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(Central Compliance)

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FINANCIAL SECRETARY-

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Summary:

At PBR 2007 HMRC released a technical discussion document which set out the issues surrounding measurement of direct tax revenue losses and reported some of our more robust estimates for individuals and small businesses. In that document we gave a commitment to publish further estimates as they became available. Since PBR HMRC analysts have produced figures for a later year for individuals and new analysis of direct tax revenue losses from large business and avoidance ... Note that the latest analysis for individuals suggests a slight increase in the level of revenue losses over the period 1999/00 to 2002/03.

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Background

Previous publication of tax loss estimates

1. Broadly, the tax gap is the difference between the tax that should be paid and that which is actually paid. We have for some years published estimates of the main indirect tax gaps. The numbers here are large – c. £15bn a year. Although they have led to some criticism, most notably when MTIC fraud jumped in 2005/6, on the whole the reaction has been fairly muted, largely because of the balancing good news story that strategies to address these gaps have resulted in them falling.
2. Similarly statistics for fraud and error in Tax Credits have been published since 2005. Although the numbers are not as large – c. £1bn a year – these figures have attracted a fair amount of media coverage.
3. The position is different for direct tax. Direct tax gaps are much more difficult to measure. This is due to the lack of independent data describing income but also because the taxes themselves are more complex. Nevertheless HMRC has been working on the development of direct tax gap estimates for some years. First preliminary estimates were produced in 2004 and 2005. This work was heavily based on assumptions and experience in other countries, to provide a broad handle on the range in which the gap might fall. This work, which is the subject of a FOI request, estimated the overall tax gap as lying in a range of £ 11-40bn p.a. (including £5bn-15bn being attributable to avoidance). The methodology was not robust, but the overall figures at 4-16% of total tax yield were broadly consistent with the 8-13% that had been calculated in other countries. An assumption that the UK tax

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gap was of this scale was stated in the O'Donnell report on the merger leading to the creation of HMRC.

4. Since then, work has continued to improve methodologies. At PBR we published a technical discussion paper which described the measurement issues and included estimates of revenue losses for Individuals who receive a tax return and small and medium businesses (the estimates amounted to around £5bn). The document also contained a commitment to publish figures for other parts of the tax gap when robust methodologies are in place. Since PBR figures for individuals have been produced for a later year (2002/03). The analysis now suggests a slight increase in the level of revenue losses for individuals over the period 1999/00 to 2002/03 from 11% to 15% of total liabilities. Note that these figures do not reflect more recent developments such as the impact of the offshore disclosure facility.
5. We have yet to publish figures for tax losses attributable to large business or avoidance, which are widely (and rightly) assumed to be significant contributors to the overall direct tax revenue losses. HMRC now has estimates of the revenue losses in these two additional areas. These show identified net revenue losses of around £5bn p.a. from the use of avoidance schemes and a further £2.5bn p.a. revenue losses arising from other issues identified operationally. It is important to recognise that these figures do not give a current picture. Much of the underlying data refers to 2004/05 and some of the revenue loss will have been stemmed by legislation. We have worked up a revised version of the technical document published at PBR (draft attached) with new chapters to describe the new estimates for large business and avoidance and then to set the figures in the context of the international work. The Government has a good story to tell on the

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advances in our capacity to measure losses, which puts the UK at the forefront of the international work.

6. ... Over the course of the SR04 period we estimate that overall losses for direct and indirect taxes have reduced by around £4bn through a mixture of operational developments and legislative action. ...
7. ... However the recent TUC-sponsored paper on the size of the UK tax gap, which featured a headline figure of £25bn for avoidance, has brought the issue into focus. ...
8. Our figures for avoidance are considerably lower than those suggested by the TUC paper. Nevertheless these figures could still prove to be contentious. Large business and accountants are likely to object to any suggestion that avoidance and highly technical tax issues should be counted towards a 'tax gap', particularly if the losses are misrepresented by commentators as resulting from fraud. ...

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Decision Points_

1. Whether to produce a revised direct tax losses document containing new estimates of losses for large business and avoidance.

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