

Uncollected tax revenue – who is underpaying and what we should do about it

Dr Arun Advani, University of Warwick and CAGE

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Each year, Her Majesty's Revenue and Customs (HMRC), the UK agency responsible for collecting the nation's taxes, releases figures on how much tax was owed but not collected last year. For the last ten years, this number has been around 6%, which means that £33 billion was not collected in the last year alone.

That total is more than is raised from council tax or fuel duty. If it were a tax of its own, 'uncollected revenue' would be the fifth largest single source of government revenue. And in spending terms, it is as much as we spend on police, old age social care, nursery places and buses combined.

Of all the major areas of tax, self-assessment tax has the highest rate of non-compliance. One in every six pounds is not collected, totalling almost £8 billion in lost revenue. This report explains who owes this money; what HMRC is doing to bring it in; and how they could do better.

Who is underpaying?

Around 10 million people a year, a third of all individual taxpayers, file 'self-assessment' income tax returns. The main income sources reported are employment, self-employment, interest, dividends, pensions, and properties. In total, HMRC estimates that £48 billion of self-assessment tax should be paid annually, of which £8 billion is not collected. In the context of Labour plans to nationalise the water industry for £14.5 billion, or the hopes of some Conservatives to scrap inheritance tax at a cost of £5.2 billion, this is a considerable amount of money.

To understand who is not paying, I use a programme of random audits conducted by HMRC. Although most audits are carefully targeted, it can be hard to know precisely who to audit. To ensure everyone faces some chance of audit, and to understand who is not paying, a few thousand taxpayers a year are randomly selected for audit. Looking at audits conducted over a ten-year window, I can see the results of these audits and learn who was or was not correctly paying their taxes.

The first finding, surprisingly is how widespread underpayment is: one in three taxpayers underpay by some amount. While this might make us sound like a nation of cheats, most of these people owe relatively small amounts. It might be that some of these cases are genuine mistakes.

The majority of the missing £8 billion is owed by only a tiny minority of individuals, who make up only 2% of self-assessment taxpayers. To bring in the missing money, it is therefore important to target audits effectively towards the people who are likely to be underpaying.

Looking across individuals at what characteristics predict underpayment, a few key results jump out:

- Men are one and a half times more likely to under-report than women and – since on average they have higher incomes – they also underpay more.
- Working age individuals under-report more than pensioners, partly because pension income is harder to under-report than self-employment income.
- A quarter of people with property income under-report, but that quarter under-report more than half the property income they make.
- On average individuals with the top 20% of incomes owe about one and half times as much as individuals in the bottom 80% of incomes.
- Under-reporting is most prevalent in the construction, transport and hospitality industries, where more than half of taxpayers under-report. What's more, those in transport and hospitality who under-report do so substantially, missing out more than half their total income.
- Almost half of self-assessment filers based in Northern Ireland under-report.

