National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs

Tackling the tax gap

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Key facts

£31bn

HM Revenue & Customs' (HMRC's) estimate of the size of the tax gap in 2018-19. The tax gap is the difference between the amount of tax theoretically owed and the amount collected

4.7%

HMRC's estimate of the size of the tax gap as a percentage of total tax due in 2018-19

1.1%

reported percentage point decrease in the annual tax gap between 2015-16 and 2018-19

£34.1 billion	yield from HMRC's tax compliance activities in 2018-19 (increase of £7.5 billion since 2015-16)
7:1	the estimated amount of additional tax revenue from each pound HMRC spent making sure individual taxpayers complied with tax rules in 2018-19
44:1	the estimated amount of additional tax revenue from each pound HMRC spent making sure large businesses complied with tax rules in 2018-19
£4.6 billion	estimated additional tax yield arising from HMRC initiatives to promote compliance and prevent non-compliance before a taxpayer submits a tax return between 2016-17 and 2018-19
33%	reduction in the number of HMRC compliance enquiries and audits between 2016-17 and 2018-19

Summary

Introduction

1 HM Revenue & Customs (HMRC) is responsible for administering the UK's tax system. One of its three departmental objectives is to "collect revenues due and bear down on avoidance and evasion". HM Treasury leads on the design of the tax system. It agrees HMRC's revenue and efficiency targets, and levels of funding.

2 HMRC reported record tax revenue of £627.9 billion in 2018-19, an increase of £22.1 billion (3.6%) on 2017-18. Tax administrations rely heavily on taxpayers reporting and paying their taxes in line with the rules. In 2018-19 HMRC received 90% of total tax owed this way. Inevitably some taxpayers make mistakes, others choose not to comply, and some cannot pay because of insolvency. In other cases, taxpayers interpret tax rules differently from HMRC, which can affect the amount of tax they pay, or construct artificial arrangements to avoid tax. HMRC's most recent estimate of the difference between the amount of tax theoretically owed and the amount collected – known as the tax gap – was £31 billion in 2018-19, equivalent to 4.7% of the total tax owed. HMRC estimated that its compliance activities, which range from educating taxpayers to fraud investigations, increased tax revenue by £34.1 billion in 2018-19 (5.2% of total tax owed) against a target of £30 billion.

3 HMRC defines the tax gap as "the difference between the amount of tax that should, in theory, be paid to HMRC, and what is actually paid". A wide range of factors affect the tax gap, some of which are outside the control of tax administrators. For example, the state of the economy, demographic changes (such as more people in self-employment) and the perceived fairness of tax policy can all affect how many voluntarily pay tax (voluntary compliance). Tax administrators can increase tax revenue by encouraging voluntary compliance and stopping non-compliance. This includes making the tax system easier to use, detecting mistakes when taxpayers submit their returns and catching deliberate attempts not to comply.

4 HMRC considers "the best way to tackle non-compliance is to prevent it happening in the first place, while cracking down on the minority who do break the rules". As such its strategy aims to:

- **promote** compliance by designing it into systems and processes, enabling taxpayers to get things right from the outset;
- **prevent** non-compliance by using data to spot mistakes, prevent fraudulent claims, personalise online services and automate tax calculations; and
- **respond** to non-compliance by identifying and targeting the areas of greatest risk, and tackle those who deliberately try to cheat the system.

5 The National Audit Office and the Committee of Public Accounts have previously identified areas for improvement in HMRC's approach to tackling the tax gap. For example:

- We have noted that HMRC needs to consider the right balance between pre-emptive measures to promote tax compliance and those designed to identify and tackle non-compliance. We identified potential for HMRC to strengthen its understanding of the link between risks to revenue, the resources used, and the cost and return of different compliance activities.
- We identified that the quality of service experienced by personal taxpayers may have an impact on tax compliance. HMRC has found that customers who have a more positive experience are more likely to think evasion is unacceptable.
- The Committee of Public Accounts has repeatedly recommended that HMRC should set targets for reducing the tax gap. HMRC maintains its long-term strategic ambition is to drive down the tax gap and accepts that it is right to be assessed on movement in the tax gap over time. However it believes that reducing the tax gap is not a suitable annual performance target as the tax gap is affected by a range of factors outside its control; it cannot be measured in a timely way; and it cannot directly inform operational decisions such as where to allocate resources.

