National Audit Office

REPORT

Managing tax compliance following the pandemic

HM Revenue & Customs

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HC 957

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HM Revenue & Customs

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

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The National Audit Office study team consisted of:

Andrea Jansson, William Johnson, Rich Sullivan-Jones and Calum White, with assistance from Christian Mucicka and Meihad Osman, under the direction of Andy Morrison.

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157–197 Buckingham Palace Road
Victoria
London
SW1W 9SP

020 7798 7400

www.nao.org.uk

@NAOorguk

Key facts

1,356

average number of full-time equivalent (FTE) compliance staff HM Revenue & Customs (HMRC) redeployed to support its COVID-19 schemes in 2020-21 (peaking at 4,396 FTE in May 2020), reducing the staff available for its core tax compliance work by 12%

£9bn

estimated total reduction in the revenue raised by HMRC's compliance work (compliance yield) across the two pandemic years compared with historical average

2,500

approximate increase in HMRC's compliance staff between 2021-22 and 2022-23

£731.1 billion	total tax revenue collected in 2021-22, a 20% increase from 2020-21 after an initial reduction during the pandemic
£30.8 billion	HMRC's estimate of its compliance yield in 2021-22, down from a peak of £36.9 billion in 2019-20 in cash terms
29%	reduction in compliance cases HMRC closed in 2020-21 compared with 2019-20 (103,000 fewer cases), while it also opened 32% fewer cases (114,000)
30%	proportion of compliance yield in 2021-22 from HMRC's 'upstream' work to prevent non-compliance before it happens (up from 22% in 2019-20), for example by using nudges and prompts or changing legislation to close loopholes

Summary

1 HM Revenue & Customs (HMRC) is responsible for administering the UK's tax system. Its objectives include to collect the right tax, to make it easy to get tax right and hard to bend or break the rules, and to maintain taxpayers' consent through fair treatment and protect society from harm. HM Treasury leads on the strategic policy design of the tax system; it agrees HMRC's revenue and efficiency targets, and levels of funding.

2 The COVID-19 pandemic changed the priorities and make-up of HMRC's work. At short notice, it had to implement new COVID-19 support schemes and provide additional support to taxpayers, including more time to pay tax. The need to prioritise direct responses to the pandemic meant redeploying staff from across the department, reducing its overall capacity for tax compliance work. Lockdowns and social distancing affected its ability to conduct investigations in person.

3 A wide range of factors influence levels of tax compliance, some of which were affected by the pandemic. For example, the state of the economy putting pressure on the finances of individuals and businesses, the government changing tax rules and processes at short notice, and taxpayers' perceptions of the fairness of the tax system can all affect how many voluntarily pay the correct tax.

4 HMRC's estimates indicate that without its compliance work at least 10% of taxes owed would not be paid. It records how much its compliance work yields and estimates this normally reduces overall levels of non-compliance to around 5% of taxes owed. HMRC uses two main approaches to improve tax compliance:

- **Upstream** compliance work to encourage voluntary compliance and prevent non-compliance before it happens. It includes legislative changes to close tax loopholes; changes to HMRC processes to reduce opportunities to avoid or evade tax; and operational activities to prevent non-compliance before it occurs. HMRC promotes compliance using education, nudges and prompts to reduce errors and support taxpayers to get their tax affairs right first time.

- **Downstream** compliance work to identify and tackle non-compliance after it has happened. It involves monitoring risks of non-compliance, investigation and follow-up action. These actions include educating the taxpayer to put their tax affairs right, collecting any taxes owed, issuing penalties and, where necessary, pursuing matters through tribunals or through civil or criminal courts. HMRC includes the behavioural impact of this work on future revenue when measuring performance.

5 Before the pandemic, HMRC's strategy increasingly focused on upstream compliance, which it considers more cost-effective and better for customers because it aims to help taxpayers get their tax right first time. HMRC uses downstream activity to respond to non-compliance, including more severe forms such as tax evasion and other criminal activity, and to maintain a strong deterrent effect to encourage other taxpayers to take compliance seriously. The pandemic reduced HMRC's ability to conduct downstream investigations. It now faces a challenge to restore compliance performance following the pandemic.

