Measuring the "tax gap" – an update

HMRC is today releasing details of analysis from 2005 that attempted to derive broad-brush estimates of the direct tax gap (i.e. across all taxes) at the start of the decade.

Such analysis is highly problematic due to lack of data, subject to high margins of error and therefore unreliable. For this reason HMRC does not publish estimates of the overall tax gap. Only two other countries have published an analysis of their tax gaps, the United States (estimated direct tax gap of 14% in 2001) and Sweden (first estimated total tax gap of 8% in 2000, now around 10%).

Among the reasons that analysis of the overall direct tax gap is problematic are:

- there is no straightforward way of arriving at a top-down estimate of the theoretical tax liability (unlike for indirect taxes). For example, it is possible to derive an estimate of the total VAT liability from aggregate consumption figures, but similar figures for direct tax cannot be derived in the same way from income or profits figures because of the many other factors that affect the liability of an individual or business;
- many issues bearing on the determination of tax liabilities involve judgements that are not unambiguous and may ultimately only be settled in the Courts. This is especially true of corporate tax; and
- many of the high-risk activities are derived from concealment or operate in the hidden economy. Detailed income data, required to estimate the tax base, is largely derived from tax data, which, by definition, does not include a large proportion of these undisclosed activities. There is, for example, not even a reliable estimate of the size of the informal/hidden economy.

In addition to the points above, the data available for this period was very patchy – in particular for avoidance, the informal economy, Inheritance Tax, Stamp Duty Land Tax and large business.

The table below summarises the estimates by type of tax.

<table>
<tr><th></th><th colspan="3">General non-compliance</th><th colspan="3">Avoidance</th><th colspan="3">Non Payment</th><th colspan="3">Total</th></tr>
<tr><th></th><th>Point</th><th>Lower</th><th>Upper</th><th>Point</th><th>Lower</th><th>Upper</th><th>Point</th><th>Lower</th><th>Upper</th><th>Point</th><th>Lower</th><th>Upper</th></tr>
<tr><td>Income Tax, CGT, NIC</td><td>8.1</td><td>3.7</td><td>17.1</td><td>3.9</td><td>1.9</td><td>5.9</td><td>0.5</td><td>0.5</td><td>0.5</td><td>12.5</td><td>6.1</td><td>23.4</td></tr>
<tr><td>Corporation Tax</td><td>2.9</td><td>1.4</td><td>6.9</td><td>4.4</td><td>2.1</td><td>6.6</td><td>0.2</td><td>0.2</td><td>0.2</td><td>7.4</td><td>3.7</td><td>13.7</td></tr>
<tr><td>Inheritance Tax</td><td>0.1</td><td>0.1</td><td>0.4</td><td rowspan="2">1.5</td><td rowspan="2">0.7</td><td rowspan="2">2.2</td><td>0</td><td>0</td><td>0</td><td rowspan="2">2.0</td><td rowspan="2">1.0</td><td rowspan="2">3.5</td></tr>
<tr><td>Stamp Duty</td><td>0.5</td><td>0.2</td><td>1.0</td><td>0</td><td>0</td><td>0</td></tr>
</table>

The upper end of the ranges was based on extreme assumptions on the extent of undetected non-compliance and avoidance. For example, the estimates for avoidance were driven by assumptions based upon agents fees reported in the accountancy press, which are likely to include commercial tax planning as well as the use of artificial avoidance schemes.

The 2005 estimates, even with a range of between £10bn and £40bn (roughly 5% to 15% of liabilities), are not only subject to a wide margin of error but, as mentioned above, are based on historical data prior to the major transformation in HMRC's strategy, so don't reflect today's situation. This has included support for those who are aiming to pay the right amount of tax and a range of well-targeted interventions for those who are not, which will have reduced the tax gap. This strategy is described in more detail in *Protecting tax revenues*, published today.

For large businesses a new strategy was launched in 2001, with the first Review of Links with Large Business. As a result of this review, HMRC took the first steps towards a more supportive relationship, built on mutual trust and a greater focus on the more significant areas of tax risk. This approach was reinforced by Sir David Varney's 2006 review.

HMRC now aims to help large businesses achieve greater and earlier certainty on their liabilities, so that their returns are based on an agreed view of their tax position on major transactions. Alongside this, there is a much sharper focus on risk assessment, so that businesses with a reliable track record of managing their own tax risks and being open in their dealings with HMRC benefit from fewer HMRC interventions, while those with the highest risk profile can expect robust challenge from dedicated, specialist teams as part of the High-Risk Corporates Project.

For individuals and smaller businesses, HMRC's approach has increasingly focussed on help and support to ensure that returns are correct, rather than on interventions after an error has been made. Improved risk profiling and use of information ensures that any necessary interventions are well targeted.

This targeted approach to tackling tax risk has been reinforced by a number of specific initiatives. The disclosure rules, introduced in 2004, marked a turning-point in HMRC's strategy to counter avoidance, enabling swift action to be taken to close loopholes, often before they have led to serious leakage of tax. This has had a major impact on marketed schemes, in line with HMRC's aim to change the economics of avoidance to make it less attractive.

HMRC has also developed novel and targeted approaches to tackle evasion. The highly successful offshore disclosure initiative, launched last year, encouraged disclosure of around £400m in liabilities. Finally, significant advances have been made in deterring criminal fraud and tackling it where it does occur. In addition to strengthening its strategy to tackle MTIC fraud, HMRC has launched strategies since 2000 which aim to attack the economics of excise fraud.

These changes have already had a substantial impact. Operational initiatives brought in since 2002/03 to improve direct tax compliance, which are being monitored as part of HMRC's PSA targets, are expected to reduce underpayments this year for direct taxes alone by about £2½ billion compared with five years ago.