The UK Tax Gap

September 2021

/uncheckeduk
@unchecked_uk
www.unchecked.uk

unchecked.uk
LET'S PROTECT WHAT MATTERS MOST

Contents

About Unchecked UK

Unchecked UK makes the case for common sense protections which help keep people safe and allow businesses to thrive.

We are a rapidly growing network of leading and diverse **civil society organisations** who see sensible, properly enforced protections as the framework for a decent society - where the food we eat and the things we buy can be trusted, the natural environment is protected, our homes and workplaces are safe, and our rights are safeguarded.

We carry out research and investigations to highlight the loss of protection for the UK public that results from the erosion of important regulations and of the public bodies which enforce them. Closing the UK's tax gap would make it easier to protect the things that matter most to the public.

We are a non-partisan organisation, incubated as a project of The Ecology Trust.

Find out more about our work: www.unchecked.uk

Acknowledgements

We would like to thank the Joffe Trust for funding this work. We are also grateful to Brad Marshall for his work on this report.

Executive Summary

The UK tax gap - the money owed to the taxpayer which Her Majesty's Revenue and Customs (HMRC) fails to collect - stands at £35bn a year.* This is more than our entire annual spend on police, fire services, courts, and prisons combined. This is approximately the equivalent of:

- £ **Three** times the Health and Social Care Levy being funded by recent increases to national insurance contributions.[1]
- £ **Twice** the amount we need to fund the coronavirus catch up programme for schoolchildren[2]
- £ **Twice** what is required to fund the transition to net zero carbon emissions[3]
- £ **Six times** what the Government is investing into the Levelling Up Fund[4]

We know that the public take a hard line on those who do not pay their fair share. Given the intense pressures on public finances, the Government needs to make a clear and ambitious commitment to reduce significantly the tax gap.[5]

Investments made by HMRC to recover this lost tax generate huge returns. On average, for every £1 invested in compliance there is a return of £15. When investigating large businesses HMRC gets £44 in return for every £1 invested. The Government's own public spending watchdog, the National Audit Office (NAO), says that HMRC's 'high overall returns on investment indicate HMRC should invest more across its compliance activities.'[6] If HMRC were a company, it would be one that generates incredible returns. With these returns, and with so much money at stake, there is a clear case for increasing investment. As well as helping ease the pressures on the public purse, it would ensure that everyone is playing by the same rules.

**According to some experts, were HRMC to include much of the complex tax planning by multinational firms, this figure would greatly exceed £35bn. However, in order to address HMRC's analysis on its own terms this report will stick to HMRC's figures.*

But instead of increasing investment, HMRC faces a 'crisis' in pay and working conditions.[7] Over the past 15 years HMRC has lost nearly 40% of its staff. The number of staff doing the basic compliance work has fallen by a quarter since 2015.[8] Basic tasks like audits and investigations fell by a third between 2016-19.[9] Consequently, customer service standards have plummeted to levels *The Times* has described as 'rock-bottom'[10] with over half of callers to HMRC being left on hold for more than ten minutes. With this lack of support for taxpayers it is no surprise that £10bn of taxes is lost to various errors every year. All this means that HMRC now estimates that the yield from its compliance work is likely to fall in 2020-21.[11]

Cutting back at HMRC costs us all. Unfortunately, this is part of a wider problem. The institutions whose job it is to enforce the rules which we all rely on, have faced similar and, in some cases, deeper cuts. As with HMRC, this has meant less people doing the important task of ensuring that rules are followed, as shown by Unchecked UK.[12]

This is the moment to slash the tax gap. From the push for a minimum global corporate tax rate to President Biden's plans for record investment in the Internal Revenue Service (the US equivalent to HMRC), governments around the world are investing to get to grips with collecting tax. Increasing investment could make Britain a global leader in fair tax enforcement once again. Of course, the money we could collect would also be a huge bonus for Britain. Even if we only collected half the tax gap, it would be enough for us to triple the Government's £4.8bn levelling up fund or invest £27m in every constituency in the country.

