TAX WATCH

Briefing

HMRC's "Tax Gap"

- Latest HMRC estimate of avoidance and evasion £35bn
- 2018 figure the highest in cash terms on record. An increase of 17% since 2016
- HMRC estimate does not include profit shifting by multinational companies. A major area of concern
- Presentation of the Tax Gap as "one of the lowest in the world" by government misleading

The Tax Gap, the annual estimate of the amount of tax lost to avoidance, evasion and criminal activity in the UK has become a matter of huge public interest in recent years.

HMRC has been collecting data and making estimates of the tax gap since the early 2000s, and has published them every year since 2008.

IN BRIEF

This briefing sets out what the tax gap is, how it is measured in the UK, and why it is not a reliable estimate of the true scale of tax avoidance.

CONTACTS

George Turner
Director
+44 7540 252 850
george@taxwatchuk.org

The UK Tax Gap

In the UK the Tax Gap is defined as “The difference between the amounts of tax that should, in theory, be collected by HMRC, against what is actually collected”. The UK Tax Gap is a net figure, and takes into account ‘compliance yield’ - which is the amount of tax collected though enforcement activity. The difference between the net and gross tax gap is substantial. In 2015/16 HMRC reported that it had collected around £9bn in cash though compliance activity, whilst the net Tax Gap was reported as £32bn. This suggests that he gross tax gap was £41bn.

The gap in the gap - tax avoidance

The UK Tax Gap does not estimate the impact of all types of tax avoidance and evasion. HMRC explicitly does not measure the impact of profit shifting by multinational companies in their tax gap methodology. This is a serious problem. Profit shifting is the most high profile form of tax avoidance, the type of avoidance employed by large global businesses like Google, Starbucks, Apple and Nike. Profit shifting is thought to cost the UK billions of pounds in lost revenue a year, and the exclusion of it from the Tax Gap calculations means that these figures cannot really be considered to be a comprehensive or reliable estimate of tax avoidance in the UK. It is certainly not a measure of tax avoidance that the public would recognise.

The term, “what should be collected” is also problematic as the word “should” is of course open to interpretation. HMRC defines what “should” be collected as - “the tax that would be paid if all individuals and companies complied with both the letter of the law and HMRC’s interpretation of the intention of Parliament in setting the law (referred to as the spirit of the law)”. This is in effect a measure based on how HMRC chooses to apply the law.

This is problematic. It suggests that HMRC can easily reduce the tax gap by simply being more lenient in the way it interprets the law. This a concern as there is evidence to suggest that HMRC does not take a particularly aggressive approach to countering tax avoidance. In recent years HMRC has won almost every anti-tax avoidance case it has brought to court. This exceptionally high success rate indicates that HMRC is not pursuing more difficult cases.

This puts HMRC in a difficult position with regards to the Tax Gap. If there was demand for HMRC to take a tougher stance on tax avoidance, that in itself would cause in increase in the tax gap, leading to a perception that the agency was performing poorly. It means that the way in which the Tax Gap is calculated creates an incentive for HMRC to take a more lenient approach, and demonstrates the difficulties HMRC faces when it is being asked to mark its own homework.

Another consequence of this approach is that the Tax Gap does not consider how legislation should be changed to deal with problems with the tax system. Say for example HMRC considers a certain practice to be a form of tax avoidance, but some defect in the law prevents HMRC from pursuing the matter. The classic case of the legal loophole. HMRC would not count the impact of such loopholes in their calculation of the Tax Gap. Indeed, where HMRC has decided that a particular scheme employed by a company or individual is an unlawful act of tax avoidance, but has lost the case in the courts, future users of that scheme will not be included in the Tax Gap.

This is inconsistent with the approach taken with the HMRC compliance yield calculation, which includes estimates of the impact of changes in legislation that HMRC has advised on.

HMRC could look at a broader gap, a tax policy gap, what could be collected if all forms of evasion and avoidance were eliminated and all tax subsidies were abolished. HMRC was advised to put together these estimates by the International Monetary Fund when it last reviewed the HMRC Tax Gap methodology in 2013 – HMRC has not implemented this recommendation.

Top Down vs Bottom Up

There are broadly two approaches to measuring tax gaps, the top down approach and the bottom up approach. HMRC uses both methods, depending on which part of the tax gap it is measuring. It uses the top down approach for its estimate of the VAT gap, and the bottom up approach for most other forms of tax. The top down approach will tend to give larger estimates of the Tax Gap than the bottom up approach

The top down approach seeks to work out the total theoretical tax liability of a country and compare this to the amount of tax collected. It is a simpler approach, and in theory should require fewer resources to calculate, but the definition of the tax base can be difficult to arrive at.

Top down approaches should in theory be better at getting at the Tax Gap that HMRC cannot see. The wealth hidden though evasion, the underground economy or undisclosed tax avoidance schemes, but such estimates are not fool proof as data which adequately captures such areas are difficult to calculate with any degree of accuracy.

The bottom up approach uses tax authority data to build up a picture of the tax system. This includes the tax returns of individuals and companies. HMRC use the bottom up approach for calculating the Tax Gap in personal income tax and corporation tax. HMRC conducts a random audit of tax returns, calculates the rate of errors and omissions and then grosses up the results from the sample in order to arrive at a picture for the whole country.

