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REPORT

Tax measures to encourage economic growth

HM Treasury and HM Revenue & Customs

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Tax measures to encourage economic growth

HM Treasury and 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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Key facts

£204bn
summed cost of non-structural tax reliefs using latest available estimates in 2022-23

341
number of non-structural reliefs in 2023

£16.6bn
cost in 2022-23 of 39 reliefs aimed at incentivising business investment

256	number of estimates for non-structural reliefs that HMRC has costed (of which 104 were costed over multiple years)
25	number of non-structural reliefs evaluated since 2015
£600,000	the budget in 2023-24 for commissioning evaluations of tax reliefs
£4.76 billion	cost of Research and Development (R&D) small and medium-sized enterprise (SME) tax relief in 2021-22
575%	overall cash increase in the annual cost of the R&D SME relief between 2013-14 and 2021-22
£1.04 billion	estimated amount of R&D SME relief lost to error and fraud in 2020-21 (the latest year for which data is available)

Summary

1 The government can use tax measures to encourage economic growth by providing tax relief to incentivise certain sectors or activities. Tax reliefs reduce the tax an individual or business owes, and some reliefs make payments back to taxpayers. Some 'non-structural' tax reliefs reflect specific policy choices by ministers to support particular groups or sectors (for example the housing market), while others are designed to incentivise behaviour. As at December 2023 the UK had 341 non-structural tax reliefs intended to achieve social or economic objectives. The government can introduce, amend or remove a relief without making wholesale changes to the wider tax system.

2 Ministers introduce and amend tax reliefs through 'fiscal events' (predominantly legislative changes made once or twice a year announced at the Spring Budget and Autumn Statement, and voted on by Parliament). HM Treasury and HM Revenue & Customs (HMRC) are responsible for all aspects of the effective working of the UK tax system, including tax reliefs. Both departments are responsible for monitoring the effectiveness of reliefs overall. HM Treasury is responsible for strategic oversight of the tax system, including providing evidence-based advice to ministers covering its overall effectiveness. HMRC is responsible for administering the system, including the monitoring and evaluation of specific tax reliefs.

3 HMRC's latest estimates indicate the cost of all non-structural reliefs was around £204 billion in 2022-23 (the latest year for which it has completed all routine estimates). The largest non-structural reliefs – making up around £129 billion of the 2022-23 cost – are not those targeted explicitly at economic growth. These include tax reliefs for pensions, capital gains tax relief on people's main home, and zero-rated VAT on food. Aggregating the cost of non-structural reliefs gives a sense of their scale, but it does not reflect the amount of tax that would be generated if they were removed as some taxpayers may change their behaviour if the reliefs were removed, and there may be wider economic impacts.

4 The National Audit Office reported on non-structural tax reliefs in 2014 and 2020.[1] In 2020 we found that HM Treasury and HMRC had responded to our recommendations by increasing their oversight of non-structural reliefs and actively considering their value for money, but that these steps were very much still in development. We said both departments needed to make substantial progress and ensure sufficient coverage and rigour in their work, including evaluating and reporting on non-structural reliefs. Since then, and in response to our and the Committee of Public Accounts' (PAC's) recommendations, HMRC has made progress in publishing more information on the reliefs, in particular their costs, and has established a framework for future evaluations of reliefs' effectiveness.

5 Tax reliefs can require careful administration to check that they achieve their objectives and costs do not rise disproportionately. Some reliefs can be costly to administer. Our reports, and our annual work on HMRC's financial statements, have recorded instances of large-scale error and fraud involving some reliefs, most recently the Research and Development (R&D) small and medium-sized enterprise (SME) relief. The scale of error and fraud against this relief is still becoming apparent, but it has likely cost the Exchequer several billion pounds.

Scope of the report

6 This report focuses on reliefs intended to promote economic growth, within the wider system of tax reliefs. We examined whether HM Treasury and HMRC have an effective system in place to manage and respond to risks affecting tax reliefs with economic objectives in a timely and proportionate way. We considered:

- to what extent HMRC has improved its assessment of the costs of non-structural reliefs;
- whether HMRC has proportionate and timely monitoring and evaluation of whether objectives are being achieved;
- whether HMRC assesses and monitors the risk that tax reliefs are misused and acts sufficiently quickly to respond where abuse arises; and
- whether HM Treasury and HMRC learn and apply lessons from experience to minimise the risk of abuse and meet objectives in an administratively efficient way.

