

Confidential filing.

Review of counter-measures against tax  
evasion and the "black" economy.

ECONOMIC POLICY

February  
April 1981.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
<del>28-1-81</del>							
<del>30-6-81</del>							
<del>6-7-81</del>							
<del>Sept-82</del>							
<del>14-11-83</del>							
<del>16-11-83</del>							
3/6/85.							

PREM 19/1464



File  
THE BOARD ROOM  
INLAND REVENUE  
SOMERSET HOUSE

SIZE OF THE BLACK ECONOMY

Line to Take

Over the years there have been a number of estimates of the size of the black economy ranging from approximately 2 per cent to 16 per cent of GDP. Any estimate must contain a large amount of hypothesis. The Inland Revenue's estimate of the size of the black economy is in the range of 6 per cent to 8 per cent of GDP. This is kept under review and of course Professor Minford's report, on which we have no more information than appeared in Press Reports today, will be studied very carefully.

J MAWSON

Technical Division  
3 June 1985

J H ROBERTS Technical Division

### Background Note

The black economy is taken as that part of the economy which is not reported to agencies such as the Inland Revenue or Customs and Excise.

In March 1979 the then Chairman of the Board, Sir William Pile, told the Expenditure Committee that it was "not implausible" that the black economy could amount to 7½ per cent of GDP. This was a broad judgement made in response to much higher estimates - up to 15 per cent - by others. The view that the black economy amounts to between 6 per cent and 8 per cent of GDP has been reiterated by the Inland Revenue - most notably to the PAC in November 1981 and April 1982. Since then the topic has remained under review but there has been no substantive evidence to lead us to a different view.

The Revenue line on substantially larger estimates for the black economy has been that these are implausible.

A watch is kept of reports on the black economy in other countries, especially in the USA. Care has to be taken in drawing comparisons and it is interesting to note that estimates of the size of the black economy in the USA show similar large variations. Again none of these estimates have provided any information which would cause us to alter our estimate.

In view of the number of assumptions and hypotheses it is necessary to use in estimating the size of the black economy such estimates must vary widely. By its nature it is impossible to put any demonstrably correct figure on the size of the phenomenon. The report by Professor Minford will be reviewed by the Inland Revenue as part of the continuing interest in this topic.

# Black economy *TIMES* *3/6* 'now £45bn'

By Sarah Hogg, Economics Editor

The shadow or "black" economy unseen by the taxman was on the scale of 14.5 per cent of national income by 1983 - equivalent to nearly £45 billion, according to new estimates by the Liverpool Research Group.

This calculation, from a group of economists headed by Professor Patrick Minford, who is known to have influenced the Prime Minister's thinking, comes significantly on the publication day of the reviews of social security by Mr Norman Fowler, Secretary of State for Social Services.

The Liverpool estimates are larger than previous guesses as to the size of the black economy. They will add to the debate on the Fowler reviews, because the Liverpool group says that its research shows a link between the size of the black economy and the scale on unemployment benefits, one of the elements of the welfare state questioned by the reviews.

The new quarterly economic bulletin produced by the group also paints an optimistic picture of the British economy. Although it forecasts only 3.4 per

cent growth in real national output this year, it expects higher growth of 4 per cent next year, when most economic institutes are predicting a slowdown.

The Liverpool Research Group expects consumer price inflation to decline to 2.6 per cent in 1986, thus stimulating consumer spending; it also expects exports to be strong despite the slowdown in the United States.

The quarterly bulletin also forecasts a rise in public spending, which will erode the Chancellor's scope for tax cuts if he sticks to his financial strategy - an assumption on which the whole forecast is based. Professor Minford deplores this failure and also criticizes the Treasury for taking a short-term view in resisting policy changes (like the abolition of State earnings related pensions).

The Liverpool group forecasts a modest decline in unemployment. Its estimate of the number of jobless flattens out at 3.2 million during 1985, dropping to three millions in 1986 and 2.8 millions in 1987.

## Chapter 4

### Little Mo and the Moonlighters: Another Look at the Black Economy by Kent Matthews and Anupam Rastogi

The Black economy is a subject that most of us can claim to know something about. It is a subject that frequently turns up in the thick of 'pub gossip'. Just about everybody, in Liverpool at least, seems to know, or know of someone who is involved in moonlighting activity or has purchased the 'services' of a moonlighter. Most of us can relate the experience of being quoted two prices by a mechanic or builder, – the cash price and the cheque price. Yet despite the wealth of anecdotal evidence that exists there is no reliable estimate of the size of the Black economy. This is not surprising. By its very nature the Black economy is something that defies measurement. It lies on the very boundary of the illegal/legal divide and as such its *raison d'être* is concealment.

How large is the Black economy? How fast has it grown? Answers to such questions cannot even begin without some attempt to measure what some would consider to be the unmeasurable. Estimates of the size of the Black economy vary from around 3% of national income<sup>(1)</sup> to as much as 22% in the early 70's.<sup>(2)</sup> The 'semi-official' estimate is that provided by Sir William Pile<sup>(3)</sup> in his evidence to the House of Commons Expenditure Committee 1979. Sir William estimated the extent of tax evasion could be in the order of 7.5% of national income. Yet the Inland Revenue have never outlined the assumptions and methodology underpinning this estimate. It may represent no more than just a judgemental guess on the part of those officials who are in the 'front line' of the investigation into this activity. A cynic might be forgiven for thinking that the figure 7.5% is a particularly comfortable one. It is large enough to cause official concern and warrant further manpower resources to the Inland Revenue. However it is not so large that it would give the impression that the Board of Inland Revenue is not effective in this area.<sup>(4)</sup>

Independent estimates of the Black economy suggest that the figure could be almost 'double' that suggested by Sir William Pile. But what confidence can be assigned to any particular estimate? Certainly the standard error surrounding any estimate **could** be so large as to render the estimate meaningless in any economic sense. This paper attempts to estimate the size and growth of the Black economy, detailing the methodology and assumptions at each stage of the process.

There are two ways estimates of the Black economy can be obtained. The simplest but perhaps the most unreliable method is to ask people in the form of Sample Surveys. The problem here, is the representativeness of the sample and the honesty of the answers, particularly if people perceived the survey as an 'official' one. This approach can provide intriguing results on attitudes to tax evasion if this was the subject of the survey<sup>(5)</sup> but attempts to gauge its size as Dilnot and Morris (1980) do from the Family Expenditure Survey and Household Income surveys will necessarily provide underestimates as the respondents would perceive the survey as 'official' and will treat it with appropriate suspicion.

An alternative approach is to glean estimates from

observed statistics and employ economic theory to differentiate aspects of the official statistics that could be driven by Black economy activity from that of recorded economy activity. One suggestion is that since there is every incentive for the moonlighter to under-report his income but little incentive for the purchaser of such services to under-report expenditure, discrepancies between official estimates of national income based on expenditure and that based on income statistics are indicative of the Black economy.<sup>(6)</sup> Clearly not all the discrepancy could be attributed to the Black economy since some of it must represent the random component of measurement error. However, if the initial gap between GDP(E) and GDP(I) which is referred to as the Initial Residual Difference (IRD) can be shown to have a systematic component which in turn is explicable in terms of an indicator of tax evasion (say the tax rate), then the gap can truly be considered to be symptomatic of increasing underground activity.<sup>(7)</sup>

Again such methods do not provide us with an estimate of the size. The expenditure estimate itself could be deficient in that those involved in underground economic activity would wish to disguise their expenditure if they are already underreporting income. The non-response rate to the Family Expenditure Survey on which the expenditure estimates are based is 30% and the non-response rate by that group who are most likely to be involved in Black economy activity (the self-employed) is in excess of 40%. Such figures do not instil confidence in this method of measurement.

Another, more aggregate, method is to gauge the size of the Black economy from official currency statistics. The underlying assumption here is that those engaged in Black economy activity would prefer payment in cash and offer appropriate discounts for cash payments. Consequently the scale of Black economy activity will show up in the figures for notes and coin. Such an approach has been applied to the US by Gutmann (1977) and Feige (1979). Their estimates of the Black economy are 10% and 33% of national income respectively. Gutmann derives his estimate from the trend in the ratio of currency to deposits on the assumption that the ratio that prevailed in 1937 is 'normal'. Feige obtains his estimate from the Fisher Quantity theory identity ( $MV \equiv PT$ , where M is currency plus cheque accounts and V is transaction (not income) velocity of income). In the absence of the Black economy the ratio of PT (where P is the price level and T is an index of transactions) to nominal income will be a constant. Independent estimates of PT are obtained and the

(1) Dilnot and Morris (1980).

(2) Feige (1981).

(3) Former Chairman of the Board of Inland Revenue.

(4) It is interesting to note that the US Internal Revenue Service estimated the Black economy in 1979 to be in the range of 5.9 to 7.9% of GNP. See Internal Revenue Service Estimates of Income Unreported on Individual Income Tax Returns (Washington, D.C., September 1979).

(5) See, for instance, Miller (1979) and Clarke and Matoney (1984).

(6) See MacAfee (1980).

(7) Such an approach was taken by Matthews (1984) who found that 70% of the variation in the IRD could be explained in terms of a representative average tax rate.

corresponding size of total income, both white and black, is then calculated.

Ingenious though this method is, a fundamental flaw in its analysis is that it fails to separate out changes in the currency-deposit ratio and velocity of income due to changes in the conventional influences on the demand for money, such as interest rates and income, and changes in Black economy activity. Empirical models that have tried to differentiate between these two influences have been originally estimated for the US by Cagan (1958) and more recently by Tanzi (1980) (1983). In the UK an empirical study was originally conducted by Shepard (1969) and more recently by Matthews (1982).

The purpose of this chapter is twofold. First to estimate an empirically stable demand for money and second to derive estimates of the Black economy from it.

The elevation of monetary base (M0) to the status of an intermediate target within the Medium Term Financial Strategy has meant that macroeconomic models have had to hurriedly incorporate an empirical relationship representing the demand for M0.<sup>(8)</sup> The original specification for the demand for real balances in the Liverpool Macroeconomic model was in terms of M1. The shift in emphasis towards M0, a move we have fully endorsed in previous Bulletins, has resulted in the incorporation of a demand for real M0 to replace the original specification. The specification draws on conventional empirical findings. The demand for real money base is posited as function of the short-term rate of interest and real income defined as measured disposable income and unmeasured (Black economy) income. The demand for currency has to satisfy the transactions motive for both white and black income. The second purpose of the investigation is to indirectly evaluate the size of the Black economy by positing a secondary behavioural function linking the size of the Black economy to its determinants.

An obvious determinant of the size of the Black economy is the tax rate. As the tax rate rises people substitute moonlighting for overtime and regular forms of work. Small firms are also likely to take on casual labour not strictly on 'the books' at a wage rate beneficial to both employer and employee. Similarly employers' contributions could play a part in determining the Black economy. Again a rise in employers' contributions provides the incentive for small firms to take on unofficial labour. The sum of the employers' tax rate and the employees' tax rate represents the gap between what the employer pays and what the employee receives. This is the **wage gap**. The larger the wage gap the greater the incentive for both employer and employee to collude to purchase labour services at mutually beneficial rates. Hence both employers' and employees' tax rates contribute to the Black economy.

Another important variable is the level of real unemployment benefits. It has already been shown that this variable is a key determinant of the natural or equilibrium level of unemployment.<sup>(9)</sup> In point of fact all three variables are supply-side factors that determine the actual and natural rate of unemployment. The rise in permanent unemployment is linked to these three variables but

particularly unemployment benefit which puts a floor on the wage in the non-union sector. It also represents the implicit subsidy to Black economy activity. Workers with a low marginal value product for labour will frequently find themselves 'better off' on the dole by supplementing their family income with Black economy work. The movement of these three supply-side variables over the post-war period is charted in Minford et al. (1983) and is represented in the following two charts. Real unemployment benefits for a married man with two children (including ERS) rose 32% in real terms between 1961 and 1983. Employers' contributions rose by 7.3% of the average wage and average tax rates (including NIC) rose by 11.9% of the average wage.

CHART 1: REAL UNEMPLOYMENT BENEFIT

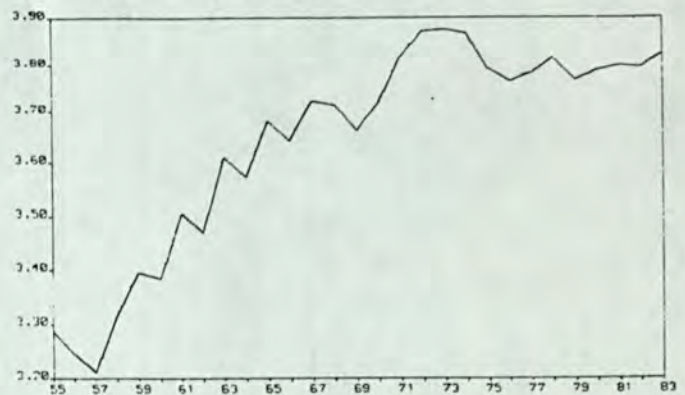


CHART 2: EMPLOYEE CONTRIBUTIONS AND AVERAGE TAX RATE



It turned out that the one-year lag in interest rates performed better than the contemporaneous value. But this could be due to timing problems in the data. Both real M0 and interest rates are annual averages whereas an end period stock would perhaps have been more appropriate. The preferred specification performs well in estimation with a high coefficient of determination, parameters that appear significant at conventional levels and the ordinary least squares specification passing a conventional test for stability in the parameters.

Too much cannot be claimed for parameters based on 27 observations but the statistical significance of the supply-side variables are at least indicative of hidden activity. The size of the Black economy is derived from the instrumental variable estimates, and presented in Table 1. The base year was taken as 1960; the size of the Black economy was assumed to be negligible in this year.

<sup>(8)</sup> A recent Government Economic Service publication outlines the Treasury's view on the demand for M0. See Johnston (1984).

<sup>(9)</sup> See Minford et al. (1983)

The methodology of evaluating the size of the Black economy from the demand for money is outlined below. The desired demand for real balances is hypothesised as:

$$\log \left( \frac{M}{P} \right)^* = \alpha_0 - \alpha_1 R + \eta \log Y^T \quad (1)$$

where M is M0, P is the price level, R is the interest rate,  $Y^T$  is total disposable income and an \* denotes a long-run desired level. Total disposable income is defined as

$$Y^T = Y(1-t_y) + Y_u \quad (2)$$

where Y represents observed income and  $t_y$  represents the average tax on labour. Consequently  $Y(1-t_y)$  is a proxy for disposable income. The variable  $Y_u$  represents unrecorded or Black economy income.

To equation (1) we add a conventional costs of adjustment schema.

$$\log \left( \frac{M}{P} \right) - \log \left( \frac{M}{P} \right)_{-1} = \lambda \left[ \log \left( \frac{M}{P} \right)^* - \log \left( \frac{M}{P} \right)_{-1} \right] \quad (3)$$

$0 < \lambda < 1$

Substituting (1) and (2) in (3) we have:

$$\log \left( \frac{M}{P} \right) = \alpha_0 \lambda - \alpha_1 \lambda R + \lambda \eta \log(Y(1-t_y) + Y_u) + (1-\lambda) \log \left( \frac{M}{P} \right)_{-1}$$

which can be rewritten as:

$$\log \frac{M}{P} = \alpha_0 \lambda - \alpha_1 \lambda R + \lambda \eta \log Y(1-t_y)(1+k) + (1-\lambda) \log \left( \frac{M}{P} \right)_{-1} \quad (4)$$

$$\text{where } k = \frac{Y_u}{Y(1-t_y)}$$

At this stage we introduce the subsidiary hypothesis on the determination of the Black economy.

$$k = \gamma + \beta t_y + \delta t_e + \phi \log B \quad (5)$$

where  $t_e$  is the employers' labour tax and B is the real level of unemployment benefit.

Substituting (5) in (4) and noting the approximation that  $\log(1+k) = k$  and adding a stochastic term we arrive at our final estimating equation.

$$\log \frac{M}{P} = \pi_0 - \pi_1 R + \pi_2 \log Y(1-t_y) + \pi_3 t_y + \pi_4 t_e + \pi_5 \log B + \pi_6 \log \left( \frac{M}{P} \right)_{-1} + V$$

where V is an error term.

The size of the Black economy as a proportion of GDP can be derived from an arbitrary base level as:

$$\frac{Y_u}{Y} = (\pi_3 t_y + \pi_4 t_e + \pi_5 \log B)(1-t_y) / \pi_3$$

TABLE 1: Black economy income as % of GDP

Year	GDP(E)	Black economy as % of GDP(E)	Total Income	Growth
1961	128622	3.0	132480	6.6
1962	130145	2.6	133529	0.8
1963	135636	4.8	142147	6.5
1964	142853	4.9	149853	5.4
1965	146607	7.4	157456	5.1
1966	149476	7.6	160836	2.1
1967	153646	10.3	169472	5.4
1968	160605	10.9	178111	5.1
1969	163171	10.9	180957	1.6
1970	166388	12.8	187686	3.7
1971	170554	13.3	193238	3.0
1972	172965	13.1	195623	1.2
1973	187037	13.3	211913	8.3
1974	185509	14.3	212038	0.0
1975	184317	14.3	210674	-0.6
1976	191496	14.0	218305	3.6
1977	193593	14.1	220890	1.2
1978	199355	14.1	227464	3.0
1979	203053	13.0	229450	0.9
1980	199317	13.8	226823	-1.1
1981	197477	14.6	226309	-0.2
1982	200339	14.7	229788	1.5
1983	207172	14.5	237212	3.2

We considered two alternative specifications for the proxy for disposable income. One was an adjustment based on total government tax receipts as a proportion of income (on a national accounts basis). This is an aggregate tax rate (see table 0 of Chapter 2) and includes indirect taxes as well as capital taxes. The other was the average tax rate faced by a married man with two children.<sup>(10)</sup>

The specification that included the average labour tax performed better in estimation. We report both the ordinary least square and instrumental variables estimates for this specification.

In contrast to earlier estimates, it appears that the greatest growth in the Black economy occurred in the 1960's. The 1970's saw a continuation in the growth of the underground economy to a plateau of around 14%. The average growth in total income in the 1960's was around 4.0% and in the 1970's this was 2.3%. During the 60's the growth in measured income was usually less than in total income, but interestingly the downturn in measured activity in the 70's and in 1980/81 is greater than that for total income. This means that in the down phase of the

(10) The reason for this somewhat arbitrary measure is because the existing model does not contain a tax rate that would readily translate the conventional measure of disposable income to GDP.

Dependent variable is  $\log \left( \frac{M}{P} \right)$ ; sample 1957-1983; 't' values in parenthesis.

	Constant	$R_{-1}$	$\log Y(1-t_y)$	$t_y$	$t_e$	$\log B$	$\log \left( \frac{M}{P} \right)_{-1}$	$R^2$	F
OLSQ	-2.463 (1.39)	-.660 (1.48)	.565 (2.76)	.304 (1.47)	.178 (1.53)	.120 (1.83)	.622 (6.38)	.9837	.15
CHOW (15, 12) = 1.08									
INST	-2.915 (1.57)	-.545 (1.52)	.635 (2.71)	.332 (1.90)	.188 (2.33)	.114 (1.92)	.598 (6.19)	P = -0.28	-.09
P = 1st order AR. coefficient									

business cycle, the Black economy acts as a buffer mechanism or a safety valve, absorbing the shock. The estimates for the 80's are similar to that obtained by Matthews (1983). The size of the Black economy appears to have reached a kind of saturation level. The reduction in employers' contributions and average taxes in 1983 more than offset the 3% rise in real benefits leading to a stabilising in the size of this sector. The reduction in the rates in the coming years coupled with the abolition of the National Insurance Surcharge will further provide the necessary ingredients for a reduction in the Black economy and a substitution back into the observed economy.

In conclusion, we have obtained a stable demand for M0 which satisfies both theoretical and empirical priors. We have also obtained estimates of the size of the Black economy which confirm the results of previous studies. The size of the Black economy in 1983 amounts to around £1100 in 1980 prices per member of the working population. We have carefully outlined the assumptions and methodology employed in obtaining our estimates. This must represent an advance on 'ad hoc' empirical models. The figures we present are not implausible and can be justified in the context of the theory employed. Needless to say, further work has to be done in refining methods of estimation. We found no role for VAT in our estimates; it would seem therefore that our figures, if anything, still represent an underestimate of the full size of this burgeoning and productive sector. The implications for the official measures of output and unemployment are obvious.

#### Date definition

- M0 Wide Money Base annual average.
- P Consumer Price Index 1980=100.
- Y GDP expenditure at factor cost, 1980 prices.
- ty Average amount lost in taxes and national insurance for married man + 2 children (Proportion of average earnings).
- te Employers' national insurance contributions (proportion of average earnings).
- B Real benefits for married man + 2 children, including school meal, + 30% weight on ERS.
- R Treasury Bill rate annual average.

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se BT

Note Prime Minister discussed this with C/Ex. He explained the background, in particular need to satisfy PAC and need to maintain equity between day full time plumbers and moonlighters. Prime Minister not totally convinced but agreed on the understanding that figure of 850 would be approached gradually.

PRIME MINISTER

Inland Revenue and the Black Economy

I have discussed with the Treasury your suggestion that Inland Revenue manpower devoted to tax evasion should be increased from 70 to 200. This is causing the Treasury some difficulty. My letter of 15 Nov stands. ATM informed.