This briefing makes the case for closing the tax gap. Cutting back at HMRC is a false economy. The Government should commit to providing the investment necessary for HMRC to restore the number of audits and routine compliance work to (at least) 2016 levels. Restoring HMRC's capacity would require an increase in spending of at least £300m.[13]

Government should also set a target for reducing the tax gap. This currently stands at 5.3% of the total tax bill. The Government should aim to reduce this to 2%.

To do this there should be a boost of investment and a clear plan based on an in-depth analysis of where increasing tax compliance staff, investigations, and other resources could yield the greatest returns on investment into HMRC.

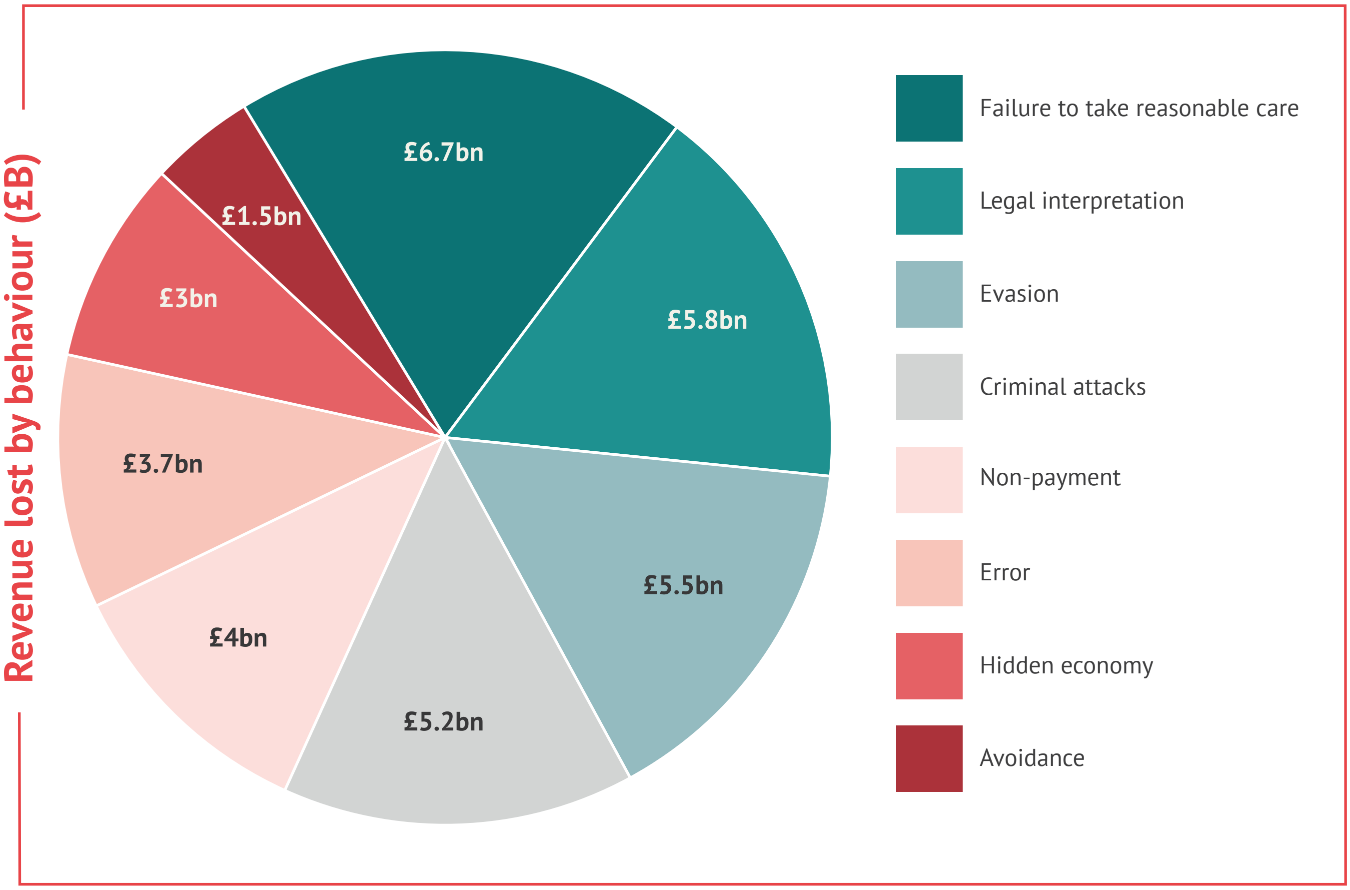
At a time when Britain is looking to build back better, make the transition to net zero, pay for an ageing population and level up its economy, we can't afford a tax gap of this scale. Tackling it will bring in cash whilst ensuring fair play and reinforcing the importance of the rule of law. If done properly, it will restore HMRC to its position as a tax body that other countries want to emulate, as well as making voters feel confident that the system works for them. Putting forward a clear plan to tackle the tax gap will put the UK at the forefront of the fight for fair taxation systems. Altogether, tackling the tax gap will help bring about a stronger, fairer and richer Britain.

