

**SWP 3/91 TACKLING TAX EVASION IN THE UK**

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## TACKLING TAX EVASION IN THE UK

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### Introduction

Although tax evasion is a world-wide problem, it appears to be a greater problem in some countries than in others. In previous studies the level of evasion has been correlated with a number of economic and social variables including taxpayers' incomes, the perceived tax burden (Bawly, 1982; Baldry, 1987); the marginal rate of tax (Myddelton, 1969, p.227); the general public perception of the purpose for which the taxes are raised (Cowell and Gordon, 1987); and the age distribution of the population (Marrelli, 1987, p.220). But a further set of factors relate to the efficiency with which the tax authorities combat evasion and thereby retain confidence in the tax system. Studies have identified the probability of detection as a tax evader, the penalties levied for evasion and the numbers already partaking in the black economy as key conditions (Allingham and Sandmo, 1972; Benjamini and Maital, 1985; Cowell, 1987). Therefore, lessons may be learned by studying the way in which evasion is tackled in different countries.<sup>1</sup> The purpose of this chapter is to look at the methods adopted in the UK in the light of estimates of the size of the UK black economy. The black economy, alternatively sometimes referred to as the shadow or hidden economy, is made up of economic activities in which illegal dodging of tax liabilities occurs.

In the UK tax administration is divided mainly between two departments of state, the Inland Revenue and Customs and Excise. The Inland Revenue administers Income Tax, Corporation Tax (on company profits), Capital Gains Tax, petroleum taxation (relating to oil exploration and extraction in the UK and surrounding waters) and Stamp Duties (eg. on land transactions). The levying of VAT, tax on gambling and customs and excise duties is the responsibility of the Customs and Excise Department. In addition to these two revenue

departments, local authorities levy the new "Community Charge" (poll tax) and the Department of Social Security is responsible for national insurance contributions.<sup>2</sup> National insurance contributions began life as payments for state unemployment and sickness benefit and pension entitlements, but since the link between payments and receipts is largely broken are now in effect a further tax on incomes. For reasons of space, the discussion below is largely limited to the two taxes considered to involve the most evasion in the UK - Income Tax on the self employed and VAT.

The chapter begins by considering various estimates of the size of the UK's black economy. The structure, management and powers of the Inland Revenue and Customs and Excise departments are then detailed before the performance of the departments is discussed.

### **The Size of the UK Black Economy**

Tax evasion in the UK is as old as taxation itself and certainly pre-dates the high levels of taxation imposed since 1945. In the mid-nineteenth century when income tax was low and affected relatively few, Parliamentary Select Committees took evidence on the nature of evasion; while the Board of Inland Revenue in the 1860s concluded that it had "as usual, abundant evidence ...[of a] .... number of fraudulent returns" (Sabine, 1966, p.104).

We might expect, however, that the total amount of tax lost through evasion is related to the number of taxpayers and therefore evasion today is both economically more significant and widespread than in earlier periods. In the UK the number paying income tax has risen appreciably since the Second World War, so that the tax is now paid by most earners. There were 3.8m income taxpayers in 1938/39 and 21.4m by 1978/79 (*Inland Revenue Statistics*, 1984, Table 1.3). Also, in the past the prevalence of large firms in the British economy, which are unlikely to participate in flagrant tax evasion, has probably helped to depress the size of the black economy. In recent years, however, encouraged by

the potential for tax evasion has increased. The number of unincorporated business accounts and company accounts received annually by the Inland Revenue increased from 2m to 2.25 million and from under 600,000 to nearly 700,000 respectively between 1984/85 and 1988/89 alone (*Inland Revenue, 131st Annual Report, 1989*).

Balanced against these developments, since 1979 marginal rates of tax have been reduced thus lowering the gains from evasion especially for the higher paid; though for some on low incomes the loss of state welfare benefits combined with income tax still produces effective marginal rates of close to 100%. In addition, the introduction of VAT in the UK in 1973, replacing Purchase Tax, led to a substantial increase in the number of businesses and individuals paying and collecting the tax. In particular, many services became liable to tax for the first time and services may be especially prone to evasion, e.g. home improvements, taxis, etc.. Furthermore, in 1979 the main rate of VAT was raised from 8% to 15%, thus increasing the gains from VAT evasion.

A number of attempts have been made since the 1970s to estimate the extent of the black economy in the UK and to assess whether it is growing or diminishing (for summaries see e.g. Heertje et.al., 1982; Smithies, 1984; Smith, 1981 and 1986). In 1981, after a random selection of 5,500 self employed files, Inland Revenue Inspectors concluded that at least 20% of accounts submitted probably under-revealed the true profits earned. This implies widespread evasion by the self-employed. The self-employed, however, are, a group especially prone to evading tax and it cannot be deduced from this sample that around one-fifth of all taxpayers are necessarily involved in evasion. Companies are subject to independent audit in the UK; while employees have tax deducted at source under the PAYE system, hence the scope for evasion is dramatically reduced.

Equally, even if a large percentage of the self-employed evade tax, the total income undeclared may be small in relation to GNP. Household spending on those services likely to be especially prone to evasion amounts to only around 2.5% of total household spending. In

a stab at estimating the black economy's size, Sir William Pyle, Chairman of the Board of the Inland Revenue, in March 1979 suggested that it could be equivalent to around 7.5% of GNP. This estimate was subsequently repeated by the Association of Her Majesty's Inspectors of Taxes (the main professional body for high level tax officials) and the House of Commons Public Accounts Committee. However, its precise basis remains unclear and the suspicion remains that it was little more than an "educated guess"; a guess by a Chairman anxious to impress Parliament of the need for more resources for the Inland Revenue, while wishing to avoid criticism of the competence of his department (Peacock, 1988).

Research into the size of the black economy in the UK by economists has suggested estimates varying widely from a low of 2% to a more worrying 15% of GNP. This wide range reflects the difficulty in measuring something on which by its very nature information is scanty. Also, as Bruno S. Frey and Hannelore Weck of the University of Zurich (1981) have noted, estimates of the size of the black economy are sensitive to the criteria for measurement used (also see O'Higgins, 1981; Marrelli, 1987). Broadly, four methods have been adopted (for a fuller description of these methods see eg. Pyle, 1989):

- (1) All purchase transactions imply a corresponding economic activity in production. Therefore, the amount of cash used in the economy may shed light on the amount of evasion. Broadly three approaches have been adopted: (i) this considers that the desired currency ratio compared with bank deposits is generally constant so that changes in the ratio reflect changes in the size of the black economy; (ii) alternatively, and on the premise that the black economy is essentially a cash economy, an increase in the use of large denomination bank notes is evidence of a growing level of tax evasion; and (iii) based on the Quantity Theory of Money, a change in the relationship between the cash stock and the total value of recorded output may indicate a change in the scale of evasion.

notes and coins. This led Edgar Feige (1981) to argue that the black economy could account for 15% of UK GNP, nearly twice as large as Pyle's "guesstimate". Feige also claimed that the black economy had probably grown rapidly in the first half of the 1970s, peaking in 1974. Studies by Bhattacharyya et. al. (1986) and Matthews and Rastogi (1985) have also reported evidence of a large black economy. Bhattacharyya's estimate based on cash transactions suggests a black economy of up to 10.6% of GNP; while Matthews and Rastogi, analysing monetary trends alongside factors likely to affect the demand for real currency holdings, put the figure nearer Feige's estimate, at up to 14.5% of GDP.

There are, however, major problems with the whole monetary approach to estimating the scale of tax evasion. In particular, it assumes that, leaving aside any growth in the black economy, there is a fairly stable relationship between the cash stock and recorded output. In fact, changes in the financial system in the UK, including from the 1960s a substantial rise in the use of non-cash transactions with the spread of bank accounts, credit cards and other financial instruments, probably largely accounts for cash financing a falling share of economic transactions. Moreover, there is no evidence that the black economy is limited to cash transactions; a significant part may, for instance, involve barter trade. Estimating techniques have been refined to take account of such problems, but they continue to complicate estimation of the size of the black economy by this method (Kay and King, 1990, p.57; Smith, 1986, p.108).

- (2) An alternative broad approach to estimating the size of the black economy involves comparing income and expenditure based estimates of national income. These should be identical since they are measuring the same flow of income around the economy. Where recorded national expenditure considerably exceeds national income this might reflect under-declared incomes.

Adopting this approach, Kerrick Macafee (1980) of the Government's Central Statistical Office estimated that tax evasion in the UK amounted to around 3.5% of GNP and three-quarters of this was probably accounted for by evasion amongst the self employed. Macafee concluded that whilst there was some evidence that tax evasion was on the increase in the UK, the rise was probably not dramatic. O'Higgins (1980) has come to a similar conclusion.

However, the income and expenditure method has well-known defects. Activities in the black economy may deflate both income and recorded expenditure figures, notably through under-revelation of sales of goods and services subject to VAT. Hence, comparing expenditure and income figures involves comparing two sets of defective estimates. Moreover, the gap between national expenditure and income figures in the late 1970s, which formed the basis for Macafee's estimates, has been largely eliminated since by statistical revisions.

- (3) Another method, now more widely favoured, involves measuring the black economy using data collected by government surveys, notably the Family Expenditure Survey, or by direct questioning of those sections of the population most likely to be involved in tax evasion. However, like the other approaches to black economy estimation it is not without its problems. Notably the Family Expenditure Survey may not accurately reflect spending patterns, while questionnaire based procedures are subject to all the usual questionnaire biases. Tax evaders may be reluctant to reveal their activities to researchers, despite assurances that the information will remain confidential.

A survey by Brown, Levin, Rosa and Ulph (1984), using Treasury data on "second jobs", where evasion might be expected to be prevalent, concluded that about 5% of workers in Britain held two or more jobs and that the income tax lost from "second job" tax evasion probably amounted to around 1.1% of income tax receipts or 0.3% of

national income. The total tax evaded in the UK may be considerably higher, however, because of inaccurate responses to the questionnaire from which the data were derived. Also, the study excludes evasion by persons having only one job (which includes large numbers of the self employed), Capital Gains Tax and VAT evasion, and evasion of tax by companies.

