National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs

Tackling the tax gap

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HM Revenue & Customs

Tackling the tax gap

Report by the Comptroller and Auditor General

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This report examines the effectiveness of HM Revenue & Customs' (HMRC's) approach, in partnership with HM Treasury, in reducing the tax gap, the difference between the amount of tax theoretically owed and the amount collected.

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Contents

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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.

Part One

Understanding the scale of the tax gap

1.1 Calculating the tax gap is inherently difficult as it seeks to measure non-compliance with tax rules that individuals and businesses are either unaware of or want to keep hidden. In this part we consider how well HM Revenue & Customs (HMRC) understands the size of the tax gap. We consider:

- the definition of the tax gap;
- the main causes of the tax gap;
- trends in the tax gap;
- uncertainty in the measure; and
- the strengths and limitations of HMRC's tax gap publication.

1.2 We have not sought to evaluate the judgements made by tax professionals about the scale of specific risks to tax revenue.

Definition of the tax gap

1.3 In July 2020, HMRC reported the estimated tax gap for 2018-19 – the latest year for which data are available – as 4.7% of all tax owed (or £31 billion). 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" (**Figure 1** and **Figure 2** on page 16).[1] HMRC's estimate of the tax gap includes tax avoidance (arrangements which comply with the letter but not the spirit of the law). It excludes cases settled in favour of the taxpayers. It does not include tax planning arrangements that cannot be addressed under UK law and that will be tackled multilaterally, for example, through the Organisation for Economic Co-operation and Development (OECD).

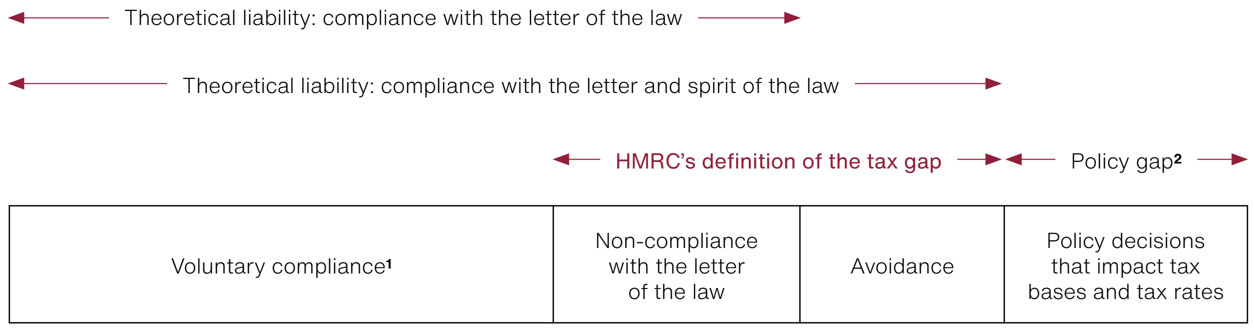
1.4 HMRC does not measure the 'policy gap' which would include the effect of tax reliefs (as shown in Figure 1). We have previously examined HM Treasury and HMRC's management of tax reliefs.[2] This report focuses on the tax gap measured by HMRC, that is, the uncollected revenue due to taxpayer non-compliance.

1 HM Revenue & Customs, *Measuring tax gaps 2020 edition*, July 2020.
2 Comptroller and Auditor General, HM Revenue & Customs, HM Treasury, *The management of tax expenditures*, Session 2019-20, HC 46, National Audit Office, February 2020.

Figure 1

HM Revenue & Customs' definition of the tax gap

HM Revenue & Customs' (HMRC's) measurement of the tax gap includes both non-compliance with the letter of the law (such as tax evasion) and non-compliance with the spirit of the law (such as tax avoidance)



Notes

1 Voluntary compliance is also influenced by HMRC's actions to promote compliance and deter non-compliance.

2 The European Commission defines the policy gap as the difference between the total amounts of tax theoretically collectable under the general rules of tax law (that is, if no exemptions, etcetera, would apply) and the total amounts of tax theoretically collectable based on the applicable tax law.

Source: National Audit Office presentation of HM Revenue & Customs' definition of tax gap

The causes of the tax gap

1.5 HMRC publishes a breakdown of the tax gap by taxpayer group, tax type and behaviour (**Figure 3** on page 17). Small businesses accounted for the largest share of the tax gap in 2018-19.

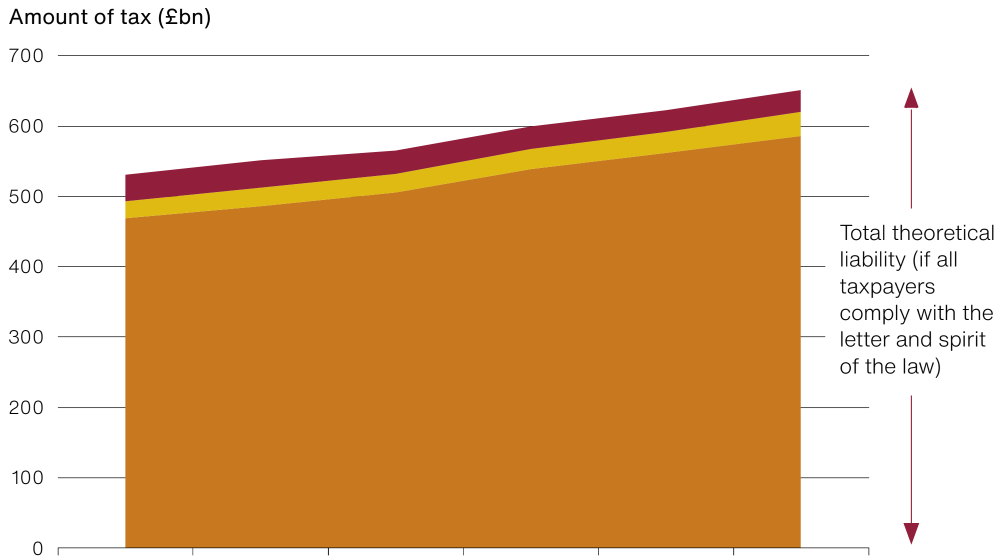
Trends in the tax gap since 2005-06

1.6 HMRC estimates that the tax gap fell as a proportion of all tax owed from 7.5% in 2005-06 to 4.7% in 2018-19 (**Figure 4** on page 18). HMRC calculates the tax gap both as a percentage of the tax that should be paid in theory and in nominal terms. The percentage tax gap provides a better measure of compliance over time as it takes into account some of the effects of inflation, economic growth and changes to tax rates. As HMRC explains in *Measuring tax gaps 2020 edition,* "in a growing economy where the tax base is increasing, even if the percentage tax gap remained level, the cash figure would grow".[3] We have summarised the tax gap trends by tax type in Appendix Three.

3 See footnote 1.

Figure 2
Total tax due and collected between 2013-14 and 2018-19

Most tax is collected voluntarily, without the need for direct HM Revenue & Customs (HMRC) intervention, and the net tax gap in 2018-19 was £31 billion (4.7%)



	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Net tax gap (£bn)	38	38	33	32	31	31
Impact of HMRC interventions (£bn)	23.9	26.6	26.6	28.9	30.3	34.1
Tax collected voluntarily (£bn)	469.1	486.4	505.4	539.1	561.7	585.9

Note

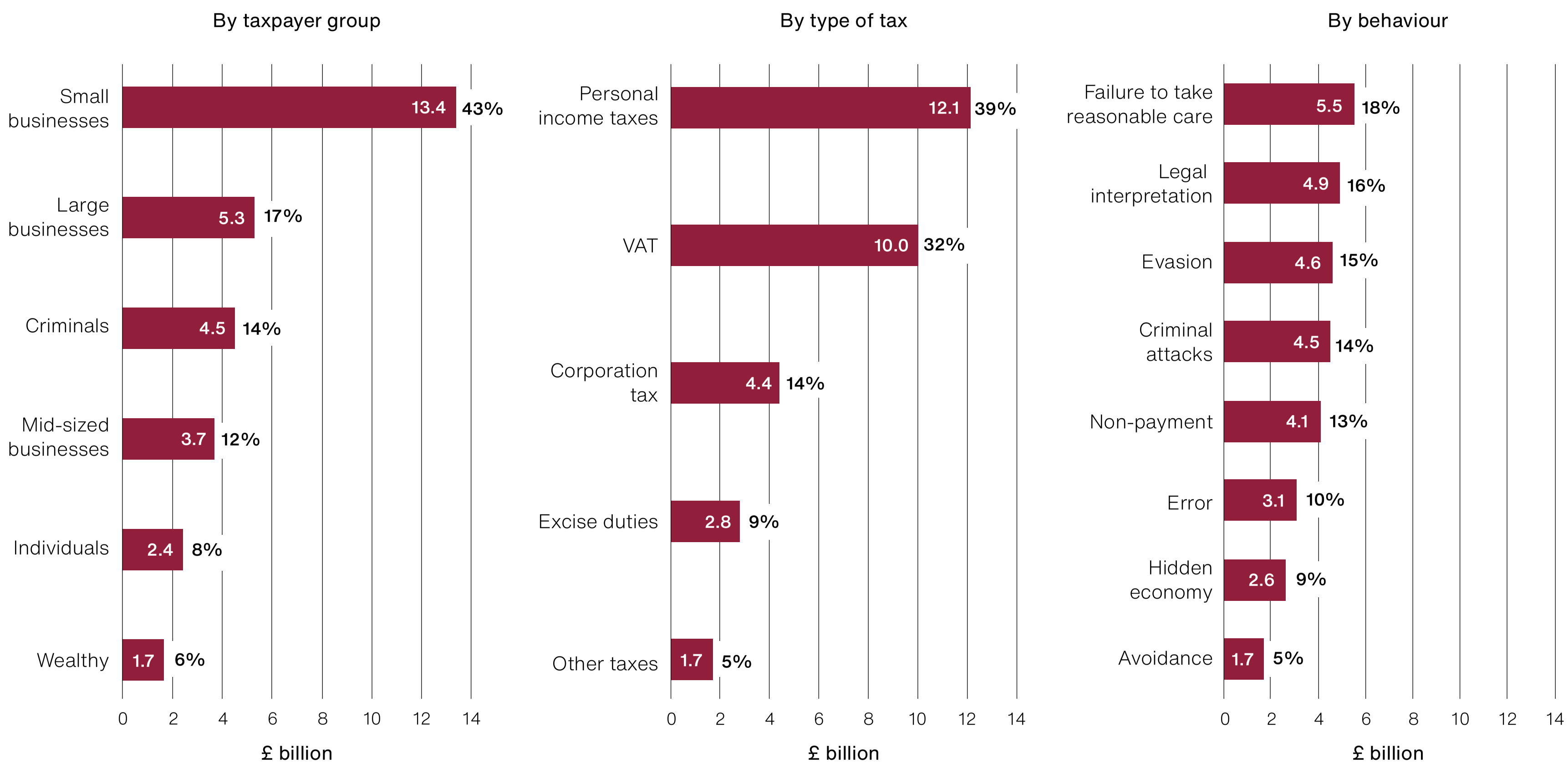
1 HMRC calculates its tax gap net of compliance yield. HMRC records compliance yield, its measure of the impact of its interventions on Exchequer receipts, based on the year its activities have an impact. Therefore not all of the compliance yield and, by extension, voluntary receipts shown in this figure relate to the financial year when the tax was due and the total amount of tax collected voluntarily and HMRC interventions, as shown in this figure, will not necessarily be the same as the amount of revenue reported by HMRC in a particular year.

Source: National Audit Office analysis of HM Revenue & Customs data published in *Measuring tax gaps 2020 edition* and *HM Revenue & Customs 2018-19 Annual Report and Accounts*

Figure 3

Breakdown of the tax gap in 2018-19, by taxpayer group, type of tax and behaviour, as estimated by HM Revenue & Customs (HMRC)

In 2018-19, HMRC estimated 43% of the tax gap was attributable to small businesses



Notes

1 The 2018-19 estimate of the tax gap discloses an estimate for wealthy taxpayers (who HMRC defines as those with income of at least £200,000 or assets of at least £2 million) for the first time.

