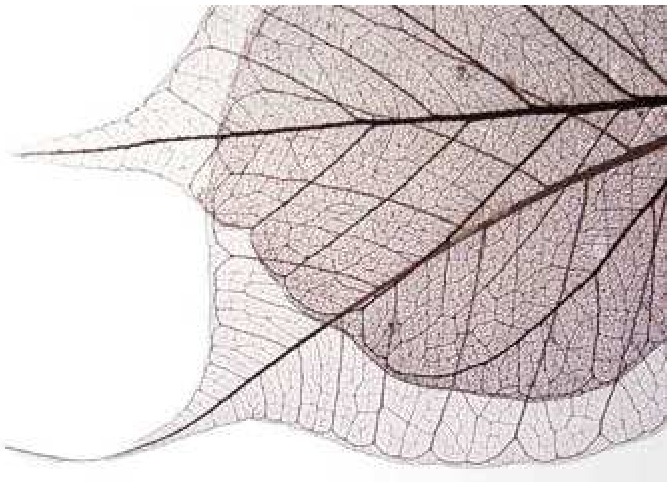
TAX TRANSPARENCY: TAX GAP



Introduction

1. The Tax Gap has become a much used term. HMRC says it is used to help make sure HMRC's resources are used in the most effective fashion. Critics use it as evidence that HMRC is failing to act effectively to reduce the Tax Gap. It features in discussions on the UK Budgets cuts, HMRC's role and performance, or how to categorise a range of customer behaviours. There are many different opinions on what it is, how it is measured and whether it is really of any use to policy makers, tax authorities or NGOs.

2. This short paper tries to give some of the main contentions and discusses whether or not it matters for tax administrations and the public. It begins by discussing some of the theoretical aspects of what a Tax Gap is and how to measure it. It then considers the numbers these methods have produced for the UK. The authors hope it removes some of the misunderstandings that have emerged and gives people who read it the chance to make up their own mind. It is written by a Trade Union inside HMRC and was accepted by a diverse group of organisations and people close to the debate.

Background

3. One way of describing the Tax Gap is to call it the difference between actual and anticipated tax revenues. Put like this it seems simple but, in fact, it is full of pitfalls and dispute over what certain terms mean, consequently it is hard to get universal acceptance of any number.

4. The term Tax Gap has long been used by HMRC's precursor Departments (HM Customs and Excise and HM Inland Revenue). It was more widely discussed in indirect taxes, where it was possible to use relatively more straightforward measurement techniques. Estimates of the UK indirect tax gap were published from 2001.

5. It became part of Inland Revenue approaches to assessing risks to the tax base and was specifically discussed as part of the O'Donnell Review that lead to the creation of HMRC, published

in March 2004.[1] Creating HMRC was seen as providing an opportunity to improve compliance activity, and also embed the Tax Gap approach across all taxes and duties covered by the new Department. Indeed, Gus O'Donnell gave evidence to this effect to the Treasury Select Committee in April 2004[2]. This view was formally expressed in the 2005-2008 Public Service Agreement (PSA) between the Treasury and HMRC, with specific targets to reduce the tax gap.[3]

6. Tax Research LLP prepared a paper "Mind the Tax Gap", published in 2006, that set out to quantify the UK corporation tax gap[4]. In October 2007 HMRC published a technical discussion document which included estimates for the direct tax losses for small and medium businesses and individuals - "Developing methodologies for measuring Direct Tax Losses."[5]

7. Tax Research published a further and wider report (The Missing Billions) for the TUC in February 2008.[6] The first time HMRC published its analysis in full was on 9 December 2009 (*Measuring Tax Gaps 2009* for 2007/8). Since then HMRC has published annual estimates – one of the few countries in the world to do so.