Another and more recent study has attempted to compare the consumption patterns of employee and self-employed households at different income levels using government data. Figures on household spending by different groups in society were compared with recorded incomes for these groups. In effect, this meant estimating two consumption functions - one for employees the other for the self employed. The employee function was assumed to reflect the true income and differences between employee and self employed patterns of spending were taken to reflect under-declared income. The extent of income concealed by the self employed was found to be between 10% and 20%, producing an estimate of evasion of up to 5% of GNP (Smith, 1986, p.152).

Two further studies, based upon income and expenditure data drawn from Family Expenditure Survey data, also provided modest estimates of the size of the Black economy. Dilnot and Morris (1981) concluded that evasion possibly amounted to as little as 2.5% to 3% of national income; while Pissarides and Weber (1989) found "that on average true self-employment income is 1.5 times as much as reported self-employment income." At that time, self employment accounted for around 10% of employment and national income. This implied that the size of the black economy was about 5 per cent of GDP. This approach to estimating the size of the black economy assumes that employees do report their incomes correctly.

- (4) Finally, a fourth broad method of estimation, pioneered by Frey and Weck (1983), involves "soft modelling" of the black economy. In this case, the size of tax evasion

is related to a number of explanatory variables. Like all econometric estimation, however, the results are sensitive to the model specification, assumptions made about the size of the relative coefficients and data availability (Marrelli, 1987, p.212).

To date the emphasis in soft modelling has been on providing international rank orderings of the likelihood of high levels of evasion. The most noteworthy study is the analysis of OECD countries, including the UK, by Weck-Hannemen and Frey (1985). Isolating six explanatory variables affecting the level of tax evasion - tax immorality, tax burden, regulatory burden, labour force participation rate, working hours, and foreign workers as a share of the labour force - they estimated evasion in the UK in 1978 at around 8% of GNP.

(Table 1 around here.)

Table 1 summarises the results from the above studies. The monetary approach to estimating the size of the black economy is responsible for the largest estimates. But at the same time this approach looks to be the most suspect. Therefore the high estimates of up to 15% of GNP can probably be discounted. The other approaches tend to suggest a figure of up to 8%, which is, interestingly, not so different to the Inland Revenue's widely quoted "guesstimate" of 7.5%. The lower range estimates, which appear to be the more reliable ones, imply that tax evasion in the UK is not excessive, especially when compared with estimates of evasion from other countries (cf. Frey and Weck, 1983). This might be interpreted, at least in part, as a sign that the tax authorities in the UK have been successful in suppressing evasion. However, what is unclear from such studies, usually based on one year's data, is whether the black economy is expanding, static or declining. Clearly much more research is needed into *trends* in the UK black economy before we can be certain.

### Organisation and Powers of the Inland Revenue

The structure of the Inland Revenue varied little from the First World War down to the 1970s and this structure has left its hallmark on the department today. This is evident in the degree of autonomy given to local offices and the separation of the department into two halves. These comprise the Inspectorate of Taxes responsible for assessing tax liabilities and the Collector of Taxes responsible for collecting the tax assessed.<sup>3</sup> In 1975 a Review Committee (Inland Revenue, 1975) advocated major changes in organisation to improve the department's attack on evasion and these were subsequently introduced. Figure 1 is a current organisation chart provided by the Inland Revenue.

(Figure 1 around here.)

The structure is portrayed by the department as a wheel and spoke organisation but in fact it is essentially hierarchical with the Chairman of the Board of the Inland Revenue at its head. This reflects the need for political accountability and to ensure that tax administration is standardised across the country. Nevertheless, in the 1980s there has been an attempt to introduce more local management responsibility to improve efficiency. To this end the department has introduced new management information systems and in 1987/88 a new line-management budgeting system was implemented. Local managers, known as District Inspectors, are now responsible for running their own budgets and deploying resources within those budgets. At the same time, the department has become more accountable for the quality of its work and its costs. Hence, the department has begun to publish Departmental Statements and Management Plans. These detail workloads and costs over a three year period and are designed to help decide objectives, strategies and targets. A further contributory factor in raising efficiency and changing the organisation of work in the Inland Revenue recently has been the rapid pace of computerisation, albeit after years of delay. Between 1984/85 and 1988/89 the number of computer terminals in local tax offices increased from zero to 38,000 (Inland Revenue, *131st Annual Report, 1989*, p.22). In 1990 a new computerised collection scheme will be implemented and an on-line Corporation Tax

system should be in place by 1993.

The Board of the Inland Revenue (known formally as the Commissioners of the Inland Revenue) is responsible to the Treasury and ultimately to the Chancellor of the Exchequer for the operation of the department. At the head office level, specialist work and management is undertaken through numerous "Technical and Management Divisions", while a policy division based in the Treasury provides advice to government on new legislation and the impact of tax changes.

Below head office, there are 15 regions covering the UK, each headed by a senior inspector known as a Regional Controller. Each Regional Controller is responsible through a number of Group Controllers for the tax districts in his region. To achieve economies the number of tax offices has been reduced from over 750 to 629 since the early 1980s, but the number of staff in each office and at different grades has in general varied very little. The exception is a reduction in the number of junior clerical staff (now called Revenue Assistants) which results from a movement away from paper records (see Table 2).

(Table 2 around here.)

Each tax district is headed by a District Inspector, assisted by a small number of inspectors, usually around 7 (the organisation of a typical tax office is detailed in Figure 2). Of these typically 3 will be inspectors, often graduates, who have received an intensive and demanding three year training in tax law and practice and accountancy, including accounts investigation. They deal primarily with large business and company accounts. The remainder of the inspectors who do not have this level of expertise tackle evasion in small businesses where complex legal and accounting problems are rare.

(Figure 2 around here.)

These are headed by Revenue Executives, who manage sections of the office or undertake higher level clerical duties (eg. PAYE compliance by directors of companies). Underneath them come the Revenue Officers and Revenue Assistants who handle day to day routine administration. In the early 1980s, after a successful experiment, it was decided to appoint 730 higher grade tax officers and 120 inspectors across the country based in tax offices to trace "moonlighters" and "ghosts" (people unknown to the tax authorities) by following up anonymous letters and perusing the local newspapers, telephone directories and trade directories etc. However, due to staff shortages this target has not been met. Throughout the 1980s the department, like other areas of the civil service, has been under continuous pressure to reduce staffing levels. The number of employees, rising steadily until the late 1970s, has since declined by 22% (see Table 3).

(Table 3 around here.)

In addition to the District Offices, Special Offices and Enquiry Branch handle the more complex and larger evasion cases, especially those which can be best tackled centrally rather than at local level. These offices initiate their own investigations as well as receiving cases referred up from the District level. Enquiry Branch deals with all cases where fraud or the honesty and competence of accountants is suspected. District Offices are not permitted to handle fraud cases as they require special legal knowledge. There are 10 Enquiry Branch offices spread across the UK and because of their complexity investigations last on average for two to three years, although sometimes far longer. Special Offices are newer and were established from the mid-1970s when it became apparent that some investigations overlapped district boundaries and were best handled centrally. There were 4 to 5 Special Offices in 1980 and 10 by 1986. They have proved particularly successful. The tax yield by Special Offices from investigations rose from £20.5m in 1980 to over £100m by 1985. Like Enquiry Branch, they are staffed largely with inspectors or accountants and both the Special Offices and Enquiry Branch are currently developing computerised data banks to assist their investigations (Halpern, 1990).

A further specialist unit of the Inland Revenue is PAYE Audit, which is integrated into the Collection branch of the department. It is staffed by auditors with support staff. Their primary role is to check compliance with income tax PAYE regulations and the subcontractors special deduction scheme for the construction industry.<sup>4</sup> They are the only part of the Revenue which systematically visits business premises and checks books and records. They made 69,000 visits in 1987/88 and in over 40% of inspections unearthed some irregularities (Inland Revenue, *123rd Annual Report*, 1981, p.18). A common failure involves the non-deduction of PAYE tax by directors. The discovery of failures to deduct tax on the payment of emoluments to directors yielded £183m in 1986. Where there is a suggestion of wider evasion or poor business records, then the local district tax office will be advised so that a fuller investigation can be mounted.

In addition to the above sections, the department contains a number of small specialist investigation units which work independently or in conjunction with tax offices. One such unit is the Special Trades Investigation Unit set up in 1986 to combat tax losses arising from the closing down of companies in the textile industry owing large amounts of back tax. The directors of such companies would then move on and set up further companies undertaking the same work but freed of tax debts (a process known as "Pheonixation"). Further specialist units worth noting are Special Investigations Section, which deals with complex tax avoidance cases, and Investigation Office, which is part of Collection. Investigation Office pursues suspected cases of fraudulent claims, usually involving personal allowances against tax, inflated expenses and the misuse of subcontractors certificates under the subcontractor tax scheme. 90% of their investigations lead to prosecution and conviction (Sabine, 1986).

Since most tax investigations occur at the local tax office level, the following discussion centres upon their methods. In 1976 the Inland Revenue introduced a radically new approach to tackling tax evasion by businesses and companies with the objective of raising

sometimes briefly and enquiries were made affecting around 30% of them. Sometimes the enquiries related to trifling sums of business expenses. Fuller investigations, known as "back duty" cases, only took place where there were appropriate grounds, eg. an informant's letter or an unexplained build up of private capital.