What is the tax gap?

The tax gap is the difference between the amount of tax that should be paid to Her Majesty's Revenue & Customs (HMRC) each year and the amount that is actually paid. In 2020-2021 this figure was £35bn. This is money that could be spent on paying down our debt, meeting the cost of the pandemic, investing in the health service, tackling climate change, or helping level up the country. £35bn is more than we spend on police, fire services, courts, and prisons combined every year. Three times the Health and Social Care Levy which is being funded by recent increases to national insurance contributions.

This money would allow the funding cuts to the enforcement agencies and local authorities on which we rely for protection to be reversed multiple times over.[14]

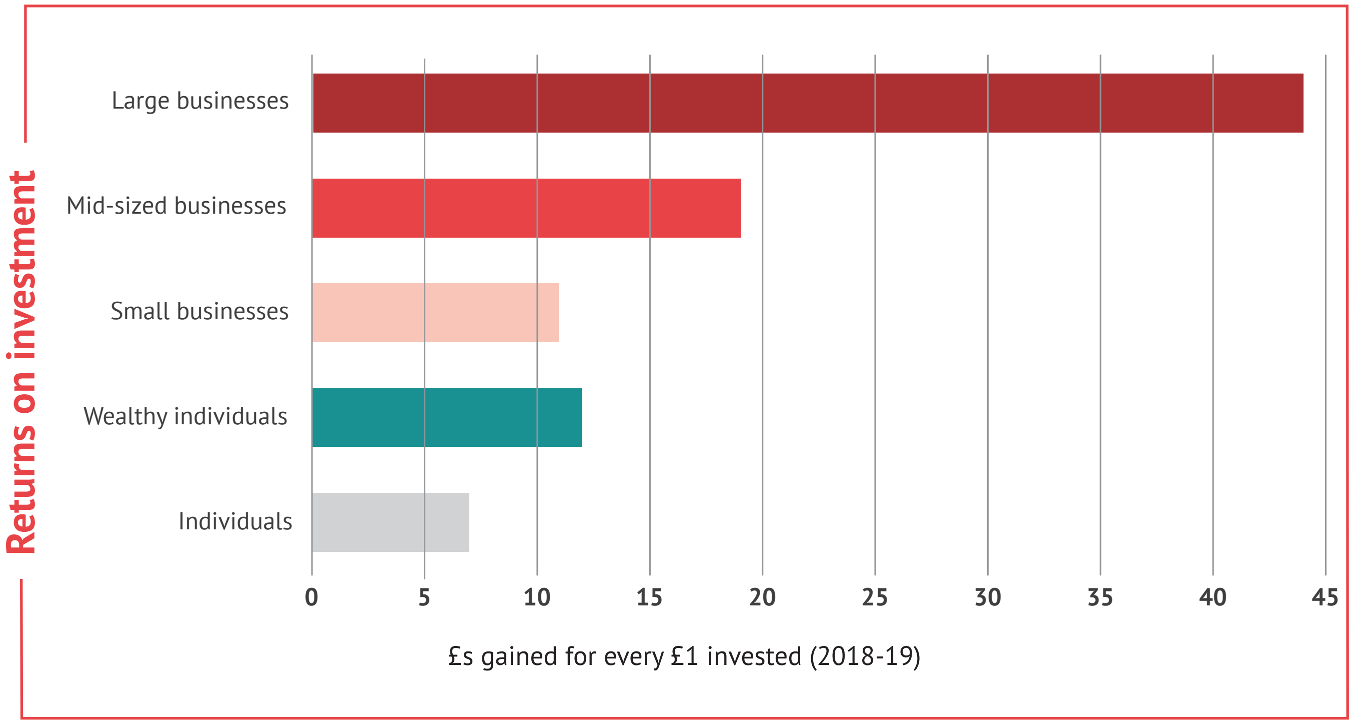
HMRC divides the tax gap into two different categories.[15] Its figures show that £10.4bn is lost to errors by taxpayers and by HMRC, and that £13.7bn is lost to illegal behaviour by criminals, tax evaders and the hidden economy.