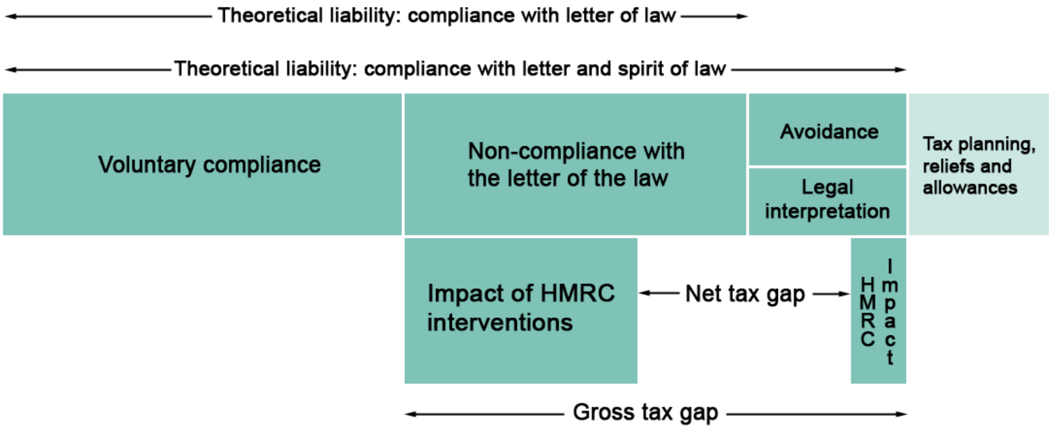
Methodology – general

8. All tax systems will have a tax gap. It is inevitable that there will be some differences between the planned tax take and what actually comes in. There are many opinions, across the world, on the best way in which to provide robust estimates on the scale of the tax gap. Apart from figures produced by a few individual countries, some of these come from academic studies by economists and statisticians, some from campaigning groups, and some from official bodies such as the OECD. None ever seem to agree, some disagree very substantially.

9. Indeed, the O'Donnell review anticipated many of these later difficulties when it reviewed the calculation of the Tax Gap: "Making estimates of the tax gap is methodologically and empirically difficult, although easier for indirect taxes where tax can typically be related to consumption. Direct tax gaps are particularly difficult to estimate because the aggregate figures for income, for example, are built on tax data."[7]

[1] http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/media/3/2/odonnell_fore_ch1_245%5b1%5d.pdf
[2] http://www.publications.parliament.uk/pa/cm200304/cmselect/cmtreasy/556/4042803.htm
[3] http://www.hmrc.gov.uk/psa/psatn2005_08.pdf.
[4] http://www.taxjustice.net/cms/upload/pdf/Mind_the_Tax_Gap_-_final_-_15_Jan_2006.pdf
[5] http://webarchive.nationalarchives.gov.uk/20071105003237/http://www.hmrc.gov.uk/pbr2007/mdtl-direct.pdf
[6] http://www.tuc.org.uk/economic-issues/missing-billions-uk-tax-gap
[7] http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/media/2/0/odonnell_ch2_497.pdf

10. The chart below summarises HMRC's approach to calculating the Tax Gap.[8]



Pitfall 1

11. It is at this point that we start to encounter some of the pitfalls. A basic question is how to deal with that part of the expected tax revenues that are not paid at the correct time. Clearly account has to taken of unpaid tax. But is this all tax paid late, even if by a few weeks? Or should it be the tax that will never be paid? HMRC takes the view that all tax paid late is not really part of the Tax Gap because most tax is finally collected. Campaigning groups like Tax Research UK have included all tax paid late in their definition.

12. HMRC argues that the Tax Gap should only include amounts never collected, or likely to be never collected (e.g. liquidations or bankruptcies). Furthermore, if late payments from Year 1 are counted as part of the Gap for Year 1 then their recovery in Year 2 has to be excluded from the expected receipts for Year 2. So, if the value of late payers is broadly the same from one year to another, the two will generally cancel each other out.