2 Small businesses are defined as businesses with turnover below £10 million and less than 20 employees.

3 Personal income taxes include Income Tax, National Insurance Contributions and Capital Gains Tax.

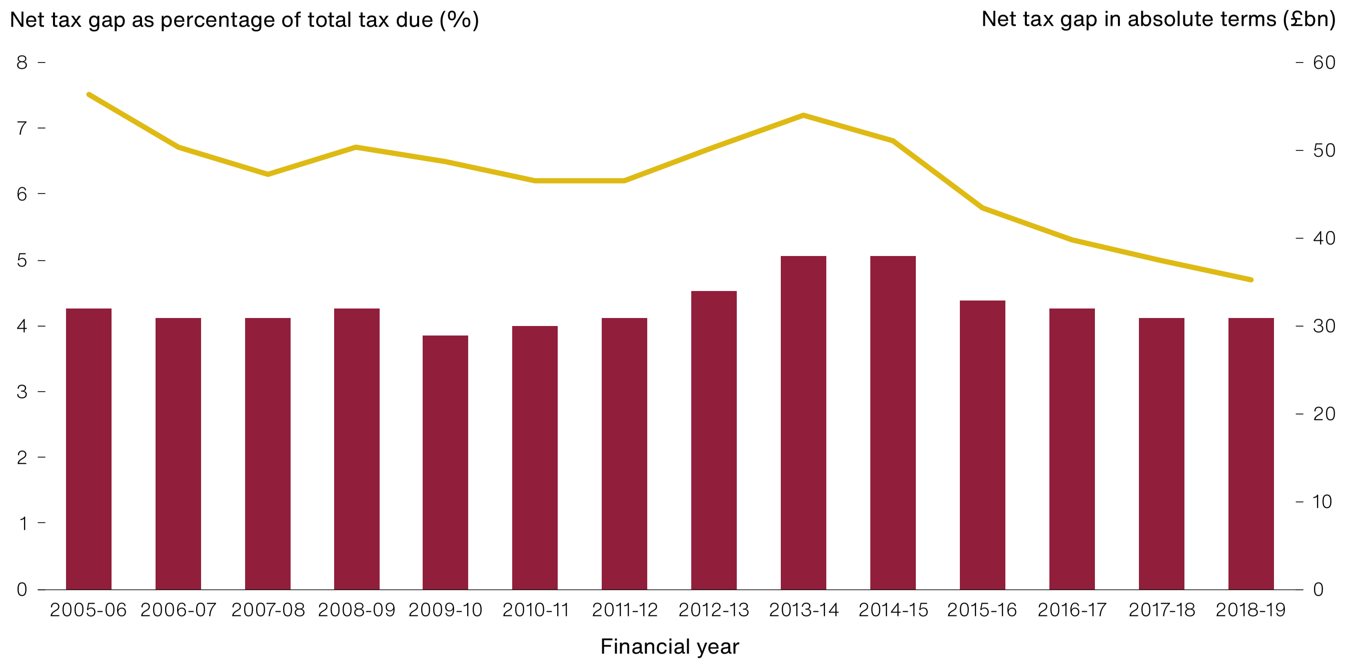
4 Totals may not add to 100% due to rounding.

Source: HM Revenue & Customs, *Measuring tax gaps 2020 edition*

Figure 4

The estimated tax gap in absolute terms and as a percentage of all tax due from 2005-06 to 2018-19

HM Revenue & Customs' (HMRC's) estimate of the tax gap, both in absolute terms and as a proportion of all tax due, has decreased since 2013-14



	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Net tax gap (£bn)	32	31	31	32	29	30	31	34	38	38	33	32	31	31
Net tax gap as a proportion of total tax due (%)	7.5	6.7	6.3	6.7	6.5	6.2	6.2	6.7	7.2	6.8	5.8	5.3	5.0	4.7

Note

1 The net tax gap is the remaining tax gap after HMRC has deducted the money it brings in through compliance activities.

Source: HM Revenue & Customs, *Measuring tax gaps 2020 edition*

1.7 HMRC faces a continual challenge to prevent the tax gap growing because taxpayers and their advisers change their behaviour. The component parts of the tax gap provide HMRC with some insight into the risks it faces in closing the gap and may indicate how well its initiatives and interventions are working. HMRC estimates tax avoidance fell by 26% between 2013-14 and 2018-19 (from £2.3 billion to £1.7 billion) mainly due to success in tackling mass-marketed tax avoidance, although challenges remain through the continuing use of disguised remuneration schemes and mass-marketed tax avoidance schemes. These now target more people on middle incomes, rather than those with higher incomes as in the past. The tax avoidance gap excludes disputed cases settled in favour of taxpayers and international arrangements that cannot be addressed under UK law.[4]

1.8 To understand recent changes we looked at the tax gap by tax type, taxpayer group and behaviour since 2015-16 (**Figure 5** on pages 20 and 21).[5] With the exception of the tax gap associated with non-payment, the tax gap estimates for the various components of the total tax gap, by tax type, behaviour and taxpayer group, have all decreased as a share of total tax revenue. The tax gap for VAT decreased by £0.9 billion since 2015-16. The non-payment tax gap increased by £1 billion (32%) over the same period exceeding trends in revenue.

1.9 In 2018-19 HMRC reported the tax gap for the wealthy for the first time. Public perception tends to regard large businesses and the wealthy as least likely to pay tax. In 2017 the Institute for Fiscal Studies found that the likelihood that a self-assessment taxpayer is non-compliant does not vary significantly with income.[6] The average amount of cash under-reported by non-compliant taxpayers was £2,200 across all individuals apart from the top 20% of earners (average: £3,530). The proportion of tax under-reported was lower for higher-income groups.

Other countries' tax gap estimates

1.10 The UK reports a lower tax gap than other countries. The most recent net tax gap figure for the USA, covering the period 2011-2013, was 14.2% of total tax due, while in Australia the net estimate was 7.4% to 7.7% in 2015-16, the most recent year available (**Figure 6** on page 22).[7] The absolute size of any country's tax gap is a function of the size and structure of its economy and tax base. International comparisons of the magnitudes of the tax gaps as a percentage of overall taxes due while possible are also difficult to undertake on a like-for-like basis because of methodological differences and the large numbers of influencing variables, such as tax collection methods and wider economic conditions.

4 HMRC excludes some forms of Base Erosion Profit Shifting on the basis these cannot be addressed under UK law.
5 Figures for this period are likely to be revised once HMRC replaces projections, on which the estimates are based, with data.
6 Institute for Fiscal Studies, *Who does and doesn't pay taxes?,* October 2017.
7 Analysis of the 2011-13 tax gap in the USA by the Internal Revenue Service is available at: www.irs.gov/newsroom/the-tax-gap. Analysis of the 2015-16 tax gap in Australia by the Australian Taxation Office can be found at: www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Australian-tax-gaps-overview/?anchor=Summaryfindings#Summaryfindings (Table 4d)

Figure 5

Trends in the tax gap between 2015-16 and 2018-19

HM Revenue & Customs (HMRC) has had some success in tackling the tax gap

	2015-16 tax gap (£bn)	2018-19 tax gap (£bn)	Change in tax gap (£bn)	Tax gap trend relative to tax revenue[1]	Commentary
Type of tax					
VAT	10.9	10.0	-0.9		Growth in VAT receipts has outstripped the growth in the net VAT total theoretical liability.
Self-Assessment (SA)	6.6	6.5	-0.1		The tax gap from sole traders and small partnerships contributed the majority of the SA tax gap estimate (£4.1 billion) in 2018-19.
Corporation Tax (CT)	4.5	4.4	-0.1		General downward trend over time.
Excise duties	3.3	2.8	-0.5		Mainly due to decreases in tobacco duty-related criminal attacks.
Taxpayer group					
Small businesses	13.2	13.4	+0.2		The largest element of the tax gap. Many cases involve relatively small amounts of tax. The taxpayer population changes frequently, reducing the impact of HMRC's interventions.
Large businesses	5.7	5.3	-0.4		The CT gap for large businesses has shown a general downward trend over time.
Mid-sized businesses	4.0	3.7	-0.3		Non-compliance driven mainly by companies' interpretation of the tax rules, with the largest risks related to VAT. The CT gap for mid-sized businesses has shown a general downward trend over time.

Figure 5 *continued*

Trends in the tax gap between 2015-16 and 2018-19

	2015-16 tax gap (£bn)	2018-19 tax gap (£bn)	Change in tax gap (£bn)	Tax gap trend relative to tax revenue[1]	Commentary
Behaviour					
Criminal attacks	5.3	4.5	-0.8	↓	Mainly tobacco and alcohol evasion.
Legal interpretation	5.5	4.9	-0.6	↓	Mainly large and mid-sized businesses.
Evasion	4.6	4.6	0	↓	Evasion risks persist in the non-PAYE population of individuals and small businesses.
Non-payment	3.1	4.1	+1.0	↑	Increase driven by rise in VAT debt associated with small and micro businesses.
Error	3.3	3.1	-0.2	↓	HMRC expects Making Tax Digital to reduce errors.
Hidden economy	2.6	2.6	0	↓	Mainly individuals working off-payroll and small businesses.
Avoidance	1.7	1.7	0	↓	HMRC has tackled mass-marketed tax avoidance schemes and reduced large businesses tax avoidance, although disguised renumeration schemes remain a challenge.

Change in the tax gap relative to tax revenue: ↑ = increase of more than 5% ↓ = decrease of more than 5%

Notes

1 Trends relative to tax revenue are based on relevant taxes for tax types and total tax liabilities for taxpayer groups and behaviours. The tax gaps, relative to tax revenue, for individuals and failure to take reasonable care have also decreased.

2 The 2018-19 estimate of the tax gap discloses an estimate for wealthy taxpayers for the first time. This has reduced the tax gap estimates for large and mid-sized businesses and individuals.

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

Figure 6

Examples of countries that measure and publish a tax gap

While some countries measure and publish tax gaps, comparisons are difficult because of methodological differences and the large number of influencing variables

Country	Tax gap as a percentage of overall taxes (%)	Size of tax gap	Methodology	Types of tax included
UK	4.7 (2018-19)	£31 billion (2018-19)	Top-down, bottom-up, experimental, data-matching	VAT, Income Tax, Corporation Tax, social security, excise duties, other direct and indirect taxes (for example, stamp duty)
USA	14.2 (2011–2013)	$381 billion (2011–2013)	Bottom-up and data-matching	Individual income tax, employment tax, estate tax, corporate income tax, excise tax
Canada	10.6 to 12.6 (2014)	$21.8 billion – $26 billion (2014)	Top-down and bottom-up	VAT, personal income tax, corporate income tax
Australia	7.4 to 7.7 (2015-16)	$29.6 billion – £30.9 billion (2015-16)	Top-down and bottom-up	Individual income tax, corporate income tax, transaction-based tax
Italy	18 to 19 (2013)	€92 billion (2013)	Top-down	VAT, personal income tax, corporate income tax

Notes

1 Data for Canada and Italy are reported before the impact of enforcement activities.

2 Top-down estimates are produced by using Independent, external data on consumption to estimate total tax due. The actual amount of tax paid is subtracted from this to estimate the tax gap.

3 Bottom-up estimates are produced by using administrative tax data – for example, random enquiries, risk registers and data-matching – to estimate the tax gap.

4 Countries categorise their methodologies in different ways. For example, the UK categorises ‘data-matching’ and ‘experimental’ as separate methodological approaches, while Australia includes data-matching and illustrative approaches in its definition of ‘bottom-up’.

Source: National Audit Office review of tax documentation published by the relevant tax authorities

1.11 Many countries publish estimates of the tax gap for VAT. The estimated UK VAT gap (10.6%, based on 2017 data) is near the median point of EU countries (**Figure 7** overleaf).[8] Several countries have much lower VAT gaps. HMRC has observed that Sweden and Estonia – which have estimated VAT gaps of 1.5% and 5.4% respectively – have been able to make very large reductions in their VAT gaps by introducing various types of transactional reporting regimes, where tax authorities have access to business transactions captured electronically. Making Tax Digital for VAT now requires VAT-registered businesses with taxable turnover above the VAT registration threshold to keep digital records and submit VAT returns to HMRC using compatible software. HMRC expects that it will reduce arithmetical and transposition errors in tax returns. However, HMRC does not have access to the underlying transactional data.

Uncertainty in the tax gap measure

1.12 Measuring the true value of the tax gap is challenging because elements such as the hidden economy (which taxpayers conceal from HMRC, deliberately or otherwise) and evasion are inherently less visible, masking the extent of under-reporting. The true total tax gap figure is therefore unknown. Around 20% of the tax gap (by value) is also estimated using experimental methods, which carry a greater degree of uncertainty than established methods.