The returns

The compliance work HMRC does offers very high returns on investment to the taxpayer. The last available HMRC analysis across all groups suggested that on average it collects £15 for every £1 invested in compliance.[16] The very lowest returns come when HMRC investigate individuals, where the returns are still a worthwhile £7 for every £1 invested.

At the other end of the scale, when investigating large businesses, HMRC gets an extraordinary £44 for every £1 invested. The chart below shows just what strong returns HMRC can generate in each customer group.



These rates of return show that the work HMRC does is an effective way of raising money. However, despite this efficiency, over £35bn continues to go uncollected every year. This includes around £6.1bn from large businesses where returns are 44:1 and over £15bn from small businesses where the returns are still a strong 11:1.

The Government's public spending watchdog, the National Audit Office (NAO), clearly stated in its most recent analysis of HMRC's work that 'more staff could increase rates of return'.[17] Instead, there have been reductions in the number of staff working in key areas such as small businesses 'even though this has the largest share of the estimated tax gap'.[18] This has been done in order 'to live within funding constraints'.[19] However, when HMRC is so clear about how much income these staff generate, these reductions are a false economy.

The last available HMRC analysis across all groups suggested that on average it collects £15 for every £1 invested in compliance.

What has been cut?

Recent years have seen a gradual erosion in investment into collecting taxes. Firstly, HMRC's budget was reduced by 40% from 2000 to 2016.[20] Following this, the Treasury committed only to giving HMRC the resources necessary to keep performance at 2015-16 levels.

Staying at this level shows a clear lack of ambition. Indeed, in 2019, the HMRC's interim permanent secretary, Jim Harra, called out the 'crisis' in pay and working conditions after HMRC staff saw their pay stagnate or even cut, with some administrators working at below the statutory minimum wage.[21] That year, HMRC staff were found to be amongst the most dissatisfied in the Civil Service.[22]

HMRC's budget was reduced by 40% from 2000 to 2016.

The compliance work

Between 2016 and 2019 the number of audits and investigations conducted by HMRC fell by a third (from around 580,000 to 390,000).[23]

Better targeting and digitisation has meant that each action brings in, on average, more money than it did previously. However, the overall decline in the amount of compliance work taking place means that the cash coming in has 'not kept pace with general increases in tax revenue', according to the NAO.[24]

Additionally, HMRC now has around 62,000 members of staff, down from a peak of 100,000 in 2006. In recent years, HMRC has continued to lose both experienced staff and younger staff with strong potential. According to the Public and Commercial Services Union, the organisation lost staff with 17,000 years of collective experience in 2018 alone.

Between 2015-16 and 2019-20 HMRC reduced the number of staff doing routine compliance work by around 25%.

Studies also show that visible compliance plays a key role in ensuring that tax payers play by the rules. Further contraction of HMRC's capacity could tip the UK into a situation where these incentives become less common therefore reducing overall deterrence.

The NAO has regularly warned HMRC and the Government that money is being lost due to limited resources, and has cautioned that continued reductions in staff risk damaging the current yield from compliance work.

HMRC has prioritised maintaining coverage of all taxpayer groups rather than focusing resources on groups offering the highest returns. This has reduced tax revenues. Further reductions in capacity are likely to result in less coverage of some high-risk taxpayer groups and areas of growing risk.

The NAO is clear, cutting back at HMRC is a false economy which loses the taxpayer money.