Pitfall 2

13. A second and possibly even bigger pitfall is how to deal with what HMRC describes as tax avoidance. HMRC places a value of £4bn on this in the 2011/12 Tax Gap estimates. It does so under the heading (see 9 above) of the 'spirit of the law'. It defends this position on practical grounds, as they believe it helps HMRC give a complete picture of the challenges it faces to ensure compliance. This view was recently supported by the IMF in a technical assistance report on an assessment of HMRC's Tax Gap Analysis.[9]

14. On the other hand, academics and members of the accountancy profession have argued the opposite, that any estimate should not include avoidance as referenced by the "spirit of the law". For example, during a Treasury Select Committee Hearing on *The Administration and Effectiveness of HMRC*, Judith Freedman (Professor of Tax Law, Oxford University) commented "I really take issue with the spirit of the law part, because either you have law or you don't have law and the law has to state what it is."[10] If that view prevails, the HMRC published estimate is too big.

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[8] http://webarchive.nationalarchives.gov.uk/20100330144254/http://www.hmrc.gov.uk/pbr2009/protect-tax-revenue-5450.htm
[9] United Kingdom: Technical Assistance Report— Assessment of HMRC's Tax Gap Analysis
[10] Closing the Tax Gap: HMRC's record at ensuring tax compliance Twenty-ninth Report of Session 2010–12

15. There are also cases where HMRC and taxpayers disagree on the interpretation of a set of facts, or the application of the law to those facts. HMRC places a value of £4bn on this but, as with the spirit of the law, critics argue that until the courts reach a decision any tax involved cannot be part of the Tax Gap. Nonetheless, in theory it could be possible, all other things being equal, to agree on a definition of "the tax gap, excluding avoidance and legal interpretation issues". Whether this is of practical value would remain to be seen.

Pitfall 3

16. Even if it is agreed that "avoidance" is a legitimate part of defining the Tax Gap another, and even trickier pitfall, is what commentators or HMRC mean when they use the term avoidance. Some people seek to distinguish 'planning' from avoidance, i.e. using the reliefs and allowances that are there, and accepting all the consequences. An example of this might be a company choosing to remunerate a Director by means of a dividend, instead of a bonus on which NIC would be due for both company and individual.

17. There are some clear examples of tax lost which cannot be attributed to avoidance. The OECD reported on what it termed Base Erosion and Profit Shifting. In it they highlighted that tax was being lost because of mismatches in the international tax rules, so that tax deductible expenses claimed in one country were not matched by taxable receipts when received in another country[11]. Such amounts do not appear in HMRC's Tax Gap analysis. It is possible that they would appear in the spectrum of activities (para 9) described as tax planning, reliefs and allowances.

18. There is also the claim, made by some analysts, that HMRC does not treat as avoidance the various legal ways that large businesses can companies use to reduce tax bills. For example, large intra-group company loans can generate high deductible payments of interest on the part of the borrower which may or may not be taxed as receipts in the lender, either in whole or in part. Another example would be internet companies generating substantial sales in the UK but not recording commensurate profits. If HMRC accepts that the accounting and tax treatment accords with the law it will not see the "lost" tax as forming part of a Tax Gap.

Pitfall 4

19. There are also issues to do with whether to measure the "gross" or the "net" tax gap, i.e. before or after HMRC compliance activity. Although HMRC "interventions" are shown in para 9, in practice none of the methods take any account of that compliance work HMRC does to recover or prevent underpayment of tax. In 2012/13 HMRC reported this as c£20bn. Similarly, there can be differences when comparing the differences between figures in the published accounts showing commercial accounting profits and the statutory and unpublished tax returns and computations.

Tax Gap Estimates

20. Tax Research produced an estimate in 2008 which its author last August viewed as still providing the benchmark for an alternative measurement to that offered by HMRC. Based on this work (The Missing Billions), and a later study in 2010, Tax Research estimated a total tax gap of not less than £123 billion made up of £70 billion of tax evasion, £25 billion of tax avoidance and £28 billion unpaid tax.[12].