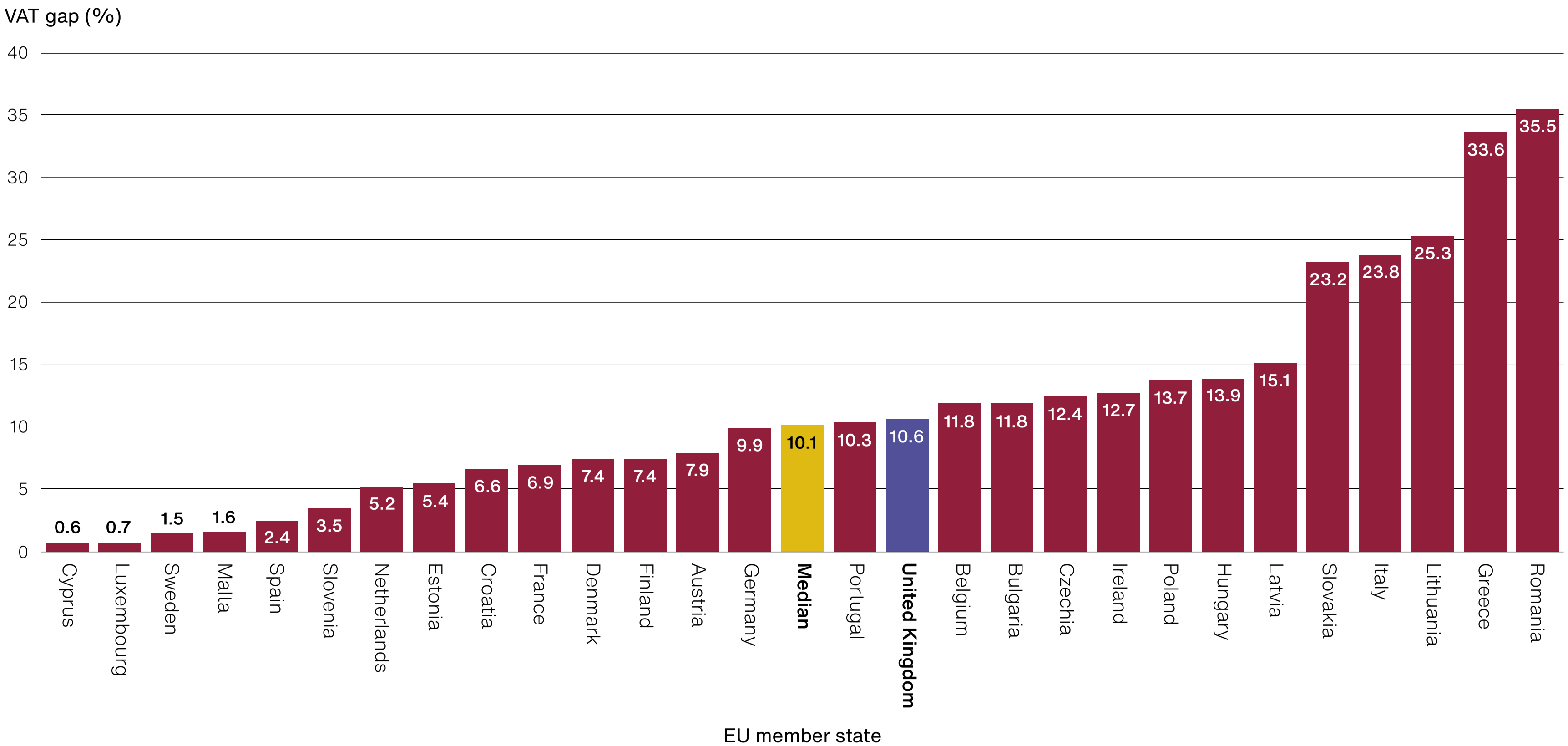
1.13 HMRC does not present estimates of the overall scale of uncertainty associated with the tax gap estimate alongside the headline tax gap figure. It is able to estimate a range of uncertainty for around 42% of the tax gap's value but data limitations mean it cannot produce range estimates for the remainder. Where it can, such as for self-assessment and small business corporation tax, HMRC highlights the uncertainties around different aspects of the tax gap using range estimates, and explanations in the text of *Measuring tax gaps.*[9] In 2018-19, the combined total of the reported ranges was £9.6 billion greater than the total reported tax gap for those elements (£13.1 billion). The lower limits were around £6.6 billion less. HMRC considers that any upward or downward bias in estimates is likely to cancel out to some extent and that it is therefore highly unlikely the true value of the tax gap would be at the upper or lower limit of the combined confidence intervals.

8 Centre for Social and Economic Research and Institute for Advanced Studies, *Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report*, September 2019. These data are the most recent international comparison available and reflects the position in 2017 when the UK was a member of the European Union. The UK left the EU on 31 January 2020.

9 The latest version was HM Revenue & Customs, *Measuring tax gaps 2020 edition,* July 2020.

Figure 7
VAT gap in EU member states in 2017

European Commission research indicates that the estimated UK VAT gap (10.6%) is near the median point of all member states



Notes

1 These data are the most recent international comparison available and reflects the position in 2017 when the UK was a member of the European Union. The UK left the EU on 31 January 2020.

2 The median calculation includes EU member states and the UK, as the UK was a member state in 2017.

3 The figure for the UK VAT gap published by the European Commission differs from that calculated by HM Revenue & Customs in its *Measuring tax gaps* publication, as the methodology is different. However, we have used the European Commission data here to show a relative assessment of performance across member states.

Source: National Audit Office analysis of data from Centre for Social and Economic Research and Institute for Advanced Studies, *Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report*, September 2019

Strengths and limitations of HMRC's estimated tax gap calculation

1.14 HMRC's tax gap methodology is complex, consisting of multiple different data sources, independent analyses and assumptions. In May 2019, the Office for Statistics Regulation (OSR) praised HMRC's tax gap statistics, for example, for its inclusion of an estimate for the size of the hidden economy, the appropriateness of data sources and their value in helping HMRC make the best use of its resources.[10] The OSR highlighted areas where HMRC can improve the transparency and trustworthiness of the published statistics. It said HMRC should review the potential to use UK multipliers, instead of US multipliers, to estimate under-detection of non-compliance during tax audits. US multipliers do not mirror perfectly the types of taxpayers or risks in the UK tax system. HMRC makes adjustments to the US multipliers for the risks and taxpayer groups it has identified in the UK random enquiry programme. More accurate multipliers could have significant consequences for the estimate.

1.15 In 2013, the International Monetary Fund (IMF) reviewed HMRC's methodology for estimating the tax gap. The IMF concluded that HMRC produced one of the most comprehensive studies of the tax gap available internationally. It found that HMRC's methodology was sound and consistent with the approaches used by other countries. The IMF recommended broadening the scope of HMRC's tax gap analysis to include the impact of policy choices on tax revenue, which HMRC continues to exclude (known as the policy gap, as shown in Figure 1).

1.16 In 2015, we identified a number of the strengths and limitations associated with HMRC's tax gap methodology. We recognised the value in HMRC's publication of a comprehensive analysis of its tax gap estimates so that the basis and limitations of the measure were clear and understood. We noted the time lag and the lack of an estimate of the scale of uncertainty around the tax gap.[11] HMRC has since reduced the time lag associated with the tax gap from 18 months to 15 months after the tax year under consideration in 2019 and 16 months in 2020.

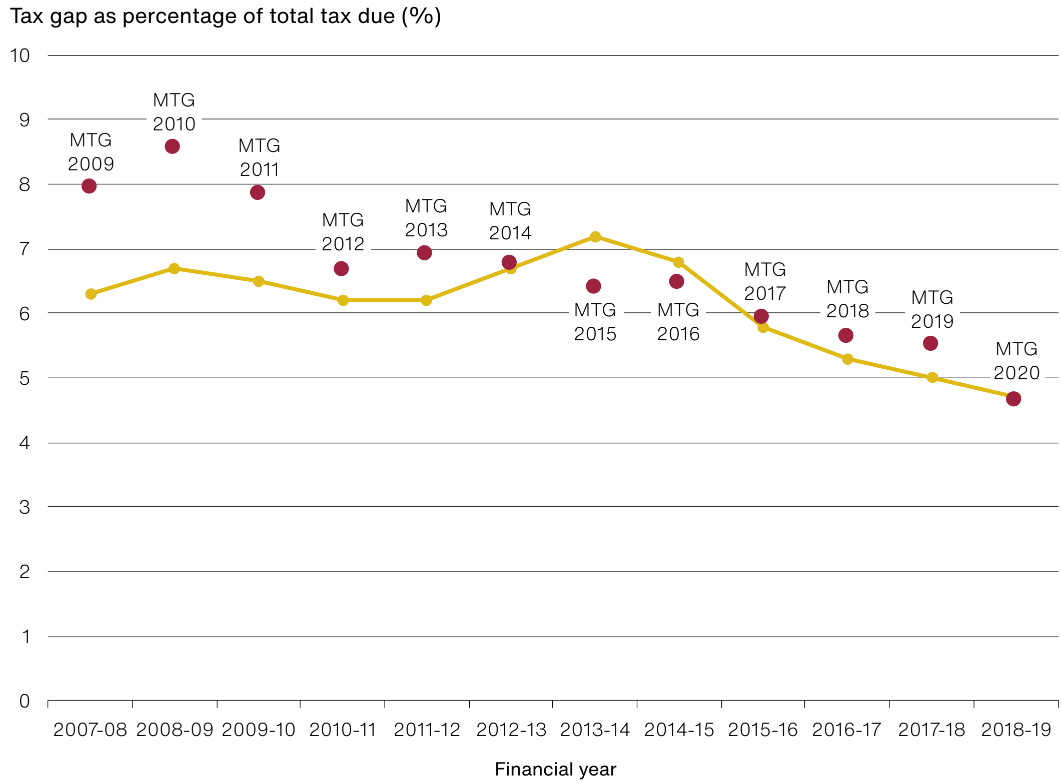
1.17 HMRC updates the methods for calculating the tax gap each year to improve their accuracy and its understanding of trends. Tax gap estimates are also revised when more up-to-date data become available. HMRC revises previous years' tax gap estimates every year to ensure consistency over time (**Figure 8** overleaf).

10 The Office for Statistics Regulation is the regulatory arm of the UK Statistics Authority. It provides independent regulation of all official statistics produced in the UK.
11 Comptroller and Auditor General, *HM Revenue & Customs 2014-15 Accounts, Report by the Comptroller and Auditor General*, July 2015.

Figure 8

Revisions by HM Revenue & Customs (HMRC) to published estimates of the tax gap

The figure shows how the latest estimates of the tax gap compare with the original estimate made for each year



	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
● HMRC's original published estimate (%)	8.0	8.6	7.9	6.7	7.0	6.8	6.4	6.5	6.0	5.7	5.6	4.7
● 2020 tax gap estimate (%)	6.3	6.7	6.5	6.2	6.2	6.7	7.2	6.8	5.8	5.3	5.0	4.7

Note

1 MTG 2009, MTG 2010 etcetera – these refer to the year of the HMRC *Measuring tax gaps* (MTG) publication in which the original tax gap estimate was first published for that year. HMRC first published its assessment of the tax gap in 2009.

Source: National Audit Office analysis of HM Revenue & Customs published tax gap data

1.18 In July 2020, HMRC made substantial revisions to previous estimates of the tax gap (**Figure 9**).[12] In the previous year it had reported that the tax gap increased by £5 billion (to 5.6%, £35 billion) between 2015-16 and 2017-18. Its most recent publication now estimates the tax gap reduced by £2 billion (to 5.0%, £31 billion) over the same period. It also estimates the tax gap increased significantly for some previous years, notably the peak in 2013-14 is greater than previously thought (HMRC reported the tax gap had decreased at the time). Estimates of the most recent years are the most tentative. HMRC can be more confident about historic years because it has settled more cases and is less dependent on projections and forecasting the value of open cases. The most recently published data illustrate the potential for significant change in the tax gap figures many years later. The scale of the variations between years makes it difficult to rely on the tax gap analysis as a useful measure of trend performance. While this limits its value in making operational decisions, the analysis is still helpful for HMRC to understand the relative size of each aspect of the tax gap. The process of estimating the components of the tax gap is also important for

Figure 9

HM Revenue & Customs' (HMRC's) latest revisions to its tax gap estimates

HMRC has substantially revised all of its tax gap estimates

	2013-14 (%)	2014-15 (%)	2015-16 (%)	2016-17 (%)	2017-18 (%)
2019 tax gap estimates	6.5	6.2	5.3	5.5	5.6
2020 tax gap estimates	7.2	6.8	5.8	5.3	5.0
Size of revisions	**+0.7**	**+0.6**	**+0.5**	**-0.2**	**-0.6**

Note

1 Percentage tax gap is the tax gap as a percentage of the amount of tax that should, in theory, be paid to HMRC.

Source: HM Revenue & Customs, *Measuring tax gaps 2020 edition*

12 See footnote 1.

HMRC's understanding of how to tackle non-compliance.

1.19 The changes HMRC makes to its total tax gap estimate reflect a large number of lower level revisions made to improve the accuracy of tax gap estimates across all taxes. In its most recently published tax gap results HMRC made around 30 revisions to various components of the tax gap.[13] The most significant changes were:

- revisions to the VAT tax gap estimate as a result of incorporating new and updated data from the Office for National Statistics (ONS); and
- revisions to HMRC's self-assessment tax gap estimate (excluding large partnerships) following the settlement of long-running cases.

1.20 We have summarised strengths and potential areas for improvement in the tax gap publication in **Figure 10**. The tax gap is an important measure. It provides HMRC with valuable insight on the scale and nature of non-compliance with the tax rules. HMRC points out in the start of its *Measuring tax gaps* publication that the tax gap is difficult to measure and there are many sources of uncertainty and error.[14] In 2018-19 HMRC has provided greater detail around the reasons for revisions to improve transparency. HMRC can improve the insights which the tax gap measure can offer by developing more established methodologies to estimate the components that are currently illustrative, making greater use of random enquiries and audits and conducting more research into taxpayer non-compliance.