Scope of this report

6 This report examines the extent to which HMRC is well-placed to manage its compliance work following the pandemic, including new risks and challenges to tax compliance. It covers whether HMRC:

- understood the immediate impacts of the pandemic and organised an effective response;
- has a good understanding of its compliance performance and what this shows about its performance since the start of the pandemic; and
- has a clear vision and plan to manage tax compliance risks following the pandemic.

7 This report focuses on HMRC's tax compliance work. It does not evaluate related areas that we have reported on since 2021, including HMRC's management of debt and of fraud and error in its COVID support schemes.

Key findings

Tax compliance during the pandemic

8 Early in the pandemic, HMRC redeployed compliance staff to the COVID-19 response, reducing capacity for other compliance work. Throughout 2020-21, HMRC had redeployed an average of 1,356 full-time equivalent (FTE) staff from its Customer Compliance Group (CCG) to support its new COVID support schemes. In May 2020, a peak of 4,396 CCG staff were working on the schemes, before reducing over time. A large part of the CCG's staff was required to work on existing priorities such as EU Exit. Compliance staff available for remaining compliance work reduced by 12% in 2020-21 (to 15,581 FTE). HMRC is actively recruiting and training new staff to fill the gap, but in the short term its compliance staff will be less experienced than before the pandemic (paragraphs 1.8 and 1.9).

9 HMRC has conducted substantially less downstream compliance work since the pandemic began, partly due to reduced capacity. In 2020-21, HMRC closed 103,000 (29%) fewer compliance cases compared with the previous year and opened 114,000 (32%) fewer. HMRC's strategy to focus increasingly on upstream compliance and prioritise higher-impact cases meant downstream case numbers were already reducing before 2020. The pandemic reduced downstream activity further. Recognising the pressures on taxpayers, HMRC offered them the option to pause enquiries, except in cases where it suspected fraud or criminal activity. HMRC eased other requirements, such as allowing more scope to file returns digitally. The pandemic accelerated HMRC's strategy to move away from face-to-face casework, as it aims to target investigations more cost-effectively. In-person visits for individuals and small businesses remained 36% lower in 2022 compared with 2019. HMRC has not yet assessed how these changes have affected detection of non-compliance or the behavioural effect on attitudes to paying tax among those it has investigated (paragraphs 1.10 to 1.12).

10 Alongside its response to the pandemic, HMRC needed to continue monitoring and addressing new and emerging risks. The tax system is a continual target for fraud and criminal attacks. HMRC therefore needed to continue monitoring risks of such attacks during the pandemic and addressing any criminal activity. For example, shortly after lockdown in March 2020 the income tax self-assessment repayment system was subject to a new type of attack, involving fraudulent claims. The total value of repayment claims rose by around £1.5 billion (19%) in 2020-21 compared with 2019-20. HMRC stopped around £1.1 billion of these payments before they were made but estimates that between £52 million and £219 million was extracted by fraudsters. HMRC strengthened systems and controls, and claims returned to expected levels by July 2021 (paragraphs 1.14 and 1.15).

11 Tax revenues fell in 2020-21 before reaching record levels in 2021-22, but levels of non-compliance during the pandemic are not yet known. With economic activity significantly reduced in the first year of the pandemic, total tax revenues fell in cash terms from £636.7 billion in 2019-20 to £608.8 billion in 2020-21. With the economy largely reopening in 2021-22, total revenues rose by 20% to a record level of £731.1 billion. This growth was higher than commentators had anticipated because of economic factors, in particular wage growth and inflation. HMRC's latest estimate of the tax gap – which is the difference between taxes theoretically owed and those actually paid – suggests that the tax gap was stable at around 5% of total taxes theoretically owed in 2020-21, equivalent to £32 billion. Tax gap data are not yet available for 2021-22 (paragraphs 1.16 and 1.17).