Other impacts

A reduction in staff has other impacts. As mentioned previously, HMRC's standard of customer service affects the tax gap. When taxpayers like small businesses struggle to speak to a member of staff, they are more likely to make the sort of mistakes that cost up to £10bn in 2019-20. Recent reports have suggested that HMRC is falling far short of their own customer service targets. *The Times* described customer service as reaching 'rock-bottom' whilst the Institute of Chartered Accountants in England and Wales said that its members have experienced poor performance across HMRC. HMRC's statistics bear this out.

Whilst HMRC's target is that 85% of callers should speak to someone within ten minutes, just 48% of calls met this target in February 2021.

Likewise, HMRC pledged to process 95% of online forms within seven days but only managed 45%. If, as HMRC suggests, customer service has a direct bearing on the tax gap, this severe underperformance will contribute to increasing the gap in the years to come.

An additional problem is that HMRC currently appear to lack the data necessary to determine how to lower the tax gap. The NAO have pointed out that HMRC should have strong data 'on marginal rates of return' to 'inform judgements about how increasing or decreasing staff numbers would affect tax revenue'. According to the NAO, this data was collected between 2010 and 2015 (when there were significantly more compliance staff) and this data suggested doubling the number of employees would 'result in significant additional yields.' As the NAO suggests, improved data would allow HMRC to make 'better informed resource deployment decisions' and in doing so help close the tax gap.

Improving this data would be the best way of ensuring that future investment brings the highest returns.

A useful comparison is between HMRC and a large business. HMRC currently has a source of income offering 44:1 returns. It knows there is a further £6.1bn up for grabs. However, it does not seem to know how much money hiring more staff would bring in. Getting a rough estimate for this would mean HMRC could present a strong case to the Government for the money it needs to slash the tax gap.

The resource crisis was exposed by the COVID-19 pandemic. By September 2020, £3.9bn had been lost to furlough fraud. HMRC simply doesn't have the resources to clamp down on this problem.[25] With HMRC so overwhelmed, the tax money it collected through compliance work for April to June 2020 fell to £7.5bn, compared with £15.4bn in the same period in 2019. This is an enormous loss to the taxpayer and means the tax gap is likely to rise even faster in years to come.

Despite the evidence, the Government hasn't increased the funding for HMRC compliance work since 2015-16. Indeed, Government funding for HMRC can be contrasted with the significant resources made available to the Department for Work & Pensions (DWP).

According to Tax Watch UK, the Department for Work & Pensions (DWP) employs more than three times as many staff to investigate welfare abuse as HMRC employs to collect underpaid tax.

To rebalance this, we would need 62,000 new compliance staff at HMRC. Clearly, where there is the political will to crack down on an important issue there is room for increased resources.

Why it matters?

The tax gap is a significant drain on taxpayers across the country. The £35bn lost every year is more than the Government's annual spend on police, fire services, courts, and prisons combined. Even closing the tax gap a little would allow the funding cuts to the agencies and local authorities on which we rely on for protection to be reversed multiple times over, safeguarding the things we care about. It would allow increased investment into the agencies that make sure our rivers aren't polluted by big water companies, that rogue traders can't sell unsafe products online and that employers treat their workers fairly.

The £35bn lost every year is more than the Government's annual spend on police, fire services, courts, and prisons combined.

Additionally, there is a tremendous public appetite to ensure that tax collection is fair.[26]

Recent polling by Unchecked UK showed that 76% of voters in Wales think that regulations which prevent people and companies from avoiding tax should be more strongly enforced.[27]

Previous Unchecked UK research has shown that young Brexit supporters are significantly more likely to support stronger regulations on tax, rather than a weakening of existing safeguards.[28] If HMRC were a business, UK taxpayers would be its shareholders. They should demand a better deal.

However, the steady drop in HMRC's capacity is taking place when it is more important than ever that we as a country take steps to close the gap.

Cracking down on the tax gap would also allow the UK to lead the way internationally. President Biden has proposed spending an extra $80bn over the next decade to double the capacity of the US Internal Revenue Service (the American counterpart to HMRC). The plan is to hire 87,000 new staff, and to collect an extra $700bn of tax revenue over the next decade. This sort of ambition is exactly what we need to tackle the UK tax gap. We believe that the UK is in a unique position to join the USA in leading a global effort to ensure that tax gaps are tackled worldwide. If HMRC were funded properly Britain could be the world leader in the fair collection of tax.