Figure 10

Summary of the National Audit Office's (NAO's) assessment of HM Revenue & Customs' (HMRC's) published tax gap analysis[1]

Our review of HMRC's methodology for assessing the tax gap identified strengths and areas where it can be improved

Strengths	Areas for improvement
Documents methodological caveats extensively.	Develop more methodologies to cross-check the accuracy of estimates.
Explains the use of different data sources in detail.	Explain uncertainty around the total tax gap estimate.
Explains rationale for changes to the methodology and amends prior years.	Not always clear how far revisions to published estimates are due to changes in the underlying data and the impact on the figures.
A separate published methodology document explains detailed calculations.[2]	The sensitivity of the assumptions on the estimates is not published in every case.

Notes

1 The NAO assessment was based on evidence available in the public domain, primarily HMRC's *Measuring tax gaps* publications.

2 HMRC publishes a methodological annex on its website at www.gov.uk/government/statistics/measuring-tax-gaps.

Source: National Audit Office analysis of HM Revenue & Customs' published tax gap analysis

13 See footnote 1.
14 See footnote 9.

Part Two

HMRC's performance in closing the tax gap

2.1 The tax gap varies across different taxes and types of taxpayer and is caused by a range of different behaviours, from error through to evasion. HM Revenue & Customs' (HMRC's) strategy to tackle the tax gap emphasises work to promote compliance and prevent non-compliance, before responding when non-compliance occurs. This part examines HMRC's performance in closing the tax gap, in particular:

- trends in the amount of tax HMRC estimates its interventions have generated (compliance yield);
- HMRC's rates of return from its compliance activities;
- allocation of resources to HMRC compliance activity; and
- the link between compliance yield and the tax gap.

Trends in compliance yield

2.2 HMRC assesses its performance in closing the tax gap by estimating the amount of compliance yield from its initiatives to promote compliance and its interventions to protect or collect tax that would have otherwise been lost to fraud, evasion, avoidance or other non-compliance. We have reported regularly on the design and implementation of HMRC's compliance yield measure in our reports on HMRC's annual accounts.[15] These reports found that compliance yield is a reasonable proxy for assessing the impact of individual interventions and to support the allocation of resources. We concluded that HMRC has established an adequate methodology for measuring yield and effective processes to ensure data quality, but that it should be clearer that not all yield is cash and include ranges for the estimated elements.[16]

15 Most recently in Comptroller and Auditor General, *HM Revenue & Customs 2017-18 Accounts, Report by the Comptroller and Auditor General*, July 2018.
16 Comptroller and Auditor General, *HM Revenue & Customs 2014-15 Accounts, Report by the Comptroller and Auditor General*, July 2015.

2.3 HMRC has met its annual compliance yield target every year since 2011-12, with compliance yield also increasing every year except 2015-16 (**Figure 11**). Compliance yield increased in nominal terms from £23.9 billion in 2013-14 to £34.1 billion in 2018-19. The measure brings together estimates for different types of tax losses. The main components include £13.1 billion of cash raised tackling past non-compliance and estimates of non-cash impacts, including £9.3 billion from preventing tax losses (including stopping fraudulent repayment claims and disrupting criminal activity) and work to change taxpayer behaviour (£7.6 billion). Other factors, including tax design and customer service, also have a bearing on the tax gap but are not captured in HMRC's compliance yield performance measure. Part Three considers HMRC's plans to measure other factors affecting the tax gap.

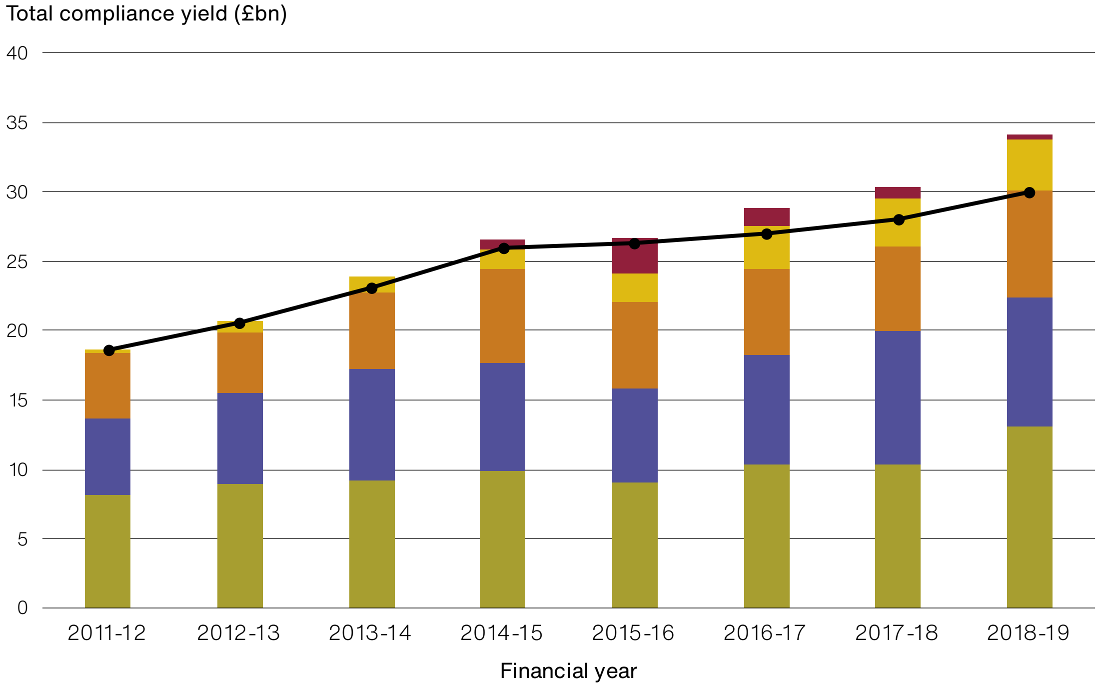
2.4 Annual increases in compliance yield targets have exceeded overall increases in tax revenue since 2011-12. However, the rate of increase has slowed since 2015-16 after a change of formula gave more weight to maintaining existing levels of compliance. At the start of the 2015 Spending Review period the government committed to "providing HMRC with the funding it needed to maintain existing levels of compliance performance while making efficiencies". HMRC and HM Treasury agreed a formula for compliance yield targets for HMRC to maintain its 2015-16 level of compliance yield but adjusted for increases in forecast tax revenues.[17] The targets then included an added amount for the expected yield from the new measures announced at fiscal events. Between 2011-12 and 2014-15 compliance yield targets increased by 11% to 13% a year. After 2015-16 targets increased by 3% to 7% each year.

2.5 Between 2016-17 and 2018-19, HMRC increased the number of initiatives to promote compliance and prevent non-compliance before a taxpayer submits a tax return. HMRC more than doubled the amount of additional revenue from this work, raising £7.8 billion (23% of total compliance yield) from 105 initiatives in 2018-19 compared with £3.2 billion from 61 initiatives in 2016-17 (**Figure 12** on page 32). HMRC increased the average yield reported from these initiatives while also increasing their number.

17 HMRC maintained its 2015-16 level of compliance performance throughout the 2015 Spending Review period.

Figure 11
Trend in compliance yield, 2011-12 to 2018-19

HM Revenue & Customs (HMRC) has reported an increase in compliance yield nearly every year since 2011-12, meeting its annual target each year



	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Accelerated payments (£bn)	0.0	0.0	0.0	0.8	2.4	1.3	0.8	0.3
Product and process yield (£bn)	0.2	0.8	1.2	1.3	2.1	3.0	3.4	3.7
Future revenue benefit (£bn)	4.7	4.4	5.5	6.7	6.2	6.3	6.1	7.6
Revenue losses prevented (£bn)	5.5	6.5	8.0	7.9	6.8	7.9	9.7	9.3
Cash expected (£bn)	8.2	9.0	9.2	9.8	9.0	10.3	10.3	13.1
Total (£bn)	**18.6**	**20.7**	**23.9**	**26.6**	**26.6**	**28.9**	**30.3**	**34.1**
● Target (£bn)	18.6	20.6	23.1	26.0	26.3	27.0	28.0	30.0

Notes

1 Accelerated payments: the amount that users of avoidance schemes have paid to HMRC upfront while their dispute is being resolved, as well as an estimate of the behavioural change that this policy has generated.

2 Product and process yield: the annual impact on net tax receipts of legislative changes to close tax loopholes and changes to HMRC's processes that reduce opportunities to avoid or evade tax.

3 Future revenue benefit: an estimate of the effect of HMRC's compliance work on taxpayers' future behaviour.

4 Revenue losses prevented: the tax revenue HMRC has prevented from being lost to the Exchequer (for example, by stopping fraudulent repayment claims and disrupting criminal activity).

5 Cash expected: HMRC's estimate of the additional revenue due when it identifies past non-compliance.

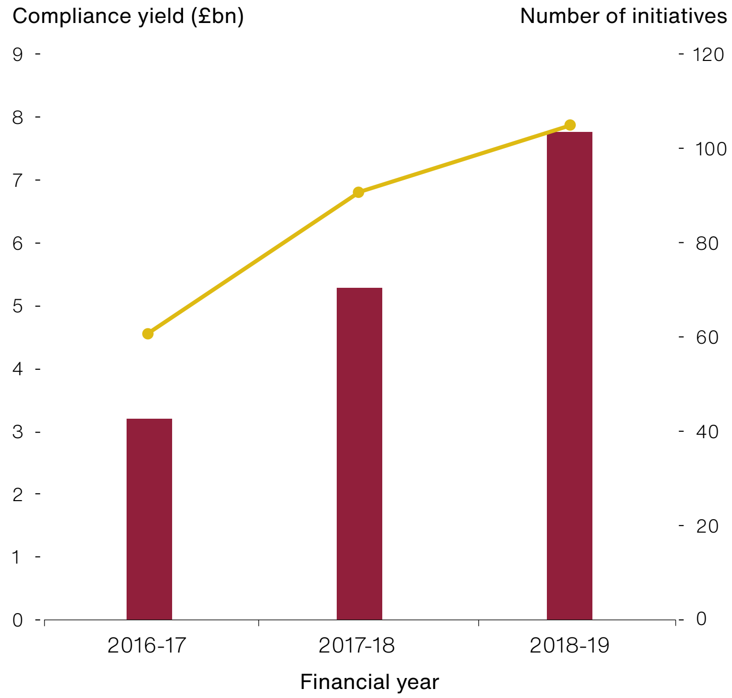
6 The yields for each category may not add up to the total compliance yield due to rounding.

Source: HM Revenue & Customs

Figure 12

Trend in HM Revenue & Customs' (HMRC's) initiatives to promote compliance and prevent non-compliance

Since 2016-17, HMRC has more than doubled the amount of yield from initiatives to promote compliance and prevent non-compliance before a taxpayer submits a tax return



	2016-17	2017-18	2018-19
Compliance yield (£bn)	3.2	5.3	7.8
Number of initiatives	61	91	105

Note

1 The initiatives included in this figure are a subset of the initiatives that result in compliance yield which HMRC classifies as 'promote' and 'prevent'.

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

2.6 In line with its strategy to intervene earlier in the tax cycle, and the need to live within funding constraints, HMRC reduced the number of compliance enquiries and audits by one-third. Compliance yield from compliance enquiries and audits fell by £0.7 billion in 2017-18 before recovering in 2018-19 in nominal terms (**Figure 13** overleaf). The average yield per intervention increased from £44,156 in 2016-17 to £67,298 in 2018-19. However, the total amounts collected from compliance audits have not kept pace with general increases in tax revenue. HMRC told us it had increasingly focused its compliance interventions on the highest risks to non-compliance. It uses a range of techniques (both one-to-one and one-to-many interventions) to influence customer behaviour before and after tax returns are submitted.[18] HMRC told us that it had increased its 'one-to-many' approach, where it intends to influence taxpayers' behaviour by sending the same information to many taxpayers at once, reducing the need to open a traditional enquiry or audit. It told us this can be more effective in tackling risks associated with high-volume taxpayer groups such as small businesses.

2.7 HMRC has so far achieved its aims to support more prosecutions of "serious and complex" tax crimes, although it has identified a risk it may not do so in 2020-21. By March 2020, HMRC had delivered 121 positive charging decisions against its cumulative internal goal of 110.[19] In July 2019, HMRC recognised that it risked falling short of its target of delivering a further 100 positive charging decisions on serious and complex tax crime by the end of 2020-21.

Rates of return from HMRC compliance activities

2.8 HMRC's compliance activities are led principally by its Customer Compliance Group, whose directorates focus on different taxpayer groups. A one-off HMRC analysis indicated it achieved an average rate of return of 15:1 for the Customer Compliance Group as a whole in 2017-18, compared with an average of 8:1 from across HMRC.

2.9 HMRC's more recently reported cost and yield data for the compliance activities carried out on its different taxpayer groups highlight that each area achieved high returns but with considerable variation (**Figure 14** on page 35). In 2018-19, returns ranged from £7 for every £1 spent on compliance activities for individual taxpayers to £44 in the case of large businesses. These figures compare favourably with returns from HMRC's compliance transformation programmes announced under the Budget.

