive a tax credit.	Support UK film industry		*550*
8 Relief on employer National Insurance Contributions for employees under 21.	Encourage employment of under-21s	Recently established (3 to 5 years)	610
9 Relief on employer National Insurance Contributions for apprentices under 25.	Encourage apprenticeships		160
10 Enterprise investment scheme – a venture capital scheme that grants income and capital gains tax reliefs to individuals investing in small companies.	Encourage investment in companies with high potential growth	New or recently amended	*720*[4]
11 Relief on stamp duty land tax for first-time buyers (no duty or reduced rates on homes up to £500,000).	Support home ownership and first-time buyers		*520*
12 Structures and buildings capital allowance – companies carrying out capital works on non-residential buildings can make a deduction from profits over a 50-year period.[5]	Support business investment		–[6]

Figure 1 *continued*

Case study tax expenditures covered in this report

Notes

1 Most 2018-19 costs are projections based on previous years' actual data. Projections are shown in italics to distinguish from actuals.

2 R&D expenditure credit is mainly claimed by large companies, although it is available to small- and medium-sized enterprises in certain circumstances.

3 Expenditure must be on goods and services used or consumed in the UK to qualify for film tax relief.

4 Cost is the total of the income tax (£600 million) and capital gains (£120 million) elements of the tax expenditure.

5 Some capital allowances have elements of both structural reliefs (that is, they help define the boundaries and thresholds of the tax system) and tax expenditures. Tax expenditures are tax reliefs which government uses to encourage particular groups, activities or products in order to achieve economic or social objectives.

6 HM Revenue & Customs reports the total cost of all capital allowances rather than the cost of each allowance such as structures and buildings.

Source: National Audit Office

Key findings

The number and cost of tax expenditures

9 Tax expenditures represent a large and growing cost to the Exchequer. In July 2019, the OBR reported that the known cost of tax expenditures had risen in the past decade. Our analysis of latest data published by HMRC in October 2019 shows that, between 2014-15 and 2018-19, the cost of tax expenditures increased by 5% in real terms, from £147 billion to £155 billion (forecast). Twenty-three tax expenditures each costing more than £1 billion accounted for 92% of the total forecast cost in 2018-19. The largest tax expenditures were the reliefs on pension contributions, the reliefs from VAT on food and new dwellings, and the relief from capital gains tax on people's main homes (paragraphs 1.5, 1.15 to 1.17 and Figure 3).

10 HMRC has committed to publishing more information on the cost of tax expenditures. HMRC has calculated the cost of 111 of 362 tax expenditures. It plans to estimate the costs for more tax expenditures between 2020 and 2022, prioritising those tax expenditures it regards as higher risk (paragraphs 1.5, and 1.18 to 1.19).

11 The number of tax expenditures presents government with a significant oversight challenge. The International Monetary Fund states that tax expenditures require the same amount of government oversight as public spending. The scale of tax expenditures in the UK is larger than most other countries and it will be challenging to give tax expenditures the same amount of attention as spending. HMRC is improving its understanding of the different types of tax expenditures by categorising tax expenditures by purpose. Its initial work indicates that many are intended to incentivise behaviour. While HMRC's new categorisation is useful in understanding the broad types of tax expenditures, it is not sufficiently detailed to group those targeted at similar sectors or those with similar social or economic objectives (paragraphs 1.6, 1.7, 1.13, 1.14, 1.20 to 1.21 and Figure 4).

The design and monitoring of tax expenditures

12 The exchequer departments are improving their oversight of tax expenditures. In 2016 HMRC set up a central team to oversee its management of tax reliefs. The team identified the officials responsible for specific reliefs and established compulsory guidance. It introduced a framework to record information on reliefs in a consistent manner across the Department. In 2017, HM Treasury piloted monitoring of tax expenditures, prioritising those with specific policy objectives worth more than £40 million a year. By 2019 it had informally assessed whether 63 tax reliefs were value for money, as part of its policy-making process. The exchequer departments' monitoring processes are still in development, and not yet integrated with one another. They plan to develop a single framework for administering and reviewing tax expenditures, drawing on relevant UK and international good practice (paragraphs 2.9 to 2.14).

13 When designing tax expenditures, HM Treasury has not given enough consideration to how it will measure impact. When designing a new tax expenditure HM Treasury undertakes many of the activities that we would expect at this stage including consulting with relevant stakeholders. However, we did not find any cases among tax expenditures introduced since 2013 where government had set out plans for their evaluation at design stage, or triggers for evaluation if costs or benefits differed significantly from their forecasts (paragraphs 2.3 to 2.6 and Figure 9).