21. Tax Research recently updated their analysis. The Executive Summary notes that "*Combining data from both the EU and HMRC' work on tax gaps it is clear that around £1 trillion of trading income should have arisen in the UK in 2011-12. If VAT is lost on about 10 per cent of all*

[11] http://www.oecd.org/ctp/BEPSActionPlan.pdf)

[12] http://www.tuc.org.uk/sites/default/files/documents/completedownload.pdf; http://www.taxresearch.org.uk/Documents/PCSTaxGap.pdf

VAT chargeable sales then it is highly likely that about 10 per cent of all sales, or £100bn per year in 2011-12, were unrecorded.” [13] Based on this the report suggests £40bn of tax lost, rising to currently £47bn “*because of inflation, GDP growth and forecast increases in the VAT gap*” (p68). Some of this tax is thought to be already shown within the HMRC estimates, leaving £22bn to be found in the recorded and ‘shadow’ corporate sector (p.66).

22. Estimating the scale of, and trends in, the tax gap is not widely attempted but some other countries produce Tax Gap analyses. The UK does this more frequently and is regarded as one of the tax authorities leading work in this area. The UK compares well internationally: In 2010/11 the UK’s net tax gap was 6.7% of its total tax liabilities; the USA’s tax gap is 14 per cent; in Sweden it is 10 per cent and in Mexico it is 23 per cent.

23. HMRC produces an annual set of figures, which show three ways in which their overall figures can be presented[14]: regime (or “head of duty”, like VAT), type of behaviour, type of customer:

HMRC views 2011/12 Tax Gap

Head of duty

IT/NICs/CGT	£15.3bn	44%
VAT	£11.4bn	33%
CT	£1.1bn	13%
Excise duties & other indirect taxes	£2.5bn	7%
Other direct taxes	£1.1bn	3%

Taxpayer behaviour

Criminal attacks	£4.7bn	13%
Hidden economy	£5.4bn	15%
Evasion	£5.1bn	15%
Avoidance	£4.0bn	11%
Legal interpretation	£4.3bn	12%
Non-payment	£4.4bn	12%
Failure to take reasonable care	£4.3bn	12%
Error	£2.9bn	8%

Customer group

Small and Medium Enterprise Sector (turnover of up to £30 million)	c.£16.7bn	Est 48%
large businesses (companies with a turnover in excess of £30 million	c. £8.8bn	Est 25%
individuals	c.£4.7bn	Est 14%
losses from criminal attacks	c.£4.7bn	Est 13%

24. A recent IMF study presented the figures in a different way, showing how HMRC had calculated the individual components.

[13] http://www.taxresearch.org.uk/Documents/Intheshade.pdf
[14] www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf

Table 1. Summary of Tax Gap Estimates and Methodologies—2011

Tax	Component	Main Components of Methodology 1/	Proportion of the 2011 Gap 2/
Income Tax, National Insurance Contributions (NIC), Capital Gains Tax	Pay-as-you-earn (PAYE): small-medium enterprises (SMEs)	Bottom-up estimate based on random audit results.	2%
	PAYE: large taxpayers	Constructed estimate based on the results for the SMEs.	7%
	Self-assessment: individuals and businesses	Bottom-up estimate based on random audit results.	14%
	Self-assessment: large partnerships	Constructed estimate bases on error levels comparable to results for the SMEs.	2%
	Nondeclaration of income by individuals not in self-assessment	Bottom-up estimate based on cross-matching PAYE data with third party information.	3%
	"Moonlighters"	Estimate based on study results.	6%
	"Ghosts"	Estimate based on labor force survey and immigration data.	4%
	Avoidance	Estimate constructed using avoidance schemes being tracked in the "risk register."	7%
Corporation Tax	Large business services (LBS) clients	Constructed estimate based on data on Tax under Consideration (TuC) data from the LBS case management system.	4%
	Large and complex businesses	Constructed estimate based on the results for the LBS clients.	4%
	Small-medium enterprises	Bottom-up estimate based on random-audit results.	4%
VAT		Top down estimate based on consumption statistics. (A bottom-up estimate is also performed in order to determine the composition of the gap).	30%
Excises	Alcoholic beverages, Tobacco	Top-down estimate based on consumption statistics.	7%
	Petroleum fuels	Top-down estimate based on travel distance statistics and fleet characteristics, and "cross-border shopping."	1%

Methodology - details

25. It is worth stressing that calculating the Tax Gap is more of an art than a science. It requires the use of judgements, estimates and assumptions. HMRC says that it is compiled from 30 separate tax gap estimates. So it is seems unlikely that there will be a consensus on the final figures.