By the mid-1970s there was growing public and parliamentary concern about what was popularly perceived to be a growing black economy problem in the UK, yet the amount of tax recovered by Inland Revenue investigators had fallen appreciably in real terms from the mid-1960s<sup>5</sup>. With the aim of raising efficiency, in 1976 a new and more selective method of choosing cases for investigation was instituted. This led to fewer accounts being challenged but each investigation was to be conducted in more depth. Since that date, accounts received in tax offices are initially screened quickly by a senior inspector who gives each account one of three possible classifications. Those accounts accepted without query are marked "A", which stands for "accept"; those which have obvious computational or other errors which require limited correspondence on specific points are marked "R", meaning "review technical points"; while a small percentage are taken up for full enquiry with a view to unearthing evasion and are marked "E", which indicates "examine in depth". "A" accounts are passed to clerical staff for assessments to be issued based on the taxpayers' figures. "R" and "E" accounts are allocated to inspectors. The method is known within the Revenue as the "ERA system" (Bingham, 1980; Reader, 1981).

To help identify potential investigation (ie. "E") cases and to assist in the most efficient use of the department's limited inspector resources, each tax district has an *Investigation Plan*. The Plan will normally include:

- \*  
(a) a profile of the types of businesses dealt with in the district;  
  
(b) comparative reviews of business results within similar trades;

- (c) a list of corporation tax accounts for companies where the basic accuracy of the accounts may be wrong or, in the case of larger businesses where the tax computed warrants checking;
- (d) information from other sources indicating evasion;
- (e) other information leading to the detection of "black economy" businesses (Lundberg, 1989).

The department has given repeated assurances to the private sector that its officers are not permitted to initiate enquiry cases at random but only where there is good cause. Also, despite the onset of computerisation, the department appears to have no plans to introduce computerised selection of investigation cases. This involves identifying variables which are likely to indicate a high risk of evasion, and is used in the USA, Denmark, Italy and France. Instead the criteria for selection of accounts for investigation should fall within the terms of a 1977 agreement between the Inland Revenue and the Consultative Committee of Accounting Bodies (Cunliffe, 1990). This sets out a code of conduct for investigations which states that the inspector must have good grounds for suspecting evasion before an enquiry begins.

The change in the department's approach to *selecting* cases for investigation in 1976 also involved a change the *method* of investigation. Traditionally, investigations were based on enquiries into the business proprietor's personal expenditures against declared incomes. Unexplained capital accretions were then deemed to be a product of income which had evaded tax (a method known as *capital statements* and which is still used extensively within Enquiry Branch when attempting to obtain sufficient evidence to prosecute for fraud). In tax districts the method has switched towards an analysis of the business records with a view to discovering errors and inconsistencies and, once discovered, recomputing profits based

"business economics" (Reader, 1981; Sabine, 1986). This has meant that since the mid-1970s Inspectors have had to be trained much more thoroughly than previously in accounting and the examination of business records.

In general an investigation will tend to involve one or more of the following approaches to discrediting records and recomputing profits:

- cash flow tests on the business records;
- the reconstruction of the accounts based on standard gross profit rates for the trade;
- access to bank account statements and documents relating to other investments to check on capital accretions;
- means tests (and still on occasions capital statements) which balance incomes against expenditures.

Inland Revenue investigations begin whenever an Inspector is not "satisfied" that a tax return is correct and complete or where no return is made. Generally, the following factors may lead to an account being singled out for examination during the screening process, ie. marked "E", though the list is not exhaustive:

- low profits or turnover compared with similar businesses;
- the relationship between sales and purchases;
- an unexplained fall in profits;
- businesses where there is a predominance of cash receipts (eg. public houses, taxis);
- accounts drawn up by poor quality, often unqualified, accountants;
- information from PAYE audit or Customs and Excise of accounting irregularities;
- low drawings by proprietors or low salaries of directors;
- information from informants or from banks regarding undeclared bank interest;
- low gross profit rates compared with similar businesses.

Where returns are not made or the Inspector is not satisfied that the return is correct and complete, the Inland Revenue issues *estimated* assessments, that is assessments of tax liabilities based upon the inspector's estimate of the likely profits made. These are likely to be well in excess of what the taxpayer states were earned. The issuing of estimated assessments is the Inland Revenue's means of ensuring that a taxpayer co-operates with their enquiries. The taxpayer can appeal against the assessments to an independent tribunal known as the General or Special Commissioners.<sup>6</sup> But before these Commissioners the major onus is on the taxpayer to show that the assessments are excessive rather than on the inspector to show that his estimate of profits is reasonable. In 1987/88 3744 appeals were received against assessments, but the vast majority were settled by prior agreement with the local inspector and hence without recourse to the Commissioners.

An investigation normally involves the inspector seeing the books and records of the business, investigation of personal tax returns and interviews with the taxpayer (and his accountant where relevant) (Sabine, 1989). Although traders and companies are expected to submit accounts each year in support of their tax returns, there is no statutory requirement to this effect.<sup>7</sup> Also, there is no legal requirement under UK income and corporation tax legislation to keep books and records. Failure to do so, however, will prevent accountants from preparing proper accounts and will provide the inspector with ammunition to argue that the accounts are wholly unreliable. In 1955 the *Royal Commission on the Taxation of Profits and Income* (Cmnd. 9474) recommended that a statutory obligation be introduced regarding record keeping but this was not pursued.

The taxpayer is not normally obliged to provide the inspector with access to his records or allow him to visit the trade premises to inspect the business. However, failure to do so while concealing sources of undeclared income leads to a Commissioners' hearing where the Commissioner may take copies. Prior to 1976 the Inland Revenue could not require the production of accounts together with supporting books, documents and other accounts and other

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fraud or wilful default (intentional failure to comply with the tax legislation). Since sight of such documentation was usually necessary to substantiate a tax offence, the Revenue was seriously hampered.

More widespread powers were introduced in 1976 to support the department's new drive against evasion based on the "ERA system". District Inspectors and other senior Inland Revenue officials could now order the production of accounts and certain other business records, with major restrictions relating only to access to accountants' working papers and the records of solicitors and barristers (Jeffery, 1989). Other powers introduced in 1976 included the right to search premises and seize documents in cases where fraud was suspected (but subject to the consent of a Circuit Judge). In the first six years of the power's existence, only 83 search warrants were obtained in respect of 15 cases, which reflects the assurances given to Parliament that searches would be confined to the most serious cases of suspected evasion (Drummond, 1988). This did not prevent, however, considerable adverse publicity about Revenue methods when the Revenue raided the offices of *Rosminster*, an organisation associated with marketing what the Revenue judged to be artificial tax avoidance schemes (Gillard, 1987).

An investigation is completed with the signing by the taxpayer of a *Statement of Assets*, detailing the taxpayer's assets, and a *Certificate of Full Disclosure*, which confirms that the taxpayer has fully revealed to the inspector all matters relevant to his tax affairs. The taxpayer is warned of the serious consequences (potential fraud) of signing these documents while concealing relevant income or assets (the department tends to prosecute where major sources of undeclared income are subsequently discovered). The taxpayer is then required to make an *offer in settlement* to cover tax, interest and penalties. This "offer" (normally arrived at after discussion with the inspector) is then agreed by Technical Division (Penalties) at head office, thus broadly standardising across the country the penalties charged by local offices.

Until October 1988 the Board of the Inland Revenue set targets for investigation work in local offices based mainly on the number of investigations in relation to accounts received. Also, inspectors were subject to a "scoring" system based largely on the number of cases completed. This, not surprisingly, led to a tendency in local tax offices to concentrate upon completing as many investigation cases as quickly as possible. Longer and more complex enquiries, but perhaps enquiries that would eventually unearth major evasion, tended to be neglected. In October 1988 a new system for business accounts was introduced to give greater recognition to the quality of the investigation and the time required to undertake it. Under the new *Accounts Investigation Monitoring System (AIMS)* offices and staff are assessed by points awarded which reflect not only the number of cases completed but also the type of settlement achieved, the complexity of the investigation and the manner in which the case was conducted. The aggregate points from all settlements in relation to resources are used to gauge the overall efficiency of the department's investigation effort and as performance targets for District Inspectors (Inland Revenue, *131st Annual Report* 1989, p.46). Similar performance indicators have also been developed for Enquiry Branch and the Special Offices.

Following the *Rossmminster* case there was considerable concern voiced in Parliament about the methods used by the Inland Revenue in pursuing tax evaders. In response, the Conservative Party in 1979 gave a commitment to instigate a thorough review of powers when elected to Government. The product was the setting up of a committee under the chairmanship of Lord Keith of Kinkel in 1980 to review the revenue departments' enforcement powers. In March 1983 the Committee reported (*Committee on Enforcement Powers of the Revenue Departments*, Cmnd.8822, March 1983) and many of the recommendations were subsequently implemented. A main result of the Committee's deliberations was a major revision of penalty provisions for tax offences.<sup>8</sup>

Revised Inland Revenue penalties were introduced in 1989 and led to a significant increase in the penalty charges especially those which had been eroded over the years by the effect

of inflation. The new penalty charges are summarised in Figure 3 and can be broadly divided into three groups:



- tax-geared penalties of up to 100% of tax evaded for offences that put tax seriously at risk - eg. omissions from tax returns and long delays in completing tax returns;
- fixed limit penalties of up to £3000 for each offence relating to the submission of certain incorrect returns- eg. returns of directors' benefits;
- fixed penalties for delay in making returns of £300 for the initial offence and £60 per day thereafter.

(Figure 3 around here.)

In all of these cases the penalty charge is mitigated where the taxpayer cooperates with the tax enquiry, makes a full confession or the offence is deemed to be minor, eg. small amounts of tax were involved. This means that in practice, normally penalties of 20 to 40% are charged in tax office investigations. Indeed, a greater financial burden is often placed on evaders by the interest charge levied on the tax evaded and paid at the end of the investigation. This default interest is in addition to any penalty payments and is calculated from the time the tax would have been paid had there been no offence to the investigation settlement date. The interest rate charged reflects current interest rates in the economy and therefore is revised frequently. It is also worth noting that inspectors can levy interest and penalties and recover tax evaded over the previous 20 years in serious cases. In other cases, investigations are normally limited to discovering evasion within the previous 6 years.