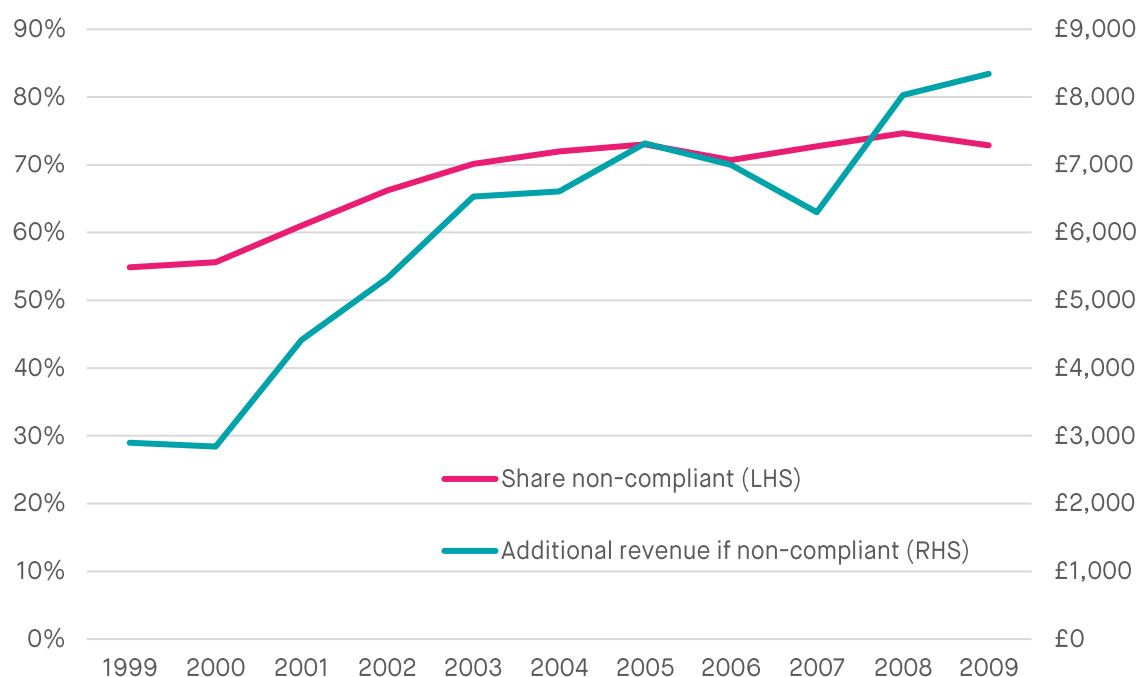
An important point to note is that this is all focused on people not paying everything they are legally required to, either by mistake or by deliberate evasion. It does not include avoidance behaviours, or so-called 'tax planning'.

What HMRC is doing about it

Given all this information, there is a lot of scope for targeted audits and, unsurprisingly, HMRC make good use of this tool. Although there are only a few thousand random audits, there are a hundred times as many targeted ones. These make use of all the data that HMRC has to identify who is likely to be under-reporting and who is likely to owe significant amounts of money.

Over a ten-year period, HMRC was able to increase the proportion of targeted audits that uncovered non-compliance by a third – from 55% to 75%. Even more importantly in terms of revenue, when non-compliance is uncovered the amount of revenue under-reported rose from £3,000 to more than £8,000 (see Figure 1).

Figure 1: HMRC has got better at identifying who is under-reporting – and particularly identifying people who are under-reporting large amounts



These numbers just count the money owed that was uncovered by the audit. My work shows that audits also change people’s behaviour. They report higher level of incomes for five to eight years after being audited, compared with people who weren’t audited but could have been. This suggests that audits are reducing under-reporting.

Using analysis of individual behaviour to understand what causes this change, it seems to be driven by information. Once HMRC knows a taxpayer’s income in one year, they can only slightly under-report the next year without looking suspicious. But over time, they can slowly reduce what they report until they eventually return to their previous behaviour.

Even with this decline in good behaviour, the additional money raised in the five years after an audit is around one and a half times the amount that is uncovered directly at the audit. This makes audits much more valuable than was previously thought.

What HMRC could do better

The numbers above show how much money can be raised by audits. But audits are not free: they take time, and time has to be paid for. Although the cost of an audit is not reported publicly, a quick calculation using estimates of auditors’ salaries, overheads and the number of audits performed per year suggests an average cost of £2,500 per audit.¹