Originally a pilot project of 70 men was established. The Chancellor believes that this has been proved to be cost-effective and the time has now come to choose between winding-up the experiment or extending the effort nationwide.

The Chancellor has been over these proposals in some detail with Inland Revenue who originally proposed devoting over 2,000 men to this task. He decided to recommend 850 which presents approximately one man in each tax district. He does not feel that he could justify, say to the PAC, covering only part of the country. Sir Robert Armstrong's minute of 15 November does not meet this point.

On the question of announcement, the deployment of staff will have to be disclosed to the unions and as a result is likely to become public knowledge. In consequence the Chancellor feels he has no choice but to make a proper announcement.

You may feel that in the light of this you can now agree to the Chancellor's proposals. Alternatively you could raise this with the Chancellor at the bilateral tomorrow morning though he will want to devote most of the time to the Autumn Statement.

16 November 1983

AT 19/11

AT

mf

1 copy in the  
district



10 DOWNING STREET

Prime Minister ①

After I had minuted out  
you a agreement to the  
Chancellor's proposals, Sir  
Robert Armstrong minuted  
suggesting no increase in  
the anti-evasion effort and  
no announcement.

After discussion with Sir  
Lawrence Avey, he put  
in a new minute - attached.

I see no reason for you  
to come to a different  
conclusion but thought  
you might like to be  
aware of this

Sir Robert's minute <sup>AT</sup> 15/11  
echoes my own original  
feelings - I think it would  
be better to proceed more

slowly - say to go  
from 70 to 200 and  
no announcement. Let us  
be then whatever happens.  
not



Ref. A083/3259

MR BUTLER

Inland Revenue Manpower and the Black Economy

I minuted you about this yesterday (Ref. A083/3245). with AT

2. Sir Lawrence Airey has now seen a copy of my minute. He said that the CPRS report on the black economy had demonstrated that there was no ground for thinking that the black economy had been helping to maintain the level of economic activity and to dampen the adverse effects of a high level of unemployment, since increased activity in the black economy depresses activity in the "white" economy. To the extent that the detection of tax evasion in the black economy takes resources out of the black economy it puts them at the disposal of the Chancellor of the Exchequer to redistribute more in accordance with the Government's economic objectives. Sir Lawrence Airey tells me that the Chancellor of the Exchequer and Treasury officials have accepted the CPRS analysis.

✓ 3. I remain less than totally convinced by this. My instinct is that the total level of economic activity has been higher as a result of the black economy because some of the activity now undertaken in the black economy would not occur if it was caught by Inland Revenue taxation and VAT. But I clearly cannot prove that; and I note from Sir Lawrence Airey that it would be advantageous, in presenting further manpower cuts in the Inland Revenue to the Civil Service unions, to be able to say there is some redeployment of staff into the detection of tax evasion in the black economy. I would not wish my point to be proceeded with, if the Prime Minister is content that the Chancellor of the Exchequer should go ahead as he proposes.

4. I am sending copies of this minute to the Private Secretaries of the Chancellor of the Exchequer and Sir Lawrence Airey.

RA

15 November 1983

ROBERT ARMSTRONG

No if  
don't -



10 DOWNING STREET

*From the Private Secretary*

15 November 1983

Inland Revenue Manpower and the Black Economy

The Prime Minister has seen the Chancellor's minute of 10 November and has agreed to the expansion of the effort to tackle tax evasion in the black economy. She has also agreed to announcement of this through a Written Answer.

I am sending a copy of this letter to Richard Hatfield (Cabinet Office).

Andrew Turnbull

Miss Margaret O'Mara,  
HM Treasury.

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Not sent to PM  
AT 15/11

File

Ref. A083/3245

MR BUTLER

Inland Revenue Manpower and the Black Economy

*with AT*

The Chancellor of the Exchequer sent me a copy of his minute of 10 November, proposing a redeployment of 850 Inland Revenue staff to work on the problem of tax evasion in the black economy.

2. I can see the arguments for wanting to tackle the problem of "moonlighters" and "ghosts". But in the wider interests of maintaining the level of economic activity I wonder whether this is a matter on which it makes sense to be quite as officious as the Chancellor suggests. There is some reason to think that the black economy has been helping to maintain the level of economic activity and to dampen the adverse effects of a high level of unemployment. There is something to be said for leaving well alone, at any rate while unemployment is at its present level.

3. I should therefore be inclined to argue that it would be better for the Inland Revenue to discontinue this work, or perhaps to keep it at its present level of 70 staff and not to make the increase now proposed by the Chancellor of the Exchequer. That would presumably have the additional advantage of enabling the Inland Revenue to make a larger reduction of staff - nearer 8,000 than 7,000 - in the period up to 1988.

4. If the increase in the level of staff is to go ahead, I think it is a question of whether we really need an announcement.

5. I am sending a copy of this minute to the Private Secretary to the Chancellor of the Exchequer.

*14*

Approved by  
ROBERT ARMSTRONG  
*and signed in his absence.*

14 November 1983

CONFIDENTIAL



10 DOWNING STREET

From the Private Secretary

Prime Minister

Initially you resisted the Treasury's proposals but eventually agreed. Treasury originally proposed deploying 400 base men, but went ahead with an experimental 70. They think they earned their keep and now propose 850.

You might like to see the minutes Tim Lankster wrote. I agree with him. This need not be a dampener on the economy if the tax collected is used to lower tax rates generally rather than to finance more public spending

AT 11/11

✓ NO



Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

PRIME MINISTER

**INLAND REVENUE MANPOWER AND THE BLACK ECONOMY**

In 1981 Geoffrey Howe, with your agreement, authorised the experimental deployment of 70 Inland Revenue staff to tackle the problem of "moonlighters" (whose second job is self-employment) and "ghosts" (those who are not on the Revenue's books at all). The experiment has proved very successful, showing a high detection rate, with a first-year revenue yield of four and a half times the staff cost, subsequently rising to ten or more times the cost.

2. None of this work I might add, has damaged the interests of small traders or aroused adverse comment from the trading community, or in Parliament or the press. In fact, the Revenue have received encouragement from small businessmen and others in their efforts to bring this type of tax evader to book, on the grounds that those who honestly pay their dues to the community need protection against unfair competition by tax evaders.

3. With only 70 staff doing this work, the Revenue have inevitably been able to cover only a very small part of the country. It would be very difficult to justify such discrimination in the level of tax enforcement on a permanent basis, and the time has come to decide whether to extend this effort nationwide or to discontinue it altogether. Accordingly, I have approved the redeployment of 850 staff to this work in the period up to 1988. After taking account of this I aim to make a reduction of some 7,000 in Inland Revenue staff over the same period.

4. It would not be possible to make this redeployment without it becoming known. In fact, I believe there would be advantage in a public statement. I am therefore proposing to make the announcement in a Written Answer and I attach a draft.

5. I am sending a copy of this minute to Sir Robert Armstrong.

Margaret O'Mara

(N.L.)  
10 November 1983

(approved by the Chancellor  
and signed in his absence)



Q. To ask Mr Chancellor of the Exchequer, how the Inland Revenue staffing figures for 1984-88 will affect the Department's work on tax evasion and the black economy.

A. The new manpower targets will still enable the present level of investigation work against tax evasion to be maintained generally. For work in the area of 'ghosts' (people unknown to the Revenue) and 'moonlighters' (those with undeclared income from secondary occupations), I have approved the redeployment of 850 staff over the four-year period. This is a substantial increase on present levels of investigations in this area.

Econ Pol,  
Feb 1981  
Counter Measures  
against the Black  
Economy.

11 NOV 1983



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*Econ Pol.*

*attached*

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**THE BLACK ECONOMY**

A report by the CPRS

Contents

	Page
1. Introduction	1
2. Who participates in the black economy? How big is it?	7
3. The effects of the black economy on the whole economy and on society	15
4. Harnessing the energies of the black economy	24
5. Enforcement and monitoring	29
6. Summary and list of recommendations	44
Annex A Studies of the size of the black economy	50
Annex B The enforcement work of the revenue and benefit departments	71

September 1982

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**CHAPTER 1 - INTRODUCTION**

**Structure of report**

1.1 In commissioning this study of the black economy, the Prime Minister asked for as thorough an assessment as possible of the facts; and she referred particularly to the relevance of the black economy to enterprise, the will to work and unemployment. In this report we look at the nature of the black economy (this Chapter); at its composition and the mostly quixotic attempts which have been made to quantify it (Chapter 2); and at its worth (Chapter 3). We also consider how some at least of the energy manifested in it could be harnessed to the white economy (Chapter 4). Finally we examine ways of controlling its size through enforcement (Chapter 5). A summary of our conclusions is provided in Chapter 6 along with a list of our recommendations.

**Definition**

1.2 First we need to make clear what we mean by the phrase 'black economy': it is commonly used as if it denoted something obviously separate from normal economic activity, but on closer examination the boundaries turn out to be imprecise and shifting.

1.3 By 'black economy' we mean that part of the production of goods and services in exchange for money (or money equivalent) which is not declared to the authorities, and where there is underpayment of tax or overpayment of social security benefits. We thus include for example -

- a. The full-time self-employed window-cleaner who earns enough to be liable for income tax but is unknown to the Inland Revenue: he is a 'ghost'.
  
- b. The ambulance driver, paying tax on his regular income, who also undertakes building work in his spare time, and avoids tax on his income from that source: a 'moonlighter'.

- c. The self-employed businessman who understates his earnings and overstates his expenses in his tax return.
- d. The prosperous company director who charges some of his living expenses to the company.
- e. The immigrant garment worker for whom no income tax or national insurance contributions are paid.
- f. The restaurant waitress who declares only a fraction of the tips she receives.
- g. The 'unemployed' worker who works to increase his family's income above the level of social security benefit he receives, and does not declare the extra income: 'working and drawing'.
- h. The owner of a large house who does not declare rent income from letting some of its rooms.

1.4 There is no received definition of the black economy and we have drawn the boundaries of this study in the way which seemed most sensible to us. So our definition excludes some activities that others might have included - for example the huge amount of unpaid work that takes place within households, families or communities. All this adds to the national product, in some unquantifiable sense, but is not taxable. We have devoted some considerable space to tax evasion, none to tax avoidance (which is legal). We have not made a special study of pilfering and other criminal activities although taxability may be an issue. We have not looked at certain types of social security fraud (such as giro cheque fraud) where paid work is not involved.

1.5 The Inland Revenue believe that the bulk of tax evasion is committed by moonlighters (example b in paragraph 1.3 above) and by the self-employed (example c); together these groups may be concealing between £8 bn and £12 bn of their income, or between 4 per cent and 6 per cent of GDP in 1981. As we see later the other components of the black economy are relatively small; for instance the 'working and drawing' component (example g) may amount to no more than £½ bn or ½ per cent of GDP (see paragraph 2.14).

1.6 The examples in 1.3 by no means exhaust the variety of people and trades involved, or laws and regulations broken. They do however illustrate an important point. The black economy is not the prerogative of one section of society. Its practitioners (and its customers) are to be found in the pages of 'Who's Who' as well as on the unemployment register. If, in current usage, the typical member of the black economy is the man providing cheap house maintenance services in return for cash, it is perhaps because he is the newest and most visible recruit. What is new is not the service he performs, but the fact that, with the lowering of the level at which income tax is paid compared with the average wage, he has in recent years become liable to tax. (In 1938-9 fewer than 4 million people were assessed for income tax; today the figure is over 20 million). The black economy is as old as taxation itself. But it is only since the second world war that, by bringing the vast majority of the working population into income tax, the Government has itself widened enormously the scale of potential tax evasion. (The introduction of VAT has had a similar effect, by increasing the number of taxable transactions.) Thus the single handed house painter or plumber has, for the first time, the chance to join the much older ranks of the tax evaders and the welfare scroungers.

**The two faces of the black economy**

1.7 If an essence can be distilled from the wide variety of black economy activities, it is that of challenge to the state, not only as grinding tax-collector but also as faceless bureaucrat, mindless regulator and hostile purveyor of charity. In classical economics, efficiency depends on a free market bringing the wishes of producers and consumers into concordance. A worker will work hard and long to the extent that the wages he obtains make up for his effort, and the employer will pay them up to the point where they equal his marginal product. Taxation, or loss of benefit as earnings increase, make this concordance impossible, since the worker brings home less than the employer pays. Distortions to the free market are also imposed by regulations, by form-filling, by employment protection and general interference. From this point of view, the black economy is in a sense a pure economy, freed from the trammels of the state; the archetypal entrepreneur is the 'ghost'. Nor are these advantages merely theoretical. Anecdote, for want of a better source, suggests that at least some black economy workers

do a better job, more quickly and more cheerfully, than their tax-paying competitors. Part of this may be due to satisfaction at beating the system, but part also to the fact that 100 per cent of the extra amount earned can be kept. It is not the case that the only good work is done in the black economy, but some of it is. Even 'working and drawing' shows that some people are prepared to go out and market their services successfully in bleak conditions of high unemployment.

1.8 Seen from this point of view, therefore, the black economy reminds us of how (in certain respects only) economies once worked, and of where the state may have gone wrong. Perhaps the extreme example of this is the Soviet Union, where the economic regime is so oppressive, complicated and inflexible that a large black economy must flourish if the economy is to work at all. In the West, much of the vigour and resilience of the Italian economy is said to come from the 'black' manufacturing sector. In this country the black economy is unlikely to be crucial to our economic survival, but it might be a nursery of human resources for economic resurgence. And if it helps to make formal unemployment more bearable it may have an important social function.

1.9 But there is another side to the story. Few people would be prepared to see the state wither away. Most people would agree that we need defence forces, even though there is argument about their nature and extent. Similarly, we need law courts and police; and most people want some provision of education, health care, and financial support for the very poor, and some regulation, eg of child labour. There is disagreement about the extent of state activities, and pressure to push them back after the growth of earlier decades. But again there is general acceptance of our democratic system and the laws of the land as the framework for arguing over the extent of state responsibility, and hence there is also acceptance of taxation as the means to pay for it. In other words, most people who want, for example, adequate defence forces are also in principle willing to contribute their fair share of the cost of defence through taxation. Tax evasion and welfare fraud both increase the tax burden borne by honest members of the community, thus making them poorer and increasing market distortion. Moreover, a trader

who is evading tax can charge a lower price for his goods than is possible for his honest competitor. The latter's resentment is well founded, and he may find himself forced to choose between curtailing his business or evading tax himself, thus further increasing the burden on honest tax payers.

1.10 There are thus two fundamentally different approaches to the black economy. One sees it as a useful antidote to state interference, with useful side-effects; the other as a fraudulent attempt to slide out of paying a fair share of taxation while continuing to enjoy its fruits. Most people's attitudes probably contain elements of both approaches. For example, it seems to be a fairly common view that tax should be paid on ordinary earnings in the daytime, but that there is not the same obligation to declare income from overtime and second jobs. Actual behaviour is affected not only by moral beliefs but also by the perceived likelihood of getting caught and paying a penalty. People may find their way in to the black economy through sheer inertia or ignorance and then stay in for fear of being caught coming out. They may nevertheless resolutely condemn other parts of the black economy. Contrariwise, citizens who are entirely honest in their own tax affairs may condone or encourage dishonesty in others, for example when asked to choose between a higher price for a service including VAT, or a lower price, payable in cash, no questions asked. And while there is often strong antagonism to 'working and drawing', not least from honest neighbours who do not have the benefit of two incomes, there is also sometimes opposition to the 'snooping' and other methods of enquiry which may be necessary for its detection.

#### **A way forward**

1.11 This public ambivalence, sometimes verging on muddled thinking, about the black economy is an important political fact, since it is likely to limit the Government's freedom of action in the area. It is tempting to suggest a way out of the ambiguity. The present Government, it could be argued, has gone a long way in its attempts to cut down the unnecessary burden of the state. Maybe there is more to be done; but now people should obey the law and pay their taxes honestly so that the total tax burden can be spread as widely and therefore as lightly as possible. But this argument on its own will have little effect on people's behaviour. Other means at the Government's disposal for



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tackling the black economy are also likely to affect the problem only at the margin. We believe therefore, that it would not be useful to try to reach a firm conclusion whether the black economy as a whole is a good or a bad thing. Instead our approach will be to look at particular facets. Where they have potential value, are there ways in which the benefits can be transferred to the regular economy? Will they then do better, freed of the constraint of concealment? Where there are harmful features, can a simplification of the structure or a rearrangement or strengthening of controls lessen the damage, or would the costs outweigh the benefits? It would be wrong to expect instant solutions. Equally, it would be wrong to decide in advance that no policy changes can be made, not least because the black economy is in effect a creation of government itself.

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## CHAPTER 2: WHO PARTICIPATES IN THE BLACK ECONOMY? HOW BIG IS IT?

2.1 The black economy is to be found everywhere: we cannot here do justice to its width and complexity. We shall briefly outline some characteristics of the main groups operating within it.

2.2 The self-employed and small owner-run companies frequently evade taxes - for example by underdeclaring their profits and turnover, by drawing on the takings for personal use and by use of property belonging to the business. These enterprises are largely in the services sector (eg retail distribution and household services such as plumbing) and in construction. Preliminary results from an Inland Revenue study of a sample of self-employed traders are that up to 20 per cent of them give clear indications of significant evasion, 40 per cent show weak indications and the remaining 40 per cent show no indication of evasion. After investigating suspected traders the Inland Revenue obtain settlements in which the amount of under-declared profits agreed with tax payers is, on average, about £2,000 pa, or 40 per cent of declared profits, but the true amount of under-declaration is likely to be significantly larger. On this basis Inland Revenue estimate that the total amount of under-declared profits by the self-employed may be as much as £2.5 bn pa (see paragraph 41 of Annex A for details of their calculation). They will be able to provide firmer estimates in 1983 when their sample study will be complete. Customs and Excise have a similar experience. They discover under-declaration of VAT by over 37 per cent of registered traders, with cash traders being particularly prone (eg 46 per cent of pubs); the average amount of VAT under-declaration in these cases is in excess of £1,000; they believe that the total amount of VAT evaded is in the region of £200m to £400m a year.

2.3 Inland Revenue believe that there is relatively little evasion by employees in relation to the earnings from their primary employment because most employers meet their obligation to deduct tax and national insurance contributions through the PAYE system. Evasion is limited mainly to cases where employer and employee collude, eg by paying wages in cash and not reporting them, and by abusing the provisions that allow casual workers to be paid without deductions. Other examples are waiters under-reporting tips and employees inflating their expense accounts.

2.4 By contrast moonlighters (people doing a second job) constitute a large part of the black economy. Some moonlighters do of course pay their taxes, but many of them conceal part or all of their secondary earnings. The Family Expenditure Survey reports that about 9 per cent of the employed population have a second job and the true proportion may be much higher. A very high proportion of these second jobs, perhaps 90 per cent, are in the services sector, and they are mostly done for a few hours a week or irregularly. The majority of moonlighters work for somebody else (eg as a barman or petrol pump attendant) but a third or more are running their own business on a part-time basis - anything from hairdressing to servicing cars. Some will be using this as a trial period before setting up in business full-time.

2.5 'Ghosts' are mainly people who trade on their own account but manage to keep their activity secret from the Inland Revenue, often for many years. This may be quite widespread. For example the Inland Revenue recently discovered that nearly 20 per cent of the taxi drivers in one city were ghosts, many of them earning around £8,000 a year but paying no tax. Some ghosts are likely to be registered as unemployed and claiming social security benefits. Others, especially those with substantial earnings, may feel that claiming benefits exposes them to unacceptable risks of being detected; they will be among those who are classified as unregistered unemployed. A third group of ghosts will be among those classified as economically inactive; many of these will be married women and pensioners with concealed earnings, often on a small scale from part-time or casual work. The numbers of ghosts falling into these three categories are unknown but many of them probably evade national insurance contributions, as well as income tax, by concealing their activity from the Department of Health and Social Security (DHSS).

2.6 An Inland Revenue list of the more commonly found activities of ghosts and moonlighters is given in Table 2.1. Very little of their activity seems to fall in the manufacturing sector. This is probably because it is difficult to conceal a manufacturing activity in this country. Small manufacturers usually have to sell to other firms who are registered for VAT and the VAT procedures will lead Customs and Excise from the latter to the former. Thus small manufacturers will become known to Customs and Excise and they

**Table 2.1: Some examples of 'ghosts' and moonlighters encountered by the Inland Revenue**

Hawkers  
Driving Instructors  
Mobile caterers  
Ice cream vendors  
Newsrounds  
Building repairs etc  
Back garden nurseries, poultry  
Private garage car maintenance  
Printers  
Pub/Club entertainers  
Collectors' fairs  
Saturday markets  
Mobile discos  
Fairgrounds  
Mobile hairdressers  
Franchisemen - Hometune etc  
Canvassers - Double glazing, wall insulation etc  
Contract cleaners  
Car traders  
Carpet fitters  
Professional football clubs - agents, scouts, turnstile stewards  
Football referees - local leagues  
Wholesale news deliveries  
Sub-contracting monumental masons  
PSV license holders - private coach operators  
Out workers, especially in garment trade  
Private medical care, including fees for certificates  
Professional services, eg architects  
Draughtsmen  
Taxi and mini-cab drivers

probably assume, wrongly, that Customs and Excise will automatically inform the Inland Revenue of their existence. Also the use of premises and the employment of labour are likely to attract attention. So small manufacturers are unlikely to try to operate completely underground although they can much more easily evade tax by under declaring their profits.