Rarely does the Inland Revenue resort to the criminal prosecution of tax evaders. Instead, the department prefers to reach a negotiated settlement with the taxpayer which includes recovery of tax lost along with mitigated penalties and the interest charge (Cunliffe, 1990).

Criminal prosecution tends to occur only where there has been serious fraud often involving theft of monies from the Revenue (eg false claims for repayment of tax), where accountants are involved in promoting evasion or where there is dishonesty by Revenue officials (see Table 4). Following the reforms introduced in 1989, tax misdemeanours are classed as "fraudulent or negligent conduct". It is unusual, however, for tax offenders to be accused of the criminal offence of fraud during an investigation. Fraud involves alteration or falsification of documents with the intention to deceive and requires a high degree of proof if prosecutions are to succeed in court. In contrast, negligence is merely carelessness beyond what could be expected of a reasonable person in the conduct of his tax affairs. It simply implies a want of care and attention. All evaders successfully investigated by local tax offices are accused of negligence. Fraud cases are dealt with by specialist units, notably Enquiry Branch and the Special Investigations Section.

(Table 4 around here.)

#### **Organisation and Powers of the Customs and Excise**

Today VAT accounts for around 57% of the revenue collected by the Customs and Excise who are also responsible for collecting excise duties and gaming taxes and preventing drug and other smuggling. The organisation of the Customs and Excise department is summarised in Figure 4. A regional structure exists for VAT with 19 collection areas in the UK and headquarters in Southend, Liverpool and London. Evasion of VAT is tackled by local VAT offices and in more serious cases by the Customs and Excise Investigation Division. About 12,500 Customs and Excise staff are involved in VAT work and approximately 8,200 of these are located in 87 local VAT offices. At a time of staff cutbacks their workload has continued to increase. Between March 1980 and March 1989 the number of persons registered for VAT in the UK rose from 1,196,7900 to 1,623,866. Consequently, while in 1982/83 the department handled 6,085,000 VAT returns by 1988/89

worrying loss of staff especially to private accounting firms where morale and pay levels are superior. Only better management and hard work by remaining staff has enabled investigation yields to continue to rise

(Figure 4 around here.)

The department publishes a Management Plan at the start of each financial year which is agreed with the Treasury. It sets out the department's priorities, principles and objectives. Also, and as in the case of the Inland Revenue, in recent years the department has implemented new planning, accounting and budgetary processes and new management information systems. Such reforms have been geared to improving the cost effectiveness of VAT collection.

VAT was introduced in the UK in 1973 and is a self assessed tax. Every registered trader, which is anyone who is in business in the UK (unless trading in one of a small number of exempted categories eg. finance) and with a turnover in excess of £25,400 in 1990/91, must make regular (usually quarterly) returns to the VAT authorities. These returns detail the VAT the trader has paid on inputs purchased (*input tax*) and the VAT charged on goods and services sold (*output tax*). The trader then pays the net VAT charged over to the Customs and Excise or, where the input tax exceeds the output tax, receives a VAT repayment of the net amount.

The basis on which these returns are prepared and consequently their reliability is then periodically checked by the Customs and Excise, principally through what are called *control visits*. Where the Customs and Excise challenge returns they may issue estimated VAT assessments. Appeals against VAT assessments are considered by VAT Tribunals where the onus, once again, is on the taxpayer to prove that the tax assessment is excessive. There is then a possibility of a further appeal to the courts on a point of law. However, as in the case of Inland Revenue investigations, Customs and Excise prefer to achieve an agreement

with taxpayers without recourse to the tribunals or courts. For example, in 1988/89 there were 2954 appeals of which nearly one-half were withdrawn before the tribunal hearing occurred.

The amount of tax revenue lost through VAT evasion is reckoned by many economists to be comparatively small compared with the sums lost through income tax evasion. Large companies undertake the bulk of economic transactions by value and their managements are unlikely to risk evading VAT, especially since they would be unlikely to benefit directly. Smaller businesses where evasion might be expected to be a much greater problem will often be below the VAT threshold for registration. Hence, the moonlighting joiner who undertakes minor house repairs for cash may not be obliged to levy VAT. Also, businesses evading tax will be limited in the input tax they can reclaim thus reducing the financial gain from evasion and hence the incentive to evade VAT. Nevertheless, it would be wrong to be too complacent about compliance with VAT legislation in the UK given the sums recovered by VAT investigators annually.

Central to Customs and Excise policing of VAT is the control visit. Indeed, control visits absorb around a half of all local VAT office manpower. During a control visit a VAT officer attends the business premises and inspects the books and records of the business to ensure that VAT is being correctly recorded for all transactions. Initially it was intended that most traders would receive a control visit around every three years. In fact, the frequency has been much lower, partly because of staff shortages and partly because the department quickly realised that the yield from VAT investigations would be best maximised by concentrating resources where evasion was most suspected. The department's aim has been to maximise cost effectiveness by allocating time to those trades and traders identified to be most prone to evasion (*H.M. Treasury Working Papers*, 1986 and 1987).

Since 1978 the department has used operational research techniques to identify such trades and thus to regulate the frequency of control visits and the length of time spent on each

visit (usually between a half a day and three days). Those trading where tax is considered to be most at risk can expect to be visited annually. Identification of such trades is based upon certain characteristics, such as the type of trade and the amount of turnover, with information drawn from a data bank built up by Customs and Excise.

The introduction of selectivity led to a marked increase in yields from control visits. The average underdeclaration of tax discovered per visit rose from £152 in 1978/79 to over £1000 by the mid-1980s (Smith, 1986, p.59). In 1988 the system was upgraded with the introduction of the *VAT Operational Planning System (VAVOPS)* in a further effort to improve the effectiveness of selecting businesses for visits and to measure performance more accurately.

Performance targets arising out of the selectivity system have been introduced at the local level to stimulate management. These targets are based upon the actual time available for visits given staffing levels. Since the notional times are set with regard to likely revenue at risk, they are geared to achieve optimum cost effectiveness with a view to improved cost/yield ratios. This approach to measuring and monitoring the use of the department's scarce resources is complemented by further performance indicators, such as additional tax discovered per control visit. Using these measures the performance of local VAT offices is monitored and action taken to revise or review targets as necessary or to adjust staffing levels. The department calculates that the use of key output and performance indicators as part of the department's planning system produced £16m in additional VAT in 1985/86. Moreover, a global yield target is applied at the national level to assess whether the department's total resources are being used in their most effective manner. National targets (though not local targets) are sometimes published. In 1988/89, for example, the department's Management Plan required unit costs to be reduced and an extra £700m to be discovered during control visits (a rise of 15% in real terms). The department actually outperformed this figure, achieving an extra £750m in revenue.

Turning to the powers of Customs and Excise officers in the collection of VAT, these are more extensive than those available to inspectors in the Inland Revenue and this may account for a general perception that their approach to investigations is less "gentlemanly" (Kelsey, 1987). Besides the right to enter business premises regularly during control visits and inspect records, VAT law lays down the records traders must keep to ensure an accurate recording of input and output tax (in contrast, and as already noted, there is no legislative requirement relating to business records for income tax purposes). Customs and Excise can also at any other reasonable time enter premises and *inspect* (though not *search*), request the production of records, remove documents from traders' premises, question customers with a view to identifying evaded VAT and inspect certain accountants' (but not solicitors') papers. Officers can also obtain search warrants from a magistrate where fraud is suspected and like their Inland Revenue colleagues have power of arrest for fraud. However, such powers are used only at the discretion of senior officers.

Assessments to VAT can be made for up to 20 years where civil or criminal fraud occurs but otherwise they must be made within 6 years of the end of the appropriate VAT return period. When VAT was introduced there were few enforcement powers other than the costly procedure of adopting criminal proceedings. Reaching the level of proof for criminal proceedings proved to be a protracted affair and thus investigations were rarely cost effective. Also, there were no interest charges for late payment of VAT due. Not surprisingly, this state of affairs led to underdeclarations of tax of up to £600m per annum, 5m late VAT returns each year and constant arrears of tax totalling around £1200m. (Jordan, 1989). To remedy this, the Keith Committee recommended the introduction of penalties for serious misdeclarations and interest charges for default.

Consequently, extensive new powers were introduced by the 1985 Finance Act and phased in over the following 5 years (in addition, powers to prosecute in very serious cases of criminal fraud remain; the maximum sentence is 7 years imprisonment). These new powers allow

is evidence of dishonesty. Also, there are now automatic penalties for the late submission of VAT returns, late registration and unauthorised issue of VAT invoices or breaches of other VAT regulations, for errors in returns which fall short of criminal fraud and for persistent understatement of VAT liabilities. Moreover, interest is now chargeable on VAT evaded or paid late. The various classes of offence and the related penalties are summarised in Figure 5.

(Figure 5 here.)

In the vast majority of cases Customs and Excise officers, like their Inland Revenue counterparts, finalise an investigation with a negotiated settlement to cover the tax evaded and the appropriate interest and penalty charge. For some offences the penalty charge may be mitigated by up to 50% to induce taxpayers to cooperate with investigations. Although Customs and Excise appear more willing than the Inland Revenue to prosecute, for example in 1986/87 there were 196 instances where the department resorted to criminal proceedings, it appears that even in serious cases a negotiated settlement is preferred to prosecution (Smith, 1986, p.60).<sup>9</sup>

#### **Efficiency and Effectiveness of the Revenue Departments**

The changes in the organisation and the powers of the revenue departments detailed above had their origins in a desire to increase the cost effectiveness of investigation work. To those who can see merit in tax evasion, for example because they believe that a thriving black economy increases national production (eg. Weiss, 1976; Bracewell-Milnes, 1979, pp.68-70; ed. Seldon, 1979), any improved effectiveness of revenue investigations is at best a mixed blessing. But the approach adopted here is to equate improved cost/yield ratios and other productivity measures with improved efficiency. The approach also ignores both the important issues of the "excess burden" from taxation and the effect of compliance costs because of the difficulty in measuring them. A simple definition of the excess burden or

deadweight loss from taxation is given by Auerbach (1986, p.67): "The deadweight loss from a tax system is that amount that is lost in excess of what government collects". It represents a net welfare loss. Sandford, Godwin and Hardwick (1989) have pointed to the large but mainly hidden costs imposed upon the private sector by having to comply with the tax system (eg. operating the PAYE system).