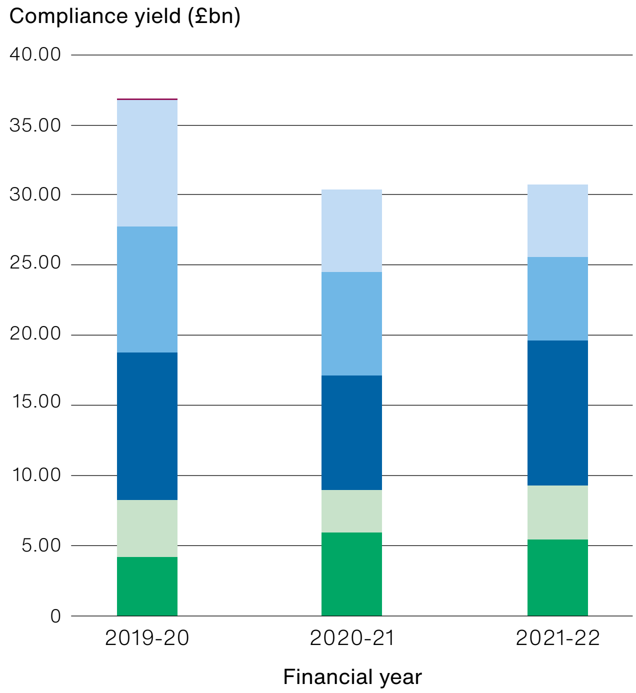
Understanding compliance performance

12 **HMRC's compliance work has raised around £9 billion less revenue (compliance yield) since the pandemic began, compared with historical levels.** In the five years before the pandemic, HMRC estimated that its compliance yield was on average 5.2% of total revenues. Compliance yield as a proportion of total revenues decreased from the previous average of 5.2% to 5.0% in 2020-21, equating to a £1.5 billion reduction. It then fell further to 4.2% in 2021-22 (the lowest level since 2011-12), equating to a £7.5 billion reduction. With revenues reaching record levels in 2021-22, the reduction in compliance yield is likely to be at least partly driven by reduced compliance work, although the impact of wider economic factors on yield is not yet clear (paragraphs 2.6 and 2.7).

13 **Upstream yield makes up an increasing proportion of total yield, up from 22% in 2019-20 to 30% in 2021-22.** Recent trends in the different components of compliance yield are shown in **Figure 1**. Upstream yield increased during the pandemic mainly due to 'product and process yield' improvements. These are policy, legislation or system design changes to improve compliance, for example by closing loopholes. Cash expected from downstream interventions, and the expected impact on customers' future compliance (future revenue benefit) both fell in successive years. The length of time needed to work on compliance cases means the full impact of the pandemic on downstream compliance yield will not become clear for several years (paragraphs 2.8 and 2.9).

Figure 1
Upstream and downstream components of compliance yield, 2019-20 to 2021-22

Upstream compliance yield increased slightly during the COVID-19 pandemic, while downstream yield fell



	2019-20	2020-21	2021-22
Accelerated payments	0.1	0.0	–
Future revenue benefit	9.0	5.9	5.2
Cash expected	9.0	7.4	6.0
Revenue loss prevented	10.6	8.2	10.3
Upstream operational yield	4.1	3.1	3.9
Upstream product and process yield	4.2	5.9	5.4
Total compliance yield	**36.9**	**30.4**	**30.8**

Notes

1 Values are in cash terms and have not been adjusted for inflation. Yield as a percentage of tax revenues is shown in Figure 7.

2 For explanations of each category of compliance yield, see Figure 6.

3 Between 2014-15 and 2020-21, HM Revenue & Customs (HMRC) recognised a separate yield component called 'accelerated payments'. From 2021-22, HMRC includes these within cash expected and upstream product and process yield. These are disputed amounts that people using tax avoidance schemes are required to pay upfront, and an estimate of the behavioural change caused by this policy.

4 2019-20 included an exceptionally large settlement of £4.2 billion of yield, which was spread across Revenue Loss Prevented and Future Revenue Benefit.

5 Figures may not sum exactly due to rounding.

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

14 **Compliance yield has limitations as a performance measure, and we found some areas where HMRC's estimates may be overstated.** Compliance yield is HMRC's primary measure of its performance in bringing in additional tax revenue, and it captures only positive returns. Negative impacts, such as losses from weaknesses in tax systems, are captured under HMRC's annual assessment of the tax gap. HMRC carries out high-level quality-assurance of its upstream yield, but this does not involve detailed accuracy testing. There are inherent uncertainties that may lead to understatement or overstatement. Inconsistencies in the way HMRC applies assumptions about inflation may also lead to understatement or overstatement (paragraphs 2.15 to 2.17 and 2.20). We identified two further aspects of the way HMRC calculates downstream yield that may result in substantive overstatement:

- **HMRC identifies and corrects errors in its downstream yield but does not use its findings to adjust the overall estimate.** In 2021-22, HMRC's quality assurance arrangements found errors in 80 out of 400 downstream compliance cases selected. Errors generally overstated how much tax would be recovered. From cases totalling £736 million, net errors overstated compliance yield by £59.7 million (8% of the value of cases selected). HMRC's testing also found seven cases where it had overcharged taxpayers (none of which were large businesses), by a total of £32.2 million. HMRC subsequently took corrective action to ensure the tax position was remedied. HMRC told us its sampling approach does not allow it to extrapolate errors to compliance yield overall, meaning it does not know how much its compliance yield is overstated or how much it has overcharged taxpayers. Using the approach to extrapolating errors we take in our financial audits of government accounts, we found a wide range of potential error which limited the precision with which an overall error could be estimated. This is because, in 2021-22, HMRC tested only small numbers of cases in some areas where it found high levels of error (paragraphs 2.12 to 2.14).

- **HMRC has not updated its compliance yield assumptions for non-payment of tax debt since 2010.** Levels of tax debt more than doubled in real terms during the pandemic. Caseworkers assess the likelihood of receiving payment when calculating the expected yield, and HMRC also assumes that some expected yield will not be collected in practice because taxpayers go insolvent or are otherwise unable to pay their debt. However, it normally only applies this to the 'cash expected' component of compliance yield for individuals and for small and medium businesses. It has not updated its assumptions about non-payment rates since 2010, despite evidence that rates of non-payment have risen during the pandemic (paragraph 2.17).

15 **Although compliance yield reduced during the pandemic, this has not resulted in an increased tax gap estimate.** HMRC's latest estimates suggest compliance yield reduced by 0.8% of total tax revenue in 2020-21 but the tax gap remained stable at 5.1% of total taxes theoretically owed. The tax gap estimates for 2020-21 are subject to increased uncertainty due to the pandemic. In theory, changes in compliance yield should affect the level of the tax gap (unless underlying levels of taxpayer compliance also change). In practice, HMRC calculates the tax gap and compliance yield in different ways, based on different time periods, making precise comparisons difficult. Methodological changes can improve or reduce the comparability of the estimates. HMRC made three adjustments to the 2020-21 tax gap to account for the pandemic's impact on the data it uses. This included spreading out a large reduction in self-assessment 'cash expected' yield by matching the reductions more closely to the relevant tax year. HMRC's tax gap methodology states this was to preserve consistency in the time series, but HMRC did not adjust the methodology for prior years as it normally does for changes in the tax gap. Without the change, the tax gap as a proportion of total liabilities would have increased, by 0.1 percentage points. HMRC told us it would describe small movements between years as showing the tax gap to be broadly stable (paragraphs 2.18 to 2.21).

16 **Criminal prosecutions decreased markedly in the pandemic when many courts were unable to operate**. Before the pandemic, the number of prosecutions had reduced as HMRC focused more on serious and complex cases, from around 900 in 2017-18 to around 700 in 2019-20. During the pandemic, there were periods in which many courts were closed or operating with less capacity. In 2020-21, there were just 163 prosecutions, rising slightly to 236 prosecutions in 2021-22. HMRC does not publish targets or expectations for overall numbers of prosecutions. In its 2019-20 annual report, HMRC said that its focus was on achieving the right overall outcome for the UK, rather than chasing arbitrary targets in arrests and prosecutions (paragraphs 2.23 and 2.24).

Managing tax compliance in future

17 **It is not yet clear whether the pandemic has affected risks to tax compliance.** HMRC's CCG maintains a detailed and comprehensive register focused on current and short-term compliance risks. In its 2021 assessment, HMRC judged that the overall level of risk had so far not changed significantly. However, HMRC quantifies the scale of risk based on the latest data on levels of taxation and estimates of the tax gap, which take one to two years to become available. HMRC told us that some risks are likely to become more significant in the next two iterations of its risk assessment, and that the figures do not yet reflect the full impact of the pandemic. Possible impacts of the pandemic include higher levels of non-payment, and potential changes in taxpayers' willingness and capability to comply (paragraphs 3.2 to 3.4).