2.7 One tax where evasion is very small is rates. In 1979-80 the outstanding bills for domestic and non-domestic rates amounted to £95m, which is only about 1½ per cent of the total rate bill, and some of this arose from bad debts rather than evasion.

2.8 Working and drawing is a rather different form of black economy activity in which an individual conceals earnings from the Department of Health and Social Security (DHSS) or the Department of Employment (DE) in order to masquerade as unemployed and fraudulently to claim social security benefits. The scale of the fraud varies widely from those who are running highly profitable businesses (eg a roofing contractor) to those who occasionally earn a few pounds (eg as a gardener). The large scale defrauders are probably cheating in other ways by not paying income tax, VAT and national insurance contributions. But the small scale defrauder presents a problem to DHSS or DE only since his earnings are likely to be below the tax and national insurance thresholds (but above the levels that are disregarded in assessing benefits).

#### **The size of the black economy**

2.9 By definition the black economy consists of activities which are unrecorded by the authorities. There can therefore be no official accurate and comprehensive statistics of its size.

2.10A direct approach to measuring the black economy would employ survey methods. The obvious problem is that most people who are active in the black economy will wish to conceal their activities and will therefore refuse to participate in surveys or will give false information. For this reason most of the analytical studies in this field have used indirect methods based on indicators such as -

-the gap between income and expenditure-based measures of GDP in the National Accounts;

-the amount of currency in circulation;

-the value of transactions in the economy.

2.11 A summary of these studies is provided at Annex A. There we conclude that none of the studies (which give widely different estimates of the size of the black economy) provides a reliable answer. Each study is based upon one or more crucial assumptions that cannot be checked independently; different, but equally plausible, assumptions lead to quite different answers. Furthermore some of the studies cover only part of the field.

2.12 Some conclusions are however possible. In brief they are -

a. The black economy probably accounts for between 5 per cent and 10 per cent of GDP. Greater precision is impossible.

b. Just as there is no reliable measure of the size of the black economy so there is no reliable indicator of how it has developed over time. It seems probable however that it has grown gradually over the last 30 years as the tax system (direct and indirect) has embraced more people and more transactions.

c. There is no convincing evidence that the black economy is more (or less) likely to grow during periods when the official (white) economy is expanding than in periods when it is shrinking.

d. Public awareness of the black economy has grown sharply in recent years but this does not imply a major change in its size.

2.13 Even on this rather tentative basis it is clear that there is a huge loss to the Exchequer from tax evasion, although views differ about its precise nature and extent. Much depends upon the assumptions to be made about whether,

and how, the tax burden on the white economy would be lightened if the black economy were to pay its proper taxes. Also assumptions have to be made about the size of the black economy, the tax rate it would face and the consequent disincentive effects, its propensity to spend and other factors. One approach is to assume that the present average effective rate of income tax in the white economy, which is about 25 per cent, would also apply, on average, to the black economy. If we further assume that the size of the black economy is in the middle of the range we consider plausible, ie  $7\frac{1}{2}$  per cent of GDP, or about £16bn in 1981, the first-round tax loss would be about £4bn. But there are quantities to be offset against this figure. First some black economy income already finds its way to the Exchequer: that portion of black economy income that is spent on consumption will incur indirect taxes and will increase earnings in the white economy which will then be subject to direct taxation. One analysis\* has suggested that this second-round tax gain might amount to one quarter of the first-round tax loss, or £1bn on our assumptions. This leaves us with a net tax loss of about £3bn. Another important offsetting second-round effect, which is much more difficult to quantify, is on the supply side; if the black economy faced the disincentive effect of full taxation some of its activity would reduce. But similar second-round effects apply, in a reverse direction, if we assume that tax collected from the black economy would be used to finance a general cut in tax, with effects on the white economy. If the Government could ever capture the tax evaded by the black economy, then it could consider a general tax cut of £4bn - which is about one seventh of the present income tax burden on the white economy. Some of this, perhaps £1bn, would find its way back to the Exchequer through taxes arising from the extra expenditure on consumption. The improvement in incentives would increase activity and thereby broaden the tax base. We discuss the second-round effects more fully in Chapter 3.

2.14 Information about the size of the 'working and drawing' component of the black economy has improved recently as a result of the work of DHSS's newly formed Specialist Claims Control (SCC) teams. These teams visit local offices

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\* A Peacock and C Shaw, 'Calculating the Revenue Loss from Evasion' Journal of Economic Affairs, July 1982

and typically investigate perhaps the most suspicious 5 per cent of the unemployed who are receiving benefit in that area. Typically between 30 per cent and 70 per cent of the people investigated withdraw their claim or have their benefit stopped or reduced; strong evidence of fraud, of the undeclared earnings variety, is obtained in most of these. In some cases the amount of revealed earnings is small but in the majority of cases it exceeds the total amount of benefit entitlement. A minimum estimate of the registered unemployed who are secretly working is thus around 2½ per cent of the total.\* The full extent of 'working and drawing' is unknown but it is likely to be larger than this minimum, and probably much larger, due to activities among the 95 per cent of unemployed benefit recipients who are not investigated by the SCC teams. It is quite plausible that, say, 10 per cent of those receiving benefit as unemployed are not entitled to it. In this case the annual loss to the Exchequer might be about £500m and the unemployment register would be inflated by some 300,000.

**Could we find out more?**

2.15 The only way to obtain reliable estimates of the size of the black economy would be to carry out widespread random checks on the honesty of the citizens. (At the moment checks are confined to cases where there are grounds for suspicion). The United States Internal Revenue Service (IRS) carries out a Tax Compliance Measurement Programme which does involve both random checks on the innocent and passing IRS information to other organisations - both of which actions would be illegal here\*\*. However we do not believe that a comprehensive system like the American one would be justified here because we do not believe that the Inland Revenue, or government generally, needs to know, to such a degree of precision, the size

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\*The Rayner scrutiny on Payment of Benefits to Unemployed people suggested a minimum estimate of 8 per cent on similar grounds but this was based upon the more limited data that was available then.

\* The US authorities can justify the methods of their Tax Compliance Measurement Programme because they have a system of self assessment and it is accepted that this needs some form of audit. Using their methods they have estimated that the US black economy represents between 6% and 8% of the GDP, excluding illegal sources of income.



of the black economy. Operationally it is enough for the Inland Revenue to know, as they do, that the extent of tax evasion is considerably larger than the amount they discover by their investigation work; thus, as we describe in Annex B, they can be reasonably confident that any extra effort or improved technique that they apply to their investigation work is likely to prove worthwhile. This confidence is confirmed by their experience that the point of diminishing returns from investigation work has not yet come into sight.

2.16 As for social security fraud, the Rayner scrutiny on Payments of Benefit to Unemployed People recommended that measurement of the incidence of fraudulent claims be conducted as a matter of urgency in 1981. Ministers accepted this recommendation in principle, but a direct approach would have to include the investigation of random samples of benefit recipients displaying no prior evidence of fraud; many of these would be completely innocent. The objections are obvious and DHSS Ministers have been understandably cautious; they have not yet sanctioned a direct measurement study. But there are good reasons why Ministers should ascertain, roughly, the incidence of 'working and drawing', in particular to assess the adequacy of the current anti-fraud procedures in the processing of benefit claims. The only really reliable way to do this is by the direct approach mentioned above. A less controversial method, though giving less reliable results, would be to extend progressively the scope of SCC investigations in experimental areas so as to include an increasing proportion of the cases giving some grounds for suspicion whilst still leaving untouched those cases where there are no grounds at all for investigation. From the proportion of these additional cases that were found to be fraudulent it would be possible to calculate a much improved estimate of the size of the fraud problem; if the incidence of detected fraud was found to decrease sharply as more cases were brought progressively into the investigation net then we could be more confident in assuming a negligible incidence of fraud in the apparently innocent cases not now investigated. We recommend that Ministers sanction an experiment along these lines if they judge the direct approach to be unacceptable.

CHAPTER 3:

THE EFFECTS OF THE BLACK ECONOMY ON THE WHOLE ECONOMY AND ON SOCIETY

3.1 If there is a lack of hard information about the size of the black economy, even more do we lack firm data about its economic and social impact. But some progress can be made by arguing from first principles.

3.2 The black economy is not a separate ghetto. There are, it is true, some trades where tax evasion and 'working and drawing' are particularly extensive: for example the building industry, scrap metal dealing, taxi driving, and catering and hotels. But there are also honest people in these trades: and black economy practices are far more widespread.

3.3 Starting from the existing tax burden and tax and welfare systems the black economy can be regarded as receiving a subsidy, equal to the amount of tax it should but does not pay plus the amount of benefits it should not but does receive.

3.4 One possible effect of the subsidy is that the black economy operator charges a lower price to the customer. In the extreme case, all the benefit may be passed on to the latter; if for example no VAT is paid a service can be offered for 13 per cent less than the regular price. More often part of the subsidy will go to lowering prices and part will be retained as increased earnings. A restaurant, for example, whose casual employees pay no tax or national insurance contributions, can undercut the prices of honest competitors and still retain more profit. The honest competitors may then be forced to lower their prices. In turn lower prices will bring two kinds of benefit. Sometimes they will increase customers' demand for, and consumption of, the product; sometimes they will enable them to spend more on other goods as well, with a multiplier effect.

3.5 Alternatively black economy operators may keep all the subsidy as extra income, eg taxi drivers who are constrained to charge a fixed tariff. They may then save more; they will almost certainly spend more. They will pay Value Added Tax on many of their purchases; and through multiplier effects other people's incomes, and the taxes they pay (if they do), will also increase.

3.6 The likely outcome, considering only the results of the subsidy, will be to increase real national income by more than the amount of the subsidy, to increase somewhat the incomes of black economy operators, and to decrease somewhat the prices of their products and thereby increase the consumption of these products.

3.7 But the subsidy has to be paid for. Let us assume that public expenditure and the PSBR are held constant and that the cost is borne by honest taxpayers paying more tax. As a result of the extra tax, net money incomes and expenditure in the white economy will be lower than if there was no black economy, and prices higher. Here too there will be multiplier effects, this time working in a constricting direction.

3.8 The negative consequences for the white economy of having to shoulder the tax burden of the black economy may not exactly cancel out the positive consequences of the latter's subsidy. Elasticities of demand, propensities to save etc may vary between the two sectors. But there is no a priori reason to expect that national income will be higher or lower nor that the overall rate of inflation will be affected. The distribution of disposable income between individuals will be different and to the extent that it diverges from the distribution envisaged in the tax legislation, and is contrary to what Parliament intended, it will be inequitable. The composition of expenditure and output will be different; roughly speaking, sectors where the black economy is more pervasive will be larger at the expense of sectors where it is not.

3.9 Some of these effects may be illustrated by looking at an individual case. Let us imagine a self-employed 'ghost' plumber. He earns £15,000 a year, and saves himself tax and other contributions amounting to say £5000, his subsidy in the terms described above. Part of this is passed on to his customers in the form of lower prices, undercutting his white economy competitors.

3.10 Now let us suppose that the Inland Revenue catch up with him, after he has advertised in a local paper to attract more custom. In future he will have to pay tax; and he will have to work harder to pay his arrears and any penalties levied; (Inland Revenue usually set penalties at levels that are not so great as to bankrupt traders). He therefore becomes part of the white economy, losing his subsidy. To the extent the market allows, he will raise his prices to help pay tax, and demand for his services will somewhat fall. He will be worse off, and so, from the point of view of plumbing, will his customers. For some of them his services will be too expensive and they may forego them altogether. But if they spend less on plumbing, they will spend more on something else. And the white economy will have slightly less tax to pay, and will therefore be better off. If, as is less likely, the plumber gives up in disgust, rather than work and pay taxes, he may become unemployed and start drawing benefit. But some demand for plumbing will remain. Thus some new employment and (perhaps) another job will be created. Whether it will be filled by someone leaving the unemployment register, or out of the black economy, will depend partly on local sentiment about the likelihood of getting caught. Furthermore to the extent that demand for plumbing falls because of higher prices demand for something else will rise.

#### **Dynamic effects**

3.11 The black economy also has dynamic effects, on the ease with which small businesses may be set up, and possibly on company size and efficiency.

3.12 The "subsidy" which the black economy offers may prove a powerful incentive to set up one's own small business - whether as a part-time moonlighter or whole-time. (We do not suggest that the scope for tax evasion is the only lure of the black economy; there may also be a psychological attraction, as well as an aversion to form filling and other aspects of bureaucracy.) Small black economy enterprises fulfil many useful functions, and not only for their customers. Individuals are given opportunities to exercise qualities of responsibility, enterprise and industry, which are denied them when employees. The black economy worker may indeed develop his business to the point where he wishes to employ others. The black economy could be seen as a nursery for small vigorous firms. Freed of bureaucratic interference, form filling, and employment, health and safety regulations as well as tax, the black economy 'ghost' is a one-man enterprise zone.

3.13 On the other hand, the black economy's freedom from the normal burden of taxes may lead to serious distortions. The moonlighter may put lots of effort into his second job to the detriment of his main employer. And he may close off a job opportunity for one of the unemployed. He may resist changes in working arrangements sought by his main employer, eg in rosters or shifts, because of his moonlighting commitments. In some fields - eg building - larger firms in the white economy may, despite their overheads, in principle be able to operate more cheaply and efficiently than small firms. But the gains from specialisation and economies of scale can be more than offset by the black economy firm's ability to evade taxes. By patronising or tolerating the black economy we may be discouraging efficiency.

3.14 Indeed some sectors such as small scale building services may become so deeply penetrated by the black economy that the white - whether the small, honest firm or the larger firm which would find it much more difficult to evade taxes - is driven out. Small scale electrical work or plumbing, for example, may well become the exclusive preserve of the black economy firm. But the small black economy firm which wants to grow may be imprisoned by its need for secrecy: if it becomes too large detection becomes certain. The black economy may therefore impose unnecessary rigidities on the market. There may develop a gap between larger white economy firms and smaller black economy ones; a customer may not be able to find an established firm willing to do a small contract, yet he may not want - or know how to find - a black economy firm. There may be similar harmful effects on employment: small, black economy enterprises may not be able to expand their workforce without risking detection, while large firms do not take on workers to do small contracts.

3.15 We do not intend to suggest that there is always competition between white and black economy firms or that the former are always at a disadvantage. Sometimes there is no clash. The lady who runs a black economy business providing home hairdressing for old age pensioners may be rendering a useful service which her clients could not otherwise afford. Her and her customers' gain is not the loss of the High Street hairdresser.

3.16 Another kind of distortion occurs when workers who are on strike during a dispute in their official employment are able to compensate for their loss of wages by working in the black economy, either temporarily or as an intensification of regular moonlighting work. Anecdotal evidence suggests that this can sometimes be a factor in determining how long workers hold out in a prolonged strike.

3.17 The black economy might also be thought to have a useful dynamic effect on the level of prices and wages in the economy generally. Black economy prices can be lower, and non-tax paying workers should be willing to work for lower wages. On the other hand, we point out in paragraph 3.7, these effects will be counterbalanced by higher prices and wages in the rest of the economy. The black economy is likely to be less prevalent in manufacturing and in internationally traded services, given its need for unobtrusiveness and small-scale operations. Hence, a growth in the black economy may raise prices and wages in the internationally traded sectors of the economy (thus reducing international competitiveness), while lowering them in other sectors, which will be encouraged to expand.

3.18 Interestingly the effect of the black economy in Italy is rather different, favouring the internationally traded sector. Compared to the situation here the Italian black economy appears to be much more active in the manufacturing and trading sectors but less so in services, especially household services\*. Often, it seems, black economy firms and individuals act as suppliers and sub-contractors to larger white economy manufacturing and assembly firms. Thus a major effect of the black economy 'subsidy' is to make Italian traded goods more competitive in international markets. Moreover the small black economy manufacturers operate outside the social security, safety, and labour regulations; the workforce may consist of the members of

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\* By contrast to the United Kingdom, most urban Italians live in apartments in large blocks, usually rented. Thus at least some of the household services that would be bought here by individual house owner-occupiers and supplied by black economy operators would, in Italy, be bought by property owning companies who could engage registered white economy contracting firms and record the transactions, as tax-deductible costs in their accounts.

one family and the 'factory' may be in someone's home. Thus their overheads are low, there are no trade union restrictive practices and they can respond flexibly and efficiently to changing patterns of demand for their products. This in turn benefits their customers - the larger white economy firms - who, if they had to undertake the work of their black economy suppliers themselves, would have to bear more of the pain of adjusting to changing demand and would cope less well.

### **National statistics and economic policy**

3.19 The figures for Gross Domestic Product in the national accounts are lower than would be the case if the whole of the black economy were included, although the Central Statistical Office is able to adjust for part of its effect. Unemployment is overestimated because of the working and drawing problem. These inaccuracies are sometimes politically harmful, presenting the state of the nation as worse than it really is. Unfavourable international comparisons can be made. But other countries' figures may be no less misleading than ours on this account (some, eg Italy's, will be more so); and there are many other factors distorting such comparisons (eg differences between countries in the extent of unpaid household work). For practical policy decisions the inaccuracies probably do not matter much because the most relevant statistics are those describing the movements in output, unemployment etc, over the short and medium terms, rather than their absolute values. The black economy will not seriously distort the statistics on movements unless it grows or shrinks rapidly over the same period and out of phase with the white economy, which we do not believe; in any case other errors are likely to dwarf those arising from the black economy.

### **Social effects**

3.20 Little is known about the non-economic effects of the black economy, either on its members or on society as a whole. They are likely to be as disparate as the black economy itself. Some researchers have pointed out the beneficent effects for social cohesiveness. Some black economy goods and services are provided not only or even mainly for profit, but are part of a network of mutual obligation and helping out. On the other hand, the black economy may lead to harmful secretiveness, or to laying oneself open to blackmail. It may sometimes have its own moral code, but it is not likely to foster respect for the law. And it often harms and annoys honest citizens, who may blame the government for not taking action to bring it under control.

3.21 Working and drawing is a form of black economy activity with a rather different social effect. It is probably much smaller, as a total, than tax evasion (see paragraph 2.14). It can be regarded as more immoral than tax evasion because it often requires more deliberate acts of deception, because it appears to be closer to direct theft from the state and because it represents abuse of a quasi-charitable welfare benefit. On the other hand it can be regarded as more excusable, or at least understandable, because the amounts of money involved are often much smaller and because if benefit recipients declared their earnings many of them would experience effective tax rates of 100 per cent or worse; these high tax rates occur because, as earnings increase above the (very modest) disregard levels, Supplementary Benefit is abated £ for £, other benefits may be lost entirely and national insurance contributions and income tax become payable. Moreover, at a time of high and growing long-term unemployment, concentrated in particular areas and groups, undeclared odd jobs or more regular work in the black economy may alleviate poverty and so provide a useful safety valve for the pressures which may build up, as well as an introduction to work and perhaps to particular skills. It would be better still if these jobs could be provided in the regular economy, but this may be difficult, not least because of benefit rules such as low disregards. More clamping down on offenders without other changes in the system would be likely to lead to increased social pressures.

3.22 Potentially, there would be a much more serious negative social effect if the black economy grew so much that more and more of the white economy was unable to compete, gaining a momentum that could be stopped only by the most drastic measures. We might then be in danger of suffering the kind of social damage experienced by Italy. There the tax subsidy in the black economy is so large and tax and social security payments bear so heavily on the white economy that honest private sector firms find it hard to thrive and a large portion of the white economy is dominated by large, heavily subsidised, state-owned enterprises. The government machine itself cannot function properly. Civil servants are forced to supplement their meagre incomes by moonlighting, to the extent that their main jobs are often entirely neglected, and corruption is encouraged. All this increases the pressure on honest firms to cheat before they are driven under. Ironically, if the black economy



were to expand greatly in this country we might suffer the same kind of social damage as in Italy but because the structure of our black economy is so different we would probably not enjoy the compensatory economic benefits, especially to the trading sector, that occur in Italy and which we described at paragraph 3.18.

3.23 In chapter 5 we describe how the revenue and benefit departments are improving their ability to enforce compliance and we offer some suggestions of our own for further improvement. In these circumstances we doubt that there is a real threat of a black economy take-over in this country. We do however see one cause for concern. While most people may have strong moral beliefs on some matters, tax honesty apparently comes rather low on many people's scale of values. (This attitude, so far from being a reflection of a decline in values, may be as old as taxes themselves.) What keeps many people on the path of tax probity, therefore, is less moral beliefs than lack of opportunity and the fear of being found out. For tax liable to collection by PAYE the opportunities for evasion are small, unless the employer colludes, and the system is policed by the Inland Revenue auditors. But the scope for employees to evade tax on secondary earnings, moonlighting, is enormous and they need have little fear of detection in most cases. The opportunities are also good for the self-employed. They can understate income, overstate expenses, delay and obfuscate. They can find accountants who will help them. And provided they keep their misstatements within reasonable limits, the likelihood of their being found out is small, and they know it. Some of them, 'ghosts', can even go to the extent of keeping their entire activities secret. Even if they are found out, the penalties are generally so pitched as to be bearable. Working and drawing has also appeared to be a fairly safe activity, at least until recently. This climate of deception is not a healthy one, nor necessarily a stable one. Accordingly we return to this subject in Chapter 5.