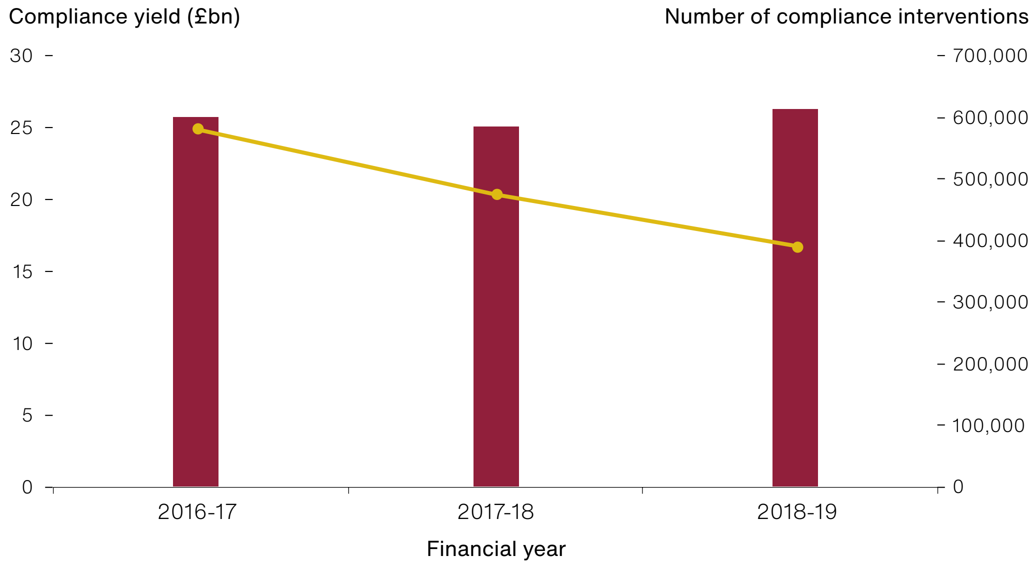
18 A one-to-one intervention is, for example, where HMRC might contact a taxpayer directly with a query about a tax return. A one-to-many intervention, in contrast, is where HMRC, for example, might send a standard letter to many taxpayers with advice on a change in the tax rules.

19 HMRC is not a prosecuting authority. Its aim is to secure "positive charging decisions" rather than prosecutions. The purpose of making a charging decision is to determine whether a suspect should be subject to criminal proceedings.

Figure 13

Trend in HM Revenue & Customs' enquiry and audit-based enforcement interventions

The number of compliance interventions has fallen while yield has remained stable



	2016-17	2017-18	2018-19
Compliance yield (£bn)	25.7	25.0	26.3
Number of compliance interventions	581,163	474,490	390,917

Note

1 Compliance interventions range from light-touch low-level compliance checks to complex criminal investigations.

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

2.10 In practice rates of return are one of several factors HMRC needs to consider when determining the amount of resource to allocate to its compliance directorates. These include compliance yield targets, alignment with HMRC's compliance strategy, the relative size of the estimated tax gap in a particular area, responding to changing compliance risks, the need to develop and maintain staff capabilities, reputational factors and affordability within HMRC budgets. HMRC's ability to reallocate its staff to different lines of work is also made more difficult by the specialist nature of each directorate's work.

2.11 Figure 14 shows that funding has increased in both HMRC's areas of highest return (large businesses) and lowest return (individuals). It has also increased funding for compliance work with the wealthy. HMRC explained that it has needed to reprioritise resources in order to ensure sufficient coverage of each area to maintain levels of voluntary compliance. However, small business compliance, which has the largest share of the tax gap, experienced the greatest reduction in resources.

Figure 14

HM Revenue & Customs' (HMRC's) returns from its compliance activities in 2017-18 and 2018-19

HMRC generated substantial returns from its compliance activities in 2017-18 and 2018-19

Taxpayer group	2017-18				2018-19			
	Tax gap estimate	Costs of compliance activities	Yield	Rate of return	Tax gap estimate	Costs of compliance activities	Yield	Rate of return
	(£m)	(£m)	(£m)	(Yield per £ spent)	(£m)	(£m)	(£m)	(Yield per £ spent)
Individuals	2,000	320	2,700	8.4	2,400	355	2,400	6.8
Wealthy individuals	1,600	135	1,000	7.4	1,700	145	1,800	12.4
Small businesses	13,100	525	5,400	10.3	13,400	490	5,600	11.4
Mid-sized businesses	4,000	225	3,500	15.6	3,700	210	4,000	19.0
Large businesses	5,800	205	9,000	43.9	5,300	230	10,000	43.5

Notes

1 The yield and cost data do not necessarily directly correlate to each other due to timing differences. While the costs relate to the financial year under consideration, the yield will be the outcome of activities that cover a number of years.

2 HMRC is not able to measure the impact of its compliance activities on levels of voluntary compliance.

3 The total yield shown in this figure (£23.8 billion in 2018-19) is only a subset of the total yield reported by HMRC (£34.1 billion in 2018-19 as shown in Figure 11). HMRC also reports yield from other types of activity, for example, those targeting criminals.

4 Changes to costs between 2017-18 and 2018-19 are the result of HMRC's decisions on the allocation of its business-as-usual resources and HM Treasury-agreed fiscal event investments.

5 The figures presented in this table are in nominal terms. Tax gap and yield figures are estimates.

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

2.12 The high overall returns on investment indicate HMRC should invest more across its compliance activities. HMRC explained that diminishing returns can set in quickly in some areas, such as large business, where there are a relatively small number of taxpayers and compliance yield can be distorted by small numbers of very large settlements. HMRC does not routinely collect data on marginal rates of return to inform judgements about how increasing or decreasing staff numbers would affect tax revenue. The most comprehensive HMRC analysis we saw covered the period 2010-11 to 2014-15. This suggested that doubling HMRC's coverage for Corporation Tax, self-assessment and VAT would result in significant additional yields. We could not find evidence of similar analysis for subsequent years.
The increases in returns on investment noted in paragraphs 2.5 and 2.6 indicate that the marginal rate of return has increased for promotional and responsive-type activities. Further information on how changing staff numbers across taxpayer groups would impact compliance yield and the tax gap would allow HMRC to make better informed resource deployment decisions.

Allocation of resources to HMRC compliance activity

2.13 Government sets departmental budgets in advance through Spending Reviews, with these formally approved by Parliament, scrutinised throughout the year by HM Treasury, who approves changes. Our 2018 review of government's planning and spending framework found that HM Treasury had demonstrated, over many years, highly effective control of public spending. However, long-term funding was not supported by a good understanding of the longer-term value for money of public spending.[20]

2.14 HM Treasury considers a wide range of factors when considering HMRC bids for funding for compliance activities and other resources. Alongside returns on investment it considers the need to maintain a deterrent effect and an assessment of HMRC's capacity and ability to deliver on proposals for funding. HM Treasury also needs to consider political factors and fiscal rules, such as borrowing limits which restrict the government's absolute levels of spending.

2.15 Under the Spending Review 2015, the government committed to providing HMRC with the funding it needed to maintain its compliance performance at the 2015-16 level, while making efficiencies. The funding arrangement incentivises efficiencies in business-as-usual compliance activities. Any additional funding announced at fiscal events could then increase expected amounts of compliance yield above 2015-16 levels, potentially closing the tax gap.

2.16 Over the past 10 years, HM Treasury has announced additional ring-fenced funding for HMRC to pursue particular policy objectives. HM Treasury awarded HMRC around £2 billion in additional funding at fiscal events to tackle tax avoidance, evasion and other forms of non-compliance. It reported in March 2019 that this prevented revenue losses of £13.5 billion since 2010, indicating a return of investment of around 7:1.[21] Additional funding included:

- Spending Review 2010: £900 million to bring in an additional £7 billion a year in tax revenues by 2014-15 - for example, through cracking down on offshore evasion and investing more resources in preventing tobacco and alcohol fraud. HMRC secured compliance revenue of £26.6 billion in 2014-15, £10 billion more than the 2010-11 baseline;
- Summer Budget 2015: £800 million to bring in £7.2 billion by 2020-21 – for example, by investing in new teams to investigate organised crime and increasing the number of prosecutions and criminal investigations. By the end of 2018-19, HMRC had delivered £7 billion against the forecast of £8 billion;

20 Comptroller & Audit General, *Improving government's planning and spending framework,* Session 2017–2019, HC 1679, National Audit Office, November 2018.

21 HM Treasury and HM Revenue & Customs, *Tackling tax avoidance, evasion, and other forms of noncompliance,* March 2019, Annex A (page 22) provides a complete list of measures to tackle tax avoidance, evasion and non-compliance announced by the government from Budget June 2010 to Budget 2018.

- Autumn Budget 2017: £155 million to bring in £2.3 billion by 2022-23 – for example, by investing in new technology to tackle the hidden economy and developing HMRC's ability to tackle non-compliance among mid-sized businesses and wealthy individuals. HMRC has not evaluated the revenue delivered so far; and

- HMRC and HM Treasury continued to take action to reduce the tax gap between Autumn Budget 2017 and Budget 2020. For example, in Budget 2018 the government announced a package of 21 measures to tackle tax avoidance, evasion and unfair outcomes estimated to raise £2.1 billion by 2023-24. These measures included legislation to tackle the use of profit fragmentation and removing a loophole to prevent abuse of Entrepreneurs' Relief.[22]

2.17 Under the Spending Review 2015, HMRC committed to spending £1.8 billion on transformation between 2016-17 and 2019-20 to help it become one of the most digitally advanced tax administrations in the world. It committed to achieving:

- £1.9 billion of efficiency savings over the four years (reaching annual efficiency savings of £717 million a year in 2019-20);

- reducing business customers' costs by £400 million over the four years to 2019-20;

- collecting £920 million of additional tax revenue (including £310 million by 2019-20 and another £610 million in 2020-21); and

- ongoing benefits and efficiencies beyond the period of investment.

2.18 Following this commitment, HMRC allocated £193 million to its 'Compliance for the Future' programme, which aimed to build internal capability at HMRC and improve data and end-to-end compliance. The programme was due to deliver £505 million of efficiency savings over its lifetime. However, HMRC closed the programme in 2018 as it prioritised work to prepare for the UK's exit from the EU.

2.19 The funding increases announced in Budgets since 2015 have offset reductions in HMRC's other compliance staff numbers. Between 2015-16 and 2019-20, the total number of staff in HMRC's Compliance Group has remained broadly constant at around 23,000. During this period, HMRC has reduced staff carrying out routine compliance activities by around one-quarter in most of its compliance directorates.

22 Profit fragmentation is the practice whereby traders and professionals avoid tax by arranging for their taxable business profits to arise in territories where significantly lower tax is paid than in the UK.

2.20 In making efficiencies, HMRC has needed to prioritise maintaining coverage of all taxpayer groups over decisions to prioritise resources to areas offering the highest returns. This has reduced tax revenues. Further reductions are likely to result in less coverage of some high-risk taxpayer groups and areas of growing risk. HMRC intends that its work towards greater digitisation of the tax system and greater voluntary compliance with tax rules to help compensate for reduced staffing levels. However, if these factors are not in place then further reductions in staff numbers could drive reductions in compliance yield.

2.21 HMRC will reconsider its plans following the government's announcement in Budget 2020 of a number of measures to tackle tax avoidance, evasion and other forms of non-compliance. The measures included investment in additional compliance officers and new technology for HMRC. This investment (£63 million for 2020-21 with the rest to be settled under future spending reviews) is forecast to generate £4.4 billion of additional tax revenue up to 2024-25. To achieve value for money, HMRC will need to consider returns on investment and marginal rates of return when expanding its activity. Greater average returns are available from large businesses, but the limited number of taxpayers may mean that diminishing returns take effect more quickly than other areas.

Compliance yield and the tax gap

2.22 Increases in compliance yield do not always result in reductions in the tax gap. Between 2011-12 and 2014-15 compliance yield increased from 3.7% of total amount of tax owed to 4.8% while the tax gap also increased from 6.2% to 6.8% of tax owed over that period. Between 2014-15 and 2018-19 compliance yield has stabilised around 5% of the total amount of tax owed, while the tax gap has reduced from 6.8% to 4.7% (**Figure 15**).