The efficiency of revenue departments is usually measured by cost/yield ratios which equate the cost of collecting taxes to the amounts of tax recovered. Cost/yield ratios are given below but are supplemented with a number of other productivity and cost related indices. Annual figures are used to trace changes in operating efficiency over time and particularly since the major organisational changes referred to earlier.

Cost/yield ratios have the advantage that they are relatively easy to calculate. However, they may be affected by changes in tax legislation which affect the costs of tax collection and by economic and demographic changes outside the control of the revenue departments (eg. the rise in the number of small businesses in the UK in the 1980s). They also tell us nothing about the accuracy and quality of the work performed. There has been much concern in the UK in recent years regarding the number of incorrect tax assessments issued and delays in answering postal enquiries from taxpayers. The other productivity measures which can be readily constructed also suffer from similar defects and this should be born in mind when interpreting the statistics below.

Retaining confidence in the tax system is a major goal of revenue departments and catching evaders remains essential if the vast bulk of taxpayers are to continue to comply with tax legislation. Hence, although it is impossible to put a figure on the amount of tax defended by investigation work, figures of tax directly recovered from investigations no doubt greatly underestimate their full revenue impact. This is underlined by research in the Inland Revenue into income tax accounts which have been investigated. This research suggests improvements in income declared continuing for at least 5 years following an investigation.

This effectively doubles the yield from investigation settlements (*Inland Revenue, 131st Annual Report, 1989*). To this should be added the revenue gains from improved tax compliance by friends and business associates of the identified and penalised evader.

#### *Inland Revenue*

Table 5 provides details of the number of cases investigated each year by the Inland Revenue between 1 April 1971 and 31 October 1980, along with figures of tax raised and penalties and interest charged. Up until the mid-1970s there was only a negligible increase in the number of taxpayers investigated and allowing for inflation, the tax recovered was almost stagnant. It was this poor trend in the face of growing public concern about tax evasion that led to the introduction of the "ERA system".

(Table 5 around here.)

Its introduction appears to have had the desired effect with the number of cases investigated almost doubling and with even greater gains in tax recovered. This marked improvement in performance also came at a time when the number of Inland Revenue inspectors changed very little. It seems that the more careful selection of potential investigation cases, which lies at the heart of the "ERA system", produced the desired higher tax yield and without the Government having to put in significant new resources.

The improved performance has continued through the 1980s as the figures in Table 6 confirm. Even allowing for inflation, the total tax yield rose by 592.5% through the decade with big gains being posted by all sections of the Revenue but especially PAYE audit. Also, the new special units at head office have made an impressive start. Expressing this yield in terms of staff employed, in real terms productivity in investigation work rose by just over 319% or by almost 32% per annum.

(Table 6 around here.)

Narrowing the focus to the tax offices and Enquiry Branch only, it is evident that not only are more investigation cases being taken up but that the Inland Revenue is resorting more frequently to interest and penalties. Whereas in 1980 only 42% of investigations were settled with interest and penalties, in 1989 almost 69% were so settled. The figures in Table 7 also reveal that the greater incidence of interest and penalty charges has grown gradually through the decade.

Table 8 provides a breakdown of investigation work in tax offices, where the vast bulk of investigation work is centred. These categories are accounts and non-accounts investigations and Schedule D (self-employed) and Schedule E (employee) compliance work. All these areas of investigation work appear to have chalked up impressive results, especially at a time of falling staff numbers. But the Schedule D compliance results are particularly impressive. Compliance work involves ensuring that all those who should be paying income tax are paying and that the legislation is correctly applied. Throughout the Revenue this work has proven particularly cost effective with cost/yield ratios of between 1:15 for tax offices to 1:37 for Special Offices (*Board of Inland Revenue, 131st Annual Report, 1989*). The impressive performance in Schedule D compliance follows the department's efforts since 1980 to crack down on moonlighters or "ghosts" by setting up specialist units within tax offices.

(Tables 7 and 8 around here.)

Cost/yield ratios for investigation work suggest that investigations are extremely cost effective. In the mid-1980s tax offices had a ratio of 1:6.8, Enquiry Branch 1:17.6, Special Offices 1:27 and PAYE audit 1:55. Also, in 1981 the Inland Revenue reported that the gross incremental return from extra staff engaged in investigation worked out at around

diminishing returns. Such figures do not, however, take into account the cost of investigations in terms of time and expense imposed upon the private sector or any excess burden (Topham, 1984); nevertheless, they imply that more resources put into Inland Revenue investigation work would at least generate large net gains to the Exchequer. On the whole, these resources have not been forthcoming in the 1980s.

The department's attack on evasion has been constantly hampered by a lack of trained inspectors, reflecting the department's more general difficulty in recruiting and retaining staff. There has been a large and continuous hemorrhaging of more highly qualified staff to the private sector where pay and conditions are perceived to be superior. In the year to 31 March 1988 the number of inspectors of all grades who resigned reached a record, with 6% of all fully trained inspectors leaving. One result of this and the Government's efforts, especially between 1979 and 1982 to trim public sector employment, has been a reduction in the number of inspectors, from around 6000 in April 1978 to 5300 in April 1988.

A lack of staff means that very few business accounts are challenged each year, a record which troubled the Parliamentary Public Accounts Committee in the early 1980s. At the time only around 2.8% of non-company accounts and 0.9% of company accounts were being investigated each year, but in 87% of these cases understatements of profits were revealed. The Committee interpreted this as evidence that widespread evasion was going unchallenged. In response the Inland Revenue agreed to increase the percentage of accounts investigated but then singularly failed to do so. By 1987/88 the percentage had fallen to 2.2% for non-company accounts and 0.78% for company accounts. The department blames its failure on a continuing lack of qualified inspectors; something which is unlikely to be reversed until there is more political commitment in Government to tackling evasion, supported by the allocation of the necessary resources to pay inspectors competitive salaries.

### *Customs and Excise*

The Customs and Excise department has also recorded large gains in productivity since the late 1970s. The number of staff directly employed on VAT work has risen only marginally since 1978, while the number of traders registered for VAT has increased by over 20%. The result has been a rise in the average number of traders each member of staff has to deal with (see Table 9). Nevertheless, the department has managed to increase the number of control visits, which form its main means of unearthing evasion, and this has led to a 378% increase in recoveries of tax underdeclared in real terms. The average under-declaration per control visit has similarly leaped by 335%. At the same time, the cost of administering VAT as a share of revenue raised has fallen by 48%. In all respects the department's record is impressive.

(Table 9 around here.)

The marked rise in the performance of the department could reflect a surge in VAT evasion in the 1980s. But as there is no evidence that VAT evasion is more widespread now than in the late 1970s, more likely it reflects the department's greater success in tracking down evaders. Indeed, the introduction of new and more swingeing penalties for VAT irregularities from the mid-1980s should have had the desired effect of dissuading potential evaders. The department's success appears to result from the organisational changes introduced since the 1970s and detailed earlier. In particular the department has targeted trades most prone to evasion for regular control visits and monitored the performance of VAT offices against targets, both to encourage local management and to better allocate the department's scarce resources nationally.

### **Conclusion**

The size of the black economy in the UK remains uncertain despite a number of attempts at measurement since the late 1970s. High estimates of 15% tend to make the headlines but

are likely to be flawed because they rely upon a method of calculation - cash transactions - which is highly suspect. Other methods produce estimates that the black economy is around 5% of GNP, which is not dissimilar to the Inland Revenue's own estimate of 7%. A lower level estimate implies that on an international scale, and especially compared to countries such as Italy, tax evasion is not a major problem in the UK. One possible explanation is the success of the UK revenue departments in combatting tax dodging.

Both of the major departments of state responsible for tax assessment and collection in the UK - the Inland Revenue and Customs and Excise - have undergone major reorganisations since the 1970s with a view to meeting public concern about the extent of tax evasion. In both cases there has been a noticeable move towards greater selectivity in choosing cases for investigation. This has led to a fall in the percentage of accounts and returns challenged and this in turn has led to criticism in Parliament, especially regarding the percentage of business and company accounts investigated by the Inland Revenue. But such worries may be misplaced. What is important is not the number of taxpayers challenged but the impact of investigations on the public's propensity to evade. A growing theoretical literature on strategies for tax authorities suggests that the most efficient use of tax authority resources requires a differential probability of audit across individuals (Pyle, 1989, p.178). In the UK both departments have adopted this approach.<sup>11</sup>

A positive result of selectivity has been a significant growth in tax recovered. Both the Inland Revenue and Customs and Excise have become much more proficient since the mid-1970s at identifying those trades prone to evasion and so have become more successful in raising the tax yield from each investigation. These developments have been supported by a move towards relevant performance targets for staff appraisal and more local management accountability in both departments. The overall result has been improved productivity measured in terms of cost/yield figures and similar ratios. A further change has been the introduction of more extensive penalty powers, especially for Customs and Excise with consequently a noticeable improvement in compliance with VAT legislation.

The history of tax investigations in the UK since the 1970s seems to confirm that the organisation of tax authorities can have a marked effect on performance in terms of tracking down and penalising evaders and this is an important lesson for other countries. Another clear conclusion is that tax evasion is contained by maintaining the confidence of the bulk of taxpayers in the administration of the tax system. This requires constant effort by the tax authorities. The price of protecting the tax flow to the Exchequer is eternal vigilance.