**Conclusions**

3.24 Our conclusions about the economic and social effects of the black economy are -

i. its short term economic effects are to stimulate some activity in sectors pervaded by the black economy but to depress activity in other sectors (which are effectively bearing the tax burden evaded by the black economy) and there is no good reason for believing that the net effect on national income and inflation will be good rather than bad;

ii. it redistributes income between individuals in a way that was not intended by Parliament in the tax legislation, and that is regarded by many people as unfair;

iii. in the longer term it has a number of dynamic effects on the economy, both good and bad: it can facilitate enterprise and the creation of small business but it can also distort market forces, inhibit the development of firms and favour parts of the service sector at the expense of the manufacturing sector;

iv. although black economy activities will sometimes have good social effects, the moral attitudes involved are not healthy ones;

v. national statistics understate output and overstate unemployment but not to an extent that matters much for practical economic policy decisions;

vi. although there appears to be no immediate prospect of the black economy taking over the white, if such a takeover were to occur, the negative effects would outweigh the positive ones.

**CHAPTER 4: HARNESSING THE ENERGIES OF THE BLACK ECONOMY**

4.1 Thus the black economy represents a large amount of economic activity, in itself for the most part desirable, that becomes anti-social and even harmful because it escapes the taxation that it should bear. In this chapter we consider how far it may be possible by policy changes to legitimise black economy operators or to encourage them to enter the white economy. In the next chapter we discuss possibilities for better enforcement of the tax and benefit laws.

**The tax and benefits systems**

4.2 The present levels of earnings that are disregarded in assessing benefits for the unemployed are low. No Unemployment Benefit is paid for days when earnings exceed £2. For Supplementary Benefit the amount of weekly benefit is reduced £ for £ for earnings (net of certain in-work costs) above £4 a week. These rules are consistent with the view that the benefits are intended to compensate for loss of earnings. But they provide very little incentive for someone to take up and declare part-time work where the earnings would be above the (very low) disregard level but less than or equal to the benefit level. Consider, for example, a married man with two children on Supplementary Benefit who receives about £60 a week. He has little monetary incentive to take a part-time job paying, say, £40 a week (net of in-work costs) since £36 would be deducted from his benefit. Worse still, since part-time work can sometimes lead to full-time work this lack of incentive causes people who might otherwise progress to full time employment to remain on benefit and to be inactive. Thus honest people will be discouraged from seeking work. Meanwhile less honest people will choose to work and conceal earnings so as to maintain their benefits at maximum value, thereby entering the black economy.

4.3 In the long term these and similar problems could be alleviated by reform of the tax and benefit systems so that loss of benefit and payment of tax increase smoothly in relation to gross earnings so that at all points the effective marginal tax rate is at a tolerably low level. But the scope for change in the short term is limited. Nor may the reform prove attractive even in the long-term; there are a number of difficulties including the necessity to increase the burden on some taxpayers.

4.4 A feasible short term change, which we favour, is to increase the earnings disregards for benefits. This and several other changes were considered by a working group of DHSS and DE officials on "Benefits for Unemployed People". The Working Group concluded that the case for raising the disregard for Unemployment Benefit is not strong at present because there appears to be a lack of awareness of the full scope of the present disregards and the availability of in-work benefits. Accordingly the group recommended that steps be taken to increase this awareness.

4.5 The Group concluded that there is a good case for increasing the Supplementary Benefit disregard for unemployed people who have been on this benefit for a year or more to the lone-parent level (£4 completely disregarded plus half earnings between £4 and £20). The Group also favoured paying the long term rate of supplementary benefit to the long term unemployed. They decided that it would be wrong to adopt both measures together and they preferred paying the long-term rate, mainly on welfare grounds. On black economy grounds the latter measure is not particularly attractive; the improvement in benefit might be sufficient to entice a few benefit recipients to forego their black economy earnings, but for many more the main effect will be to extend the range of earnings which are worth concealing and thereby increase the attraction of the black economy. Thus on black economy grounds we would prefer the proposal to increase the earnings disregard to the proposal to pay the long-term benefit rate. (In the CPRS report on Unemployment we commend the disregard proposal on employment grounds.) We recognise that increasing the disregard would increase Exchequer cost considerably because those who currently declare their earnings and have their benefit abated £ for £ would receive more; but there would be offsetting savings, which are very difficult to forecast, from the reduction in working and drawing and from the increase in the number of unemployed who would seek and ultimately obtain part-time and possibly full-time work.

4.6 Some other reforms of the tax and benefit systems are considered in the CPRS Report on Unemployment. They would improve work incentives by reducing the sharp peaks in effective marginal tax rates that occur in the present system. They should also have a useful, though limited, effect on the

black economy since some people would have less incentive to conceal marginal earnings at points where the effective tax rate is very high. People who would fall into this category are mainly the 'unemployed' who are working and drawing. Most black economy operators, however, would not fall into this category and would continue to gain considerably by evading some or all of their tax liability.

4.7 The changes referred to in paragraphs 4.5 and 4.6 are desirable but they would make only a minor contribution towards legitimising the black economy. More progress in this direction could be made in the short term by raising income tax thresholds. Unfortunately a major impact could be achieved only by very large changes, massively reducing the income tax yield, which are unlikely to be affordable at least in present circumstances. In the longer term a smoother rise in marginal tax rates, as described in paragraph 4.3, is the more effective reform. We have considered whether there is a case for specific tax concessions, directed at the trades most pervaded by the black economy. But we can see no good economic or social reason for favouring these trades. Although it might at present be easier for household plumbers to evade tax than, say, haulage contractors, this is not a reason for taxing them less.

4.8 The sector of the economy comprising small firms and self-employed traders - part of the "secondary sector" of the economy described in the CPRS Report on Unemployment - is, we believe, particularly prone to penetration by the black economy. Growth of the secondary sector could well lead to a larger black economy and loss of tax revenue. But, as the Government has recognised in its adoption of a wide range of policies to help small businesses, growth here is desirable for a number of reasons. In the Report of Unemployment, the CPRS develops the theme that a larger secondary sector will be particularly beneficial for overall growth and jobs in the economy as a result of increased flexibility to respond quickly to market opportunities and to absorb shocks.

4.9 The moral is not that we should hold back in our efforts to develop small businesses but that policies in this field should as far as possible be tailored to producing a secondary sector which is not only vigorous and expanding but also legitimate.

4.10 We can distinguish two separate elements in the burdens which the state imposes on small business - particularly at the formative stage. The burdens in themselves may actually be relatively tolerable. (Little tax may be payable; the health and safety requirements, for example, may be quite reasonable and not expensive to implement). It may be the process of compliance - the form filling, the negotiation with the bureaucracy, and so on - that seems to present the greater problem. Many newly established businessmen will find this side of the business particularly daunting (because unfamiliar) and a diversion from more rewarding and productive tasks. The very prospect of such contacts with the bureaucracy may well encourage traders to go underground.

4.11 The simplest route to reducing the lure of the black economy is to reduce the burdens imposed by the state. This is being done in Enterprise Zones. The CPRS Report on Unemployment proposes several ways of reducing the regulatory burden on small firms more generally, for example in the field of employment protection. We believe that any measures that lighten the burden of running a small business will also lessen (perhaps only slightly) the temptation to run such a business clandestinely.

4.12 It is also important to help the emerging small businessman over the initial hurdles in dealing with the bureaucracy. The DoI Small Firms Advisory Service has a good record in this field, and further help is now available from the growing number of local enterprise agencies. The CPRS Report on Unemployment argues also that local organisations, particularly enterprise trusts drawn from the local business community, are probably more flexible and better suited than national bodies to provide help to small businesses.

4.13 Finally, it is relevant to draw attention here to the MSC's experimental Enterprise Allowance Scheme. This scheme provides a grant of £40 a week for one year to people on the unemployment register who want to start their own business and who can raise £1,000 of capital by their own means. This scheme almost certainly attracts some people who now claim to be unemployed but are trading, or who are about to trade, in the black economy. One of the implications of participating in the scheme is that the business is reported to

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the Inland Revenue and DHSS and will then pay at least some of its tax and national insurance liabilities; also the working and drawing problem will be reduced. This linkage between help from the tax payer and compliance with the law seems to us one of the most attractive features of the scheme.

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CHAPTER 5: ENFORCEMENT AND MONITORING

5.1 We say (paragraph 2.12) that we think that the black economy accounts for between 5% and 10% of GDP. The potential yield to the Exchequer from better enforcement is thus very large. But the proportion which is detected amounts to roughly 0.3% of GDP. In other words the authorities are successful in catching up with 6% or less (possibly as little as 3%) of the total of the black economy.

5.2 Tax evasion, which constitutes most of the black economy, is a rather low risk enterprise. Nor is it generally regarded as being in the same moral category as many other forms of law-breaking and dishonesty. For these reasons among others the black economy may tend to grow. We set out in Chapter 4 some ideas for encouraging the transfer of activities from the black to the white economy, but these are likely at best to have a small effect.

5.3 In recent years the Government Departments most concerned with the black economy have put increasing efforts into detection and enforcement. (In Annex B we describe very briefly the resources and methods used.) We believe they have been right to do so and that in general these increased efforts have been amply justified. At the risk of repeating the analysis in Chapter 3 above, we emphasise that all direct taxes have disincentive effects and all indirect taxes reduce demand. While therefore tax evasion may raise incentives or increase demand in the sectors where it is practised, the evasion merely shifts the tax burden, with its penalties in terms of disincentives or reduced demand, on to someone else.

5.4 For these and other reasons, we consider that Government Departments should aim greatly to improve the rate of compliance with the tax and benefit laws. We think this can be done cost effectively and without unacceptable changes in the conventions and rules governing privacy. Our discussion covers the following main areas -



- i. review of recent important developments (5.5-5.13)
- ii. deterrence, including publicity (5.14-5.22)
- iii. declarations of secondary earnings by moonlighters (5.23-5.24)
- iv. information exchange between Departments (5.25-5.31)
- v. co-ordination of work between Departments (5.32-5.38)
- vi. monitoring the effects of enforcement (5.39-5.43)

**Present Enforcement Work**

5.5 In Annex B we describe briefly the resources and methods used by Departments to detect and deal with tax evasion and benefit fraud. There we note that the Departments are developing more cost effective techniques and are concentrating their attention more selectively onto the more serious evaders, where the yield is greater. We commend these developments and mention some of the more important ones below.

**The Inland Revenue's Enforcement Work**

5.6 The main recent developments in Inland Revenue's enforcement work are -

- The Black Economy Experiment in which extra staff have been deployed to detect ghosts and moonlighters by looking for signs of their activity in the economy (eg advertisements in newspapers, local authority registers of traders), (see paragraph 7 of Annex B).
- A more selective approach to investigating the self-employed using prior subjective judgements of the likelihood and size of evasion in individual cases (see paragraph 3 of Annex B).
- Extra staff deployed on PAYE Audit work with 'at-risk' employers being visited more often and investigated more thoroughly (see paragraph 6 of Annex B).

5.7 Although it is too early to evaluate the results of the Black Economy Experiment we draw attention to it because it could prove a very important guide for future action. The results so far suggest a very high incidence of ghosts working full-time in certain trades (eg taxi driving). Applying the

type of analysis given in Chapter 3 above, we think there is a very strong case for pursuing such people. The returns in tax collected will be high in relation to the cost of collection; and there is likely to be little public sympathy for such wholesale evasion. To judge from Inland Revenue's experience of them, most ghosts operate in trades where there are white economy operators also; in effect the black economy ghosts are competing against the white economy but with a hidden advantage. In some cases, eg taxis, the price to the consumer is fixed and all the benefit of evasion goes to the ghosts; in other cases some of the benefit may pass on to the ghosts' customers in lower prices. Either way there is a distortion of market forces which enforcement removes. Furthermore enforcement is unlikely to have the effect of suppressing the ghost's economic activity since, in most cases, his income net of tax will comfortably exceed the social security benefits he could claim if he became unemployed; also Inland Revenue normally arrange for the payment of tax owed and penalties to be spread out over a sufficiently long time to avoid bankruptcy. We would therefore expect the Inland Revenue to be able to plan an enhanced programme of work on this front when the results of their black economy experiment are available.

5.8 The experiment was in fact aimed primarily at moonlighters and initial reports suggest that it is succeeding in identifying a number of these, by new methods. The tax yield from catching an average moonlighter is much smaller than from ghosts and the case for deploying additional resources against moonlighters is therefore weaker. Moonlighters are however very numerous so that, although average earnings are small, the total at issue is perhaps the largest single component in the black economy. It is therefore necessary to preserve a credible deterrent against moonlighters.

5.9 We conclude that the recent improvements in Inland Revenue's enforcement work are wholly welcome. By concentrating on the more cost-effective forms of ~~investigative work~~ Inland Revenue are improving their performance against the more serious evaders, such as ghosts, where the case for enforcement is strongest.

**DHSS Fraud Work**

5.10 The DHSS have improved the cost-effectiveness of their work on social security fraud (see Annex B, paragraphs 11 and 12). The DHSS's concern to obtain high yields from fraud work, in terms of benefit savings, will tend to encourage fraud investigators to concentrate more of their effort on the more serious cases, where the amount of undeclared earnings, and benefit overpayments, are larger. We believe this emphasis would be right. Although the benefit claimant with small concealed earnings cannot be condoned, he is responding to a tax and benefit system that confronts him with an effective marginal tax rate of 100 per cent or worse. Accordingly we endorse the efforts that DHSS are making to improve the cost-effectiveness of their fraud work and we suggest that the cost-effectiveness principle should apply right down the management line so that investigators are encouraged to concentrate more on cases where the concealed earnings are likely to be larger.

5.11 DHSS's most striking success recently has been achieved by the Specialist Claims Control (SCC) teams (described briefly in paragraph 2.14 above). When the most suspicious 5% of those receiving benefit as unemployed are investigated, about half of them are found not to be entitled. The technique is therefore highly effective; but it needs to be handled with care. By definition it involves investigating considerable numbers of people who are innocent and the DHSS is rightly concerned about public opinion. Also it attracts opposition from the civil service trade unions. Nevertheless DHSS plan to extend the scope of SCC progressively; we support this plan.

5.12 If half of the most suspicious 5% of the unemployed on benefit are not entitled to it, there is a powerful case for investigating the next 'most suspicious' group. If the return there is also good, the number to be investigated should be increased again, and so on, until diminishing returns indicate a halt. The Department estimates that its yield from SCC work at present is about 5 times the cost, which is a better ratio than any other of its enforcement activities, and so there is probably scope for considerably more SCC work.

5.13 Moreover the programme is new. By careful monitoring of the results, the Department should be able to build up a much better picture of fraud - who is likely to commit it, the likely numbers, and so on; and so further increase the effectiveness of the drive against fraud.

#### **Deterrence**

5.14 Prevention is better than cure; we have therefore looked at the question whether more could be done by Departments to deter people from entering the black economy in the first place.

5.15 The Departments concerned believe that the best deterrent is a high detection rate. We agree that striving for high detection rates is a correct operational objective for the Departments but it does not go far enough, because:

- Detection rates are quite low in many areas of the black economy and there may be no practical and socially acceptable ways in which they can be raised more than marginally; to the extent that would-be offenders perceive this, the deterrent effect is poor and will remain so.
- Deterrence depends upon the public's perception of Departments' success in enforcement, which may be quite different from actual detection rates.

These considerations lead us to offer some suggestions for action which the Departments might take, in addition to their current efforts to improve detection rates. These suggestions have the merit of being relatively easy to try out and low in cost. If they do not succeed, little will have been lost.

5.16 Several of our suggestions could not be implemented without changes in the very stringent statutes under which the Inland Revenue operate or, in one case, without modifying Ministerial undertakings given at the time of legislation. However we note that the Keith Committee on the Powers of the Revenue Departments is expected to report soon, probably in October this

year. The Committee's recommendations may also point to statutory changes. We therefore suggest that if Ministers are attracted to our suggestions they should consider the case for making any statutory changes that are required in the context of their consideration of the Keith Committee's report.

5.17 We believe that there could be advantage in local publicity for successes in countering the black economy. The Inland Revenue are bound under their statutes to treat information about individual taxpayers' affairs as strictly confidential. But the statutes would permit a form of local publicity in which detected evaders were not identified by name but information was released on the types of activity they were engaged in, the amounts of evasion, and the nature of the settlement (tax, interest and penalties). Publicity could be given both to individual cases (with news value) and to groups of cases (eg 5 pop music groups in city x). The publicity should be designed, and the cases selected, with the aim of achieving the greatest increase in perceived detection rate. The Inland Revenue could experiment with different types of publicity in different areas and evaluate their effects. We recommend that the Inland Revenue consider giving local publicity for some of their successful investigations.

5.18 A potentially much more powerful form of publicity would be for Inland Revenue to divulge individual details of some of their most serious cases of evasion including the identities of the offenders. This would be controversial and would require statutory change. But such information would attract considerable media attention and so gain publicity. Also the deterrent effect might be strong, at least among those would-be black economy operators who would feel a sense of shame at being exposed publicly. We suggest that such publicity should be considered only for people who evade large sums, who make determined and persistent efforts to conceal income, who are demonstrably obstructive during investigation and who have attracted heavy penalties. We note that in Australia and New Zealand the tax authorities, operating under a different statutory regime, publish the identities of large numbers of detected tax evaders.

5.19 We have examined whether an equivalent form of publicity could be achieved by means of prosecution in the courts. At present Inland Revenue prosecute very few tax evaders, (only 204 cases in 1981/82 and most of these were complex company cases). The problem here is that income tax evaders would have to be prosecuted under the laws of criminal fraud and in nearly all instances it is very difficult, if not impossible, to establish a sufficiently strong case for deliberate fraud as opposed to negligence (which is not prosecutable).

5.20 Accordingly we recommend that the Inland Revenue should devise for Ministers' consideration a scheme for publishing individual details, including identities, of some of the more serious cases of tax evasion and should indicate what statutory changes it would require.

5.21 It is far easier to establish a case of criminal fraud for VAT evasion or for working and drawing than for income tax evasion. Consequently the proportions of detected VAT evaders and benefit offenders prosecuted by Customs and Excise, DHSS and DE are much higher than the proportion of detected income tax evaders prosecuted by Inland Revenue. Thus the former three departments already obtain good publicity for their enforcement successes through media reports of the results of their prosecutions. We believe that little, if any, extra publicity is needed. However we note that Customs and Excise do not normally prosecute cases involving less than £10,000 of VAT evasion; in these cases they offer the offender an alternative procedure, 'compounding', under which he pays an extra sum fixed by the Commissioners on top of the amount of VAT owed. We suggest that Customs and Excise consider the case for greater publicity for compounding cases (though not necessarily identifying individual offenders).

5.22 The DHSS has attracted, and continues to attract, much media attention for its present campaign against fraud. Rightly the DHSS is careful to minimise the amount of adverse publicity, particularly concerning the methods of the SCC teams (described at paragraph 2.14 above). At the national level we believe that there is little the DHSS could usefully add to this publicity for the purpose of raising perceived levels of risk; it is sufficient, we believe,

for DHSS Ministers to refer, from time to time, to the high success rates of the new methods, particularly the SCC teams. But at the local level some more publicity might help, although it would require careful and sensitive handling. Because of the existing public awareness of the effectiveness of the SCC teams we believe that the mere knowledge that an SCC team was about to visit an area might have sufficient of a deterrent effect to cause some fraudulent claimants to cease their claims, before waiting for the investigations to commence. We suggest that DHSS consider giving some advance local publicity to the impending arrival of SCC teams in selected areas on an experimental basis so as to assess the effect. Should the deterrent effect prove to be significant we suggest that DHSS might exploit it in two different ways:

- i. giving advance publicity to genuine full-scale SCC team visits;
- ii. giving advance publicity to 'token' SCC teams visits, in which the teams visit only briefly to conduct a small number of investigations.

A judicious mixture of i. and ii. would obtain the maximum deterrent effect from a limited amount of investigation.

#### **Moonlighter declarations**

5.23 Many moonlighters could, with some reason, claim that they are not deliberately concealing their secondary earnings from the Inland Revenue because the Inland Revenue have never asked them about secondary earnings. Only a minority (about a third in 1981) of taxpayers is asked to complete a tax return, in which they have to declare all sources of income. To save staff time the Inland Revenue do not normally send tax returns to people whose tax affairs appear to be sufficiently simple to be treated adequately by PAYE alone. Thus a moonlighter is unlikely to be sent a tax return if his primary employment is in the PAYE system and if there are no indications of complicating factors such as mortgage interest. Thus he will not have signed any declaration, such as that on the front of a tax return, that he has disclosed all sources of income to the Inland Revenue.

5.24 To some moonlighters who receive no tax return or other enquiry it might come as a genuine surprise to learn that they are under a legal obligation to take the initiative and inform Inland Revenue of their secondary earnings. Conceivably some moonlighters might declare some or all of their secondary earnings if they were given more encouragement to do so and if they were made more aware of their obligations. However we accept Inland Revenue's argument that sending tax returns to everyone would probably be far too costly a remedy in relation to the anticipated yields. A much cheaper step would be to include with the Notice of Coding or the P60 notice sent to PAYE taxpayers a very simple form, on which taxpayers would have to declare whether they did or did not have secondary earnings in the previous year. The form could be included at intervals of 5 years. Those returning forms which declared secondary earnings would need to be followed up. A possible sanction against people who failed to return forms after reminders would be to apply temporarily an emergency coding number on current PAYE deductions. Such a scheme could concentrate on primary employments known to be conducive to moonlighting (eg those with shift working). We understand that statutory changes would be required to underpin a scheme of this type. We recommend that Inland Revenue should devise a scheme for Ministers' consideration indicating the statutory changes required.