18 HMRC's internal planning indicates that it will be challenging to keep the tax gap from growing over the next three years. HMRC's CCG will need to achieve its upper planning estimate for the yield from its core compliance work to meet the yield level it thinks will be needed to maintain the tax gap. If it only achieves its mid-point planning estimate, it will fall short of the required level by £17 billion in total over the three-year period (2022-23 to 2024-25). In practice, the CCG expects to achieve yield somewhere between its upper and mid-point estimates. This will require an improvement in performance compared with the pandemic years. According to HMRC's estimates for the past two years, its core yield was closer to its mid-point estimate and fell short of the level required to maintain the tax gap by £1.5 billion in 2020-21 and £3.4 billion in 2021-22 (paragraphs 3.5 and 3.6).

19 The cost-effectiveness of compliance work reduced during the pandemic, but HMRC expects to recover performance levels from 2024-25. Compliance yield per staff member fell during the pandemic but HMRC expects to recover this over the next five years. Compliance staff generated around £1.1 million a year per staff member across 2020-21 and 2021-22 compared with £1.3 million per staff member on average in the five years before the pandemic. HMRC is recruiting and training new staff to provide capacity and support greater flexibility between tax regimes. HMRC expects the number of compliance staff to increase by around 2,500 (10%) between 2021-22 and 2022-23. However, new staff typically need up to four years to become fully effective. HMRC does not analyse rates of return for different types of compliance intervention, which it could use to understand the relative effectiveness of different activities. It also carried out little evaluation of compliance projects during the pandemic, limiting its understanding of what worked effectively during the period. It plans to rectify this as part of wider changes to compliance standards, accompanied by guidance to support policy design. A key lesson from the COVID employment support schemes is the importance of mitigating compliance risks when formulating policy (paragraphs 3.9 to 3.13).

Conclusion on value for money

20 The COVID-19 pandemic had a significant impact on HMRC's compliance work. In challenging circumstances, HMRC focused its resources on key priorities and redeployed some staff to new support schemes, which left reduced capacity for downstream tax compliance activity. It needed to make reductions to its casework, beyond those it was already making as part of a strategy to focus on upstream compliance. Compliance yield reduced significantly during the pandemic and there is a risk that more non-compliant taxpayers ultimately fail to pay the right tax or escape investigation and prosecution. It is concerning that HMRC's planning indicates that the tax gap may grow following the pandemic. It will take some time to understand fully whether the pandemic has affected tax compliance. The next two years are critical and swift action is likely to be needed to prioritise efforts and stem potential losses.

21 Understanding performance is essential for government and HMRC to deploy resources effectively. There is little doubt that HMRC's compliance work offers good value for money, but its compliance yield measure needs to be sufficiently robust and transparent to instil confidence in the absolute level of returns it can generate. HMRC is taking steps to improve how it quality-assures its measure. Particular areas for improvement include understanding how assumptions affect the range of uncertainty around compliance yield, adjusting for errors across the estimates, and understanding how much it is overcharging or undercharging taxpayers as a result of tax compliance enquiries. With a better-quality measure, HMRC can make more effective trade-offs and achieve better value for money.

Recommendations

22 HMRC can do more to demonstrate that its compliance yield measure has sufficient quality assurance and transparency. These recommendations all have consequential impacts on HMRC's understanding of the resources needed to prevent non-compliance from growing. HMRC should:

a make further improvements to its processes for estimating compliance yield. This should include:

- extending improvements made to quality assurance processes for downstream compliance yield to apply to upstream yield, including assurance work to test underlying evidence;
- reviewing its assumptions in light of the current economic climate, including non-payment rates; and
- updating how it selects and targets the sample of cases to test, so that a robust extrapolation of the errors can be used to calculate to what extent they affect the overall estimate of compliance yield each year.

b estimate and report the likely extent of official error affecting taxpayers – by either overcharging or undercharging them – in carrying out its compliance work. This should include ensuring it has the data needed to make a robust and representative estimate, and to determine whether additional testing is required.

c supplement its published compliance yield figures with more detailed commentary and analysis of trends between the different components of yield, and what these say about performance. This should indicate levels of uncertainty and could include sensitivity analysis of core assumptions used in the compliance yield estimate.

d assess the potential impacts, on taxpayer behaviour and levels of non-compliance, of changes to compliance processes that it introduced or accelerated during the pandemic and has since made permanent, such as fewer face-to-face visits and digital filing of returns.

e analyse the relative rates of return from different types of compliance intervention, and use it to help inform how it prioritises and allocates resources on areas that will be most impactful. This should build on its existing analysis of rates of return.

f ensure that there is more consistent evaluation of the effectiveness of all types of its compliance interventions and use the findings to assess value for money.