### Acknowledgement

I should like to acknowledge the assistance of the Inland Revenue Compliance and Collection Division who provided a number of the statistics used in this chapter and the library staff at the Cranfield School of Management and the London School of Economics for their help in tracking down numerous official reports and other references.

### Footnotes

1. Kay remarks: "It is apparent that there are large differences between countries in the effectiveness of their tax administration, although I know of no attempt to quantify the issue." (Kay, 1990, p.62) This chapter does not attempt to quantify differences but it is designed to shed light on the effectiveness of one body of tax authorities, those in the UK.
2. The bulk of national insurance contributions, those paid by employees, are collected by the Inland Revenue through the *Pay as You Earn (PAYE)* system and then paid over to the Department of Social Security. Under the PAYE system income tax and national insurance contributions are deducted by the employer upon payment of wages and salaries. The employer then pays over the tax and national insurance to the Collector of Taxes by the 15th day of the following month.
3. For historical reasons which appear to have their origins in a desire to minimise the risk of corruption of officials, the Revenue is divided into two broad parts below Board level. Tax assessment including the identification of evaders is undertaken by the Inspectorate. Collection of tax assessed is the responsibility of the Collector of Taxes branch.

4. Under the subcontractor scheme for the building and construction industry, all subcontractors without a special exemption certificate awarded by their local tax office (known as a 714) must be paid by contractors *net* of income tax at the basic rate, currently 25%. This system was introduced in the 1970s to combat widespread evasion of tax within the industry by self employed subcontractors who failed to file accounts with the tax authorities.

5. Alongside the lack of selectivity in instituting enquiries, a contributory factor to the decline in the yield from investigations was the increase in the administrative workload of the department due to legislative changes, especially the introduction of Corporation Tax and Capital Gains Tax in 1965.

6. There is then a further right of appeal on a point of law to the High Court, Court of Appeal and finally the House of Lords.

7. In 1989 it was decided that those with gross business earnings from self employment or the letting of property of less than £10,000 per annum need not submit detailed accounts.

8. The Committee favoured fixed penalties for tax offences but this was rejected by the Inland Revenue. The department preferred to retain some flexibility in setting penalties to encourage taxpayer co-operation with their enquiries (Inland Revenue, 1986).

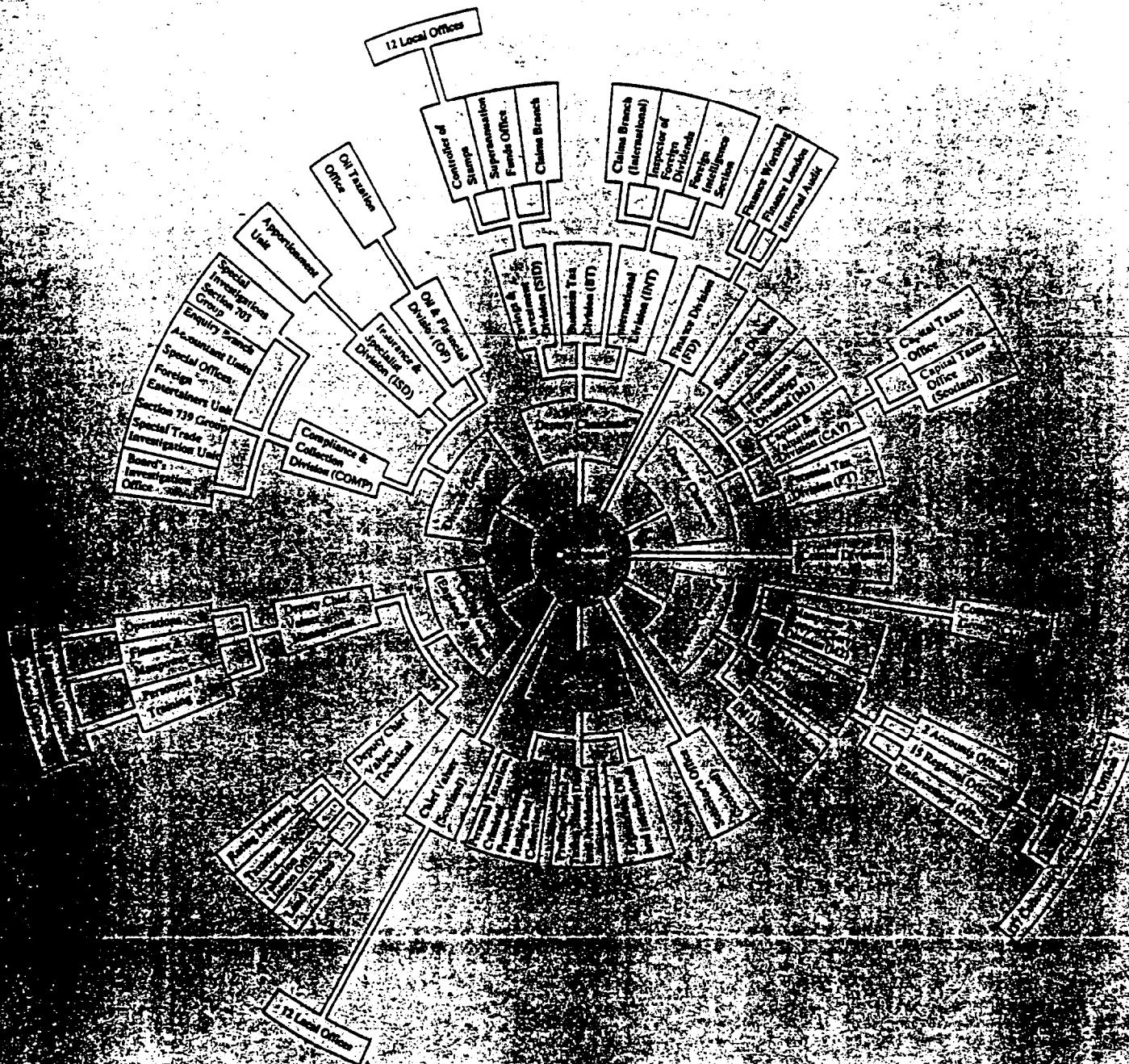
9. In addition to the above penalties, there are also penalties for accountants who connive in tax evasion; plus non-mitigable penalties for failing to make returns of PAYE tax and of national insurance contributions are being phased in by 1995 (Newth, 1989). Also, a "pay and file" system for Corporation Tax will be introduced in January 1993. Under this system the onus will be on companies to submit accounts within the normal time period (9 months of the end of their accounting period), or to estimate their profits by that date.

Automatic penalties will be imposed for late returns and interest will be charged on tax paid late. This system may in time be extended to income tax if the experiment is successful.

10. The reluctance of the revenue departments to prosecute for fraud contrasts vividly with the attitude taken by another government department, the Department of Social Security, to those believed to have falsely claimed social security benefits. Not only are those found guilty of social security abuse around 20 times more likely to be taken to court, the Department of Social Security has received considerably more resources in the 1980s to tackle abuse despite their investigations having a cost/yield ratio of only 1:3. This is far inferior to the cost/yield ratios of the revenue departments (Cook, 1989, p.117).

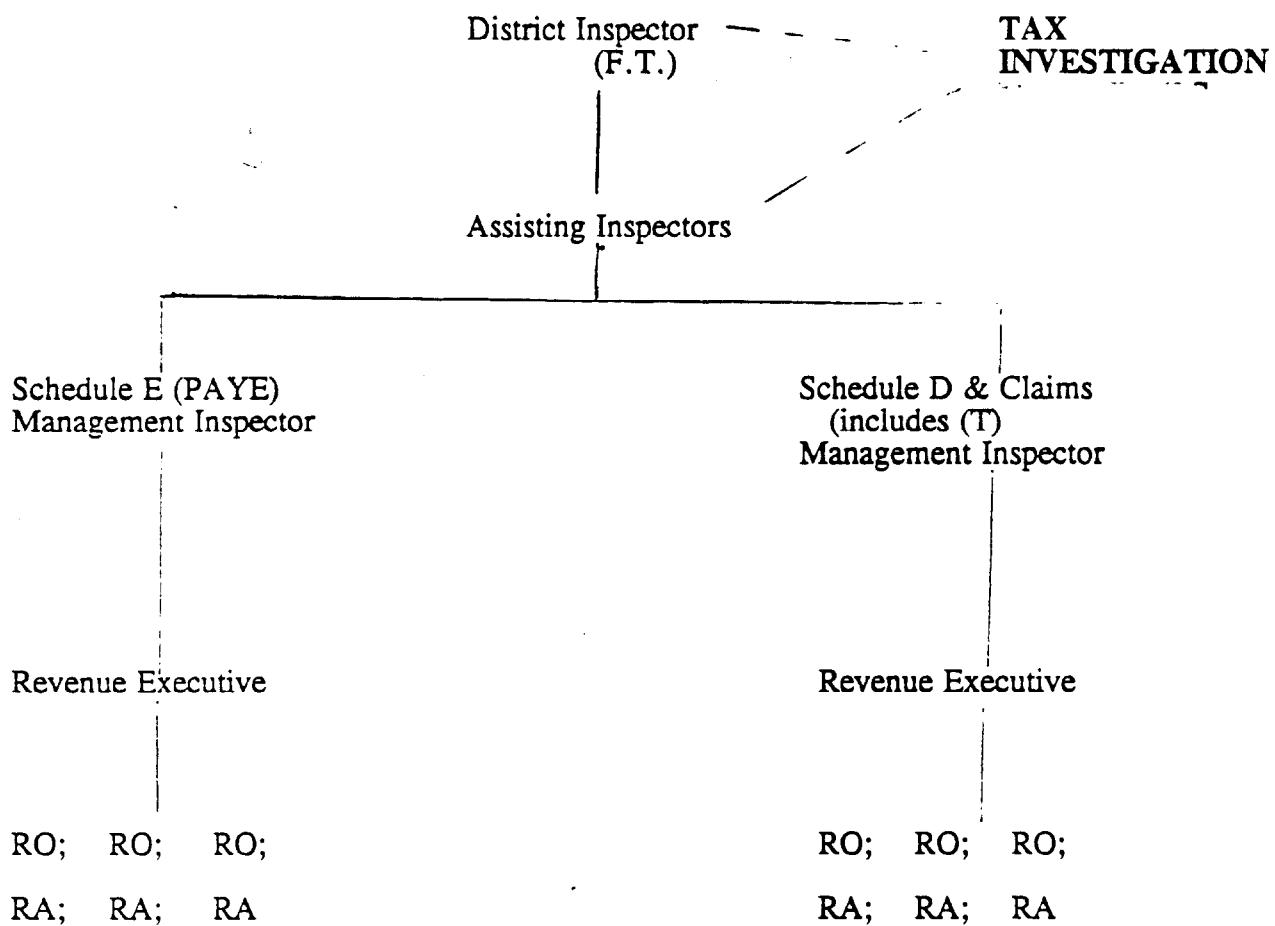
11. The intensity of auditing by the tax authorities is itself an independent variable on which the authorities must make a decision (Dardanoni and Marrelli, 1988).