**Exchange of information between Departments**

5.25 Different departments often find themselves investigating the same people. Many traders who evade VAT also evade tax and some may also evade NI contributions. Probably most of the 'unemployed' who claim benefit and conceal their earnings from DHSS also conceal the earnings from Inland Revenue. Thus the Departments stand to gain considerably by exchanging information about their successful investigations. Yet very little of such information is exchanged. The Departments tend to regard the information they hold about individuals as confidential to themselves, including information gained from their investigations.

5.26 The Inland Revenue are under strict statutory obligations to keep their personal information about taxpayers to themselves; every member of their staff signs an undertaking to this effect. Their statutes permit Inland



Revenue to exchange such information in only two specific areas - some PAYE information with DHSS and some information with Customs and Excise. Customs and Excise staff treat the information they obtain from businesses as confidential although they sign no undertakings. In the course of taking benefit claims, DHSS and DE staff often acquire a great deal of personal information but the claimant is given an understanding that this will be treated as confidential.

5.27 It might seem natural that when citizens supply detailed information about their personal circumstances to these departments, on their tax returns and benefit claims for the normal purposes of assessing tax liability and benefit entitlement, the Departments should then treat the information as confidential.

5.28 But while we could accept the current limitations on exchange of detailed personal information supplied by citizens about themselves to the Departments we suggest that the same limitation need not apply to basic non-sensitive information (such as name and address and whether the citizen is economically active) nor to information gained by Departments solely from their investigation work. It seems odd, for example, that DHSS fraud investigators who establish, from their own work, that an 'unemployed' benefit recipient is concealing earnings and evading tax can then complete their work on the benefit aspects of the case in the fairly sure knowledge that the Inland Revenue will not find out about the tax aspects. Equally it seems curious that when the Inland Revenue detect ghosts, who probably evade National Insurance contributions as well as tax, they are not permitted to inform DHSS. To the public, even to the tax evader and benefit defrauder, it might seem strange that officials of one government department protect offenders in this way from their liabilities to another government department.

5.29 Since the introduction of VAT in 1973 Customs and Excise and Inland Revenue have been empowered to disclose information to each other but, as a result of undertakings given by Ministers at the time of the legislation, it has been limited to exchanges between their Head Offices about serious evasion. The only exception to this restriction is an experimental scheme for exchange

at the local level which has been operated at Leeds since 1977. The experiment has brought a significant amount of tax evasion to the attention of the departments; from the experience (and assuming that Leeds is representative) they estimate that the benefit to them of nationwide exchange of information would be a yield of the order of £5 million per annum. Ministers have said that they will consider extending the scheme nationwide in the light of the conclusions of the Keith Committee. We would go further and suggest that Ministers then consider the case for much wider exchange between the revenue and benefit departments, particularly the information gained in the course of their investigation work.

5.30 Exchange of information between Inland Revenue and DHSS would be particularly valuable in preventing, or inhibiting, the ability of ghosts to conceal themselves from one or other department. A ghost is likely to fall into one of the following categories:

- i. possesses a NI number and currently pays Class 2 contributions (self employed);
- ii. possesses a NI number and claims Supplementary Benefit by claiming to be unemployed;
- iii. possesses a NI number but currently pays no contributions;
- iv. does not possess a NI number and is unknown to DHSS.

Someone in category i. displays clear evidence of self-employment earnings and the DHSS would usually have a correct record of his address; if this information were passed to Inland Revenue they would be well placed to bring the ghost to light. A ghost in category ii. presents more difficulty since there is no outward indication that distinguishes him from a genuine unemployed benefit claimant; his true nature will only be revealed by successful fraud investigation by DHSS, at which point the information could be passed on to Inland Revenue to their advantage. Category iii. presents

two main difficulties. First there are a number of legitimate reasons why people (other than ghosts) may pay no contributions - they may have no earnings or their earnings may be below the national insurance thresholds. Secondly, DHSS face severe practical difficulties in tracing non-contributors many of whom have no good reason for informing DHSS of a change of address. So this category is unlikely to prove a fruitful field for investigation if information flow occurs in one direction only, from DHSS to Inland Revenue. But DHSS might stand to gain considerably if information also flows from Inland Revenue to them since some people will be self-employed, gaining income which they declare to Inland Revenue under Schedule D but which they conceal from DHSS in order to evade Class 2 national insurance contributions. DHSS suspect that very few people born and bred in the United Kingdom are likely to fall into category iv. but there may be a number of recent immigrants who do, including illegal immigrants. There are severe practical difficulties in identifying such people, although it is conceivable that some submit Schedule D returns to Inland Revenue.

5.31 If Ministers decide to implement statutory changes to permit exchange of information between the Inland Revenue and other departments then DHSS and Inland Revenue could explore the scope for co-operation in this area. The first step would be to analyse a sample of ghosts detected by Inland Revenue and a sample of their Schedule D cases to discover their social security status. The analysis, which itself depends upon information exchange, would indicate the value of conducting the exchange on a routine basis, ie for DHSS routinely to inform Inland Revenue of the cases it identifies in category i. and the detected fraud cases in category ii. and for the Inland Revenue to inform DHSS of Schedule D taxpayers.

**Co-ordination of PAYE and national insurance work**

5.32 Employers have cause to be surprised at the present procedures under which they are visited by staff from two government departments who independently inspect their records of deduction from pay:

- 600 Inland Revenue PAYE Auditors look at tax deduction

- 1,800 DHSS Inspectors look at deductions for national insurance

5.33 Although their concerns differ the two groups of staff examine much the same records. Employers who are deducting insufficient amounts of tax are also likely to be deficient on national insurance, and vice versa. It would therefore seem logical to employ one group of staff to check both types of deduction on a single visit, 'higher risk' employers being visited more frequently. Within a given total number of staff this should lead to a more effective programme of enforcement. Indeed this is one area of enforcement where we believe that the Departments, especially if they pool their resources, should be able to achieve a sufficiently high level of success to deter employers who are contemplating evasion.

5.34 A working group of Inland Revenue and DHSS officials has examined the scope for co-ordinating the work of NI Inspectors and PAYE auditors. They recommend a co-ordinated work scheme in which there are two levels of inspection:

i. by DHSS Inspectors: they would check both PAYE and NI deductions and correct irregularities of both kinds; they would attempt to visit all employers over time but the more 'at risk' employers would be seen more frequently;

ii. by PAYE Auditors: they would visit only a small proportion of employers, mostly those more technically difficult cases referred to them by the DHSS Inspectors and cases revealed to be more 'at risk' by the DHSS visits.

The effect of this scheme on employers is that 'good' employers would be visited by only one group of staff instead of two as at present and that 'bad' employers will be seen by two groups and, in some cases, more often than now.

5.35 We recommend that the Working Group's proposals for a co-ordinated work scheme for NI Inspectors and PAYE Auditors be accepted and implemented swiftly.

5.36 The Working Group also considered the more radical step of merging the two groups of staff to create a unified body of inspectors under either DHSS or Inland Revenue. The Group rejected this step because they considered that most of the benefits of joint working could be obtained from the scheme outlined above and that the (small) additional benefits from a fully merged staff group would be outweighed by the costs of bringing all the staff under either Department.

5.37 We believe that in the longer term the additional benefits from a fully merged staff group would outweigh any problems-probably transitory-inherent in the merger. We feel that a logical continuation of the co-ordinated scheme is the eventual merger of the two groups of staff under one or other department. We suggest that the case for a merger be re-examined when there has been sufficient experience of the new scheme.

#### **Overlap of Fraud Work by DE and DHSS**

5.38 We observe in Annex B (paragraphs 15 and 16) that the responsibilities of DE and DHSS overlap in cases of fraud by those who receive both Unemployment Benefit and Supplementary Benefit. We consider that the demarcation of work between the two departments needs attention and we recommend that they examine it.

#### **Monitoring the Effects of Enforcement**

5.39 We think it is important that the Inland Revenue should monitor the effects of their enforcement work upon taxpayers and, in particular, should identify cases where enforcement appears to lead to a reduction in economic activity. Although one's first reaction might be to restrain enforcement work where it appears to suppress economic activity, we suggest that a more appropriate reaction is to monitor the effects and then to consider the case for adjusting the tax burden by formal means.

5.40 An example of the kind of monitoring we have in mind is provided by a pilot study in which the Inland Revenue compared the profit performance of two groups of traders over a 3-year period. One group consisted of traders who had been investigated before the start of the period and for whom evasion had been established and settlements made. The other group consisted of similar traders who had not been investigated (and had given no cause for suspicion). Over the 3-year period the declared profits for the first group tended to keep up to the levels established by the investigation and were comparable with those of the second group. This suggests that enforcement did not suppress the activity of traders in the first group.

5.41 We recommend that the Inland Revenue should monitor the effects of improved enforcement in order to assess how far it leads to a reduction in activity by the taxpayers and to consider the implications, if any, for taxation policy.

5.42 The pilot study mentioned above also shows that during the 3 year study period 'recidivism' was low, ie that once found out the traders in the first group continued to declare profits and pay taxes at (reasonably) honest levels. Enforcement work of this kind, leading to (apparently) lasting reform is particularly cost-effective. The monitoring procedure we propose should, as a by-product, throw more light on this subject and thereby assist Inland Revenue to improve the cost-effectiveness of their work still further by developing procedures that elicit durable, rather than temporary, compliance.

5.43 In Annex B we mention other examples of the revenue and benefit departments using studies of this kind to assess the effects of their compliance work on offenders' future behaviour. We commend this approach and suggest that it could be more widely exploited to improve the overall value of enforcement work.

## CHAPTER 6: SUMMARY AND LIST OF RECOMMENDATIONS

6.1 In Chapter 1 we describe the variety of the black economy and point out how widely it is active within our society. Although the black economy is as old as taxation itself, the scope for tax evasion has widened greatly over the last 30 years with the vast increase in the number of taxpayers. One view of the black economy is that it is a pure economy, undistorted by taxes and regulations, where entrepreneurs flourish - often to the customer's advantage. The opposing view points out that the black economy fails to pay its share of taxation despite enjoying the benefits; and the extra tax burden is passed to the white economy. White economy traders have good cause to resent their black economy competitors who enjoy an unfair advantage. We point out that many people sympathise with both points of view; there is much ambivalence on the subject. This ambivalence limits the Government's freedom of action. We eschew a blanket approach; our aim is to try to build on the black economy's good points (or at least learn its lessons) while improving worthwhile controls.

6.2 In Chapter 2 we look at the composition and size of the black economy. Most of it consists of tax evasion, mainly of income tax. Much of the evasion is done by companies and self-employed traders who under-declare their profits and by moonlighters who conceal earnings from second jobs. An extreme form of evasion is practised by 'ghosts': people who manage to conceal their trades entirely and so pay no income tax, and often no VAT or national insurance contributions either. Another smaller part of the black economy comprises people with undeclared earnings who claim social security as 'unemployed' - the 'working and drawing' phenomenon. Much black economy activity appears to be in services (eg retailing and household repairs) and in construction.

6.3 Of its nature the black economy defies direct measurement. Several indirect methods have been employed, using a variety of more or less tenuous assumptions and giving a wide range of answers. However we conclude that the black economy probably accounts for between 5 per cent and 10 per cent

of GDP, or between about £10bn and £21bn in 1981. It has probably grown gradually over the last 30 years, both in absolute terms and as a proportion of GDP, as the tax net has embraced more people and more transactions. As to whether the black economy as a whole moves counter-cyclically, prospering when the white economy is in recession and suffering when it expands, or pro-cyclically, there is no convincing evidence; we suspect that some components of it react in one way and others in the opposite way. If the black economy were to pay its full taxes there could be a reduction in the tax burden on the white economy of the order of £4bn.

6.4 To measure the black economy much more precisely would require an elaborate and controversial programme of random checks on the honesty of citizens which we do not consider justified. The working and drawing component is a special case where we believe better measurement is needed and could be obtained by less controversial methods.

6.5 In Chapter 3 we look at the good and the bad effects of the black economy on the whole economy and on society. In the sectors where it is active it can lead to lower prices and increased output; but on the assumption that the cost of the black economy's tax evasion is reflected in higher taxes on the white economy, the latter suffers higher prices and lower incomes. On this basis there is no reason to expect that real national income will be higher or lower as a result of the black economy, or that the overall rate of inflation will be affected either way.

6.6 We point out that because of its very freedom from taxes, form filling and bureaucratic interference the black economy could be regarded as a nursery for small vigorous firms. But these freedoms create distortion in competition because they are not enjoyed by all. Honest traders may be forced out of business by black economy competitors even if they work harder and more efficiently. The manufacturing sector as a whole is penalised (to the benefit of the services sector) and that part of it that faces international competition is disadvantaged. And profitable firms, starting up in the black economy, may choose not to expand in order to evade detection. Finally, and most obviously, disposable income is redistributed between individuals in a way that differs from that intended by Parliament and is regarded by many as unfair; and a unhealthy climate of deception is fostered.



6.7 In Chapter 4 we look at ways in which the energies of the black economy might be diverted to the white. Part of the black economy could be legitimised by changes in the tax and benefit system that would remove people from tax or reduce the marginal rates they face. But the scope for change here is limited. Large tax concessions aimed deliberately at sectors most deeply penetrated by the black economy would obviously have much greater effects but there is no good economic or social reason why these sectors should enjoy such favourable treatment, which would be at the expense of other sectors.

6.8 The black economy will also be affected by actions that the Government could take to increase the numbers and activity of small businesses and self-employed traders. Sometimes the effect will be to shift activity from the black economy to the white, eg when traders come out into the open as a result of the regulatory burden being lifted or in order to benefit from Government-financed schemes. More often the effect will be a net growth in the black economy, by virtue of the greater numbers of small businesses and self-employed traders who, as a group, are prone to evasion. Thus there need to be adequate measures to limit tax evasion but without stifling enterprise.

6.9 In Chapter 5 we look at the steps taken by the revenue and benefit departments to improve the effectiveness of their enforcement work. We suggest that further desirable improvements could be made at little or no cost, by action in four areas:

- a. deterrence by means of publicity;
- b. declarations of secondary earnings by moonlighters;
- c. exchange of information between Departments;
- d. co-ordination of work between Departments.

Our specific recommendations are listed in 6.11 below. The main aim of the suggested action is to improve the Departments' ability (both real and perceived) to detect evasion so that would-be black economy operators may be deterred at the outset and may choose to enter the white economy instead. In two of the areas (b and c) the suggested action would, among other things, remedy some situations in which some people may at present be evading tax or national insurance contributions more by accident than by design.

6.10 Sometimes better enforcement of the tax regime will suppress economic activity (though this will be offset by greater activity elsewhere, in the white economy, if its tax burden is lightened). This is an inevitable feature of any tax regime. Of their nature direct taxes reduce incentives to work and indirect taxes reduce demand. The question for government is how to spread the burden between different parts of the economy, having regard to incentive effects, among others. We note that Inland Revenue have studied the effect of enforcement on a small sample of self-employed traders where evasion had been revealed by investigation; in these cases there appeared to be no sign of a subsequent reduction in trading activity. We suggest that Inland Revenue conduct more studies of this kind, over a wider range of their enforcement work, in order to assess its disincentive effects and to consider the implications, if any, for tax policy.

### **Recommendations**

6.11 Our recommendations are listed below; the paragraphs where they appear in the report are shown in brackets.

a. Ministers should sanction an experiment to measure the extent of working and drawing either by a direct survey approach or by extending progressively the scope of Specialist Claim Control investigators (2.16).

b. On black economy grounds increasing the earnings disregard for Supplementary Benefit for the long term unemployed is to be preferred to paying them the long term benefit rate (4.5).

c. Recent and continuing improvements in the enforcement work of Inland Revenue and DHSS are to be endorsed and the cost-effectiveness principle should apply down the management line so that effort is concentrated on 'ghosts' and more serious benefit fraud where the concealed earnings are greatest (5.9 and 5.10).

d. DHSS's plan to extend the scope of Specialist Claim Control work should be endorsed (5.11).

e. In order to improve the deterrent effects greater publicity should be given to the Departments' successes in detecting cases of non-compliance; in particular consideration should be given to:

i. Inland Revenue giving local publicity for some of their successes but without identifying offenders (5.17);

ii. Inland Revenue devising a scheme for publishing the identities of some of the more serious cases of tax evasion (5.20);

iii. Customs and Excise giving greater publicity to compounding cases (though not necessarily identifying individual offenders) (5.21);

iv. DHSS giving advance local publicity to the impending arrival of Specialist Claims Control teams, on an experimental basis (5.22).

f. Inland Revenue should devise a scheme, for Ministers' consideration, in which moonlighters not now receiving tax returns would have to make a declaration about secondary earnings on a simple form (5.24).

g. Ministers should consider the case for increasing the exchange of information between Departments, particularly information gained from investigations and routine national insurance and Schedule D data (5.29 and 5.31).

h. If Ministers are attracted to any of the recommendations e. ii., f. and g., which would require changes in the statutes under which Inland Revenue operate, they should consider the case for these changes in the context of their consideration of the report of the Keith Committee, due later this year (5.16).

i. The recommendation of the official Working Group for co-ordinating the work of national insurance Inspectors and PAYE Auditors should be accepted and implemented swiftly (5.35).

j. The case for a full merger of national insurance Inspectors and PAYE Auditors should be re-examined after sufficient experience of the co-ordinated work scheme, (5.37).

k. The Departments of Employment and of Health and Social Security should examine the demarcation between them of benefit fraud work (5.38).

l. Inland Revenue should monitor the effects on taxpayers of its improved enforcement in order to assess how far it leads to a reduction in their activity and to consider the implications, if any, for taxation policy (5.41).

m. The revenue and benefit departments should conduct more studies that assess the effects of compliance work on offenders' future behaviour and should exploit the results to improve the overall value of their enforcement work (5.43).

**ANNEX A: STUDIES OF THE SIZE OF THE BLACK ECONOMY**

A.1 Several attempts have been made to estimate the size of the black economy in this country. This annex describes and reviews them. Our conclusions are at paragraphs 48 to 52. The various methods used can be grouped as follows -

- macroeconomic
- microeconomic
- informed guesswork

**Macroeconomic Methods**

**Estimate based on National Accounts**

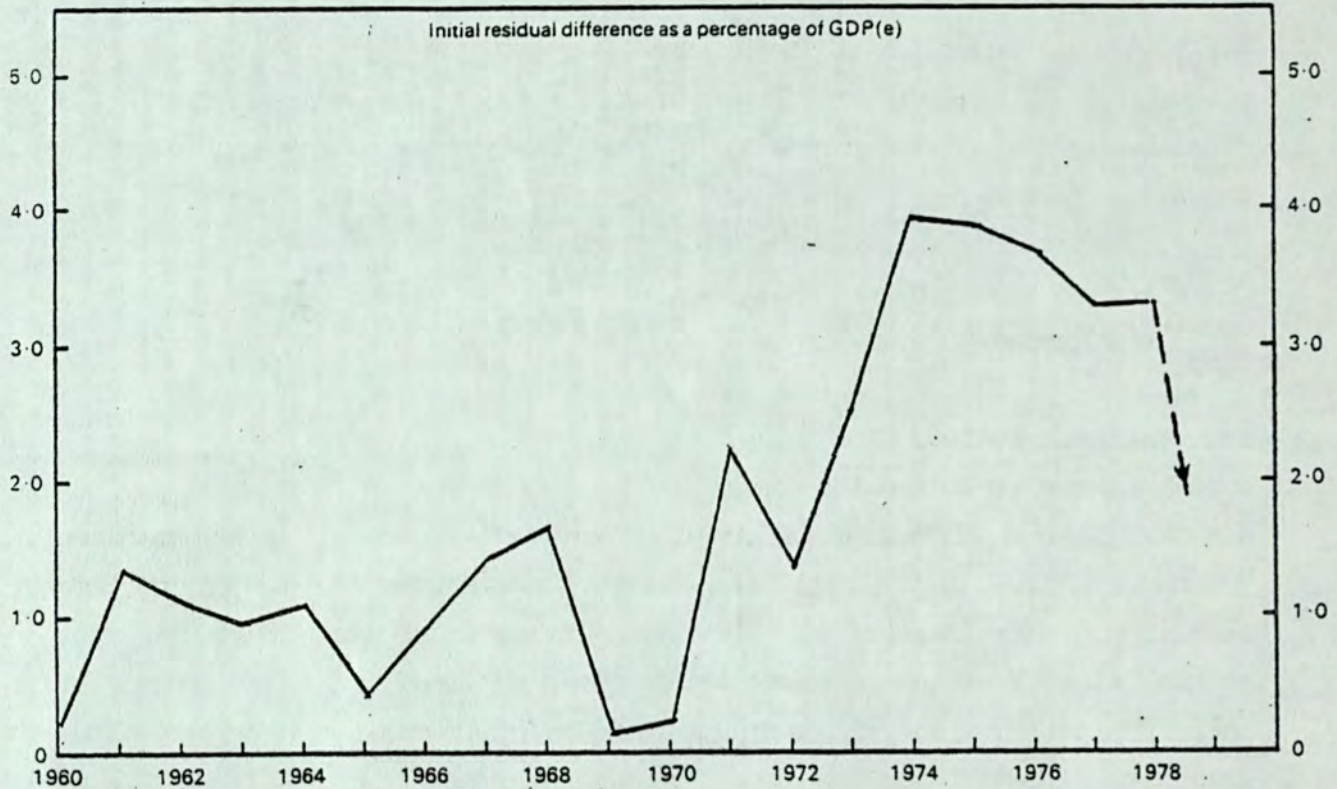
A.2 The Central Statistical Office (CSO) have attempted to use the different measures of GDP in the National Accounts to estimate the size of the black economy\*. One measure of GDP uses **income** data from official sources, mainly Inland Revenue. Income which is not declared to Inland Revenue will therefore not, in general, be included. The other measure uses **expenditure** data from surveys such as the Family Expenditure Survey (FES). A key assumption is then made that while people often understate their income to the Inland Revenue, participants in the FES will have no reason to under record their expenditure. In most years the expenditure-based measure of GDP exceeds the income-based measure by a small amount, which is called the Initial Residual Difference (IRD). It can be argued that the IRD tells us how much income is concealed from the Inland Revenue and thus how large the black economy is.