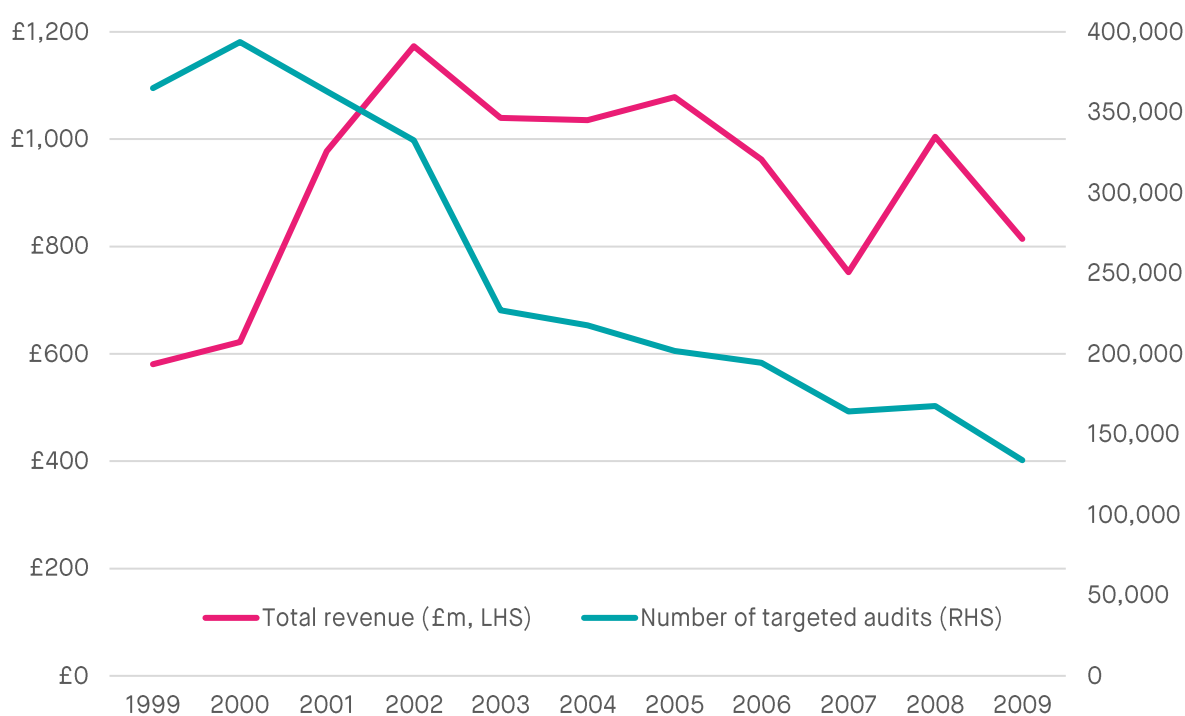
¹ Full details of the calculation are provided in the IFS Briefing Note ‘Who does and doesn’t pay taxes?’, IFS BN218.

Even auditing a random individual who files self-assessment brings in £2,100 on average, so random audits almost break-even, although at the cost of hassling the taxpayer.

But targeted audits bring in much more revenue: a conservative estimate suggests that they bring in between £10,000 and £15,000 including both the direct and indirect effect.² This is four to six times the cost of audit. Few public policies can offer better than 4:1 returns in only five years.

And here the good news story ends. While HMRC has become increasingly good at doing targeted audits, they have also reduced the number of audits they do to less than a third of their peak. Figure 2 shows this decline in the number of audits. It also shows that the revenue from audits has remained stable, as the improved targeting has offset the effects of fewer audits.

Figure 2: Number of audits has fallen, while the total revenue raised from audits has remained roughly flat



This appears to be a clear case of short-termism. More money from the Treasury to do these valuable audits would reap significant rewards, paying for itself and bringing in additional funds. With a return of at least four to one from each auditor, the Treasury could pay the auditor's salary and the salary of four additional nurses as well.

There is also an important debate to be had about fairness. The focus of audits on high-value individuals is clearly beneficial for raising money. But increasing the number of

² £10,000 comes from assuming the indirect effect from a targeted audit is the same as for an audit of someone in the top 20% of incomes. £15,000 comes from assuming the indirect effect is one and a half times the direct effect, as for the random audits.

audits on non-compliant individuals with lower levels of under-reporting would also reduce the unfairness of some people paying while others do not.

Politics is meant to be about hard choices. Increasing the number of audits is not one of them.

This report is based on [IFS Briefing Note 218 'Who does and doesn't pay taxes'](#) and [CAGE Working Paper 414 'The Dynamic Effects of Tax Audits'](#).

ABOUT THE AUTHOR

Dr Arun Advani is Assistant Professor in the University of Warwick's Department of Economics, and Deputy Director at CAGE. He obtained a PhD in Economics from University College London and holds a post as a Research Fellow at the Institute for Fiscal Studies. Arun's present research focuses on tax compliance, auditing and taxation in developing countries.

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