By its nature the bottom-up approach can't see the Tax Gap which arises from undeclared income not found by HMRC. Unsurprisingly, criminals and tax evaders do not report all of their income to HMRC and some of them get away with it. In order to account for this HMRC applies a multiple based on a study conducted by the Internal Revenue Service (the US tax authority) which tried to understand how much income random audits of tax returns miss. The Office of National Statistics has recommended that HMRC reviews the use of this multiple to see if it is possible to develop a figure which is better suited to the UK context.

The lowest tax gap in the world?

> "we have been successful in keeping our tax gap as one of the lowest in the world, safeguarding and protecting some £200 billion of tax"
>
> Mel Stride, Financial Secretary to the Treasury, House of Commons, 4th March 2019.

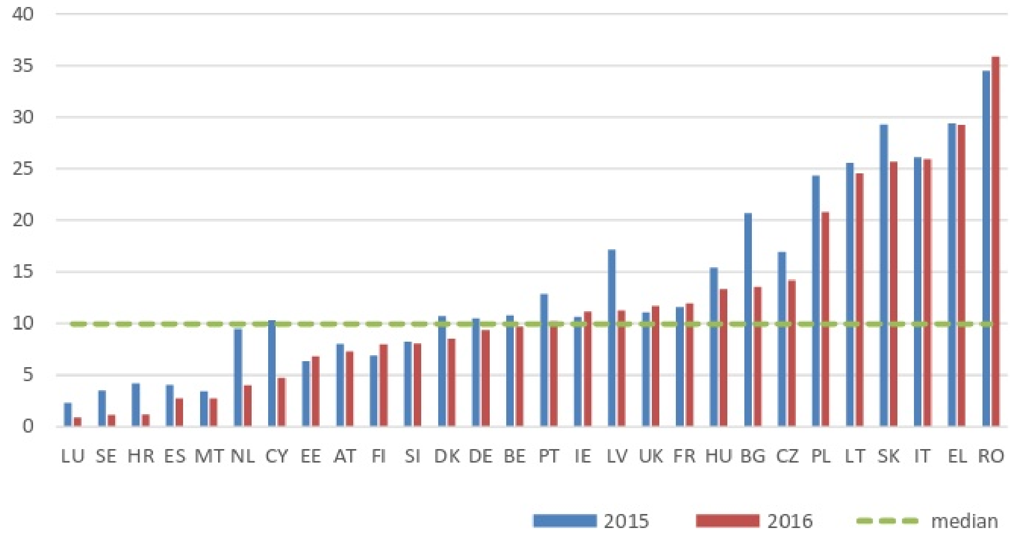
Given the widespread public concern about tax avoidance and evasion, HMRC and the Treasury are keen to talk up the government's record on fighting tax avoidance. Ministers regularly claim that the UK's Tax Gap is one of the lowest in the world. This is misleading. It suggests that at the very least there are a number of countries that measure tax gaps in a broadly comparable way. In fact, HMRC themselves say that the UK is the only country in the world that publishes an annual Tax Gap figure that deals with a comprehensive range of direct and indirect taxes.

Many countries publish Tax Gaps looking at specific taxes such as VAT. As the Tax Gap varies considerably between different types of taxes, it is not possible to compare the UK's broad figure with these estimates. However, when the figures are compared on a like for like basis (i.e. comparing the UK VAT gap with other VAT gaps) the UK does not perform particularly well.

According to the European Commission, the UK has the 11th highest VAT gap out of the 28 member countries, expressed as the percentage loss of total potential VAT revenues.

Some countries do publish comprehensive estimates, however, the they use very different methodologies and techniques. For example, the IRS publishes two estimates, the Gross Tax Gap which it defines as the difference between true tax liability for a given tax year and the amount that is paid on time. The agency also publishes a Net Tax Gap including the amount it will recover after late payments and enforcement action. The study is not published on an annual basis, but retrospectively on a periodical basis. The latest IRS Tax Gap estimate covers the tax years 2008-2010.

Figure 2.1. VAT Gap as a percent of the VTTL in EU-28 Member States, 2016 and 2015[5]



Source: European Commission

Italy publishes a broad estimate of tax losses (excluding social security payments) on a regular basis. However, Italy uses the top-down method for estimating losses to personal income and corporate tax. This is known to generate larger estimates than the UK method (the bottom up approach).

Conclusion

Overall, the UK Tax Gap, with the exclusion of large and significant areas of tax avoidance, is not a reliable estimate of the scale of tax avoidance in the UK. Together with how the gap is marketed by government, it creates the impression that HMRC constructs these figures to maximise the image of the agency, rather than as a reliable benchmark.

However, the Tax Gap is more than just a PR exercise. HMRC has suffered enormous cuts to its budget over the last ten years, and the perception that despite these cuts HMRC still manages to keep the Tax Gap as one of the “lowest in the world”, means the case for investment is not made.

This is of particular concern given recent research demonstrating that if HMRC was to invest more in targeted audits, it could relatively easily bring in an additional £8bn in revenue a year.