14 Some tax expenditures cost far more than government's published forecasts indicated. HMRC does not compare the actual costs of tax expenditures to the government's original published forecasts available to Parliament. HMRC told us that published forecasts are made on a different basis to the actual costs and a number of factors make meaningful comparison difficult. For example, the forecasts can include the impact on public finances of other changes to the tax system, other elements of tax revenue or wider economic impacts, which may not be directly comparable to the full cost of the tax expenditure. Even so, HMRC could take these factors into account to make meaningful comparisons, which would help it better understand costs. We compared forecast and actual costs for 10 tax expenditures, adjusting for differences as far as possible with the data available. The comparison indicated large differences for some tax expenditures:

- For five tax expenditures introduced since 2013, including three of the four largest, data indicated costs were generally in line with original forecasts.
- For the R&D expenditure credit, and four smaller tax expenditures introduced since 2013, data indicated costs exceeded forecasts by 50% or more.

It was more difficult to compare forecasts and actual costs for tax expenditures introduced before 2013. However, we found that the costs of three of our case study tax expenditures had grown from around £1 billion in 2008-09 to around £5 billion in 2017-18, much faster than the trends indicated in published forecasts (paragraphs 2.16 to 2.20 and Figures 10 to 12).

15 **HMRC has not fully investigated some large changes in costs.** Cost increases may indicate that a tax expenditure is working well, or that it is being used in ways not intended. However, this can be difficult to determine without a substantive assessment. HMRC had identified reasons for large changes in cost for all the established case study tax expenditures we looked at. However, it did not normally test how far the reasons explained cost movements, or compare its costs estimates with other data. Of the nine cases we looked at, HMRC checked cost changes against independent data for only agricultural property relief and R&D reliefs. For R&D reliefs, HMRC compared the total R&D companies had claimed in tax returns for UK and overseas activity, with national statistics on total UK (only) R&D activity. This comparison revealed that the R&D activity companies had claimed was rising more quickly, and in 2016-17 exceeded all UK R&D activity by 43%. HMRC is in the process of investigating the reasons for trends in data (paragraphs 2.17, 2.21 to 2.24 and Figure 13).

16 **R&D tax reliefs have been subject to increased levels of abuse.** HMRC does not hold data on tax lost from abuse and error for all tax expenditures. However, it has developed a single view of the 63 main compliance risks it faces. Six of these risks are specific to tax reliefs. Some of the other risks partly arise from tax reliefs, although HMRC's data do not show the significance of reliefs. Of the six tax relief-specific risks it has identified, the risks were increasing for three. The risk arising from the R&D tax expenditures was increasing the most. In 2017 and 2018 HMRC identified more tax at risk from poor-quality R&D claims, and from abuse by companies with a limited UK presence. In 2018 HMRC substantially increased its estimate of tax at risk from the R&D tax expenditures to a level which indicated further action was required. The time needed to train new staff and develop new systems has affected the pace of HMRC's response (paragraphs 2.25 to 2.27).

The evaluation and review of tax expenditures

17 **HMRC has formally evaluated only a minority of tax expenditures.** HMRC commissions and undertakes evaluations of few tax expenditures. Since 2015, HMRC has published evaluations of 15 tax expenditures, representing just 7% (£11 billion) of the aggregate forecast cost of tax expenditures in 2018-19. HMRC has evaluated only five of 23 tax expenditures costing more than £1 billion, and less than half of the large tax expenditures experiencing the fastest cost growth (paragraphs 3.2 to 3.4).

18 **HMRC's evaluations of tax expenditures suggest that their effectiveness varies widely.** Evaluations published since 2015 by HMRC have assessed the impact of 13 of the 15 tax expenditures covered. These evaluations found that seven of these tax expenditures (costing £3.6 billion in 2018-19) were having a positive impact on behaviour, and one (costing £1.4 billion) had had a mixed impact. However, five tax expenditures costing £5.2 billion had only a limited impact. Notably, a 2017 evaluation found that only 8% of people claiming entrepreneurs' relief in the previous five years said it had influenced their investment decision-making. The relief costs the Exchequer more than £2 billion a year (paragraph 3.6 and Figure 14).

19 HM Treasury has developed internal, informal processes for assessing the value for money of tax expenditures. HM Treasury reviews the tax system annually, including tax expenditures, as part of the Budget. In addition to this HM Treasury started a monitoring exercise in 2017 as a tool for collecting information and officials' views to help inform advice to ministers. HM Treasury's monitoring assessments have rated the value for money of 63 tax reliefs. HM Treasury told us these are internal, informal assessments that do not represent the formal view of the Department and should not be published because they are part of policy advice to ministers. We looked at monitoring templates for eight case studies and found that the assessments ask many of the questions we would expect, but that the quality of information underpinning the assessments was variable. HM Treasury was better placed to assess tax expenditures when it had information available from recent HMRC evaluations. In the case of the R&D expenditure credit HM Treasury based its assessment on an evaluation of the previous scheme aimed at large companies. HM Treasury undertakes limited quality assurance of its value-for-money assessments (paragraphs 1.22, 2.13, 3.7 to 3.12 and Figure 15).