Scope of this report

6 This report looks at HMRC's approach to tackling the tax gap. HMRC needs to understand the scale and trend of the tax gap, to gauge its performance in collecting tax revenue and to inform decisions about how to tackle non-compliance. In this report we consider:

- HMRC's understanding of the scale of the tax gap (Part One). We set out HMRC's definition of the tax gap, the main causes and trends in how it has changed, and the strengths and weaknesses of the measure;
- HMRC's performance in closing the tax gap (Part Two) including: the amount of tax it generates through its interventions (compliance yield); and whether it takes sufficient account of returns on investment and deterrence effects when deploying resources; and
- HMRC's plans for closing the tax gap (Part Three) including the evidence supporting its strategy, progress implementing the strategy and plans to develop comprehensive performance measures.

7 HMRC publishes its estimates of the size and composition of the tax gap annually. The *Measuring tax gaps* publication defines each element of the tax gap and explains the approach. Our report does not review or provide assurance over HMRC's detailed methodology for estimating the size of the tax gap, or the judgements and assumptions made by its tax specialists. HMRC produces the tax gap figure in line with the values, principles and protocols set out in the Code of Practice for Statistics. As the tax gap is an official statistic, HMRC's approach is subject to independent review by the Office for Statistics Regulation (OSR).

8 HMRC sets out the uncertainties in its tax gap calculation in its annual *Measuring tax gaps* publication. Our past work has highlighted the inherent uncertainty in the calculation and acknowledges that other commentators have published estimates of the UK tax gap using different data, methodologies and broader definitions than HMRC. For example, HMRC's definition of tax avoidance excludes international arrangements that cannot be addressed under UK law. Our report does not examine or comment on the validity of these other approaches. Our audit approach is set out in Appendix One and our evidence base is in Appendix Two.

9 As we were finalising this report the UK was continuing to manage the impacts of the COVID-19 pandemic. Its impact on UK tax revenues and the tax gap is likely to be significant, with the UK government needing to prioritise support to businesses and taxpayers over tax collection. The pandemic may increase the risks of non-payment of taxes and more people may operate in the deliberately hidden part of the economy. With the pandemic ongoing at the time of writing, this report does not attempt to account for the impact of these risks on the tax gap.

Key findings

The size of the tax gap

10 **The estimated size of the tax gap has decreased since 2013-14.** From 2013-14, HMRC's estimate of the total tax gap decreased year-on-year from 7.2% of theoretical tax owed (£38 billion) to 4.7% in 2018-19 (£31 billion). Before then it had increased from 6.2% of theoretical tax owed in 2011-12 to 7.2% in 2013-14. HMRC estimates that small businesses in aggregate contribute most to the tax gap while the wealthy account for the smallest share. The estimate of the tax gap does not include wealth or income from other jurisdictions where these do not give rise to a UK tax liability (paragraphs 1.3 to 1.6, Figure 3 and Figure 4).

11 **HMRC's latest estimates indicate it has reduced most elements of the tax gap.** Between 2015-16 and 2018-19 almost all components of the tax gap fell in absolute terms and relative to tax revenue. This included the tax gap relating to VAT, excise duties and criminal attacks with each falling by at least £0.5 billion. Non-payment of tax liabilities was the only significant area to have increased (by £1 billion or 32%) between 2015-16 and 2018-19. HMRC faces a continual challenge to keep the tax gap low as taxpayers and their advisers change their behaviour. For example, mass-marketed tax avoidance schemes now target more people on middle incomes than in the past (paragraphs 1.7 and 1.8, and Figure 5).

12 **The precise scale of the tax gap is inherently uncertain and difficult to estimate.** Evasion and the hidden economy (which taxpayers conceal from HMRC, deliberately or otherwise), are particularly difficult to estimate because they are inherently less visible. HMRC is able to estimate a range of uncertainty for around 42% of the tax gap's value. Data limitations mean that it does not produce range estimates for the rest. HMRC's analysis is one of the most comprehensive studies of the tax gap available internationally. The International Monetary Fund and the OSR have praised HMRC's analysis in terms of coverage and usefulness. In 2019 the OSR identified opportunities for HMRC to reduce the uncertainty in estimates (paragraphs 1.12 to 1.15).