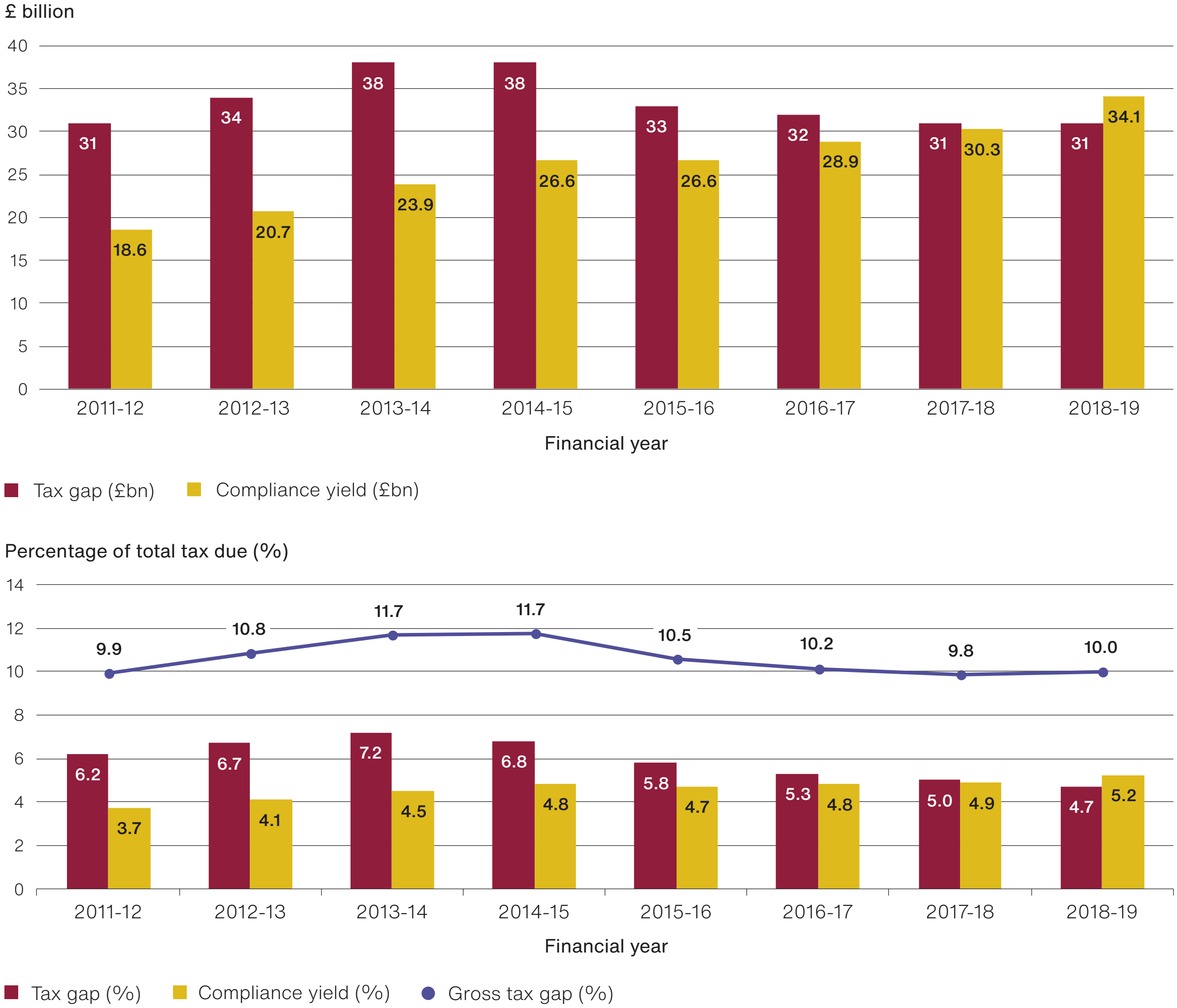
2.23 We have previously recognised that the link between the tax gap and compliance yield is not straightforward.[23] For example, should HMRC be successful in encouraging more people and organisations to comply with their tax obligations voluntarily, it is conceivable that the tax gap would fall and so would the amount of yield HMRC could generate from its compliance work.

23 Comptroller and Auditor General, *HM Revenue & Customs Annual Report and Accounts 2013-14, Report by the Comptroller and Auditor General,* July 2014.

Figure 15

Trend in the estimated tax gap and compliance yield 2011-12 to 2018-19

The gross tax gap increased each year from 2011-12 to 2014-15 and is beginning to increase again[1]



Notes

1 The gross tax gap is the tax gap before HM Revenue & Customs has deducted compliance yield, which is the money it brings in through compliance activities.

2 The compliance yield data used in this figure include all the revenue due for a given year. Some of this will relate to previous tax years. The tax gap estimates, however, only cover losses that are due to non-compliance in a specific financial year.

3 Numbers may not appear to sum due to rounding.

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

2.24 In 2016, the Committee of Public Accounts described the relationship between the tax gap and compliance yield as "confusing".[24] HMRC published a technical paper explaining the relationship between the two measures in 2017.[25] It explained that the amount of compliance yield HMRC generates and the size of the tax gap are related but the links are not straightforward. For example:

- the tax gap is affected by external factors such as the number of new businesses or taxpayers, economic conditions, tax policy and changes in tax rates; and
- the tax gap reflects a single year, and some compliance cases can cover multiple years.

2.25 Considering compliance yield as a proportion of total theoretical liabilities and looking over a number of years helps to control for the complicating factors HMRC has identified.[26] Some timing differences remain. HMRC's compliance yield data, as reported in its Annual Report and Accounts, includes tax owed from previous years, whereas the tax gap estimates only relate to the year under consideration. In some cases, the compliance yield reported in a given year may also relate to tax returns from a number of prior years. The two data sets are not directly comparable and care must therefore be taken about the inferences that can be drawn from the analysis. HMRC has considered adjusting its compliance yield data to aid comparison but concluded it would be costly to do so. Such analysis could enhance its understanding of how the propensity for non-compliance is changing over time.

2.26 Further work is needed to investigate whether the tax gap and compliance yield trends reflect uncertainty in the measures, changing attitudes to compliance or changes in the deterrence effect. Adjusting compliance yield for amounts from previous years would help HMRC to better understand the impact of its activities on the tax gap.

2.27 We have previously recommended that HMRC does more to assess the deterrent effect of its compliance activities. HMRC measures and reports the direct behavioural impact of its compliance activities on taxpayers that have been subject to its interventions. For example, taxpayers who are audited tend to declare more taxable income in subsequent years. HMRC estimates this within the Future Revenue Benefit category of compliance yield (£7.6 billion in 2018-19) (Figure 11).[27]

24 HC Committee of Public Accounts, *Tackling tax fraud*, Thirty-Fourth Report of Session 2015-16, HC 674, April 2016.

25 HM Revenue & Customs, *The tax gap and compliance yield – what they are and how they relate*, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/627609/The_tax_gap_and_compliance_yield___what_they_are_and_how_they_relate.pdf

26 It does not completely eliminate the problem that compliance yield recorded in any one year can include tax due from multiple years.

27 HMRC's Future Revenue Benefit category of compliance yield is an estimate of the effect of HMRC's compliance work on taxpayers' future behaviour.

2.28 HMRC has found it more difficult to measure the broad deterrence effect of its enforcement activities on those taxpayers that have not been directly subject to its interventions. In 2019, HMRC assessed the strength of evidence of the deterrent effect of its interventions, such as prosecutions, use of third-party data, communications and financial sanctions. HMRC found:

- taxpayers' awareness of HMRC's access to third-party data has a clear impact on taxpayers' compliance;
- less clarity around whether financial sanctions act as a deterrent; and
- strong qualitative evidence of the deterrent effect of prosecutions but limited quantitative evidence of behaviour change or increases in tax revenue.

HMRC concluded that the evidence suggested that its compliance work has a deterrent effect but not whether one type of activity is a more effective deterrent than another.

Part Three

HMRC's plans to close the tax gap

3.1 This part considers HM Revenue & Customs' (HMRC's) plans to tackle the tax gap. We consider:

- evidence supporting HMRC's strategy;
- evidence that HMRC's taxpayer compliance directorates are implementing the strategy;
- how far the strategy is followed in tackling different types of non-compliant behaviour; and
- how far HMRC's performance measures support the strategy.

HMRC's strategy to tackle the tax gap

3.2 To close the tax gap HMRC needs to help taxpayers who want to comply and stop non-compliance as early as possible. HMRC has concluded that tackling persistent forms of non-compliance requires more initiatives to make it more straightforward for taxpayers to comply. In 2014, HMRC refocused its compliance strategy to emphasise interventions it can make earlier in the tax cycle, such as educational campaigns, legislative changes and changes to tax administration systems.[28]

3.3 HMRC's shift towards promoting greater compliance is in line with other countries. The Australian Taxation Office's main objectives include making it easy for taxpayers to comply with their tax obligations, enhancing digital services and working with and through others – for example, intermediaries – to deliver an efficient and effective tax system.[29] The United States Internal Revenue Service has taken similar steps.[30]

28 Comptroller and Auditor General, *HM Revenue & Customs, Tackling tax fraud: how HMRC responds to tax evasion, the hidden economy and criminal attacks*, Session 2015-16, HC 610, National Audit Office, December 2015.
29 Australian Tax Office, Corporate Plan 2019-20.
30 Internal Revenue Service, Strategic Plan 2018–2022.

3.4 HMRC has identified factors that have helped to reduce the tax gap in other countries. These include: improving customer service; reducing the costs for customers of complying; collecting tax through intermediaries; reporting and paying tax promptly; collecting data (third-party or transactional); and enabling high-quality rules-based checks of figures prior to return. HMRC has introduced Making Tax Digital for VAT and, subject to ministerial decision, is considering extending this to other businesses and taxes.

3.5 We have previously found that the quality of service experienced by personal taxpayers may have an impact on tax compliance.[31] There is evidence of a relationship between the service taxpayers receive and their attitudes to evasion and compliance. HMRC has found that customers who have a more positive experience are more likely to think evasion is unacceptable. We have worked with HMRC to explore in more detail the links between taxpayers' experience of HMRC's services and tax compliance.[32]

3.6 HMRC can improve customer compliance by improving the design and their understanding of the tax system in addition to using fair and proportionate enforcement action. Academic research indicates that some of the factors affecting tax compliance are: the complexity of tax rules, customers' knowledge of the tax system and individual perceptions on the fairness of tax administration. Interventions including audit rates, penalties and prosecutions can reduce levels of non-compliance in the tax system.

3.7 Designing independent assurance into the tax system helps to minimise opportunities for non-compliance. The tax gap tends to be greater where taxpayers self-assess and lower where tax is withheld at source or collected by intermediaries. VAT, which has a relatively high estimated tax gap compared to other taxes, is self-assessed with the minimum data necessary collected. Income tax self-assessment has the highest levels of estimated tax gap by tax stream. In contrast, Pay-As-You-Earn (PAYE) has a low estimated tax gap, which may be in part because employers withhold tax from earnings. Comparisons with Organisation for Economic Co-operation and Development (OECD) data suggest that some other tax authorities withhold more types of personal income tax than the UK (**Figure 16** overleaf).

31 Comptroller and Auditor General, HM Revenue & Customs, *The quality of service for personal taxpayers*, Session 2016-17, HC 17, National Audit Office, May 2016.

32 For further details see National Audit Office and the Tax Administration Research Centre, *The effect of HMRC Taxpayer Assistance on compliance: An experimental investigation*, December 2017.

Figure 16
Withholding regimes for types of income

Some other tax authorities withhold more types of personal income tax than the UK

Type of income	Number of countries where income is subject to withholding[1]	Is the income subject to withholding in the UK?
Salary	53	Yes (if paid via Pay As You Earn (PAYE)) No (if paid by Self-Assessment)
Dividends	47	No
Interest	47	No
Rents	21	No
Specified business income	20	No
Royalties, patents	36	Yes
Sales/purchases of shares	24	Yes (if shares are purchased electronically through the UK's 'CREST' system)[2] No (for purchases outside of CREST, or tax on sales of shares)
Sales/purchases of real estate	14	Yes for stamp duty (where a solicitor is used to manage the purchase) No (for tax on profit from the sale of a property that is not the taxpayer's home)

Notes
1 Based on Organisation for Economic Co-operation and Development (OECD) data from 58 countries in 2017.
2 CREST is a computerised register of shares and shareowners.
3 Withholding tax is paid to the government by the payer of the income rather than by the recipient of the income. The tax is thus withheld or deducted from the income due to the recipient.

Source: National Audit Office analysis of HM Revenue & Customs published guidance and The Organisation for Economic Co-operation and Development (OECD), *Tax Administration 2019: Comparative Information on OECD and other Advanced and Emerging Economies*, September 2019

HMRC's implementation of its strategy in taxpayer compliance directorates

3.8 HMRC developed an organisation-wide approach to tackling the tax gap in 2013 and continues to make improvements (**Figure 17**). In 2017 it produced its first Compliance Plan to bring together the whole Department's approach to tackling compliance risks and set up a cross-departmental Compliance Board to provide strategic oversight of compliance issues and enhance integration across HMRC.

Figure 17
HM Revenue & Customs' (HMRC's) development of its compliance strategy

Over the past four years HMRC has developed a more strategic approach to tackling the tax gap

Year	HMRC actions
2009	First published tax gap assessment.
2013	Introduced a Strategic Picture of Risk (SPR), refreshed annually, to identify the main risks to non-compliance. The SPR includes all risks to tax exceeding £250 million and risks to the integrity of the tax system. In 2019, HMRC identified 63 such strategic risks which, if realised, had the potential to cost more than £50 billion in lost tax revenue.
2014	Refocused compliance strategy to concentrate more on the things it can do earlier in the tax cycle to promote compliance and prevent non-compliance in addition to responding to non-compliance when it occurs.
2016	Developed a way to rank strategic risks and help identify opportunities and gaps in compliance activity. Introduced specific compliance projects, taking a cross-cutting approach to tackling strategic risks across taxpayer segments.
2017	Created a plan setting out how HMRC plans to deliver compliance for each taxpayer group. Compliance Board set up to provide strategic thinking on compliance issues.
2018	Produced a forward-looking assessment of its strategic compliance risks for the next 12–24 months. Brought forward production of its SPR and the tax gap analysis to better support business planning. Introduced Risk Treatment Plans for each strategic risk to articulate in one place how it is mitigating that risk.