Of course, the money raised from closing the tax gap could make a real impact on other major issues facing the UK. The Government has set a goal to level up the country, with £4.8bn earmarked so far. Clearly, even a small reduction in the tax gap could increase this fund and help make Government rhetoric into reality.

It would also make a huge difference for local communities. We've illustrated how this would translate into real investment on the ground in the very communities the Government wants to level up.

Simply by eliminating errors made by taxpayers who have failed to take reasonable care, HMRC could generate £3.7bn, and more than double the size of the Government's' levelling up agenda.

It is also worth recognising that, as these are taxes owed to the country, their non-collection means it is every taxpayer who is left out of pocket.

If redistributed equally among taxpayers, then just halving the tax gap would put £500 in every taxpayer's pocket.

What we should do

Investment into a significant reduction in the UK tax gap will pay for itself multiple times over. The Government should make it a priority to provide HMRC with the resources they need, with a focus on what is required to get the job done and to collect the money owed to all of us.

The Government should **begin by awarding HMRC the funding it needs to reverse the drop in audits and other compliance work** which we have seen this decade. Restoring HMRC's capacity would require an increase in spending of at least £300m.[29] As shown in the analysis above, this investment can pay for itself. In the longer term, the Government must set out a strategy to significantly reduce the tax gap. Setting a clear target, such as reducing the tax gap from 5.3% of the total tax liability to 2% would be a welcome start.

However, the Government must also take steps to reform how HMRC operates and ensure there is a sharp focus on reducing the tax gap. A first step would be to collect the data needed to determine where maximum returns can be achieved. With an average return of 15:1, there is certainly room for increased efforts until the return-on-investment even approaches 1:1.

Tackling the tax gap will require a significant change in approach by the Government. However, it is a necessary one. Cutting back at HMRC is simply a false economy. When HMRC's own figures show just what excellent value for money it provides, increasing spending to increase returns is the only logical approach.

Appendix

Breakdown of tax gap

There are a variety of different behaviours which contribute to the overall gap. HMRC lists them and the costs for each category:

- Failure to take reasonable care – Carelessness by the customer in recording their transactions and/or preparing their tax returns.
- Legal interpretation – Cases where the customer and HMRC disagree over the interpretation of the law resulting in a smaller than expected return for HMRC.
- Evasion – Illegal dodging of tax owed through deliberate concealment, omission, or misrepresentation of liabilities.
- Criminal attacks – Criminal groups undertaking systematic attacks on the tax system such as smuggling of alcohol and tobacco, or VAT repayment fraud.
- Non-payment – Tax debts written off by HMRC, for example through insolvency.
- Error – Mistakes in completing tax calculations, completing returns, or in supplying other information, despite having taken reasonable care.
- Hidden economy – Economic activity undertaken with no information supplied to HMRC either by actors entirely unknown to HMRC, or customers who completely omit other sources of income. This is different to evasion in that evasion is an understatement of income to lower tax paid, whereas here the entire income is undeclared.
- Avoidance – Contrived exploitations of tax laws to operate within the word but not the spirit of legislation.

The compliance yield

The compliance yield is the money collected by HMRC's compliance efforts. In 2018-19 HMRC estimated that their work recouped £34.1bn for the taxpayer. Of this, only £13.1bn is cash collected by HMRC's compliance activities. The remainder results largely from stopping non-compliance before it takes place, and predictions of the behaviour changes that will come about due to HMRC's work.

The compliance work HMRC does can be split into two main categories: interventions to stop non-compliance before it happens, and interventions to correct non-compliance after it has occurred.

Stopping non-compliance early has been a major goal for HMRC in recent years and it has had real success. The focus here is trying to remind customers of their responsibilities before their tax is submitted, this might be through some form of contact by HMRC, often emails to multiple customers at once. This means individuals and businesses get their taxes right the first time and no further action is necessary. The recent shift in focus to this has had strong results, with revenue from this work rising from £3.2bn in 2016-17 to £7.8bn in 2018-19.

