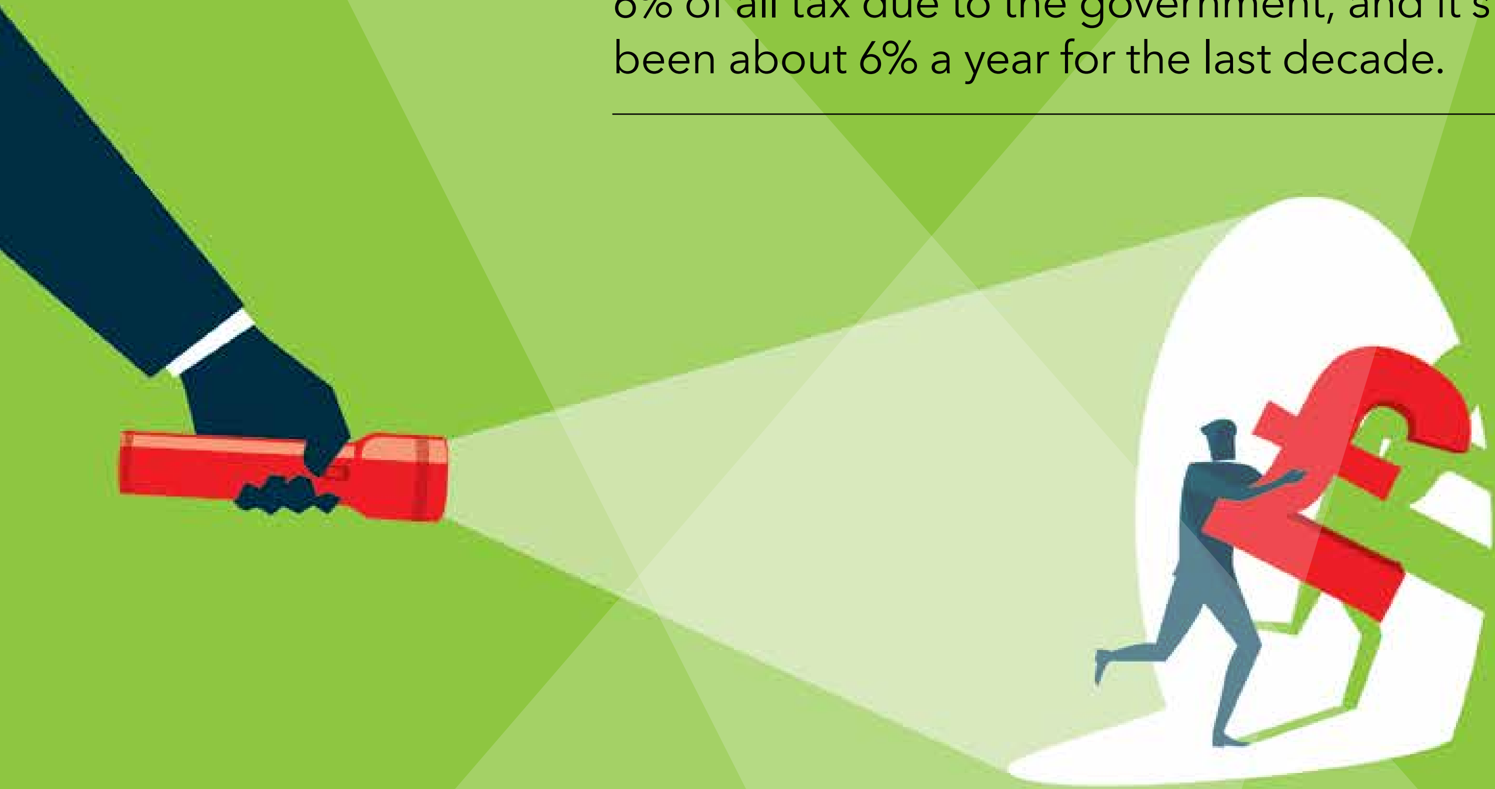
Recovering the missing billions: How auditing can improve tax collection

By Arun Advani

Last year, £35 billion of UK tax wasn't collected. To give a sense of scale, that is more than the government spends on police, old age social care, nursery places and buses combined. It amounts to almost 6% of all tax due to the government, and it's been about 6% a year for the last decade.



OF ALL THE TAXES out there, this 'tax gap' (the share of tax not collected) is largest in self-filed income tax ('self assessment'). Here, one pound in every six goes uncollected, totalling £7.4 billion.

But who owes this money? To address this question, my research combines confidential data on the tax filings of all 10 million UK self-assessment taxpayers with data on random audits conducted by HMRC over more than a decade.

The first, surprising, result is that underpayment is very common: one in three self-assessment taxpayers are found to have under-reported what they owe. While this might make us sound like a nation of cheats, most of these people owe less than £1000. In fact, the majority of the missing £7.4 billion is owed by only a tiny minority of individuals, making up just 2% of self-assessment taxpayers.

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

- Men are 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 a 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. In addition, those in transport and hospitality who under-report do so substantially, missing out more than half their total income.
- Almost half of filers based in Northern Ireland under-report.

... the majority of the missing £7.4 billion is owed by only a tiny minority of individuals, making up just 2% of self-assessment taxpayers.

Targeted audits bring in £10,000-15,000 on average, four to six times what they cost. So the policy prescription is clear: we should do more audits.

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

So how do we bring in more of that missing money? My findings suggest that increased use of targeted auditing would be a cost effective way of recouping missing tax revenue. An important part of this would be to make better use of third party information: cross-referencing what taxpayers report against information available from other sources. Having this information makes individuals less likely to misreport (since they know they will get caught), and easier to spot if and when they do under-report.

Using information already available can also go a long way to predicting who is likely to under-report. This information, like the findings uncovered in this research, allows audits to be targeted at people who are most likely to be under-reporting significant amounts, maximising the unpaid tax that is uncovered.

There is an added benefit to the auditing process: not only do audits pick up historic underpayments, they also change taxpayers' behaviour. Tax payers completing self assessments report higher levels of incomes for five to eight years after an audit, compared to people who weren't audited but could have been. This suggests that audits reduce future under-reporting, at least for a time.

Taking into account the additional revenue brought in from the changes in behaviour, audits bring in on average around two and a half times as much revenue as previously thought. Comparing this to the cost of audit, even random audits come close to breaking even. Targeted audits bring in £10,000-15,000 on average, four to six times what they cost. So the policy prescription is clear: we should do more audits.

This would help bring in the missing money – money that can be spent on schools, healthcare, defence or other public services. An additional auditor doing targeted audits would raise enough to pay their own salary and the salary of at least four nurses too.

It would also reduce the current unfairness in the tax system that most people pay their taxes properly while a small minority substantially underpay. ◀

About the author
Arun Advani is Impact Director for CAGE and Assistant Professor at the University of Warwick.

Further reading

Advani, A., Elming, W., and Shaw, J. (2019), 'The Dynamic Effects of Tax Audits', CAGE working paper no. 414.
Advani, A. (2017), 'Who does and doesn't pay taxes', IFS Briefing Note, BN218.