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

3.9 Historically HMRC's strategies to tackle non-compliance by different groups of taxpayers have been developed by the compliance directorates responsible for each taxpayer group. HMRC's Large Business Directorate, for example, has had a strategy in place since 2006. In line with OECD good practice, it is based on a cooperative approach, where customer relationship managers promote compliance.[33] HMRC is now developing organisation-wide customer strategies which focus on all aspects of taxpayers' contact with HMRC, not only compliance. The aim is to create the right experience to help taxpayers get their tax right initially and to remain compliant. HMRC was finalising strategies for some customer groups (those for wealthy taxpayers and large and mid-sized businesses) at the time of our review, with the aim of completing them all by autumn 2020. The completed customer group strategies should help HMRC to balance activities to promote compliance and prevent and respond to non-compliance.

3.10 A major challenge for HMRC is to remain ahead of changes in non-compliant behaviour, for example where taxpayers adopt new ways to avoid tax. The uncertainties in tax gap estimates noted in paragraphs 1.12 and 1.13 add to the challenges faced by HMRC in devising suitable responses. Alongside customer strategies for specific taxpayer groups, HMRC began to develop Risk Treatment Plans in 2018 for each of the major compliance risks it had identified. These plans set out the nature and extent of each specific compliance risk (in terms of the tax and taxpayer groups affected) and an assessment of how well the risk is being dealt with, including current and potential future responses. We reviewed a sample of the plans and found that in general they provided a good overview of the range of HMRC's interventions but lacked complete information on cost and benefits needed to compare the efficiency and effectiveness of the responses.

33 The OECD's cooperative compliance model is based on co-operation between large business taxpayers and revenue authorities, with the purpose of ensuring payment of the right tax at the right time.

Case studies of HMRC's approach to tackle non-compliant behaviours

3.11 To assess how far HMRC's strategy is shaping its approach in tackling tax gap behaviours we examined three case studies. Our primary focus was on specific tax gap behaviours and we then examined specific taxpayer groups within those behaviours. Our case studies indicate differing levels of progress in moving towards preventative measures:

a **HMRC's strategy to tackle incentives to avoid tax has reduced the tax gap.**

- The estimated avoidance tax gap fell in nominal terms from £2.3 billion in 2013-14 to £1.7 billion in 2018-19. Tax avoidance involves contrived, artificial transactions that serve little or no purpose other than to produce a tax advantage. In 2013 HMRC set up a Counter-Avoidance Directorate to centralise its response to mass-marketed avoidance schemes. It developed a strategy to tackle the schemes at each part of the supply chain. It made changes to the design of the system including strengthening requirements to declare schemes and introducing Accelerated Payment Notices to remove the cash-flow advantage from users.

- HMRC continues to challenge new schemes but there are far fewer. Notably disguised remuneration schemes continue to be sold.[34] The government introduced the Loan Charge from 5 April 2019, to tackle the historical use of disguised remuneration schemes. An independent review supported the purpose of the Loan Charge but found that the 20-year look-back period was not proportionate and justified. The report supported the increase in HMRC's powers, however, it found that HMRC's accountability or capacity to manage relationships with individual taxpayers had not grown to match these powers over the past decade to combat tax avoidance.[35] In Budget 2020, the government announced that HMRC will publish a new strategy for tackling the promoters of tax avoidance schemes. This was published on 19 March 2020.

34 Disguised remuneration avoidance schemes are tax avoidance arrangements that seek to avoid Income Tax and National Insurance Contributions by, for example, paying scheme users their income in the form of loans, usually via an offshore trust, with no expectation that the loans would ever be repaid.

35 Independent Loan Charge Review, I*ndependent Loan Charge Review: report on the policy and its implementation*, December 2019. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/854387/Independent_Loan_Charge_Review_-_final_report.pdf

b **HMRC expects its plan to make tax digital will reduce small business error and failure to take reasonable care.**

- Between 2015-16 and 2018-19, in nominal terms, error decreased from £3.3 billion to £3.1 billion and failure to take reasonable care from £6.5 billion to £5.5 billion. HMRC's aim is to make tax easier to get right and harder to get wrong, largely through Making Tax Digital. In addition, HMRC is aiming to continue to offer education to small businesses and their agents and to simplify the tax system to help small businesses to manage their tax affairs more easily. HMRC has no strategies dedicated to tackling error or failure to take reasonable care across all taxpayer groups.

c **HMRC has not had an overarching strategy to tackle legal interpretation.**

- Legal interpretation losses arise when taxpayers apply a different interpretation of tax law to that of HMRC. The tax gap from legal interpretation decreased from £6.1 billion in 2013-14 to £4.9 billion in 2018-19 in nominal terms. HMRC has no central unit to deal with legal interpretation. Instead much of its response is coordinated by the large business unit, where around two-thirds of non-compliance takes place. As such HMRC's strategic response to this type of risk is less well developed than other behaviours we examined. Until recently its response focused on engagement or interventions with taxpayers regarding the matters in dispute, and where necessary litigation, rather than seeking to tackle the underlying incentives of the behaviour.

- More recently HMRC's approach has shifted in favour of legislative changes to tackle legal interpretation issues and more approaches to promote compliance and prevent non-compliance. For example, in March 2020 HMRC published a consultation on a potential new legal requirement on large businesses to notify HMRC where they have adopted an uncertain tax treatment. The proposal is designed to improve HMRC's ability to identify issues where businesses have adopted a different legal interpretation to HMRC's view. This requirement is intended to help to reduce tax losses caused by businesses adopting tax treatments that do not stand up to legal scrutiny.[36]

3.12 We have summarised our assessment of HMRC's response to these case studies in **Figure 18**, with more details in Appendix Four. We found that HMRC has effective arrangements in place to prioritise compliance risks. It has a centralised approach with a team dedicated to keeping an assessment of strategic risks up to date.

36 HM Revenue & Customs, *Notification of uncertain tax treatment by large businesses*, Consultation Document, 19 March 2020.

Figure 18

Findings from National Audit Office's case studies of HM Revenue & Customs' (HMRC's) approach to tackle non-compliant behaviours

Our case studies showed that HMRC displays more good practice in tackling tax avoidance than other areas of non-compliance[1]

Behaviour	Tax avoidance	Error and failure to take reasonable care	Differences in legal interpretation of tax rules
Taxpayer group	Individuals (including the wealthy)	Small businesses	Large businesses
Criteria		Evaluation[2]	
Does HMRC understand the factors and uncertainties affecting the tax gap?	✔✔	✔	✔
Is there sufficient evidence of HMRC's prioritisation of risks?	✔✔	✔✔	✔✔
Does HMRC have an effective strategic response?	✔✔	✔	✘
Is HMRC's response in line with its overarching compliance strategy?[3]	✔✔	✔✔	✔
Does HMRC's response address the main risks to the tax gap?	✔✔	✔✔	✔
Does HMRC understand the impact of its compliance interventions?	✔	✔	✔
Do the current measures being used by HMRC fully capture the impact of its responses?	✔	✔	✔
Is there sufficient evidence that good practice and lessons learnt are being disseminated across the organisation?	✔✔	✔	✔

✔✔ = Good practice

✔ = Some evidence of good practice

✘ = Good practice not evidenced

Notes

1 Our primary focus was on specific tax gap behaviours and we then examined specific taxpayer groups within those behaviours.

2 Our evaluative criteria are based on our previous reports covering HMRC's compliance; our 'core management cycle' (see Comptroller & Auditor General, *A Short guide to Structured Cost Reduction*, June 2016); and Organisation for Economic Co-operation and Development, *Managing and Improving Tax Compliance*, October 2004.

3 HMRC's overarching compliance strategy is: promoting compliance, preventing and responding to non-compliance, with a focus on promotion and prevention.

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

3.13 We saw more examples of good practice in work to tackle tax avoidance than the other behaviours. HMRC's approach to tackling tax avoidance has evolved over time and HMRC has recently published its strategy to challenge and deal with promoters of mass-marketed tax avoidance schemes, supporting taxpayers to steer clear of avoidance and helping them to get out of tax avoidance for good.[37] The strategy provides a useful framework for it to ensure the efficiency and effectiveness of its responses. It has a number of good-practice features which could be replicated, where appropriate, for other tax gap behaviours including setting out:

- the root causes of non-compliance;
- a clear statement of purpose to tackle the underlying behavioural incentives;
- a clear overview of how its different interventions align with its vision (for example, targeting the tax avoidance supply chain by undertaking criminal investigations into promoters and enablers who design and market avoidance schemes or, in collaboration with the Advertising Standards Authority, removing misleading advertisements for mass-marketed avoidance schemes);
- progress in reducing the scale of the problem;
- the key challenges; and
- the evolving nature of the risk.

3.14 HMRC's avoidance approach included implementation of governance structures around the management of the risks and an organisation-wide approach to tackling the issue. Strategies, such as the one on tackling tax avoidance, alongside appropriate measures of progress, provide assurance to stakeholders of the effectiveness of HMRC in promoting and enforcing compliance with the tax law. This in turn can lead to improved perceptions of the fairness of the tax system and the creation of a deterrence effect to prevent non-compliance and change taxpayer behaviour.

37 HM Revenue & Customs, *Tackling promoters of mass-marketed tax avoidance schemes*, Policy Paper, March 2020.

3.15 HMRC has benefitted from having a clear approach and strategy for tackling mass-marketed tax avoidance schemes. HMRC's approach to compliance generally is organised around risks and customer groups. It has a range of different actions across the Department to deal with other types of tax gap behaviour, such as error, failure to take reasonable care and legal interpretation. However, HMRC does not bring together its responses to those behaviours in a single place in a way that is similar to that taken with tackling tax avoidance (that is to say, a framework as described in paragraph 3.13 setting out causes and responses), but instead deals with the component risks individually. There is potential for HMRC to build on its success in tackling tax avoidance by applying relevant good practice, where appropriate, to the other tax gap behaviours. This could improve the efficiency and effectiveness of HMRC's response and help to communicate its progress externally.

Development of new performance measures

3.16 Our previous reports have commented on the limitations of compliance yield as a performance measure. For example, in our December 2015 *Tackling Tax Fraud* report we noted that, while compliance yield is readily measurable and provides a hard measure of the value of HMRC's actions, it measures the output of HMRC's work, rather than outcomes so it is less reliable in assessing the impact of interventions on taxpayer behaviour.[38]

3.17 HMRC has recognised that a strong focus on compliance yield can disincentivise activity to promote or prevent non-compliance, which are inherently more difficult to measure. HMRC plans to introduce a broader range of performance measures to enable it to understand the effectiveness of the full range of its compliance work and support its strategic objectives.

3.18 We compared HMRC's proposed new measures against factors tax administrations and academic research have identified as affecting the scale of the tax gap (**Figure 19** overleaf). Overall these new measures will provide a more balanced assessment, useful to informing decision-making. HMRC plans to develop a measure of 'assured tax receipts' to help monitor how much tax independent parties have collected on behalf of taxpayers. Other countries such as Canada use the measure. HMRC also plans to develop a measure of deterrence, which will be important to better understand the balance of effort between promotion activity and enforcement action.

3.19 The range of measures should help HMRC develop a greater understanding of its performance, including in promoting compliance and tackling non-compliance. HMRC will need to compare trends across the measures, in particular maintaining a close watch on factors such as deterrence and attitudes to paying tax and how far these explain trends in the tax gap and compliance yield.

38 See footnote 28.

Figure 19

HM Revenue & Customs' (HMRC's) proposed basket of new performance measures

The new measures should help HMRC develop a greater understanding of its performance in promoting compliance and tackling non-compliance

Factors affecting the tax gap	Existing HMRC performance measures	Do current measures cover the influencing factors?	Will new measures cover influencing factors?
Levels of compliance	No existing measure	✘	✔
Levels of non-compliance	Tax gap, Compliance yield, Number of criminals and fraudsters convicted	✔	✔
Independent assurance	No existing measure	✘	✔
Levels of deterrence	No existing measure	✘	✔
HMRC cost-effectiveness	Costs to collect every pound of revenue, HMRC running costs	✔	✔
Customer costs	Customer cost reduction	✔	✔
Customer experience	Average speed of answering calls, Waiting time to speak to an adviser, i-forms and post turnarounds, Digital customer satisfaction rates, Taxpayer surveys	✔	✔
Perceptions of fairness and levels of trust in the tax administration	Taxpayer surveys	✘	✔

Notes

1 HMRC has not announced a date for the formal introduction of the new basket of measures.

2 HMRC does not measure the costs to taxpayers to meet their obligations for all groups, for example, individuals.

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

3.20 HMRC has yet to formally approve which measures it will use or set target levels. The measures HMRC has identified (in Figure 19) will help to improve understanding of a larger range of factors affecting the tax gap. It is important to set challenging but achievable targets. HMRC will need to judge its performance against the full basket of measures. The tax gap and compliance yield measures will remain important, alongside measures of customer experience, trust and deterrence.