1 Comptroller and Auditor General, *Tax reliefs*, Session 2013-14, HC 1256, National Audit Office, April 2014; Comptroller and Auditor General, *The effective management of tax reliefs*, Session 2014-15, HC 785, National Audit Office, November 2014; and Comptroller and Auditor General, *The management of tax expenditures*, Session 2019-20, HC 46, National Audit Office, February 2020.

7 Part One of this report provides an overview of non-structural reliefs, including their cost. Part Two examines the departments' understanding of whether non-structural tax reliefs are meeting their economic objectives. Part Three considers how HMRC manages and responds to risks of abuse of non-structural reliefs. We used a range of criteria to select as case studies seven reliefs with objectives to increase investment by or into businesses. These reliefs are the Research and Development (R&D) Expenditure Credit, R&D relief for SMEs, the Annual Investment Allowance, the First-year allowance for plant or machinery for oil and gas trades, Business Asset Disposal Relief, High-end Television Tax Relief, and Video Games Tax Relief. These were estimated to cost £14.9 billion in 2021-22. Appendix One describes our evidence base and methodology.

Key findings

Oversight of non-structural reliefs with economic objectives and how much they cost

8 HM Treasury and HMRC have made a number of important improvements to how they administer, evaluate and report on tax reliefs. Following our reports in 2014 and 2020 the departments have made significant improvements including: publishing objectives for all non-structural reliefs; greatly increasing the number of cost estimates to 256 (out of 341 reliefs) in 2023; and starting to publish high-level commentary on movements in the cost of significant reliefs. The departments have developed a joint framework for designing new reliefs, revising reliefs and monitoring them. In 2021 HMRC published a framework for evaluating reliefs, with criteria for selection within a dedicated annual budget (paragraphs 1.4, 1.13, 1.14, 2.5 and 2.28).

9 In 2022-23 the total cost of the 104 non-structural tax reliefs for which HMRC has data was £204 billion, equivalent to 25% of all tax revenue. This December 2023 cost estimate covered 104 reliefs where HMRC has been able to estimate costs for the last six years. For reliefs where a multi-year estimate is not possible HMRC has investigated the option to produce single-year estimates. This work has identified an additional £19 billion of cost in the years 2016-17 to 2022-23 (paragraphs 1.5 and 1.6).

10 The government has not identified the number and cost of reliefs with purely economic objectives. HMRC publicly stated the objective for each non-structural relief with economic or social objectives in November 2021. There is no agreed population of reliefs targeted at economic growth, and they are not monitored as a group, or compared, for overall effectiveness. We identified 39 reliefs with an objective aimed at increasing UK business investment, 29 of which were costed at £16.6 billion. However, this does not represent a complete list of reliefs with economic objectives (paragraphs 1.8, 1.9, 1.14 and Figure 2).

11 **Some tax reliefs with economic objectives have cost far more than forecast.** Between 2017-18 and 2021-22 just under half of non-structural tax reliefs had increased in cost. Although some increase is expected due to external factors such as inflation and economic growth, some have increased far beyond HMRC's and HM Treasury's forecasts. The R&D relief for SMEs cost around £15 billion more than HMRC expected it to cost between 2015-16 and 2020-21. The growth was due to large increases in the number of claims each year. The relief for High-end Television introduced in 2013-14 cost £762 million, £557 million (272%) more than HMRC expected it to cost during its first six years. HMRC considers this to reflect unanticipated growth in the industry. Video Games Tax Relief cost £254 million, £179 million (239%) more than initially expected during 2014-15 to 2016-17 (£75 million). Until recently, HMRC based forecast costs for the above reliefs on the Office for Budget Responsibility's (OBR's) general forecast of UK investment and nominal GDP growth, implicitly assuming that businesses claiming a relief will not increase their activity at a faster rate than the UK average. There is no meaningful public reporting where tax reliefs greatly exceed the expected cost (paragraphs 2.5, 2.8 to 2.12 and Figure 6).