13 Large revisions to the tax gap have reversed past trends reported by HMRC, highlighting the uncertainties associated with this measure. HMRC updates the tax gap methodology each year to improve accuracy. It adjusts prior years so trends are comparable. In July 2020, HMRC made substantial revisions to previous tax gap estimates reflecting changes to the national statistics used to estimate VAT and the settlement of long-running tax disputes. For example, in 2019 HMRC reported that the tax gap had increased to £35 billion or 5.6% of tax owed in 2017-18. It now estimates the tax gap reduced to £31 billion or 5.0% of tax owed in that year. It has increased its estimates of the tax gap for some earlier years. Notably for 2013-14 HMRC now estimates the tax gap increased rather than decreasing, as it first reported. While HMRC can be increasingly confident about historic years, the risk remains that its most recent estimates change again, making the trend analysis difficult to rely upon. While this limits some of its value in making operational decisions, the analysis still helps HMRC understand the relative size of each element of the tax gap and how to approach non-compliance. HMRC produces the estimate to help make timely decisions, recognising the trade-off with certainty (paragraphs 1.17 to 1.19 and Figure 4).

HMRC's performance in tackling the tax gap

14 Every year since 2011-12, HMRC has met its targets for the additional tax generated from its compliance work. HMRC has increased compliance yield – its measure of additional tax revenue directly attributable to its work – from £23.9 billion in 2013-14 to £34.1 billion in 2018-19. The measure brings together estimates for the different ways HMRC secures tax. For 2018-19 this included £13.1 billion of cash due from tackling non-compliance and estimates of non-cash impacts such as £9.3 billion from preventing tax losses (including fraud and criminal activity) and work to change taxpayer behaviour (£7.6 billion). The compliance yield measure does not capture the wider deterrent effect of HMRC's actions (paragraphs 2.2 to 2.5, 2.27, 2.28 and Figure 11).

15 The relationship between compliance yield and the tax gap is not clear. It can be difficult to reconcile how compliance yield can increase without reducing the tax gap. Between 2014-15 and 2018-19 compliance yield stabilised at around 5% of the total amount of tax owed, while the tax gap reduced from 6.8% to 4.7%. HMRC has explained that compliance yield and the size of the tax gap are related but the links are not straightforward, with the tax gap affected by factors outside HMRC's control such as economic conditions and changes in tax policy. Movements may also reflect a strengthening or weakening of HMRC's deterrent effect, which is not captured in its compliance yield measure (paragraphs 2.22 to 2.28 and Figure 15).

16 **HMRC has reprioritised some compliance work to prevent non-compliance occurring in the first place.** HMRC has shifted towards earlier interventions, increasing yield estimated from its work to promote compliance and prevent non-compliance from £3.2 billion in 2016-17 to £7.8 billion in 2018-19. This involved increasing the number of initiatives to encourage compliance, with the yield from these also increasing. At the same time HMRC reduced the number of traditional enquiries and audits investigating non-compliance by one-third. Yield from these activities fell by £0.7 billion in 2017-18 before recovering in nominal terms to £26.3 billion in 2018-19. The scale of yield from enquiries and audits has not kept pace with increases in the theoretical amount of tax owed (paragraphs 2.5 and 2.6, Figure 12 and Figure 13).

17 **HMRC's internal measures report large rates of return from its compliance directorates.** Rates of return varied from 7:1 for compliance activity on individual taxpayers to 44:1 on large business taxpayers in 2018-19. These figures compare favourably with returns from additional funding announced at fiscal events to improve compliance, which averaged around 7:1 over the last decade (paragraphs 2.8 to 2.12, 2.16 and Figure 14).

18 **HMRC has reprioritised resources to maintain sufficient coverage across all customer groups.** Although important, rates of return are not the only factor which HMRC considers when determining the amount of resource to allocate between its compliance directorates. Other factors include compliance yield targets, affordability and the need to cover different taxpayer groups. Between 2017-18 and 2018-19 HMRC increased resources in areas with the highest rates of return (large businesses) and the lowest rates of return (individuals) to maintain sufficient coverage of this group. However, to live within funding constraints, it reduced the resources covering small businesses, even though this has the largest share of the estimated tax gap and offers higher rates of return than compliance work with individuals. There is a risk that reducing resources in areas with high returns could disproportionately affect the tax gap, whereas more staff could increase rates of return up to a point, after which returns may be marginal (paragraphs 2.8 to 2.12, 2.20, 2.21 and Figure 14).

19 **Additional funding for new measures announced in Budgets since 2015 has helped to maintain the number of HMRC staff involved in compliance work.** Between 2015-16 and 2019-20, HMRC reduced the number of staff carrying out routine compliance activities by around one-quarter in most of its compliance directorates. Resources for additional work announced in fiscal events have helped to maintain the total number of compliance staff at around 23,000 a year. Furthermore, Budget 2020 announced additional resources for more compliance officers and new technology to further reduce the tax gap. This investment (£63 million for 2020-21 with future years still to be settled as part of spending reviews) is forecast to bring in £4.4 billion of additional tax revenue up to 2024-25 (paragraphs 2.15 to 2.21).