A.3 The IRD has varied considerably over the last 20 years, from close to zero in 1960, 1969 and 1970 to nearly 4 per cent of GDP in 1974 as shown in figure A.1 below. In their 1980 publication the CSO concluded that the size of the black economy in 1978, the last year for which they then had data, was around 3½ per cent of GDP.

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\*K Macafee, 'A Glimpse of the Hidden Economy in the National Accounts' Economic Trends, February 1980.

Figure A1: Initial Residual Difference (CSO Estimates)



A.4 The main weakness of this method is that it derives from a small difference between two large numbers each of which is prone to wide margins of uncertainty and measurement errors. The uncertainty is demonstrated by the number and size of revisions that CSO make to the National Accounts as new data become available and as different assumptions in the GDP calculations become more plausible. Since they published their 1980 paper CSO have revised their estimate of the IRD for 1978 from 3½ per cent of GDP down to 1.6 per cent; their latest estimate for 1981 is 2.2 per cent. Unfortunately it seems that the degree of uncertainty in the estimates can be almost as large as the quantity being measured; thus very little reliance can be placed upon the end product. We do not believe that the size of the BE could have been close to zero in 1969 and 1970 and yet as high as 1.5 per cent of GDP in 1968 and as high as 4 per cent of GDP in 1974, which is what the IRD figures suggest; much of this volatility must be ascribed to measurement errors.

A.5 The CSO have recognised this problem and have attempted to make adjustments for likely estimating errors. This exercise produces a much more stable series of 'corrected' estimates of unrecorded income: close to 2 per cent of GDP for each year since 1972.

A.6 The CSO have also pointed out that some parts of the black economy will be reported in neither the income-based nor the expenditure-based measures of GDP; examples are payments in kind, and undeclared private use of goods and services that are charged to business or trading accounts.

A.7 There is a further problem, that the expenditure-based measure of GDP under-records a significant amount of money expenditure. The main source for the expenditure-based measure of GDP is the FES. The FES collects data on the expenditure recorded by a sample of families over a 2-week period. There must be room for doubting that even the families whose incomes are entirely above board will correctly record items of their expenditure that they suspect, or know, have gone to participants in the black economy. The buyers of black economy products often have close personal relations with the providers and will therefore tend to collude with them to keep the transactions secret. Moreover respondents to the FES are asked to record their income as well as their expenditure. It seems unlikely that families with undeclared income (from black economy sources) will faithfully record all their expenditure with the result that the total would exceed their declared income. Yet another problem is that about 30 per cent of the families whose participation in the FES is sought do not respond either because they refuse to be interviewed or because they cannot be contacted. One significant group of 'uncontactable' people are those who have recently moved home: such people are likely to be major customers for black economy services in their new homes (for house repairs and decorations). Thus participants in the black economy, both producers and consumers, are likely to be more heavily represented in the 30 per cent who refuse to take part than in the 70 per cent who do. This again would result in the FES understating expenditure.

A.8. These considerations have led the CSO to conclude that the true size of the black economy is likely to be significantly larger than that indicated by their published IRD estimates. On their (confidential) judgement of the amount of expenditure not revealed by the FES and of other sources of error in the IRD approach the CSO conclude that the true size of the black economy is about 5 per cent of GDP or more. We would endorse their conclusion and regard 5 per cent as a plausible minimum for the size of the black economy; however, we note that different but equally plausible judgements about the errors in the IRD approach lead to considerably higher estimates.

A.9 The CSO believe that the size of the black economy, relative to the rest of the economy, probably grew in the post-war years up to the middle of the 1970s and that since then it has grown only slowly or may even have fallen (in relative size). There are two particular sectors where the CSO has evidence for a less rapid growth or even a decline, in the black economy in recent years. The first is agriculture where the estimates of sector income from tax returns can be checked against estimates calculated from statistics from the Ministry of Agriculture, Fisheries and Food on sale and costs; this suggests that farmers under-declare a considerable proportion of their income (possibly as much as 18 per cent in 1981) but that this proportion has remained fairly steady over the last ten years and may even have decreased. The second sector is construction, long considered one of the largest areas of black economy activity. The attack on the 'lump' system since 1975 is likely to have reduced the amount of evasion and there is some indirect evidence to confirm this: the number of self-employed in construction grew at a rate of about 8 per cent a year between 1961 and 1973 but between 1973 and the last boom year for construction (1979) it has declined at about 1½ per cent a year.

**The 'big bill' method**

A.10 This approach starts from the observation that the use of large denomination currency notes has increased far faster than currency holdings in total. Blending this observation with anecdotes about furtive tradesmen with wads of large denomination notes in their back pockets has led some commentators\* to conclude that the black economy is booming.

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\*Ross, Fortune, October 1978, and Freud, Financial Times, April 1979



A.11 Unfortunately for this method, there are other more plausible (and more mundane) explanations of why people's holdings of large denomination notes have increased. It is most unlikely that people respond to inflation by holding a greater **number** of notes of all denominations, in constant proportions. They are more likely to respond by keeping the same number of notes but substituting high value ones for low value ones. A number of researchers have shown that such a substitution effect is more than enough to account for the growth in holdings of large notes.

A.12 We conclude that this method has nothing useful to tell us about the size of the black economy.

#### **The transaction method**

A.13 The starting assumption here is that there is a stable relationship between the value of total transactions in the economy, derived from multiplying currency and bank deposits by average velocity, and national income. Other things being equal an increase in the ratio between the value of transactions and recorded national income would suggest a growth in unrecorded income, the black economy.

A.14 Feige\* has employed this method in a calculation which suggests that the black economy has increased substantially (though not regularly) since 1960 to a level of about 15 per cent of GDP in 1979.

A.15 Feige admits that his results depend strongly upon a number of assumptions in areas where empirical data are lacking and concedes that his 'estimates should be regarded as preliminary'. For example his assumptions for currency velocity are derived from estimates of the number of transactions which banknotes can bear before they are recalled by the banks as unfit for further circulation. Unfortunately a wide range of estimates of banknotes' lifetimes are plausible, leading to quite different conclusions.

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\*E Feige, 'The UK's unobserved Economy', Journal of Economic Affairs, July 1981

A.16 We conclude that until better methods are available for measuring the number and values of transactions in the economy this method will not produce reliable estimates of the size of the black economy.

**'Cash in the money supply' estimates**

A.17 This method, developed by Gutmann in the USA, starts from the assumption that black economy transactions are usually conducted for cash payment. Hence an increase over time in the ratio of cash to a narrow measure of money supply indicates, other things being equal, a growth in the black economy as a proportion of GDP. In the USA the ratio of cash to narrow money stock, M1, increased during World War 2, then declined slowly until 1961, and then grew again until by 1976 it reached the World War 2 level. Gutmann suggests that the black economy grew during wartime as a reaction to higher taxes, controls and rationing, then declined up to 1961 and then grew again. Assuming, among other things, that the pre-war ratio of cash to narrow money supply corresponds to an economy with a negligible black component, Gutmann estimates that the increase in the ratio since 1961 implies a black economy in the USA which increased as a proportion of GDP up to a level of over 10 per cent by 1976.

A.18 O'Higgins\* has applied the Gutmann method to United Kingdom money supply figures. The ratio of cash to M1 has gone through several periods of increase and decrease since 1963, making it difficult to formulate a plausible hypothesis about changes in the size of the black economy. In relation to a slightly broader measure of money supply, which includes United Kingdom private sector sterling time deposits and which we denote M\*, the cash ratio moved quite differently, declining fairly steadily to 1974 and then increasing. This measure suggests that the black economy grew steadily from a nadir in 1974. Taking this as a working hypothesis O'Higgins performs Gutmann-type calculations which suggest that the black economy in the United Kingdom rose to a level of between 3 per cent and 5 per cent of GDP by 1978.

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\* O'Higgins M, 'Measuring the Hidden Economy: A Review of Evidence and Methodologies', Outer Circle Policy Unit, July 1980.

A.19 Several writers, including O'Higgins himself, have identified serious weaknesses in this methodology -

- quite different answers flow from employing different but plausible measures of money supply, (as we saw in relation to M1 and M\*, above);
- quite different answers come from different choices of base year; (repeating the O'Higgins calculation with 1963 as base year reveals a negative black economy in 1978);
- the ratio of cash to money supply is strongly influenced by changes in the velocity of circulation of currency and of demand deposits. These effects were not estimated in the Gutman and O'Higgins calculations; in any case independent estimates of changes in velocity of circulation are difficult to obtain and subject to wide margins of error.
- people's holding of cash is influenced by factors other than their propensity to purchase from the black economy, (eg increasing use of cheques and credit cards, increasing proportion of income spent on non-essentials).

A.20 We conclude that no reliance can be placed upon estimates using this method, at least until there is a far better understanding than now about the factors, other than the black economy, governing people's holdings of cash. The next method we look at attempts to remedy this deficiency.

#### **An Econometric Method**

A.21 Matthews employs econometric techniques in a study\* that can be regarded as a more scientific version of the cash ratio method described above. He starts by formulating a hypothesis about what influences people's

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\*K Matthews: 'The demand for currency and the rise of the Black Economy 1973-79', Liverpool Research Group Economic Bulletin (No 2)

choices in the holding of cash as an alternative to bank deposits (all sterling sight deposits including certificates of deposits held by United Kingdom residents). The hypothesis states that the cash ratio will be -

- negatively related to 3 factors that make deposits attractive: inflation, interest rates and the efficiency with which deposits can be used (assumed to increase with time);
- positively related to the size of the black economy which, he assumes, is itself positively related to 3 further factors: unemployment, average effective household income tax rate and sales tax rate.

The hypothesis is then expressed in the form of a mathematical model relating the cash/deposit ratio to these 6 factors. The credibility of the hypothesis is then taken to depend upon how well the model fits with data from recent years.

A.22 Matthews attempts to fit his model to quarterly United Kingdom data from Q3 1973 to Q2 1979. He decides, reasonably in our view, not to use data from earlier years on the grounds that the large (downward) movement in the cash/deposit ratio over the period immediately preceding 1973 is heavily influenced by the effects of the relaxation of credit controls, which are not catered for in his model. He found that the model fitted his data fairly well, explaining 94 per cent of the variation in the cash/deposit ratio. But only 2 of the 6 independent variables - unemployment and income tax - bore the hypothesised relationship to the currency/deposit ratio. Nevertheless he concluded that 'given the crudeness of our black economy variables it is heartening that 2 out of the 3 appeared correctly signed and significant'. Matthews then calculated the size of the black economy from the parameters of the unemployment and income tax variables in the fitted equation and a further assumption of a zero black economy in 1973. He offers a lower estimate (using the income tax parameter only) of 3.3 per cent of GDP and a high estimate (using both parameters) of 11 per cent of GDP, both for the year 1979.

A.23 We believe that although this is a potentially fruitful approach\* it will require considerable refinement and better data over a longer time period before it can yield reliable estimates. As noted above, Matthews himself demonstrates the widely differing estimates that come from employing two different assumptions in the calculation. The assumption of a zero black economy in 1973 is both implausible and arbitrary; Matthews concedes that quite different conclusions would flow from using other 'base' years. Also the failure of 4 of the 6 independent variables to bear the hypothesised relationship casts some doubt on the correctness of the equations' specification; other factors may exert greater influence on currency and deposit holdings and their inclusion in the equation might radically alter the tax and unemployment parameters.

**Is the black economy counter-cyclical?**

A.24 Some of the macro-economic studies provide series of estimates that purport to show how the black economy has changed over time: CSO's 'corrected' series (see paragraph A.5) and those of Feige (A.14) and Matthews (A.22). It is tempting to use these series to examine whether the black economy is related to observed macro-economic variables. In particular is the black economy counter-cyclical, ie moving in the opposite direction to 'official' GDP and in the same direction as official unemployment? This would be expected on the theory that rising unemployment increases the supply of black economy workers and their 'product' is not recorded in official GDP calculations.

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\*A more successful application of this approach is the study in the USA by Tanzi, ('The Underground Economy in the USA Estimates and Implications', Banco Nazionale del Lavoro Quarterly Review No 135, December 1980.) His model was similar to Matthews' but he had more and better data available and obtained a better fit. His results for the USA, are of a similar order to those obtained by Matthew for the size of the UK black economy.

A.25 An alternative, pro-cyclical, theory says that a fall in GDP and an increase in unemployment decreases the demand for goods and services, including those produced in the black economy. Also the self-employed might be tempted in boom years to declare a smaller proportion of income to the Inland Revenue so as to avoid arguments in lean years when their income would decline.

A.26 The three series portray somewhat different pictures of the development of the black economy over the late 1970s. To some extent these may arise because lagged effects are captured to differing extents by the different methods. More likely, we fear, the estimates in the series may be more artefacts of the assumptions in their respective methods than measures of the 'real' black economy. Nevertheless, for what it is worth, the main movements in the three measures can be summarised thus -

- the CSO 'corrected' estimate increases steadily during 1969-73 and remains fairly stable during 1973-80 with a small peak in 1978-1979.
- Feige's estimate increases sharply during 1971-74, declines sharply during 1974-75 and is stable during 1975-79.
- Matthews' estimate increases swiftly during 1973-76 and is fairly stable during 1976-79.

A.27 These movements are to be compared with -

- GDP, which grew relatively swiftly in 1970-73, declined a little in 1973-75, grew slowly during 1975-79 and decreased in 1979-80.
- Unemployment, which decreased during 1971-73, increased during 1974-77 and increased again during 1979-80.

A.28 In relation to the movements in GDP and in unemployment during 1971-77 it can be seen that -

- the CSO 'corrected' estimate and Feige's estimate tend to move pro-cyclically.
  
- Matthews estimate tends to move counter-cyclically.

A.29 We noted above that all 3 series show periods of relative stability during the latter part of the 1970s. In each case these periods cover a time span when both GDP and unemployment increased so that the two macro-economic variables would have been pulling in opposite directions on either an anti-cyclical or a pro-cyclical theory. Thus without a more refined analysis taking account of relative magnitudes (which we do not think would be justified because of the crudity of the measures), we have to conclude that the periods of stability favour one theory no more than the other. Unfortunately the series do not cover the period 1979-81 which could provide a good test-bed for the theories since unemployment rose and GDP fell, ie on the counter-cyclical theory the black economy should have grown strongly.

A.30 Statistics from official household surveys offer another approach to this issue. It has been suggested that at least some of the moonlighters who conceal their secondary earnings from the Inland Revenue may report them to these surveys. On this, rather shaky, basis the reported level of double jobbing can be used as an indicator of the level of tax evasion from moonlighting and one can examine whether it moves pro or counter-cyclically. Unfortunately there is conflicting evidence from the two main surveys that ask about second jobs - the FES and the General Household Survey (GHS). A study\* of the FES results reveals a quite strong positive correlation between double-jobbing and unemployment at the national level over the period 1967-75 but a weak negative correlation between the regional rates of double-jobbing and unemployment in a particular year (1970). The same study however reveals a positive correlation between the GHS regional rates of

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\* J Alden, 'The extent and nature of double job holding in Great Britain', Industrial Relations Journal, Vol 8, No 3, 1977

double-jobbing and unemployment in 1971. More recently the FES reports a gradual increase in double jobbing in each of the years 1977-81 but the GHS reports no such increase except for a modest one in 1980. The two surveys do appear to agree on the relationship with income - regions with low average household incomes in 1971-72 showing higher rates of double-jobbing. On the whole the evidence from this (rather dubious) source gives more support to the counter-cyclical theory than to the pro-cyclical one.

A.31 We conclude that in relation to the pro and counter-cyclical theories there is some evidence on each side. But we believe that the uncertainties in the measures are too great to draw any confident conclusions about how the black economy has responded to movements in macro-economic variables.

#### **Micro-economic methods**

##### **Expenditure and income of individual households**

A.32 Dilnot and Morris\* examined the discrepancies between individuals' income and expenditure as reported to the FES during the survey period (2 weeks). They identified as potential black economy households those where reported expenditure exceeded income. They then devised procedures (which they called 'traps') to try to eliminate households where the excess expenditure could reasonably have arisen for reasons other than black economy activity, eg the purchase of a large item during the survey period, heads of households temporarily out of work who might have been running down savings or incurring debts. Realising that these 'traps' might be too strong, in the sense of inadvertently eliminating some black economy cases, the authors generated two derived samples of apparent black economy households:

- a minimum sample derived using all the traps and also eliminating pensioners;
- a maximum sample derived using only the less contentious traps.

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\* Dilnot and Morris, 'What do we know about the black economy?', Fiscal Studies, March 1981



The excess of expenditure over income was regarded as black economy income, except in cases where this excess was less than either 20 per cent of income or £3 per week (such small differences being regarded as insignificant or the product of recording errors).

A.33 Their minimum estimate suggested that 9.6 per cent of households had an average weekly income from the black economy of £31, implying that the black economy represented 2.3 per cent of GDP in 1977. The maximum estimate suggested 14.8 per cent of households earning an average £30 per week from the black economy, implying that the black economy represented 3.0 per cent of GDP.

A.34 Although this is one of the more careful and detailed attempts to study the black economy it is open to the same general objection as all the others, namely that it employs assumptions which can plausibly be altered to give quite different results. One such assumption concerns the correctness of the 'traps' employed, where the authors exercised considerable subjective judgement. A second assumption is the arbitrary cut-off of excess expenditure less than 20 per cent or £3 per week. A third assumption is that black economy households will correctly report to FES their expenditure, even when it is considerably in excess of reported income. A fourth assumption is that the amount of income reported to the FES corresponds to the amount declared to Inland Revenue for tax purposes. A fifth, and probably most crucial, assumption is that the 30 per cent of households who decline to participate in FES are no more inclined to black economy activity than the 70 per cent who agree. We suggested earlier (paragraph A.7) that this last assumption may lead to a serious underestimation of the size of the black economy. O'Higgins has demonstrated the sensitivity of Dilnot and Morris' results to changes in this last assumption; by applying subjective but quite plausible assumptions about greater black economy activity by the decliners, he shows that Dilnot and Morris' minimum estimate rises from 2.3 per cent to 6.7 per cent of GDP and the maximum estimate from 3.0 per cent to 8.2 per cent.

**Income-Expenditure discrepancies for the self-employed**

A.35 Many commentators have suggested that tax evasion is particularly prevalent among the self-employed. Certainly it is much easier for them to conceal income than it is for employees under PAYE, and it would not be surprising if they succumbed to temptation.

A.36 Some evidence for the phenomenon appears to come from the FES. An analysis by O'Higgins\* of the survey results over a 7 year period showed that the ratio of reported expenditure to reported income was consistently higher for self-employed households, both in general and at particular income levels, than employee-headed households in a variety of occupational groups; the discrepancy was greatest for self-employed households reporting relatively low levels of income. Based on these discrepancies O'Higgins estimated that the extent of under-reporting of income by the self-employed might amount to about 18 per cent of their total income, or about 2 per cent of total national income.

A.37 Unfortunately for this method there is a serious problem relating to the measurement of self-employment income in FES. Because of the week by week fluctuations that often occur in self-employment income the FES does not attempt to record the income in the two week survey period; this would be too volatile. Instead they ask those of their respondents who are self-employed to assess their income over the most recent 12 month period for which figures are available; the FES then apply this rate of income to the survey period without adjustment. The greater the rate at which nominal earnings are increasing the more this procedure will underestimate income for the survey period. O'Higgins has conceded, in a later paper, that the effect of this time-lag could, on its own, be sufficient to account for the apparent discrepancies in the FES analysis as between self-employed and employees. It therefore seems that no useful result can come from this method.

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\*O'Higgins, 'Measuring the Hidden Economy', Outer Circle Policy Unit, July 1980

**Inland Revenue 'Guesstimates'**

A.38 The Inland Revenue, unlike their counterparts in the USA, do not have the power to undertake random investigations which would, inter alia, permit them to arrive at more reliable measures of the black economy than any of the methods reviewed above. Instead Inland Revenue have made judgements of the plausibility of different levels of evasion, extrapolating from their experiences in investigation work. This approach led to the statement to the Public Accounts Committee by their Chairman that a figure in the **range of 6 per cent to 8 per cent of GDP** was not implausible.