HMRC's monitoring and evaluation of whether economic objectives are achieved

12 **HMRC has produced an evaluation plan for tax reliefs with economic and social objectives, but has so far only covered a small proportion of them.** Tax reliefs to encourage economic growth do not have a statutory timetable for review or reassessment, meaning the responsibility rests on HM Treasury and HMRC to undertake comprehensive, robust and proportionate evaluations of policy interventions as soon as practicable. In December 2021 HMRC produced an evaluation plan specifically for tax reliefs, but this does not set out a schedule for when the evaluations will be completed. Since publishing the plan HMRC has completed two evaluations covering four reliefs for creative industries and three reliefs for share incentive schemes, meaning that it has evaluated 25 since 2015. The summed annual cost of these 25 reliefs is £22.4 billion (based on 2022-23 costs). It has evaluations underway to evaluate more reliefs. Almost all the reliefs selected for evaluation have an economic objective. Once completed HMRC will have evaluated 36 of the 341 reliefs since 2015 (paragraphs 2.17 to 2.19 and 2.28).

13 **The government has reduced some reliefs following evaluation, increasing tax revenue by billions of pounds in some cases.** In the case of Entrepreneurs' Relief (now Business Asset Disposal Relief), closer monitoring of costs and the evaluation of the extent to which the relief influenced entrepreneurial behaviour helped HM Treasury and ministers understand the relief was costly, ineffective and not value for money. This led to a decision to reduce the lifetime allowance and saved the Exchequer £1.6 billion in 2021-22 alone. In the case of the R&D scheme for SMEs the evaluation identified that the relief's impact on R&D was marginal and reduced with later rate increases. This helped inform advice and led to a policy decision to reduce the generosity of the relief from April 2023. HM Treasury forecast that this change, alongside an increase in the other R&D relief, will lead to a net reduction in costs of £4.5 billion between 2023-24 and 2027-28 (paragraphs 2.22 to 2.25).

14 **In some cases government has not amended reliefs for some years after evaluations found they had had a limited effect. A range of factors may influence the speed of response, including the fact that tax reliefs can have a number of objectives and the timeframes for tax policymaking.** Reliefs that do not achieve their objectives are costly and the faster that revisions can be made, the greater the opportunity to reduce costs to the Exchequer and improve outcomes. Evaluations since 2015 have identified five reliefs that had limited effectiveness at increasing economic activity. For Entrepreneurs' Relief, and Employment Allowance, there was a three to four-year gap between the date of fieldwork and decisions to amend the relief. The remaining three reliefs have not been amended. These were the reduced National Insurance Contributions for under-21s (estimated cost £850 million in 2022-23) and under 25s (estimated cost £290 million in 2022-23), and rollover tax relief on the purchase of new assets (no cost estimate available for 2022-23). The government announces changes to reliefs, or the introduction of new ones, at 'fiscal events', normally the Budget and Spring Statement and then typically introduces changes after consultation. Ministers may take into account a wider range of factors when deciding on changes to reliefs, including wider government objectives, the priorities of each fiscal event, and levels of Parliamentary support and public perception (paragraphs 2.20 to 2.27 and Figure 9).

15 **Evaluations can contribute to changes that save billions of pounds for the Exchequer, but the government has reduced its budget for evaluation by more than a quarter in 2023-24.** External evaluations remain the main source of evidence for how well a tax relief is performing. Several years of data and claimants' experience of the relief are necessary for a full impact evaluation but reliefs are not routinely evaluated after a set amount of time. In the past three years HMRC has dedicated an average annual budget of £797,000 for evaluating reliefs, reducing the latest budget to £600,000 in 2023-24. The return from HMRC's evaluation of tax reliefs thus far is significant, with billion pound impacts on several tax reliefs where evaluations informed decision-making. This suggests that more rather than less evaluation would improve the Exchequer position. HMRC could have made more use of academic input and improved engagement and resources available for relevant research. Unlike other government departments HMRC does not publish areas of interests where academic input would be helpful. These issues were exacerbated by the closure during the COVID-19 pandemic (the pandemic) of the HMRC 'datalab', which is the facility that allows researchers to access HMRC data. HMRC is now making a range of resource and process improvements to address these concerns (paragraphs 2.29 and 2.30).

Managing the risk of abuse and responding quickly

16 **Some reliefs are subject to large-scale abuse: HMRC estimates that the most likely level of error and fraud on the R&D SME relief was 24.4% (£1.04 billion) of expenditure in 2020-21, the latest year for which data is available.** In past reports we have seen that reliefs have been targets for avoidance or evasion activity. We qualified our opinion on HMRC's 2019-20 accounts due to concerns about error and fraud in the R&D tax reliefs. In response HMRC increased its compliance work starting with a programme to randomly check a sample of claims from December 2020. The first results were not available until 2022-23 and led HMRC to retrospectively raise its estimate of the most likely level of error and fraud for the R&D SME relief in 2020-21 from 5.5% (£0.3 billion) of expenditure to 24.4% (£1.04 billion) (paragraphs 3.1 and 3.6).