HMRC’s plans for tackling the tax gap

20 HMRC’s strategy to promote compliance and prevent non-compliance aligns with other tax administrations. HMRC has found that other countries have reduced their tax gaps by modernising tax systems and making services simpler for taxpayers. HMRC is considering a range of options that could help to reduce the UK tax gap in a similar way. Measures may include extending Making Tax Digital to other businesses and taxes, subject to ministerial decision. HMRC is now seeking to finalise new customer strategies by autumn 2020, which will focus on the whole customer experience rather than only taxpayer compliance. Academic research indicates that fair and proportionate enforcement action including the number of audits, penalties and prosecutions also remain important factors in reducing the tax gap (paragraphs 3.2 to 3.6 and 3.9).

21 HMRC can build on its success in tackling tax avoidance by applying relevant good practice to other tax gap behaviours where appropriate. HMRC’s principal approach to compliance focuses on customer groups with individual plans to tackle each of the main risks to tax compliance. It has also had success by targeting types of non-compliant behaviour. For example, HMRC’s strategy to tackle the underlying incentives of mass-marketed tax avoidance schemes has helped to change avoidance behaviour over time. This approach includes having a clear statement of purpose on how it will tackle the underlying behavioural incentives and a clear overview of how different interventions align with its vision. HMRC has not developed similar strategies to tackle other non-compliant behaviours such as where taxpayers interpret tax rules differently from HMRC or fail to take reasonable care with their tax returns (paragraphs 3.9 to 3.15, Figure 18 and Appendix Four).

22 HMRC has recognised it needs a greater balance of measures to assess its performance in tackling the tax gap. HMRC’s compliance yield measure is an important means of estimating the additional tax collected as a result of its actions. It does not, however, capture the full impact of HMRC’s work to promote compliance. HMRC is developing a wider set of measures to capture its performance in administering the tax system. These include overall compliance levels, the deterrence effect of its actions and the levels of trust in the tax system. HMRC has yet to set realistic targets for these measures or what they will collectively show in terms of its overall performance (paragraphs 3.16 to 3.20 and Figure 19).

Conclusion on value for money

23 In July 2020, HMRC reported that it had reduced the tax gap from its recent peak level of around 7.2% of theoretical tax owed (£38 billion) in 2013-14 to 4.7% in 2018-19 (£31 billion). The figures can be subject to considerable revision each year making it difficult to use the tax gap as a measure to assess performance, particularly in the short-term. It does, however, help in understanding the relative size of each area of the tax gap. HMRC is developing a wider set of indicators to help improve its understanding of its performance.

24 HMRC's measure of compliance yield remains the best indicator of its performance because it calculates the direct return from its work to tackle the tax gap. Performance against this measure suggests that HMRC's work to tackle non-compliance offers good value for money, with rates of return ranging from 7:1 to 44:1. When reducing resources HMRC has chosen to prioritise areas offering lower rates of return to maintain sufficient coverage of all taxpayer groups.

25 Keeping the tax gap low remains challenging because taxpayers continually change their behaviour to exploit opportunities in the tax system. Although organised around taxpayer groups, HMRC has successfully reduced the tax gap by targeting the underlying incentives behind non-compliant behaviour, in particular in relation to mass-marketed tax avoidance schemes. Lessons from these successes have not been applied more broadly, such as where taxpayers bend the rules or do not take reasonable care. Developing approaches to change the underlying behaviours could complement HMRC's ongoing work and improve value for money.

Recommendations

26 To improve its approach to tackling the tax gap, **HMRC should:**

a seek opportunities to base more of the overall tax gap estimate on established methodologies to reduce the level of uncertainty;

b in developing its new performance measures:

- **i** develop measures for each significant factor affecting the tax gap, for example, costs to taxpayers and intermediaries of complying, taxpayer experience, perceptions of fairness and the deterrence effect of its activities;

- **ii** review the impact of compliance yield on the tax gap, and the significance of timing differences between the compliance yield and the tax gap measures;

- **iii** in partnership with HM Treasury develop shared and trusted data on the impact of different resourcing options, including the marginal rates of return from compliance activity and wider trade-offs, to help judge how to maximise tax revenues cost-effectively; and

c while recognising that it is appropriate for HMRC to primarily organise its approach to compliance by risk and customer group, consider extending, where relevant to other tax gap behaviours, good practice shown in its tax avoidance strategy and approach. For example, by setting out, in a single place for other behaviours, clear strategic objectives for tackling the underlying behaviour and a summary of the different actions HMRC is taking to achieve those objectives.