FIGURE 1 INLAND REVENUE ORGANISATION CHART



**FIGURE 2**

**A Typical Tax Office**



Notes:

RE = Revenue Executive (prior to 1988 called Tax Officers' Higher Grade)

RO = Revenue Officer (prior to 1988 called Tax Officers)

RA = Revenue Assistant (prior to 1988 called Clerical Assistants)

**FIGURE 3**

**INLAND REVENUE: PENALTIES FOR EVASION**

<b><u>Offence</u></b>	<b><u>Penalty</u></b>
Failure to make a return of income and gains	Initial penalty of £300 followed by £60 per day
Late return of income and gains (after one year following the normal year of assessment)	100% of tax assessed late
Incorrect annual tax returns and tax accounts	100% of tax underdeclared
Failure to make other returns and to supply other information	Initial penalty £300 followed by £60 per day
Fraudulent or negligent supply of other returns or information	£3000

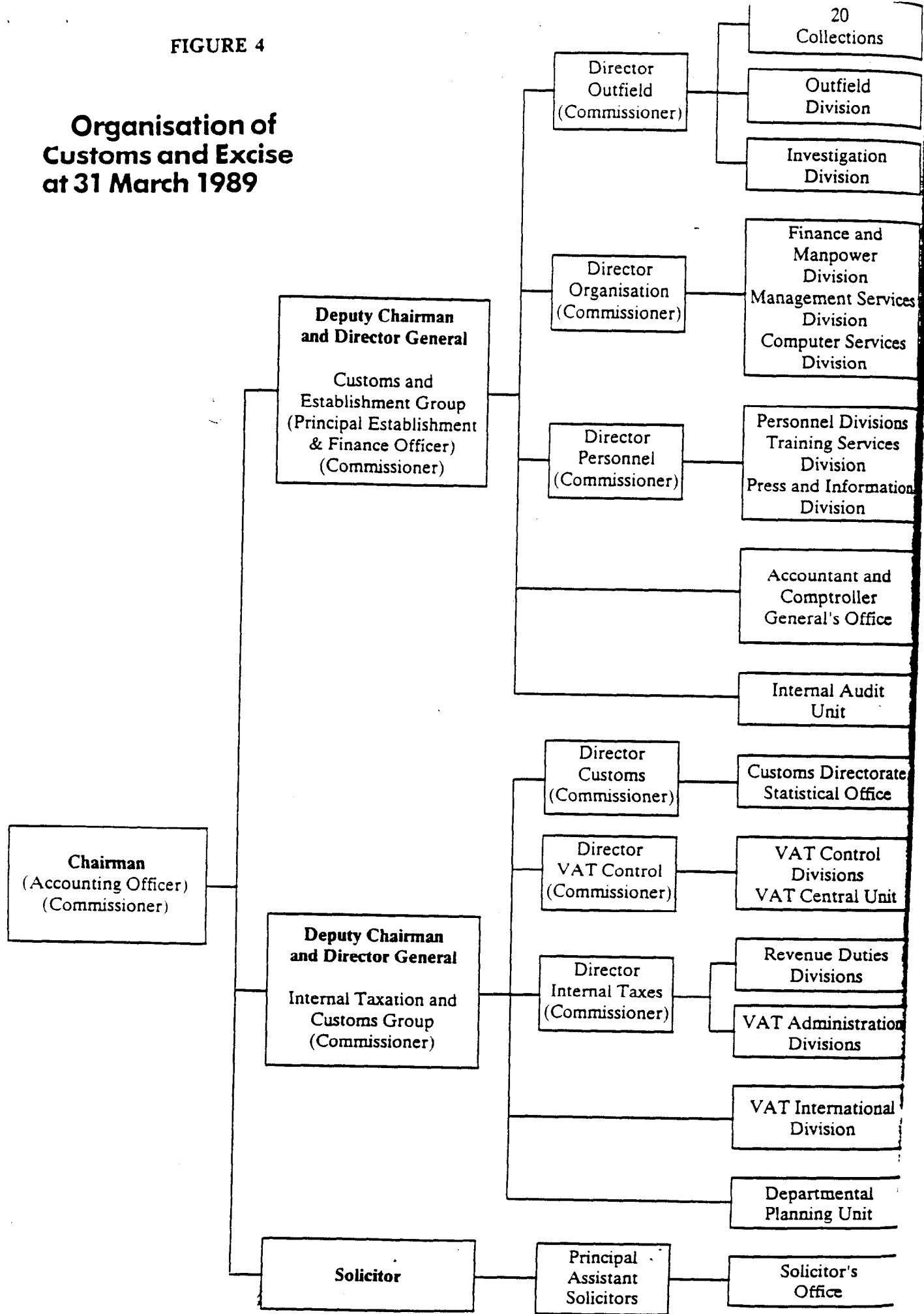
**Notes:**

This is an overview of the main provisions only. All penalties are mitigable depending upon the degree of taxpayer cooperation, disclosure by the taxpayer and the size and gravity of the offence (amount of tax at risk).

In all cases, default interest (Section 88, Taxes Management Act, 1970) is levied from the time the tax should have been paid to the time it is paid. The interest rate reflects market rates and the charge is rarely mitigated.

**FIGURE 4**

## Organisation of Customs and Excise at 31 March 1989



**FIGURE 5**

**TABLE**

**VAT PENALTIES**

**(operative on or before 1 January 1990)**

<u>Offence</u>	<u>Penalty</u>
Late VAT returns	"Default surcharge" Tax related penalties, 5-30% of tax paid late - linked to number of late returns
Serious misdeclaration (failure to declare liability or understating net VAT due)	30% of the tax which would have been lost (subject to certain conditions)
Persistent misdeclaration - persistent understatement of VAT liability in the VAT return	15% of tax lost following inaccuracy in the third and later VAT returns within a set time period
Late registration and unauthorised issue of VAT invoices	10% to 30% of tax lost
Criminal fraud: evasion of VAT involving dishonesty "beyond reasonable doubt"	Imprisonment up to 7 years and unlimited fines on conviction by an indictment in the Crown Court, or imprisonment for up to 12 months and fines up to 3 times the tax underdeclared on summary conviction in the Magistrates Court.
Civil fraud: evasion of VAT involving dishonesty on a "balance of probabilities".	Up to 100% of tax evaded, reduced by up to 50% for taxpayer cooperation
Breaches of regulatory provisions eg regarding retention of VAT records	Various, depending upon offence eg failure to keep VAT records for 6 years - maximum penalty £500.

Note: The penalty provisions for VAT evasion and breach of VAT regulations are complex. The above provides an overview of the main provisions only. Certain penalties may be mitigated for cooperation.

Interest is also chargeable on tax evaded or paid late.

TABLE 1

## ESTIMATES OF THE SIZE OF THE UK BLACK ECONOMY

Source	Method	Year	Estimate (% of GNP/GDP)
1 William Pyle (1979)	Guesstimate?	late 1970s	7.5
2 Macafee (1980)	National Income - expenditure discrepancy	1978	3.5
3 Feige (1981)	Cash transactions	1979	15.0
4 Matthews and Rastogi (1985)	Monetary trends	1983	14.5
5 Bhattacharyya, et al (1986)	Cash Transactions	1960-84	3.6 - 10.6
6 Brown et al (1984)	Labour market questionnaire	1980	0.3*
7 O'Higgins (1980)	Income - expenditure discrepancy at disaggregated level	1978	3.0
8 Dilnot & Morris (1981)	Family Expenditure survey, income - expenditure discrepancy	1977	2.5 - 3.0
9 Smith (1986)	Household incomes and spending	1982	Up to 5.0
10 Pissarides and Weber (1989)	Family expenditure survey, income - expenditure discrepancy	1982	5.0
11 Weck-Hanneman & Frey (1985)	Econometric modelling	1978	8.0

Note:

\* Second jobs only

**Table 2:**

**Numbers of Staff per Tax Office (averages)**

	<b>April 1978</b>		<b>April 1989</b>
<b>Tax Officers</b>			
Higher Grade	13.0	Revenue Executive	14.3
Tax officers	13.4	Revenue officer	21.3
Clerical Assistant	20.8	Revenue Assistant	15.2
Others	n/a	Others	5.4
Inspectors	7.8	Inspectors	8.4
Total	65.0	Total	64.6

**Source:** Inland Revenue Compliance and Collection Division.

**Table 3:**

**Inland Revenue: Number of Staff in Post at 31 March each year**

<b>Year</b>	<b>Number</b>
1950*	49,579
1960*	56,042
1970	68,632
1977	83,885
1978	85,175
1979	84,645
1980	78,312
1981	75,624
1982	73,976
1983	73,110
1984	69,832
1985	69,770
1986	69,260
1987	67,798
1988	66,612
1989	67,046

Note:

\* includes casual staff not identified separately before 1967.