17 HMRC does not know how far back large-scale error and fraud has occurred on the R&D SME relief, but we do know that costs began to increase sharply from 2013-14. The cost of the R&D SME relief increased by nearly 575% in cash terms between 2013-14 and 2021-22, when it cost £4.76 billion. The way claims are made for this relief, which offers partial relief from corporation tax for SMEs engaged in qualifying R&D activities, has made it attractive to fraudsters. From 2017 and 2018, HMRC identified more tax at risk from poor-quality R&D claims, and from abuse by companies with a limited UK presence. However, HMRC was still concluding as late as 2020-21 that the increases in cost were due to unexpectedly high take-up by eligible claimants on grounds of increased attractiveness and awareness. HMRC's methodology inherently underestimated the level of risk and therefore the level of compliance work necessary, which became clear with the results of its mandatory random enquiry programme for the year 2020-21. The time needed to train new staff and develop new systems affected the pace of HMRC's response. The pattern of cost increases would indicate that HMRC has underestimated the level of error and fraud for some years, and compliance work on older claims may be worthwhile despite the costs and difficulties (paragraphs 3.5, 3.6 and Figures 11 and 13).

18 The level of error and fraud in R&D SME relief exposed significant weaknesses in HM Treasury's and HMRC's identification and understanding of the risks affecting reliefs with economic objectives; design of controls; and capacity and agility to respond quickly. The R&D schemes use a definition of R&D based on the Income Tax Act 2007 and accompanying guidelines issued by the Department for Science, Innovation and Technology (DSIT) but understanding claims can require expert knowledge and wording is open to interpretation. Unaccredited agents aggressively solicited taxpayers to submit claims that challenged the definition. HMRC prioritised processing claims quickly in response to the surge in the volume of claims instead of tightening controls. HMRC was too optimistic in assessing the level of non-compliance and as a consequence slow to respond. Post-payment compliance work proved the only means by which HMRC could make a robust assessment of the scale of error and fraud. While the cost of intervening is relatively expensive for HMRC, it is dwarfed by the losses that occurred. HM Treasury and HMRC enhanced pre-payment checking of claims during 2022 and introduced new measures to reduce future error and fraud on the SME relief during 2023, which involved a range of enhanced pre-payment risk assessment activities. These included requiring businesses to: submit claims digitally, with more information; provide a named senior officer; and provide details of any agents involved. The department has not carried out a formal lessons learned exercise from its experience of the R&D SME relief, but has applied lessons in amending this relief and considered steps to improve controls for other reliefs (paragraphs 3.6, 3.11, 3.12 and Figure 13).

19 HMRC has made greater use of pre-checks and accredited expertise for some similar reliefs. In some cases HMRC has designed specific interventions for risky reliefs. For example, it reviews claims for Creative Industry reliefs and takes into account sectoral or technical information from partners such as the British Film Institute. HMRC has not been able to put a similar arrangement in place for R&D due to the volume of claims and the technical nature of the relief. HMRC's large increase in post-payment compliance activity since 2022-23 involved bringing in compliance staff who had received training but lacked practical experience in administering this complex relief. There have been widespread stakeholder concerns about the quality of HMRC casework and lack of support to claimants, which HMRC is promising to address through an improvement plan. In August 2023 HMRC developed a revised control framework model setting out its future approach to managing reliefs where claimants make a separate claim for a tax credit (paragraphs 3.9 to 3.13 and Figure 13).

20 HMRC does not routinely monitor how much compliance activity it is doing for other high-cost reliefs claimed within tax returns, meaning it may not know whether it has sufficient coverage of individual reliefs. Most reliefs rely on self-assessment by taxpayers. Some offer large financial incentives, such as the 'super-deduction', which offers a 130% deduction for certain types of plant and machinery between 2021 and 2023 (this means that the profit on which a claimant's tax bill is based is arrived at after deducting the entire cost of the relevant plant and machinery, and an additional 30% of that cost). HMRC recognises capital allowances among its strategic risks to tax revenue but does not routinely monitor the amount of compliance activity it is doing at the level of individual reliefs. This is because it is difficult for HMRC to identify specific reliefs within the data on compliance cases worked. At our request HMRC produced compliance data for a sample of tax reliefs with economic objectives, which showed a significant reduction in the number of compliance cases opened for the Annual Investment Allowance case study in 2022-23 compared to 2018-19, although yield from investigations had been increasing year-on-year until 2020-21. HMRC does not consider the risk of non-compliance to be reducing. This partly reflects the reprioritisation of HMRC resources during the pandemic. HMRC has not yet restored compliance work in this area to pre-pandemic levels but opened more cases in 2022-23 than in the previous two years (paragraphs 2.16, 3.8, 3.14 to 3.18 and Figures 6 and 14).