Appendix One

Our audit approach

1 This report examined the effectiveness of HM Revenue & Customs' (HMRC's) approach, in partnership with HM Treasury, in reducing the tax gap, the difference between the amount of tax theoretically owed and the amount collected.

2 In this report we examine how well the tax gap is being tackled, specifically:

- understanding of the scale of the tax gap (Part One);
- performance in closing the tax gap (Part Two); and
- HMRC's plans for closing the tax gap (Part Three).

See **Figure 20** overleaf.

Figure 20

Our audit approach

HMRC's objective	To collect revenues due and bear down on avoidance and evasion.
How this will be achieved	HMRC, in partnership with HM Treasury, is responsible for designing and managing a response to the tax gap and monitoring its effectiveness.
Our study	We examined the effectiveness of HMRC's approach to tackling the tax gap.
Our evaluative criteria	HMRC understands the size of the tax gap. HMRC's performance in closing the tax gap takes sufficient account of returns on investment and deterrence effects when deploying resources. HMRC's plans for closing the tax gap include a strategy that is supported by evidence and comprehensive performance measures.
Our evidence (see Appendix Two for details)	• We analysed data on tax gap performance and other departmental compliance activity. • We reviewed strategic and operational documents provided by HMRC. • We interviewed officials at HMRC and HM Treasury. • We drew on existing National Audit Office evidence. • We conducted three case studies of HMRC's activities to reduce non-compliance with tax rules. • We consulted with stakeholder groups. • We reviewed published policy documents, guidelines and evaluations. • We reviewed examples of tax gap calculations in other countries.
Our conclusions	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. 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. 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.

Appendix Two

Our evidence base

1 We conducted our examination of HM Revenue & Customs' (HMRC's) approach to tackling the tax gap between May 2019 and January 2020. Our audit approach is outlined in Appendix One.

2 We conducted three case studies of HMRC's activities to reduce non-compliance with tax rules. We selected these case studies based on criteria including: the amount of tax at risk; the trend in the tax gap for the area at risk; the maturity of HMRC's response; the effectiveness of HMRC's response; the extent to which HMRC's response represented good practice; the reputational risk to HMRC arising from the non-compliance; and issues arising from other National Audit Office work on HMRC. The three case studies we selected on this basis were:

- tax avoidance, with a focus on the wealthy and individuals;
- errors, or failure to take reasonable care with information, in tax returns, with a focus on how this affects small businesses; and
- legal interpretation of the tax effects of complex transactions, with a focus on large businesses.

3 For each of the three case studies we assessed the effectiveness of HMRC's response to the tax at risk, considering issues such as trends in tax loss and compliance yield, HMRC's understanding of the reasons for the observed trends, range and type of HMRC responses to non-compliance and HMRC's assessment of the impact of those responses. We collected evidence for these assessments through a series of interviews, workshops, analysis of data and document reviews.

4 We analysed a wide range of HMRC data on the tax gap including, for example, for individual taxes (such as Income Tax and VAT), for taxpayer groups (such as small businesses and self-employed people), for different types of non-compliance (such as evasion, avoidance or error) and compliance yield (tax collected, as a result of compliance activity, that would otherwise have been lost). We also examined data on the additional tax raised through compliance activity compared with the cost of that activity.

5 Our methodological community of practice reviewed HMRC's *Measuring tax gaps* publications, specifically the published report and the methodological annex, to highlight strengths and opportunities for development.[39] We also reviewed examples of how the tax gap is calculated in other countries.

6 We reviewed a wide range of HMRC documents related to its approach to tackling the tax gap.

7 We conducted a number of semi-structured interviews with officials from HMRC and HM Treasury.

8 We interviewed the Office for Tax Simplification and the Office for Budget Responsibility to get their opinions on HMRC's work to tackle the tax gap.

9 At key stages of the work, such as at our scoping and fieldwork phases, we consulted academics specialising in taxation issues (Kim Scharf, Professor of Economics, Head of the Economics Department at the University of Birmingham and Editor of International Tax and Public Finance; Arun Advani from Warwick University; and Andrew Summers from the London School of Economics) as part of our Tax Centre collaboration.

39 HM Revenue & Customs, *Measuring tax gaps 2019 edition*, June 2019.

Appendix Three

Percentage tax gap by type of tax

Figure 21

Percentage tax gap by type of tax

HM Revenue & Customs publishes tax gaps by type of tax as a share of total tax due from each type of tax

Tax	2013-14 (%)	2014-15 (%)	2015-16 (%)	2016-17 (%)	2017-18 (%)	2018-19 (%)
VAT	**11.9**	**10.4**	**8.6**	**8.9**	**8.6**	**7.0**
Tobacco duties	16.5	12.8	16.4	17.8	14.1	13.8
Alcohol duties	11.1	14.7	10.1	9.4	8.1	7.5
Hydrocarbon oils duties	0.1	0.1	0.1	0.5	0.5	0.5
Total excise duties	**6.5**	**6.4**	**6.1**	**6.3**	**5.1**	**5.0**
Self-Assessment	24.7	22.9	16.2	12.6	13.0	12.9
Pay As You Earn	1.7	1.3	1.3	1.1	0.9	1.0
Total personal income taxes	**5.6**	**5.3**	**4.1**	**3.5**	**3.3**	**3.4**
Corporation Tax	**7.8**	**9.1**	**8.8**	**7.0**	**6.8**	**7.0**
Other taxes[1]	**4.5**	**4.3**	**4.3**	**4.4**	**3.7**	**4.3**

Note

1 Other taxes include indirect taxes (Aggregates Levy, Air Passenger Duty, Climate Change Levy, Customs Duty, Insurance Premium Tax, Landfill Tax and Soft Drinks Industry Levy) and direct taxes (stamp duties, Inheritance Tax and Petroleum Revenue Tax).

Source: HM Revenue & Customs, *Measuring tax gaps 2020 edition*

Appendix Four

Case study assessment

Figure 22

National Audit Office's assessment of HM Revenue & Customs' (HMRC's) responses to tax avoidance, error and failure to take reasonable care, and differences in the legal interpretation of tax law

HMRC's strategic responses to the areas of non-compliance are of differing maturity

Evaluative criteria[1]	Case studies		
	Tax avoidance	Error and failure to take reasonable care	Legal interpretation
Risk assessment			
Does HMRC understand the factors and uncertainties affecting the tax gap?	✔✔ HMRC has a clear sense of the tax avoidance risks and the behavioural drivers that encourage taxpayers' participation in such schemes. HMRC recognises the risk that some tax avoidance schemes may not be disclosed under the Disclosure of Tax Avoidance Scheme. It therefore reviews the tax affairs of high-risk taxpayers to take enforcement action if necessary.	✔ There are inherent uncertainties in HMRC's behavioural analysis. For example, it could be difficult to distinguish between failure to take reasonable care and evasion. Such uncertainties could reduce the effectiveness of policy solutions.	✔ Relatively limited understanding of the way to influence legal interpretation but HMRC is attempting to develop its strategic response. Legal interpretation is a broad and complex behaviour involving subtle distinctions. It can be difficult to distinguish legal interpretation-type cases from outright tax avoidance.
Is there sufficient evidence of HMRC's prioritisation of risks?	✔✔ HMRC, informed by insights from its Strategic Picture of Risk (SPR), focuses on the main strategic risks, which include use of disguised remuneration schemes and sideways loss relief.	✔✔ HMRC is implementing an ambitious initiative, Making Tax Digital (MTD), to help tackle error and failure to take reasonable care in the largest component of the tax gap (small businesses), which in 2018-19 was estimated to be £13.4 billion.	✔✔ HMRC, informed by SPR insights, has identified large businesses as the main area of risk.

Figure 22 *continued*

National Audit Office's assessment of HM Revenue & Customs' (HMRC's) responses to tax avoidance, error and failure to take reasonable care, and differences in the legal interpretation of tax law

Evaluative criteria[1]	Case studies		
	Tax avoidance	**Error and failure to take reasonable care**	**Legal interpretation**
Response			
Does HMRC have an effective strategic response?	✔✔ HMRC has a specific team for tackling tax avoidance. Its strategy (changing the economics of tax avoidance by requesting payments in advance) is well developed and has been effective in reducing the tax gap.	✔ HMRC envisages MTD to be a long-term strategic response, which will lead to a sustainable reduction in the tax gap by reducing the opportunity for taxpayers to make some types of mistakes in their tax returns, particularly simple arithmetical and transposition errors.	✘ HMRC does not yet have a comprehensive strategy to tackle all legal interpretation-type risks, which in some cases can lead to inefficient and less effective responses. HMRC is in the early stages of developing a strategy led by the Large Business Directorate through the Risk Management Framework but this is not replicated across all taxpayer groups.
Is HMRC's response in line with its overarching compliance strategy?[2]	✔✔ HMRC has focused on promotional and preventive measures to tackle tax avoidance particularly with the introduction of new legislative powers. However, it also makes use of measures to tackle non-compliance such as litigation.	✔✔ HMRC has focused on preventive measures with MTD being the most prominent example, but continues to carry out measures to tackle non-compliance.	✔ HMRC has focused its efforts on promoting compliance through policy changes, guidance, and leveraging adviser interactions. It recognises that there is more to do in this area.
Does HMRC's response address the main risks to the tax gap?	✔✔ HMRC is building on its relative success in the past in closing the tax avoidance tax gap by placing greater emphasis on tackling the supply of mass-marketed tax avoidance schemes.[3]	✔✔ One of the key reasons HMRC introduced the MTD initiative is to help tackle error and failure to take reasonable care.	✔ Disputes over the legal interpretation of tax law is one of the top three behaviours resulting in the tax gap. HMRC has managed the risk in large businesses using a combination of vigilance, customer interaction and education. However, despite these efforts, HMRC acknowledges that further initiatives are required to fully tackle this part of the tax gap. In view of this, and the complexity of the risks, HMRC's focus on preventive measures is not sufficiently proportionate to the amount of tax at risk.

Figure 22 *continued*

National Audit Office's assessment of HM Revenue & Customs' (HMRC's) responses to tax avoidance, error and failure to take reasonable care, and differences in the legal interpretation of tax law

Evaluative criteria[1]	Case studies		
	Tax avoidance	Error and failure to take reasonable care	Legal interpretation
Impact assessment			
Does HMRC understand the impact of its compliance interventions?	✔ HMRC monitors the number of promoters that have been warned or prosecuted due to the promotion of avoidance schemes. However, the impact of every intervention is not always known.	✔ HMRC anticipates that MTD will deliver a cumulative reduction of the tax gap caused by error and failure to take reasonable care of £1.55 billion by 2024-25. Although the effectiveness of MTD is not yet known, HMRC has plans to measure its impact.	✔ Response-type activities generate the largest proportion of compliance yield; however, preventive measures are important levers in influencing taxpayers' behaviours. The impact of every intervention in not always known.
Do the current measures being used by HMRC fully capture the impact of its responses?	✔ Impact assessments are carried out for legislative changes, such as Accelerated Payments, but it is difficult to estimate the additional impact of some of the preventive measures, such as educational campaigns.	✔ Compliance yield captures the impact of some of HMRC's interventions. However, the impact of MTD will not be captured in the compliance yield data because, provided it is effective, it will prevent cases of non-compliance arising at source.	✔ The deterrence impact of some of HMRC's responses, such as taxpayer educational and 'nudge' campaigns, will not be captured in the compliance yield data.
Is there sufficient evidence that good practice and lessons learnt are being disseminated across the organisation?	✔✔ HMRC has had notable success with its strategy on avoidance and it has been sharing good practice, particularly in tackling other types of non-compliant behaviours.	✔ Limited scope for sharing lessons learnt from past HMRC initiatives but MTD was influenced by the success of other tax administrations around the world in digitising their tax systems.	✔ There is some evidence of HMRC sharing good practice and lessons learnt through its knowledge and exchange networks for legal interpretation. There is scope for HMRC to broaden out its cross-directorate approach to sharing lessons as demonstrated in its approach to tackling VAT-related legal interpretation risks.

✔✔ = Good practice ✔ = Some evidence of good practice ✘ = Good practice not evidenced

Notes

1 Our evaluative criteria are based on our previous reports covering HMRC's compliance; our 'core management cycle' (see Comptroller & Auditor General, *A Short guide to Structured Cost Reduction*, June 2016); and Organisation for Economic Co-operation and Development, *Managing and Improving Tax Compliance*, October 2004.

2 HMRC's overarching compliance strategy is: promoting compliance, preventing and responding to non-compliance, with a focus on promotion and prevention.

3 Mass-marketed tax avoidance schemes are those that may be sold to one or more individuals or companies to provide a tax advantage.

Source: National Audit Office analysis

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