26. There are clear and significant differences in the way in which analysts calculate the figures for the Tax Gap. As mentioned before (Pitfall 1) the treatment of late payment is very important. For the year under review Tax Research cites £28bn but HMRC uses unrecoverable payments of c.£3bn - a £25bn variation.

27. HMRC uses two main methods of estimating tax gaps: a 'top-down' approach for indirect taxes, and a 'bottom-up' approach for direct taxes based on its own unpublished intelligence data, and sources such as random enquiries and internal risk registers. HMRC uses 'top-down' where there is independently gathered data on consumption to allow a calculation of the theoretical level

of tax due. The indirect Tax Gap is measured by comparing the theoretical figure to the actual figure of tax receipts. HMRC uses 'bottom-up' for Direct tax gaps use because there is no such independent data estimate, although it notes that this allows a more detailed breakdown of the causes of tax losses.

28. Tax Research uses a variety of methods. One is to compare the projected tax based on published company accounts with the final amounts paid. This includes averaging results for the largest UK companies, then extrapolating this to the other largest companies. Critics say this ignores some factors such as double taxation relief or tax adjustments that alter the figures from published accounts. It also includes a degree of macro-economic models, similar to other work done for the World Bank. HMRC believes macro-economic models do not produce reliable data, commenting that the OECD and other international organisations have strongly advised against the use of such models.

29. HMRC and Tax Research also disagree on the role of the VAT gap in helping inform any other calculations. Tax Research says it is very relevant, arguing that the nature of business activity means that the level of the VAT Gap provides a very strong indicator of the level of the tax gap for direct taxes. HMRC disagree. It says that a VAT gap includes all forms of non-compliance up to criminal attack so it does not all arise from suppressing turnover in a way that might feed through to evasion of direct taxes. They also point to the fact that tax gaps vary considerably by type of regime. The opportunities for tax lost under regimes with significant third party reporting and deduction of tax at source are much lower than for regimes where these features are absent.

30. The recent IMF report agrees with HMRC's approaches. It says "In general, the models and methodologies used by HMRC to estimate the tax gap across taxes are sound and consistent with the general approaches used by other countries. The HMRC program follows a pattern of employing "bottom-up" based estimates for the direct tax gaps, and "top-down" estimates for the indirect tax gaps. Both approaches are applied consistently with good international practices — in fact HMRC has been leading the application of some of these methodologies."

31. Notwithstanding these good practices, the IMF later suggests that, as a point of comparison, HMRC ought to undertake some research on whether it would be theoretically possible to build in some element of top down modelling for direct taxes[15]. It accepts that this will involve some serious modelling challenges and significant data issues and points to a HMRC study documenting these[16].

Can the Tax Gap calculation be improved?

32. Apart from the IMF suggestion of further research (para 28), the bottom up approach requires estimates and data from a number of sources. It seems to the writers that the tax lost through people operating in the hidden economy could be subject to more survey of individuals and households. As the last HMRC update noted, estimating tax lost from ghosts and moonlighters "has a large margin of error and should be treated with due caution."[17] Clearly this is a highly sensitive area but pilot work could be done with external providers to test if this increases reliability. It may also now be possible to make more use of matching data across public datasets.

33. Staff numbers in the areas dealing with large business and anti-avoidance are being reduced by at least 10% over the next three years. This may create a risk that tax professionals do not fully review as many cases, leading to an understatement in the risk registers and estimates of avoidance.