Conclusion

21 Tax reliefs remain an important policy tool for the government to achieve its economic and social objectives. However, the number and cost of these reliefs makes administration a significant task, and there are too many examples where these reliefs either do not achieve their economic objectives or are subject to significant error and fraud, costing the Exchequer billions of pounds. HM Treasury and HMRC have increased the monitoring, evaluation and reporting of non-structural reliefs, but there is still some way to go. Large reliefs, particularly those aimed at economic or behavioural change require close attention. We have seen examples of tax reliefs where the costs have increased quickly, and far beyond expectations, but it has taken a number of years to identify this, understand why, and then to make changes where there are concerns. Cost increases are not necessarily a sign of failure, as they could be the result of genuine increased uptake and delivery of benefits. However, the government cannot know the cause if it has not carried out adequate compliance work to ensure only legitimate claimants received the relief, and evaluation activity to establish that the relief secures the desired outcome. It is important that the government investigates and responds to increases in costs of reliefs and evaluations promptly.

22 It is encouraging that there are now more examples of changes where evaluations have found that tax reliefs are not achieving their economic objectives. HMRC has made important commitments to improve how it evaluates non-structural tax reliefs but it still needs to achieve greater and more timely coverage. HM Treasury and HMRC must ensure that hard lessons are learned from the R&D SME relief, and that they take the steps needed to prevent such a large failure arising again.

Recommendations

23 HM Treasury and HMRC need to build on the improvements they have made so far in administering tax reliefs and make a step-change in how they assess whether tax reliefs achieve their economic objectives, are not too costly, and are not exploited to avoid or evade tax. We recommend:

a HM Treasury and HMRC identify which non-structural reliefs have economic objectives and how these could be grouped together to provide oversight on how reliefs with similar objectives are working together to deliver government objectives, for example those aimed at business investment. This should include assessing the extent to which reliefs are achieving their objectives and whether the economic gains justify the scale of relief.

b HM Treasury should support ministers by ensuring that objectives for reliefs are expressed in as specific and measurable a way as possible. For example, including an expectation of acceptable costs and timescales, and a measurable definition of what success looks like in the advice provided.

c HM Treasury and HMRC should make a clear articulation of resources required to effectively administer and evaluate tax reliefs in tax information and impact notes. HMRC needs to ensure that teams can access the subject matter expertise needed for complex or technical tax reliefs.

d HM Treasury and HMRC should ensure the annual budget for evaluating tax reliefs is commensurate with the number and complexity of reliefs that need evaluating each year. The departments should ensure evaluations are completed in a timely way and commit to publishing evaluations within three months of completion, subject to ministerial approval.

e HMRC should design proportionate controls and plan interventions at the beginning of a relief's lifecycle based on risk assessment and learnings from other reliefs to:

- establish appropriate up-front checks on generous reliefs;
- set out plans for evaluations to be carried out as soon as practicable and publish the timetable;
- plan for timely review of monitoring information to get interim evidence; and
- ensure speed of response where reliefs are identified as not meeting desired objectives or do not function as planned.

f HMRC should improve the transparency of relief costs by committing to provide comparisons of forecast and outturn costs compiled on the same basis. This should also inform internal reporting and analysis:

- HMRC should report where tax reliefs greatly exceed the initial expected costs; and
- HMRC should investigate differences, using robust evidence to form conclusions.

g HMRC should demonstrate that it has applied lessons learned from the problems with the R&D SME relief to other reliefs that could be vulnerable to similar control failures.

h Where the costs of tax reliefs rise rapidly, and beyond an economically credible scenario, HMRC should, where proportionate, investigate a sample of claims to check whether there is widespread non-compliance. It should put in place a rapid response capability where widespread non-compliance occurs.

i HMRC should monitor agent activity to assess the risks for tax reliefs and intervene early where it sees that expected standards of behaviour are not being met.

j HMRC should publicise the areas where it would welcome academic research on tax reliefs.