A.39 Inland Revenue base this view on judgements of the sizes of 5 components of evasion as shown in Table A.1 below. They concede that their judgement on 3 of the components - moonlighters, unearned income and ghosts - are little more than informed guesses; the judgements on the other 2 - companies and self-employed, and PAYE - are firmer because their enforcement work in these areas provides information that is more representative of taxpayers' behaviour in these fields. Inland Revenue regard their judgement as representing a plausible range for the size of the black economy but not lower and upper limits. In reviewing their judgements below we attempt to suggest, on a purely subjective basis, where the limits of plausibility might lie, and we list these in Table A.1.

TABLE A.1: JUDGEMENTS OF THE SIZE OF THE BLACK ECONOMY

	Inland Revenue plausible range		CPRS subjective limits of plausibility (% of GDP)	
	£bn (1981)	% of GDP	Low	High
Moonlighters	5 - 7	$2\frac{1}{2}$ - $3\frac{1}{2}$	1	$3\frac{1}{2}$
Company and self- employed profits	3 - 5	$1\frac{1}{2}$ - $2\frac{1}{2}$	$1\frac{1}{2}$	$2\frac{1}{2}$
PAYE	$\frac{1}{2}$ - 1	$\frac{1}{4}$ - $\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$
Ghosts	$1\frac{1}{2}$ - 2	$\frac{3}{4}$ - 1	$\frac{1}{2}$	$1\frac{1}{2}$
Unearned income	2	1	$\frac{1}{2}$	2
<hr/>				
Total (to nearest whole number)	12 - 17	6 - 8	4	10

A.40 In Inland Revenue's judgements the largest component is moonlighting - between  $2\frac{1}{2}$  and  $3\frac{1}{2}$  per cent of GDP, or between £5bn and £7bn in 1981. The upper end of this range would be consistent with a population of about 6 million moonlighters (nearly one-third of all employess) earning, on average, about £1,200 per year from undeclared secondary employment. In our view, and that of other commentators, this appears to represent an upper limit of plausibility; (some have said it is implausibly high). Although this is a purely subjective judgement we find it hard to believe that the number of moonlighters is more than 6 million; and whilst some moonlighters certainly get away with more than the suggested average of £1,200 per annum (eg those with full-time second jobs) there are many more who get much less (eg occasional work). Looking in the other direction we believe that the moonlighting component could be much smaller than  $3\frac{1}{2}$  per cent of GDP and smaller than Inland Revenue's lower judgement of  $2\frac{1}{2}$  per cent of GDP. In our view, and again this is purely subjective judgement, the moonlighter component might be as small as 1 per cent of GDP, or £2bn in 1981, and we regard this as the lower limit of plausibility.

A.41 Inland Revenue's judgement of the second component - companies and self-employed - is based partly on preliminary results from the pilot study of evasion by the self-employed, which we mentioned earlier (2.2). In this study a sample of self-employed case files was examined by Tax Inspectors who classified the taxpayers, subjectively, into 3 categories -

- |  |     |
|--|-----|
| a. clear indications of significant evasion: | 20% |
| b. weak indications of possible evasion:     | 40% |
| c. no indications of evasion:                | 40% |

The cases in category a. and some of those in category b. are now being investigated; the results will throw light on the reliability of the Inspectors' categorisation judgements and will also indicate the probable amounts of evasion by people in these categories. (Of the investigations completed so far in category a. significant evasion has been established in 87 per cent of cases.) For the present Inland Revenue proceed by assuming -

- i. that the judgements are reliable;
- ii. that the proportionate split between the categories is applicable to the general population (1.8 million) of self-employed;
- iii. that the proportion of declared profits that is concealed by those in category a. and would be revealed by investigation is the same as the average proportion agreed in settlements following current investigations, namely 40 per cent.

Given that the average reported profits in category a. are about £6,000 a year the total of under declarations by this category is calculated as 20 per cent x 1.8m x 40 per cent x £6,000 = £860m. For category b. a smaller degree of concealment, 15 per cent, is assumed although there is a higher level of declared profits, £7,000; this leads to an estimate of under declaration of £760m. Combining these two figures and assuming no evasion in category c. leads to a figure of £1,620m. Allowing for the fact that the true extent of profit under declaration will be greater, perhaps much greater, than that established by investigations Inland Revenue arrive at the view that the total of under declarations by the self-employed is of the order of £2½bn.

A.42 Inland Revenue do not yet have equivalent information (of the sample study type) for evasion by companies. They consider it plausible to assume that the total extent of evasion by companies is about one-third of that by the self-employed, or £½bn (one-third of £2½bn). Hence they arrive at a figure of £3bn for evasion by companies and self-employed, which is the lower end of the range quoted in Table A.1. We doubt whether the true extent of evasion could be much less than this.

A.43 The higher end of Inland Revenue's range for this component, £5bn, can be justified by assuming a degree of evasion in category b. much closer to that assumed for category a., (and by assuming a pro rata increase in the company element). This would require those in categories a. and b. to be under-declaring by about £3,500 on average, which is about one half of their average declared profits. This seems to us to represent a reasonable

figure for the upper limit of plausibility. We would enter one caveat. An even greater figure could be advocated if some of those in category c. are significant evaders despite their outward appearances. Unfortunately the Inland Revenue will not be able to test this argument since their statutes prohibit them from investigating people giving no outward sign of evasion. We believe that there is likely to be a sizeable proportion of the self-employed who do not evade to any significant extent, either because they are completely honest or because the nature of their trade makes evasion difficult. But we are not able to judge whether this proportion is as high as the 40 per cent assumed by Inland Revenue.

A.44 Inland Revenue are on firmer ground with PAYE non-compliance. As we describe later (paragraph 6 of Annex B) their auditors visit all employers over a period of time and so obtain a representative view. We see no reason to quarrel with Inland Revenue's judgement that this component of the black economy could amount to  $\frac{1}{2}$  per cent of GDP.

A.45 We are back in the realm of guesswork with the fourth component, ghosts, which Inland Revenue judge to be up to about 1 per cent of GDP, or £2bn. This would be consistent with, say, a population of around 300,000 ghosts earning an average of £7,000 per year (roughly the national average wage of employees). Whilst we consider that this is a plausible view we note that preliminary results from the black economy experiment (see B.7) are revealing considerably larger numbers of ghosts than Inland Revenue anticipated, many of whom appear to be earning £7,000 or more. But, even now, very little is known about this, the most obscure component of the black economy. Thus although we would not quarrel with Inland Revenue's judgement that 1 per cent of GDP is a plausible figure for its size we believe that any figure in the range of  $\frac{1}{2}$  per cent to  $1\frac{1}{2}$  per cent is equally plausible.

A.46 Very little is known about the size of the fifth component - unearned income - which Inland Revenue judge to be of the order of 1 per cent of GDP; we understand that they would not regard figures as low as  $\frac{1}{2}$  per cent or as high as 2 per cent as totally implausible.

A.47 To conclude we agree with Inland Revenue that it is not implausible that the size of the black economy lies within the range of 6 per cent - 8 per cent of GDP. But we suggest that the limits of plausibility suggested by their approach are somewhat wider than this; our subjective judgements mentioned above and listed in table A.1, suggest a range of 4 per cent - 10 per cent of GDP. An extreme view of evasion by the self-employed would permit a figure still greater than 10 per cent.

**Conclusions (i) - how big is the black economy?**

A.48 The estimates of the size of the black economy from the studies reviewed in this Annex are summarised in table A.2 below. They vary very widely, between 2 per cent and 15 per cent of GDP. None of the estimates is reliable; each study is forced to make crucial assumptions about factors where empirical evidence is lacking and, as many of the authors concede, alternative (but equally plausible) assumptions lead to quite different results.

A.49 We have argued that the CSO IRD measures (both the crude version 3½ per cent, and the corrected version, 2 per cent) and the Dilnott and Morris measure (between 2 per cent and 3 per cent) are all likely to be under estimates. We noted (paragraph A.8) that confidential CSO information points to a size of at least 5 per cent; this is slightly large than the plausible lower limit (4 per cent) we arrived at above using Inland Revenue's component judgements approach but is based on independent sources.

A.50 The highest estimate, 15 per cent of GDP, is provided by Feige, but we noted that his method employed some very arbitrary assumptions. We have a little more confidence in the approach of Matthews who provides the next highest estimate: his upper estimate is 11 per cent of GDP (though subject to wide margins of error). This is close to the plausible high limit of 10 per cent of GDP, which we derived above using the Inland Revenue approach.

TABLE A.2

<u>Author/Method</u>	<u>Estimated Size of Black Economy as % of GDP</u>
(i) CSO: IRD (published version)	3½%
(ii) CSO: 'corrected' IRD	2%
(iii) Feige: Transactions	15%
(iv) O'Higgins: Cash/Money supply ratio	3-5%
(v) Matthews: econometric	3.3-11%
(vi) Dilnot and Morris: Income/expenditure discrepancies in FES	2.3-3%
(vii) As (vi) with O'Higgins correction for FES bias	3-8%
(viii) Inland Revenue: informed guess	6-8%

A.51 We conclude that the true figure for the size of the black economy is likely to lie in the range between 5 per cent and 10 per cent of GDP but that within this range there is no good evidence for favouring any one figure rather than any other.

**Conclusions (ii) Is the black economy getting bigger?**

A.52 We considered above (paragraphs A.24-31) whether the black economy might be counter-cyclical, growing when the 'official' economy was in recession and falling back when it was growing. We noted that there is evidence both for and against the counter-cyclical theory and that there are no empirical grounds for believing that the black economy has grown or shrunk much since about 1976. But three general points can be made -

- a. Various official statistics suggest (but no more) that if a trend is occurring, it is a relatively gradual one.



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b. Nevertheless, it is very probable that over a longer time scale (say since 1950) the problem has grown as people have come into tax, and as public attitudes (eg to receipt of social security benefit) have changed.

c. The last few years have seen a growing awareness of and interest in the problem by the media, academics, government and the public. But this does not mean there is more black economy activity.

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**ANNEX B: THE ENFORCEMENT WORK OF THE REVENUE AND  
BENEFIT DEPARTMENTS**

B.1 Under the heading "enforcement" we consider the anti-evasion work of the Inland Revenue and Customs and Excise, the work of DHSS in compliance (ensuring proper payment of National Insurance Contributions) and the work of DHSS and the Department of Employment (DE) on benefit fraud. In this Annex we review briefly the enforcement work of these departments with particular regard to their recent success in developing more cost-effective methods.

B.2 The front line of the Inland Revenue's enforcement forces consists of the Tax Inspectors in District Offices to whom are submitted company accounts and personal tax returns. Some of the time of these Inspectors and their support staff is devoted to investigation, usually of cases where there are positive indications of evasion. The amount of time available for investigation is limited. Normally the aim is to secure the taxpayer's co-operation in establishing a reasonable figure for his tax liability; this figure may often be less than the true amount of liability but the latter figure would often be impossible or very time-consuming for the Inland Revenue to establish with conviction. Inland Revenue encourage the taxpayer to co-operate in an investigation (ie to remedy previous non-declarations) by offering to treat him more favourably when assessing penalties if he does so. (Penalties are an administrative fine which the Inland Revenue are empowered to levy for tax evasion; a typical settlement of a case when significant tax evasion is established would lead to a yield made up of 3 elements: the amount of tax due for current and previous years, an interest charge, and a penalty of between 25 per cent and 100 per cent of the tax due).

B.3 Traditionally Districts selected cases for investigation mainly on the strength of the indications of evasion, enough of them to fill the available staff time. Recently more weight has been placed in the selection of cases on the likely yield; at the same time investigation procedures have been streamlined. The majority of the work is concerned with the self-employed and companies. In 1981 the whole time equivalent of about 1,150 staff were employed on this work which yielded about £92 million - a yield-cost ratio of about 4:1. There are already signs of higher yields in 1982, partly due to improved procedures and the selection of higher yielding cases.

B.4 The Inland Revenue also employ staff on specialised enforcement functions; these are summarised below along with approximate staffing and yield figures for 1981 (where appropriate):

- PAYE Audit - to check that employers correctly operate the PAYE system and deduct tax and national insurance contributions; yield £20 million, 400 staff, ratio 4:1;
  
- Special offices - mainly to investigate areas of widespread evasion and avoidance where large amounts of tax are at risk (eg employment in Fleet Street of casual labour under fictitious names); yield £29 million, staff 102, ratio 19:1;
  
- Enquiry Branch - to investigate cases where there is a large amount of evasion or serious fraud; yield £23 million, staff 144, ratio 13:1;
  
- Board's Investigation Office - mainly concerned with administering a special scheme for collecting tax from sub-contractors.

B.5 Special Offices and Enquiry Branch obtain high yield ratios, by comparison with those of mainstream District work and PAYE Audit, mainly because they are intended to deal almost exclusively with particular types of cases where the yield is high.\* We have already noted that the yield ratio of District work seems to be increasing as they adjust their selection of cases. But there is a limit to how far Districts can become more selective; they will always need to investigate cases where the yield may be only moderate, not least to maintain a credible degree of deterrence against people contemplating evasion on this scale.

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\* The number of Special Offices has been increased in recent years to improve their geographical coverage; a high yield ratio has been maintained.

B.6 PAYE Audit has undergone some substantial changes in the last two years. Until 1981 the average employer was visited once every 20 years although the cycle was geared so that larger employers or those in trades prone to evasion were visited every 10 years. Since then the visits have been re-organised so that more time is spent on cases showing significant irregularity. In addition the number of staff is being doubled so that employers meriting most attention will be visited more frequently. Inland Revenue consider that the scope for improving compliance in this area is sufficiently great that the present yield ratio (4:1) can be maintained even with double the number of staff.

B.7 Inland Revenue's most recent innovation is the 'Black Economy experiment' in which about 75 staff are being redeployed onto investigation work in 50 District and Special Offices. Their remit is to discover 'moonlighters' and 'ghosts' by looking actively for signs of their activity in the economy (advertisements, local authority registers etc). This approach contrasts with the traditional approach to District investigation work which starts with information coming to the Inland Revenue's files during the normal course of work; evidently the traditional approach is unlikely to catch ghosts and moonlighters. The 75 staff have no special training and were only posted in November 1981. It is too early to draw many firm conclusions from the results of the experiment to date. Nevertheless, from what we have seen, we believe that the experiment will prove successful, in that new and highly cost-effective methods for detecting moonlighters and ghosts will be identified. Already quite striking results have been achieved, for different types of target and by different methods, by the 50 offices involved in the experiment. Inland Revenue are arranging for information on these successes to be collated centrally and distributed back to the participating offices so that each office can learn from the experiences of the others, which should lead to further successes.

B.8 We commend the Inland Revenue's progress in improving the yields from their investigation work. We would suggest that they consider the balance of effort to be directed against ghosts and moonlighters. We suspect that most members of the public would be surprised to learn about the ghost problem, ie

a significant (but unknown) number of people are able to earn a good living, working on their own account, but completely unknown to the Inland Revenue and without paying any tax at all. There might be strong public support for deploying extra staff, better methods and greater powers to get these people to pay up. Added to which ghosts are likely to be cost-effective targets for extra investigation work because they will usually offer high yields. By contrast the case for extra effort against moonlighters may be harder to sustain. This type of evasion, though illegal, is probably more widely accepted by the public. The amounts evaded are often small and hard to detect, which makes moonlighters a less cost-effective target. Nevertheless the total loss of tax through moonlighting, though unknown, is likely to be large because many people are at it. Thus the Inland Revenue needs to achieve sufficient success in this area to provide a credible deterrent and to prevent the problem getting out of hand. At a time of high unemployment there is also a strong economic case for trying to reduce moonlighting because moonlighters are servicing consumer demand that might otherwise support jobs for other people in the white economy.

B.9 Persons supplying goods and services subject to VAT are not required to register and charge and account for VAT unless their annual taxable turnover exceeds £17,000. This high threshold excludes most of the moonlighters and some of the ghosts and restricts significant evasion to suppression and misdeclaration of transactions by established businesses. Customs and Excise seek to limit evasion by a computer-based programme of visits to registered traders. These visits protect the expected yield from the tax by deterring evasion and pick-up large amounts of additional tax from under-declarations discovered. 3500 visiting officers are employed; they obtained a total yield of about £160 million in 1981-2. The yield/cost ratio, ignoring the deterrent effect of the visits, is 3:1. Operational Research techniques have been employed continuously over the last 6 years to refine visit selection to enable a smaller visiting staff to concentrate greater effort on those of the 1.3 million traders where the risk of evasion is perceived to be greatest. In addition Customs and Excise employ 380 specialist staff who deal with VAT fraud. Most of their cases are in the catering and allied trades and in the second-hand car trade where compliance is very poor. Some cases involve

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*for Econ  
P.S.*

*cc Messrs. Valdes  
Wilson  
Hogan  
H. King  
Dignid*

10 DOWNING STREET

From the Private Secretary

6 July 1981

COUNTERING TAX FRAUD AND EVASION

I wrote to you on 29 June about the Chancellor's minute of 26 June saying that the Prime Minister would like to discuss it with the Chancellor. In the event, as you know, the Prime Minister and the Chancellor did not discuss it when they met last Wednesday.

The Prime Minister has now considered the Chancellor's minute further; and on reflection, she is prepared to go along with his proposals.

I am sending a copy of this letter to Jim Buckley (Lord president's Office), David Heyhoe (Office of the Chancellor of the Duchy of Lancaster), Don Brereton (Department of Health and Social Security) and Richard Dykes (Department of Employment).

**L. P. LANKESTER**

A. J. Wiggins, Esq.,  
H.M. Treasury.

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17. The Department told us that although they had earlier been satisfied with the performance of District Offices, this special exercise had now disclosed some disturbingly high error rates. These varied with the type of check, but even after excluding errors related to purely procedural matters, there still remained an inacceptably high rate of errors which did affect the receipt of tax. There was a 27 per cent error rate on assessments but the amount of tax involved was not recorded. The error rates on codings and on examination of returns were 12 and 24 per cent respectively, although in some cases the tax involved fell within the Department's normal tolerance. Extrapolation over the whole country of the errors in examination of returns would have resulted in tax under-charges of about £25 million and over-charges of £18 million.

Qs 4750-66

18. The Department did not think these results reflected on the quality of the staff, who had been under particular pressure during the period concerned, because of a succession of budgetary changes. Nor could they attribute any particular blame to supervision, on the strength of the relatively small sample made. The Department's immediate concern was to find out whether the results of the special exercise were typical. As a first step they proposed to add 60 Inspectors to the Regional inspection teams to check the standard of clerical work on the next annual visits to District Offices and they would then have a clearer idea how best to tackle the problem within their manpower constraints.

Qs 4767-8

Q 4764

Qs 4774-5

19. We too are seriously concerned about this situation because it must tend to undermine the confidence of taxpayers in the fairness of the PAYE system. We do not find wholly convincing the suggestion that high error rates may be of only recent origin, because the Department's monitoring arrangements in the past do not appear to have been designed to give much assurance about the accuracy of the PAYE work. Indeed, we are surprised that this activity seems to have been given so little attention until the Comptroller and Auditor General drew attention to it.

20. In order to justify public confidence in this major area of the country's system of taxation, the Department must maintain effective monitoring arrangements and an adequate allocation of staff resources for this and for achieving reasonable standards of accuracy in the PAYE operations. We shall wish to return to this important matter when the results of the Department's steps to investigate the current position thoroughly and to appraise the further steps necessary to secure these objectives, are available.

#### "THE BLACK ECONOMY"

21. In our consideration of the arrangements for the examination of taxpayers' accounts we also questioned the Department about the so-called "black economy"—in which the Department subsume all forms of non-declaration of taxable income. It thus includes the understatement of income and overstatement of expenses as well as the concealment of secondary sources of income from "moonlighting". Differing estimates had been made of its size but the Chairman of the Board of Inland Revenue agreed with his predecessor that a plausible estimate would be about 7½

C&AG's  
Report  
(Volume 3)  
Para 136  
Qs 4619-22

Qs 4658-60

Qs 4619,  
4641

per cent of the country's Gross Domestic Product. At current levels this would suggest a total undeclared income of about £12 billion and a tax loss of about £3-3½ billion. The Central Statistical Office put the under-declaration at only 3½ per cent; but even at this lower level the total tax loss would still be of the order of £2 billion a year.

Q 4728

22. Insofar as the black economy covers the understatement of income from sources known to the Department we hope that our suggestion for improving the examination of taxpayers' accounts will help to encourage a higher standard of compilation of tax returns. Greater difficulties are presented by the secondary sources of income of which the Department have no knowledge. The Department considered that these were likely to be more common amongst the employed than the self-employed and that a successful attack on moonlighting would require an approach different from that used in the selective examination of taxpayers' accounts. The first requirement was to identify the industries and locations in which the moonlighting was taking place and its extent in order to judge the investigative resources to deploy. The Department had already tackled one or two areas where tax evasion was particularly blatant, but the approach required would vary from case to case. Other countries had tackled this problem by the use of more extensive powers to investigate the tax affairs of individuals. This was not an approach which had hitherto been considered in this country, but the Department might eventually need to do so.

23. In terms of the loss of potential tax, and so the additional burden placed on the other taxpayers, the problem of the black economy dwarfs all other problems facing the Department; and their evidence did not lead us to think that they had yet devoted sufficient attention to it. We therefore recommend that they now undertake a comprehensive review of the problem with the aim of identifying those areas where a concerted attack might be expected to produce results commensurate with the investigative resources required. They should also consider the need for a strengthening of the Department's powers of investigation if the evasion cannot be successfully tackled under their existing powers.