20 There is no formal documentation specifying explicitly the departments' accountabilities for the value for money of tax expenditures. In 2014, HM Treasury set out its view on accountability for tax reliefs but it did not specifically consider accountability for value for money. In 2019, HMRC informed the Committee of Public Accounts that the broader question of the value for money of tax reliefs is the responsibility of HM Treasury, with HMRC providing relevant advice as part of the tax policy partnership in the normal way. Policy decisions on the value for money of tax expenditures are for Treasury ministers, who are ultimately accountable to Parliament for the tax system and policy. HM Treasury officials are accountable for providing ministers with high quality advice to make those decisions. HMRC officials also carry out administrative functions which influence the cost and impact of tax expenditures. For example, clear guidance, promoting take-up to target groups, action to tackle abuse and timely reporting can all help to improve value for money (paragraphs 1.8 to 1.13, 2.25 to 2.27 and 3.13 to 3.16).

21 Public reporting has improved but does not yet provide the information necessary to assess the value for money of tax expenditures. HM Treasury ministers are accountable to Parliament for the value for money of tax expenditures. As part of the legislative process the government publishes costings and 'tax information and impact notes' and ministers outline their aims to Parliament. However, government does not publish the information necessary for scrutiny of the value for money of existing tax expenditures. HMRC's statistical bulletin is much improved but still contains very limited information on the benefits achieved by tax expenditures, only limited commentary on their cost trends, and although HMRC included estimates for the number of claimants for the first time in January 2019, there is no trend data on the number of claimants. The bulletin does not explain how costs and benefits differ from the original published forecasts. Other countries have more comprehensive evaluation and reporting despite most having comparatively lower levels of tax expenditures (paragraphs 1.8, 2.5 to 2.7, 3.15, 3.17 to 3.20 and Figure 16).

Conclusion

22 At a forecast cost of £155 billion in 2018-19, tax expenditures represent an important means by which government pursues economic and social objectives. Evaluations show that their impact is not guaranteed, and many require careful monitoring. We have previously raised concerns about how effectively government is managing tax expenditures. Both HMRC and HM Treasury have responded to our recommendations by increasing their oversight of tax expenditures and actively considering their value for money.

23 While these steps are welcome, they are very much still in development. The large number of tax expenditures means it will take time to identify and embed good practices. Both departments need to make substantial progress and ensure sufficient coverage and rigour in the work they undertake on this matter.

24 On their own these improvements will not be sufficient to address value-for-money concerns unless the departments formally establish their accountabilities for tax expenditures and enable greater transparency. Lessons can be learned from other countries that have established clear arrangements for evaluating and reporting on tax expenditures. We look to HM Treasury and HMRC to follow suit by clarifying arrangements for value for money and improving the evaluation and public reporting of tax expenditures.

Recommendations

25 As the custodians of the tax system HMRC and HM Treasury are responsible for assessing the cost and impact of tax expenditures and communicating this to decision-makers. We recommend that:

HM Treasury should:

a **establish a framework for designing and administering tax expenditures that is commensurate with the large number of UK tax expenditures.** The framework should draw on 'Green Book' principles, international good practice and stakeholder views;

b **develop a robust methodology for assessing the value for money of different types of tax expenditures**, ensuring that assessments are quality-assured;

c **consider specifying time-periods or triggers for evaluation and review when designing each tax expenditure**;

d **each year review whether the objectives of tax expenditures still align with government objectives**; and

e **establish and document clear requirements for officials to report concerns about the value for money of tax expenditures to ministers**, for example by specifying accountability arrangements.

HMRC should:

f **further develop categorisation of tax expenditures** according to, for example, their objectives, scale, age and risks, in order to inform the allocation of administrative resources in proportion to the cost and impact that tax expenditures are intended to achieve;

g **identify and use independent data sources, where available, to further test reasons for movements in the cost of high-priority tax expenditures**;

h **develop a more systematic approach to the evaluation of tax expenditures to provide greater coverage**. We estimate that the external cost of commissioning evaluations of six tax expenditures a year would likely be between £1 million and £1.5 million. This estimate does not include the cost of HMRC's own internal costs, which could be significant;

i **develop an approach so that it understands and can report the differences between actual and forecast cost for tax expenditures it regards as high-priority in its published analysis**. In cases where it is not feasible to make a comparison for a high-priority tax expenditure, HMRC should explain why; and

j **include trend data on the number of beneficiaries of tax expenditures in published analysis**, where possible, and take account of this within commentaries.