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[15] United Kingdom: Technical Assistance Report— Assessment of HMRC's Tax Gap Analysis Para 68

[16] Rubin, Marcus, "The Practicality of a Top Down Approach to the Direct Tax Gap," http://www.hmrc.gov.uk/research/taxgap-workingpaper.pdf, August 2011.

[17] Para 8.46 and 8.49, http://www.hmrc.gov.uk/stats/mtg-2011.pdf

34. The IMF has also attempted to widen the definition and use of the Tax Gap approach. It suggests significantly broadening the scope and measure beyond those measurements currently in place. They propose including the effects of policy choices that lead to reduced revenues. The IMF refers to the impact of compliance issues on revenue as “the compliance gap” and the revenue loss attributable to provisions in tax laws that allow an exemption, a special credit, a preferential rate of tax, or a deferral of tax liability as the “policy gap.” As part of this they recommend tax avoidance schemes deemed legal through litigation should be considered part of the policy gap, not the compliance gap, and this distinction should be made clear. A similar point was made by a EU report on VAT.[18].

35. In our view the IMF’s proposal is likely to be a very complex and perhaps contentious. What would be included in “exemption”, a special credit, a preferential rate of tax, or a deferral of tax liability? Charities and pension funds, as well gains on private residences, are exempt from taxes whilst special credits are available for specific purposes (e.g. land remediation). All policy measures are already costed and published, so the information is already in the public domain. It is possible the IMF’s attempt will only increase any confusion over how the Tax Gap is measured and for what it is used. We risk losing sight of the fact that discussions on the Tax Gap are at high levels of generality, not possibly spurious granular estimates.

Whether the Tax Gap serves any useful purpose

36. Does a Tax Gap matter? If there is no clear agreement on the numbers, how they are calculated and their reliability, then is there are any point in preparing them? The Treasury Select Committee thought using the Tax Gap might be a poor use of HMRC resources, that ascribing tax gaps to particular behaviours was unhelpful, and might end up with the wrong responses. They felt that HMRC should concentrate on ensuring all taxpayers paid the right amount of tax, i.e. neither too little or too much.

37. Unless there is a high-level measure of how successfully HMG policies (as enacted through Parliament) are being applied it is hard to use HMRC resources in the most effective fashion. It would also be hard to assess the impact of Government taxation policies, or gauge if all sectors are paying the amounts due under the law. Identifying gaps also provides a focus for reassessing policies, legislation or enforcement.

38. By using this approach HMRC can judge the level and nature of its responses and provide a measure of successes (or otherwise). If, for example, the analysis showed a significant or growing loss of revenue as a result of, say, failure to take reasonable care, the best response could be to redesign some processes, improve guidance, or even change the law. As Mike Eland, HMRC’s former Director-General Enforcement and Compliance, told the Public Accounts Committee “We have looked at where our current effort is deployed, where it is short and, therefore, where we can fill in gaps or strengthen areas that we think need strengthening.”[19] The Committee itself provides such an example of changing behaviour “By far the most efficient way of closing the tax gap is encouraging voluntary compliance.”[20]

39. The key is that the Tax Gap must be viewed as a tool of HMRC’s trade and not as an entity in itself. Measuring it must be done on a consistent basis; trends must be sought and reacted to. In many ways the definition and how and to what extent avoidance (or whatever) is included doesn’t

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[18] They suggested that a possible link between the policy and the compliance gaps, as using the reliefs and allowances intended by policy could make compliance more difficult. “Reducing the policy gap may often be the simplest and most effective way to reduce the compliance gap.
http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat-gap.pdf, p21

[19] HM Revenue and Customs: Compliance and Enforcement Programme, http://www.parliament.uk/documents/TSO-PDF/committee-reports/1892.pdf

[20] Para 28, TSC Report

matter. Equally, the absolute number is arguably irrelevant[21] – the only certainty we have about it is that it will be wrong. But it remains important to measure the gap and use it as one of a variety of tools to target resources and assess HMRC's progress.

[21] If the gap reduced to £1 it is still something that would deserve focus!