**Source:** Board of Inland Revenue, *Annual Reports*, various years.

**TABLE 4 CRIMINAL PROCEEDINGS BY THE INLAND REVENUE IN RECENT YEARS**

Nature of offence	Number of persons convicted (acquittals in Inland Revenue proceedings shown in brackets)					1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
	1983/84	1984/85	1985/86	1986/87	1987/88						
False accounts or returns of income	a) 28 (2)	21 (1)	22	17 (2)	11 (6)	9 (1)					
False claims to personal allowances, deductions for expenses and repayments	a) 7(1)	4	3 (3)	3	4 (6)	3 (2)					
PAYE: False returns (offences by employers and pay clerks)	a) 20 (3)	23 (3)	19 (2)	18 (1)	9	9					
PAYE: Forgery, impersonation by employees	a) 1	—	—	—	—	N/A					
Sub-contractors exemption certificate frauds	a) 87 (5)	176 (2)	201 (7)	185 (9)	138 (4)	101 (1)					
Theft of payable orders and Giro cheques	a) 12 (10)	2	—	89	32	53					
Assaults on Inland Revenue officers	a) 3	1	—	—	—	—					
Internal frauds	a) 7	—	—	1 (1)	—	—					
Miscellaneous	a) —	2	6	4	5	11					
<b>TOTALS</b>		<b>244 (21)</b>	<b>312 (6)</b>	<b>414 (12)</b>	<b>459 (13)</b>	<b>322 (16)</b>					<b>363 (18)</b>

**NOTES**

- a) by the Board of Inland Revenue.
- b) by the Police.

Source: Inland Revenue, *Annual Reports*, 1988 and 1989.

TABLE 5

**Inland Revenue: Analysis of Investigation Cases  
involving interest and penalties**

<b>Year to:</b>	<b>No. of cases investigated</b>	<b>Total tax raised</b>	<b>Penalties levied (£'000)</b>	<b>Interest charges levied (£'000)</b>
31.3.72	11,069	13,282	1,968	2,332
31.3.73	11,792	15,431	2,943	2,355
31.3.74	11,787	16,111	3,111	2,341
31.3.75	11,707	17,291	3,365	2,541
31.3.76	12,702	23,226	4,467	3,761
31.10.76	13,561	22,823	3,793	3,488
31.10.77	15,626	37,297	6,100	7,362
31.10.78	18,521	46,815	9,106	9,909
31.10.79	21,298	63,312	11,720	13,760
31.10.80	22,465	78,890 <sup>2</sup>	14,732	17,539

Source: Board of Inland Revenue, *Annual Reports*, various years

1. Reporting date changes

2. In real terms the total tax raised almost doubled between 1975 and 1980.

## INLAND REVENUE: COUNTER-EVASION &amp; AVOIDANCE

Year	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Percent Increase 1980/89 <sup>2</sup>
£m											
Tax Offices	82.3	93.2	149.0	174.4	255.1	303.0	378.4	402.2	451.5	537.4	+552.9
Enquiry Branch	18.9	22.8	35.4	40.9	41.9	51.4	55.4	57.6	59.5	66.4	+251.3
Special Offices	20.5	28.8	50.1	52.9	52.6	100.1	91.9	118.5	134.4	101.7	+396.1
PAYE Audit	16.2	20.3	31.1	36.3	49.1	65.1	78.5	93.7	101.0	99.8	+516.0
Special Investigations	0.2	0.5	7.7	14.5	25.3	26.9	44.0	104.0	101.0	+49.9	+24,250.0
Other Head Office	137.9	165.1	265.6	304.8	399.2	594.4	694.5	741.3	877.3	955.0	+592.5
Total Yield (nominal terms)	182.0	188.2	231.1	246.9	307.4	433.9	479.2	489.3	552.7	563.5	+209.6
Total Yield (real terms <sup>3</sup> )	2324.0	2488.6	3123.9	3377.1	4401.9	6219.0	6918.8	7217.0	8297.3	9747.0	+3194
Total Yield in terms of staff (1980 prices)											
Total Yield in real terms per member of staff (1980 prices)											
Notes:											
1. Prior to 1982, figures relate to year to 31 October; from 1982 to years ending 31 March.											
2. Special Investigations Section 1985/89. Other Head Office Units 1983/89.											
3. Real figures were obtained by deflating the nominal yields by the UK retail price index.											
Sources:											
Basic data from Board of Inland Revenue, Annual Reports, various years.											

1. Prior to 1982, figures relate to year to 31 October; from 1982 to years ending 31 March.

2. Special Investigations Section 1985/89. Other Head Office Units 1983/89.

3. Real figures were obtained by deflating the nominal yields by the UK retail price index.

**INLAND REVENUE: Investigations by Tax Offices & Enquiry Branch**

Year/Type of settlement	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
No of cases resulting in interest & penalties	22,344	22,515	27,656	31,417	37,249	38,859	37,484	38,707	40,751	44,261
Additional tax only	30,870	32,589	35,649	35,392	33,585	31,747	27,105	22,949	20,702	20,296
Total cases involving interest and penalties	53,214	55,104	63,305	66,809	70,834	70,606	64,589	61,656	61,453	64,557
42.0	40.9	43.7	47.0	52.6	55.0	58.0	62.8	66.3	68.6	

Source: Basic data from Board of Inland Revenue, Annual Reports, various years.

TABLE 8

## INLAND REVENUE

## Yield from Tax Investigations in Local Tax Offices

£m y/e 31 March

Year	1983	1984	1985	1986	1987	1988 <sup>1</sup>	1989	Percentage Increase 1983/89 <sup>2</sup>
Accounts investigation	111.4	142.0	160.6	197.5	197.3	234.8	276.1	+147.8
Non-accounts investigations	59.7	79.5	94.6	99.6	127.3	127.9	137.6	+130.5
Schedule D compliance	3.3	6.3	8.0	17.2	22.5	35.1	55.5	+1581.8
Schedule E compliance	n/a	27.3	39.8	64.1	55.1	53.7	68.2	+149.8
Total (nominal terms)	174.4	255.1	303.0	378.4	402.2	451.5	537.4	+208.1
	141.3	196.4	221.2	261.1	265.5	284.4	317.1	+124.4

Source

	1980 prices <sup>3</sup>	1980 terms <sup>3</sup>	1980 prices <sup>3</sup>	1980 terms <sup>3</sup>	1980 prices <sup>3</sup>	1980 terms <sup>3</sup>	1980 prices <sup>3</sup>	1980 terms <sup>3</sup>
Figures relate to year to 31 October	174.4	255.1	303.0	378.4	402.2	451.5	537.4	+208.1
Schedule E compliance	Scedule E compliaance 1984/89	Real figures were obtained by deflating the nominal yields by the UK retail price index	Real figures were obtained by deflating the nominal yields by the UK retail price index	Real figures were obtained by deflating the nominal yields by the UK retail price index	Real figures were obtained by deflating the nominal yields by the UK retail price index	Real figures were obtained by deflating the nominal yields by the UK retail price index	Real figures were obtained by deflating the nominal yields by the UK retail price index	Real figures were obtained by deflating the nominal yields by the UK retail price index
Figures relate to 31 October	141.3	196.4	221.2	261.1	265.5	284.4	317.1	+124.4

Notes:

Sources:

Basic data from Board of Inland Revenue, Annual Reports, various years.

1. Figures relate to year to 31 October
2. Schedule E compliance 1984/89
3. Real figures were obtained by deflating the nominal yields by the UK retail price index

Year	No of regd traders at 31 March	No of staff directly employed on control	Ratios of regd traders to staff	No of staff directly employed on control	Average under-decl	Under-decl	Under-decl	Uncovered visits	Uncovered visits	VAT	Employed directly	Employed on control	as % of revenue	as % of revenue	outturn
1978/79	1,286,200	11,090	117	400,000	61	81	152	96	228	1.28	1,90	1,52	1.25	1.20	1.20
1979/80	1,327,200	10,614	126	368,000	84	96	142	146	409	1.28	1,90	1,47	1.25	1.25	1.25
1980/81	1,338,000	10,697	126	357,000	126	146	142	169	409	1.20	1,90	1,33	1.15	1.15	1.15
1981/82	1,379,500	10,614	133	358,000	133	169	147	290	472	1.20	1,90	1,33	1.11	1.11	1.11
1982/83	1,398,300	10,636	133	335,000	133	290	235	320	246	1.15	1,90	1,095	1.00	1.00	1.00
1983/84	1,433,100	10,831	133	350,000	133	290	235	350,000	914	1.11	1,90	1,095	1.00	1.00	1.00
1984/85	1,458,900	11,040	133	370,000	133	320	286	370,000	1,248	1.11	1,90	1,386	0.98	0.99	0.99
1985/86	1,477,480	10,945	136	397,000	136	396	342	397,000	1,401	1.00	1,90	1,401	0.99	0.99	0.99
1986/87	1,505,500	11,325	134	426,000	134	597	342	426,000	1,477	1.00	1,90	1,477	0.98	0.98	0.98
1987/88	1,554,000	11,615	135	443,000	135	614	387	443,000	+20.8	1.00	1,90	+20.8	-48.4	0.98	0.98
1987/88 to 1988/89	1,554,000	11,615	135	443,000	135	614	387	443,000	+811.8	1.00	1,90	+811.8	-48.4	0.98	0.98

Sources:

CM 453, London, HMSO, 1988, pp. 10-11, Table 1.

Basic data from, 79th Report of the Commissioners of Her Majesty's Customs and Excise for the year ended 31 March 1988,

TABLE 9

CUSTOMS & EXCISE: Summary of Investigation Results

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