The other key element is action taken to identify and tackle non-compliance after it has already happened, which is the traditional work of enquiries and audits. This generates far more of the overall compliance yield and has remained constant at around £26bn over the last few years. However, the number of interventions conducted by HMRC has fallen by around a third in the same period. Whilst better targeting has meant each intervention brings in more cash, such a reduction means that businesses that aren't compliant are simply less likely to get a call from an HMRC auditor. This drop means that more people are getting away with non-compliance, and there is the possibility of a decrease in financial returns in the years to come.

Other factors which contribute to the tax gap

It is also important to note that other factors influence the size of the tax gap but are not accounted for in the compliance yield. These are, primarily, tax design and customer service. Tax design is largely about the UK's relatively complex tax system which can be difficult to navigate, especially for small businesses owners and the self-employed. Simplification of this where possible could make it easier for both taxpayers and HMRC to clearly see who owes what. Customer service has been acknowledged by HMRC and the NAO as a factor influencing the tax gap. This is both due to good service helping ensure fewer errors, and a 'relationship between the service taxpayers receive and their attitudes towards evasion and compliance.'

References

1 https://www.theguardian.com/politics/2021/sep/07/boris-johnson-unveils-12bn-a-year-tax-rise-to-pay-for-nhs-and-social-care
2 https://www.thetimes.co.uk/article/education-tsar-kevan-collins-quits-after-johnson-rejects-15bn-recovery-package-5nn9dp99t
3 https://obr.uk/frr/fiscal-risks-report-july-2021/
4 https://www.gov.uk/government/publications/levelling-up-fund-prospectus
5 https://www.taxjustice.uk/uploads/1/0/0/3/100363766/talking_tax_-_how_to_win_support_for_taxing_wealth.pdf, https://unchecked.uk/wp-content/uploads/2021/03/Unchecked-UK-Attitudes-of-Welsh-voters-to-regulation-and-deregulation.pdf
6 https://www.nao.org.uk/wp-content/uploads/2020/07/Tackling-the-tax-gap.pdf
7 https://www.civilserviceworld.com/professions/article/hmrc-in-pay-crisis-admits-perm-sec
8 https://www.nao.org.uk/wp-content/uploads/2020/07/Tackling-the-tax-gap.pdf
9 Ibid.
10 https://www.thetimes.co.uk/article/hmrc-tax-office-in-turmoil-as-waiting-times-treble-qlqkfsh5n
11 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/932874/HMRC_Annual_Report_and_Accounts_2019_to_2020__Print_.pdf
12 https://www.unchecked.uk/wp-content/uploads/2020/11/The-UKs-Enforcement-Gap-2020.pdf
13 Association of Revenue and Customs (2013) Budget 2013 Submission (archived content)
14 The-UKs-Enforcement-Gap-2020.pdf
15 See Appendix for explanation of these behaviours.
16 https://www.nao.org.uk/wp-content/uploads/2020/07/Tackling-the-tax-gap.pdf
17 https://www.nao.org.uk/wp-content/uploads/2020/07/Tackling-the-tax-gap.pdf
18 Ibid.
19 Ibid.
20 https://www.taxjustice.uk/tax-takes-6.html
21 https://www.civilserviceworld.com/professions/article/hmrc-in-pay-crisis-admits-perm-sec
22 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/867298/Civil-Service-People-Survey-Main-Department-Scores-2009-to-2019.pdf
23 https://www.nao.org.uk/wp-content/uploads/2020/07/Tackling-the-tax-gap.pdf
24 Ibid.
25 https://www.civilserviceworld.com/news/article/hmrc-could-have-done-more-prevent-fraud-furlough-scheme-nao
26 https://www.taxjustice.uk/uploads/1/0/0/3/100363766/talking_tax_-_how_to_win_support_for_taxing_wealth.pdf
27 https://unchecked.uk/wp-content/uploads/2021/03/Unchecked-UK-Attitudes-of-Welsh-voters-to-regulation-and-deregulation.pdf
28 https://www.unchecked.uk/wp-content/uploads/2020/05/Attitudes-of-Younger-Leave-Voters-to-Regulation-and-Deregulation.pdf
29 Association of Revenue and Customs (2013) Budget 2013 Submission (archived content)