### CLASS XIII, VOTE 6. ECONOMIC AND FINANCIAL ADMINISTRATION: CUSTOMS AND EXCISE

#### TOBACCO PRODUCTS DUTY

C&AG's  
Report  
(Volume 3)  
Paras 91-106

24. Until the end of 1977 all imported tobacco, both manufactured and unmanufactured, was subject to customs duty. However a condition of the UK's membership of the European Communities was the conversion of any customs duties of a fiscal nature into internal excise duties applied equally to imported and home-produced goods; and by 1 January 1978 the customs duty on tobacco was wholly replaced by a tobacco products duty chargeable on the finished products.

25. Customs revenue duty had formerly been charged on tobacco leaf and other imported raw materials. From the point of import there was a close customs control of these raw materials, with high physical security,



W. R. **CONFIDENTIAL**

PRIME MINISTER

✓ Mr. Walters  
Mr. Wolfson  
Mr. Ingham  
Mr. Hoskyns  
Mr. Duguid

Tax Evasion

You commented, on my minute, that there would be less work if a dampener were put on tax evasion; consequently, less income and expenditure; and hence, lower receipts from VAT and Customs duties.

As I tried to explain in paragraph 2(ii) of my minute, less tax evasion doesn't necessarily mean lower activity in the economy as a whole. Many people who are currently working without paying tax will continue working and pay tax; and some of the spending would be diverted to people who already pay their tax - their tax bills would be lower because of the extra tax being collected from the present tax evaders.

So, total spending and therefore receipts from VAT and other duties will not necessarily fall. Even if they did, the extra income tax collected by the Revenue could very well outweigh any fall in Customs receipts.

The Chancellor's proposals in fact are aimed principally at curbing tax evasion amongst large and medium employers. This makes it less likely that the effect you fear will happen. Revenue and Customs top management clearly believe that more tax can be collected, and cost-effectively.

But in the end I do not believe the precise arithmetic is the real issue. The real issue is the integrity of the tax system, and whether we are prepared to accept tax evasion on a growing scale.

*Go ahead - and we will  
see what happens.*

*no*

*12*

3 July 1981

**CONFIDENTIAL**

CONFIDENTIAL

PRIME MINISTER

*See note on next page  
The work would create  
less income  
we should  
look the VAT  
we need  
ful. r  
the  
6 month period  
not*

c. Mr. Walters  
Mr. Wolfson  
Mr. Ingham  
Mr. Hoskyns  
Mr. Duguid

TAX EVASION

1. You remain unconvinced by the Chancellor's proposal (Flag A) to redeploy 400 Inland Revenue and a few Customs staff to counter tax evasion and fraud. May I try to persuade you that it makes sense?

2. I agree that there are benefits from the black economy. In particular:

- i) it provides extra income and employment for some;
- ii) it may raise the level of activity and employment in the economy as a whole. Income tax evasion is similar in its effect to an employment subsidy; and like an employment subsidy, someone else has to pay for it (see para 3(ii) below). Whether tax evasion results in more jobs in total depends upon whether its favourable effects outweigh the unfavourable effects of higher taxes having to be paid by others. Small businesses and self-employed "moonlighters" are arguably more dynamic than larger, union-dominated employers; and insofar as the former practice tax evasion, one can argue that its net effect on activity is positive. On the other hand, the Chancellor's proposal is aimed principally at the medium and large employers. Insofar as it would mean that more "moonlighters" would be caught, the effect on the unemployment register would be uncertain. Some would join the register; but others would carry on their work legitimately, others would stick to their main line of work (eg dustmen who do plumbing on the side), others who are drawing unemployment benefit illegally would actually leave the register.

CONFIDENTIAL / 3

3. There are some very powerful arguments against tax evasion and the black economy:

i) As Alan Walters says in his note at Flag B, tax evasion is "infectious and spreads very rapidly". Growing evasion - and there is plenty of evidence that it is growing - is bad in equity, bad for public and private morality, and bad for people's attitudes to government and the law. There is a good deal of resentment against tax evasion, including from many small businessmen (the Chancellor quotes the small builders) who resent the unfair competition it involves, though admittedly this has to be set against the advantages people derive from getting small jobs done more cheaply. And in countries such as Italy where tax evasion is worse than in the UK, there is considerably less respect for government - and I am sure it is one of the causes.

ii) The amount of tax currently lost through evasion is estimated by the Revenue at £3-3½ billion, and £2 billion by the CSO. Whatever the precise amount, it is clearly pretty large; and it means that rates of taxation have to be higher than they otherwise would be.

*Men - I feel the work would stop*

4. Other considerations are:

i) there has been criticism of tax evasion from the PAC and a recommendation that more resources should be devoted to counter it (see Flag C).

*- i. we should get less tax because of no V.A.T from cash expenditure*

ii) It is the job of the Inland Revenue and the Customs to collect the taxes that government sees fit to impose. The government should not really be interfering in what is essentially a management decision aimed at carrying out that job more effectively. Top management in both Departments have been preoccupied with the civil service strike. A refusal to go along with their redeployment

/ proposals

H. R.  
**CONFIDENTIAL**

- 3 -

proposals would have little impact by comparison; but they would still find it hard to understand.

5. On balance, I believe the Chancellor's proposal should be supported on the basis that it should be presented in a low key way. Both Alan Walters and David Wolfson share this view.

12

1 July 1981

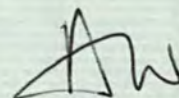
**CONFIDENTIAL**

cc Mr. Lankester  
Mr. Wolfson  
Mr. Hoskyns  
Mr. Duguid  
Press Office

B

PRIME MINISTER

1. I think the Chancellor is entirely right in putting as a first priority the integrity of the tax system. As one can see in Italy, tax evasion is infectious and spreads very rapidly. The law-abiding taxpayer is both outraged and tempted by the example of the tax evader.
2. The Chancellor's proposal to concentrate largely on the PAYE deductibility for large and medium firms is a good one. Politically it can be shown that we are not hounding the small minnows. We are out for the bigger fish.
3. Para 5 of the Chancellor's memorandum of 26 June suggests that the main target will be the casual worker, paid in cash, who is employed primarily by a medium and large employer; the chances are the small employer being visited in any year will remain very low. The second attack will be on the "self-employed moonlighter". But of course the self-employed moonlighter is rather like a very small firm and it seems there is some inconsistency between the inadequacy of the coverage of small firms in para 5 and the earmarking of the self-employed moonlighter in para 6.
4. I think the Chancellor is being rather hopeful in para 7 when he suggests that the proposals could not put up the unemployment figures. The Chancellor says he cannot see the self-employed moonlighter shutting his business down because he has to pay tax. But if social security and unemployment benefit are sufficiently high relative to his untaxed earnings from moonlighting, he may well be tempted, when confronted with tax deductions, to see the state of being unemployed and on benefit preferable to that of working. To argue the contrary, as the Chancellor does, implies that 30% or so difference in marginal earnings will not affect anyone's behaviour. I do not think that can be entirely true.
5. One of the omissions from the Chancellor's list is the problem of VAT evasion. In my experience this is very common among the casual service trades.



ALAN WALTERS

30 June 1981

MR. LANKESTER *RL*

COUNTERING TAX FRAUD AND EVASION

Re the Chancellor's memorandum of 26 June. The main thrust of the programme is to check that PAYE is being paid. Para 5 suggests that the main target will be the casual worker, paid in cash, who is employed primarily by a medium and large employer; the chances are the small employer being visited in any year will remain very low. The second attack will be on the "self-employed moonlighter". But of course the self-employed moonlighter is rather like a very small firm and it seems there is some inconsistency between the inadequacy of the coverage of small firms in para 5 and the earmarking of the self-employed moonlighter in para 6.

I think the Chancellor is being rather hopeful in para 7 when he suggests that the proposals could not put up the unemployment figures. The Chancellor says he cannot see the self-employed moonlighter shutting his business down because he has to pay tax. But if social security and unemployment benefit are sufficiently high relative to his untaxed earnings from moonlighting, he may well be tempted, when confronted with tax deductions, to see the state of being unemployed and on benefit preferable to that of working. To argue the contrary, as the Chancellor does, implies that 30% or so difference in marginal earnings will not affect anyone's behaviour. I do not think that can be entirely true.

One of the omissions from the Chancellor's list is the problem of VAT evasion. In my experience this is very common among the casual service trades.

*AW*

29 June 1981

ALAN WALTERS

CONFIDENTIAL

R H

B/C:- Mr Walters  
Mr Hoskyns  
Mr Wolfson

29 June, 1981

*BF - 30-6-81 Not on agenda  
RF for next  
mtg.*

Countering Tax Fraud and Evasion

The Prime Minister has considered the Chancellor's minute of 26 June on the above subject. I am afraid she is still not convinced that now is the time to deploy Inland Revenue staff in order to counter tax evasion. Perhaps the Chancellor would like to have a further word with the Prime Minister about this at their next meeting on Wednesday.

J. P. LANKESTER

A J Wiggins, Esq  
HM Treasury

CONFIDENTIAL

Prime Minister A1

Alan White  
Mr. Ingleton  
Mr. Wilton  
Mr. Lunt



(A)

The Chancellor is  
unhappy about his  
proposal (Plan A) to  
redeploy & remove staff

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

PRIME MINISTER

COUNTERING TAX FRAUD AND EVASION

continue to resist. The line to  
go for the black economy is  
when you can  
reduce the level of  
i.e. especially  
on smaller  
interest  
12  
26/6

to countering tax  
evasion. Can he  
go ahead?

At our meeting on 27 April to discuss the redeployment of Inland Revenue staff on countering tax evasion you expressed fears that the move might be seen as an attack on the small businessman and could even bring about an increase in recorded unemployment.

2. I recognise the importance of the points you make and I have looked at the matter again with great care.

3. First, a word about the context into which the proposed redeployment fits. The black economy is a real problem and is widely if not universally condemned. If we do not succeed in containing it there must be a risk of a decline in tax morality to the sort of levels one sees in parts of the Continent. There is no advantage, political or otherwise, in allowing this to happen; on the contrary, I should find it helpful to be able to point to something positive we are doing about the black economy.

4. On the detail of the proposal, the Inland Revenue staff concerned will be found from a - much larger - reduction in those at present engaged on the procedural side of Schedule D. So we shall see some reduction in the amount of tax paper work affecting businesses, in particular small businesses, and a more effective use of a smaller total number of staff.

5. The main task for those redeployed will be checking that PAYE tax is properly deducted and paid over from wages and salaries. This is an area where there has been a lot of criticism from the C & AG. One of his main points, which we shall aim to meet, is that more should be done to pick up casual workers who are paid in cash without proper tax deduction or

/records.





records. The principal target of the increased coverage will be the medium and large employer; a small employer's chance of a visit in any year will remain very low.

6. The second use for the Revenue staff - accounting for about one-fifth - will be to search out the self-employed "moonlighter". This is something I have been urged to do by small businesses; the Construction Industry's Joint Taxation Committee made the point very strongly in their pre-Budget representations, on behalf of bona fide smaller building firms across the country. The genuine small businessman sees the tax-evading moonlighter as unfair competition, and rightly so.

7. I see nothing in these proposals which could put up the unemployment figures. The casual who escapes PAYE will typically have a full-time job, and so will some of the self-employed moonlighters. As for the self-employed moonlighter who is running a full time business, I do not see him shutting it down because - like the rest of us - he has to pay tax. I would expect to find that some of those who are caught will be - illegally - drawing unemployment benefit; where this happens, recorded unemployment will come down.

8. As regards Customs & Excise, the redeployment of staff means that the Department can more effectively tackle anti-smuggling and fraud work - where, at present, a significant amount of work has to be left undone. The main areas are drug smuggling and evasion of restrictions on the imports of textiles (the latter at the request of Keith Joseph and John Nott, when at Trade). Here again, in no way can the actions be represented as an attack on small businessmen.

9. There is I should add nothing in the argument sometimes seen in the newspapers that collecting evaded tax reduces demand and thus prevents job-creation: if the Revenue could collect even some of the (perhaps) £4 billion presently evaded I could use the money to reduce the PSBR, to cut taxes, or to finance productive investment



in small businesses.

10. The problem about the black economy is not whether the tax should be collected, but whether it can be, in a cost effective way. I am satisfied that my present proposals will go some way towards doing that. They entail a relatively small - but more efficient - regrouping of resources within two large organisations. The effect will build up slowly over the next three years and the exercise does not represent any going back on our continued efforts to meet the 1984 manpower target.

11. Of course, I will consider carefully how best to present the moves, in order to avoid any misunderstanding about their effects or motives behind them; a pretty low-key approach will clearly be desirable. The news can probably emerge most effectively in course of evidence to the PAC, which maintains a powerful interest in this subject.

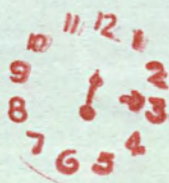
12. I am copying this minute to Christopher Soames, Francis Pym, Patrick Jenkin and Jim Prior.

A handwritten signature in dark ink, appearing to be 'G.H.' with a flourish.

(G.H.)

26 June 1981

26 JUN 1987



CONFIDENTIAL



10 DOWNING STREET

cc Mr Wolfson  
Mr Hoskyns  
Press office

Gen Pol,  
A. Walters

From the Private Secretary

28 April 1981

When they met yesterday evening, the Prime Minister and the Chancellor had a word about his minute of 21 April concerning tax evasion and the black economy. The Prime Minister said that she was not altogether happy with the Chancellor's proposal in view of the effect which they would be likely to have on employment in the black economy at a time when unemployment was still rising. The Chancellor said that he would reconsider in the light of the Prime Minister's comments.

I am sending a copy of this letter to Jim Buckley (Lord President's Office), David Heyhoe (Chancellor of the Duchy of Lancaster's Office), Don Brereton (Department of Health and Social Security) and Richard Dykes (Department of Employment).

*(Handwritten mark)*

**L. P. LANKESTER**

A. J. Wiggins, Esq.,  
HM Treasury.

CONFIDENTIAL



Civil Service Department  
 Whitehall London SW1A 2AZ  
 01-273 4400

24 April 1981

*(M. Rev)*  
*cc A. Walters*

Dear Chancellor,

Countering Tax Fraud and Evasion

In your minute to the Prime Minister of 21st April, with the purpose of which I quite agree, you made no mention of the staff target for your Department at the 1st April 1984. Would you confirm, before you are publically committed on numbers to be involved, that you will find the additional 400 staff of the Inland Revenue and the smaller number of the Customs and Excise from within the total figure of 102,600 which we agreed last autumn?

Copies of this letter go to the recipients of your minute.

*Yours sincerely,*

*Buckley*

*(Private Secretary)*

*Dictated by the hon. President and signed on his behalf.*

The Rt.Hon.Sir Geoffrey Howe, QC,MP.

24 APR 1981



CONFIDENTIAL

cc Press Office  
Mr Wolfson  
Mr Hoskyns

cc A. H. H. A

PRIME MINISTER



The Chancellor  
proposes to step up the  
anti - fraud effort  
in the Revenue. You might  
like to hear more about  
this when you see him?

Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

PRIME MINISTER

May I have a word

before any further action is  
taken. not

The Lord President has  
added a note (attached).

MS  
2/14

You will be aware of the widespread anxieties which have been expressed about evasion of tax and the black economy. It is important that, within the inevitable constraint of limited staff resources, we should take every possible step to counter tax fraud and evasion not simply because of the extra revenue which can be collected as a direct result of additional effort but also because of the indirect but undoubtedly valuable deterrent effect and impact on fiscal morality generally.

~

2. I have accordingly agreed, following the review of the question within my Departments, that some redeployment of staff effort in this direction is fully justified and should now be made. In view of the likely Parliamentary and Press interest in the proposals - and I would expect the reaction to be generally favourable - I thought you would be interested to know the details before they are announced.

3. In the case of the Inland Revenue, it is proposed that some 400 staff overall should be redeployed on countering tax evasion and the black economy in the period up to 1984. None of these will, of course, represent an addition to the total staff of the Inland Revenue. They will be found from existing staff and will be more than offset by the much larger savings which that Department expects to make from efficiency improvements, eg by means of the Rayner scrutinies, in the period up to 1984. The build-up to the 400 will be

/gradual over this



gradual over this period with a smaller number for the first year than in the later years.

4. Although the likely return from this additional effort cannot in the nature of things be precisely quantified, I am satisfied that it is likely to be very cost effective on any basis of comparison. The Inland Revenue will monitor closely the effectiveness of all aspects of the redeployment, but the sort of thing they have in mind is:

- a. More audit of PAYE, which should be particularly useful in relation to casual and part-time employees or employed moonlighters, where the C&AG has recently drawn attention to serious abuses and potentially growing loss of tax;
- b. More action specifically against some of the other more widespread forms of moonlighting; and
- c. More effort on the detection of criminal default leading to prosecution.

5. I have also agreed in principle that Customs and Excise should also strengthen their anti-drug smuggling and fraud effort. I have not committed myself to any particular numbers, but the size of the redeployment is likely to be smaller than that in the Inland Revenue. Again there will be no net addition as the staff will be found from savings elsewhere.

/I shall be considering



CONFIDENTIAL



6. I shall be considering further with the two Departments the form and timing of any announcement. In the case of the Inland Revenue, a convenient occasion to make the decision public would be when the Chairman of the Board is examined by the PAC early in May.

7. I am copying this minute to Christopher Soames, Francis Pym, Patrick Jenkin and Jim Prior.

A handwritten signature in black ink, appearing to be "G.H.".

(G.H.)

21 April 1981

ASSOCIATION OF HER MAJESTY'S INSPECTORS OF TAXES

Jb/LSW

17 NORTHUMBERLAND AVENUE

LONDON WC2N 5AP

TELEPHONE: 01-839 5585/6

cc Mr Green  
Mr Dalton  
Mr Boyd  
Mr Gracey ✓

Sir Lawrence Airey, KCB  
Chairman  
Board of Inland Revenue  
The Board Room  
Somerset House  
London WC2R 1LB

16 February 1951

*Des Lawrence 19/2*

I am enclosing as promised, a copy of the statement by the AIT and IRSF on "The Black Economy" that has been made on behalf of IRDC and sent to the Chancellor's Office.

*Yours ever*

*John*

cc Mr Adams  
Mr Moss  
Mr Byrnes ✓

JOHN BISHTON

865L

STATEMENT BY THE ASSOCIATION  
OF HER MAJESTY'S INSPECTORS OF  
TAXES AND THE INLAND REVENUE STAFF  
FEDERATION ON BEHALF OF THE TRADE  
UNION SIDE OF THE INLAND REVENUE  
DEPARTMENTAL WHITLEY COUNCIL

---

THE BLACK ECONOMY

1. Whatever the exact size of the black economy, it is generally agreed that very substantial sums are at stake. The Chairman of the Board of Inland Revenue has suggested that a figure of 7½% of GDP is a plausible estimate (in evidence to the House of Commons Public Accounts Committee on 4th June 1980). This amounts to over £3 billion in tax, and, while not all of this vast sum could be recovered without massive increases in resources, there are undoubtedly substantial amounts which could realistically be within the reach of the Exchequer. The bulk of this statement is devoted to outlining potentially profitable areas of scrutiny which could recoup significant amounts of revenue.

2. The profitability of such added scrutiny must be of interest to an administration interested in cost effectiveness - a criterion embodied in the work of Sir Derek Rayner. Employing extra staff to curb the black economy will not only bring in many times their cost to the Exchequer, it will help in keeping the Public Sector Borrowing Requirement within bounds without resort to higher taxation. Nor should this return be evaluated purely in terms of tangible revenue accrued directly as a result of the added effort. Each £ so saved can be multiplied many times over by the £££ voluntarily paid in by those discouraged by the fate of those selected for attention. The converse is also true: the failure to tackle the growing black economy (recognised by the PAC and others) can only lead to an escalation in its size and in the PSBR.

3. It is becoming fashionable to imply in some circles that the black economy represents a dynamic and innovative sector of the economy as a whole. Robbing the public purse is no more a wealth-creating exercise when done by tax evasion than by fraudulent claims for farming subsidies or price-fixing for contracts. On the contrary the black economy is actually an obstacle to the creation of wealth through individual enterprise - a point forcibly made by representatives of small business and the self-employed. The honest trader who pays his fair share of tax finds himself undercut by unfair competition forced to join the dishonest sector or go under. The uncertainty which this creates is not conducive to building a business which gives employment to others; it also detracts from the stable business climate so necessary for enterprise to flourish. Nor is the consumer necessarily the benefactor of such unfair competition: the fly-by-night contractor is more likely to do a shoddy job, be harder to track down for recompense and may be beyond legal reach if (as is likely) no receipt is given. The black economy may be growing - but it is only at the expense of the rest of us.

4. It is sometimes said that the problem of tax evasion would be ameliorated by lower rates of tax. There is no evidence that this has happened.

5. To some extent the Government has already recognised the problem: one extra Special Office has been opened (and another brought up to strength); and 200 extra Inspectors are to be appointed over four years. But the drive to reduce the size of the Civil Service is more than outweighing these extra resources. Staffing restrictions restrain the development of the Inspectorate and positive cuts, approaching 10,000 in number, have been made at clerical and executive levels.

#### INVESTIGATION OF BUSINESS ACCOUNTS

6. Since 1977 instead of giving every business account some consideration each year Inspectors of Taxes have been selecting a few accounts for detailed investigation and passing the vast majority for assessment without any detailed examination. The aim at the start of the scheme was for approximately 5% of non-company accounts to be given detailed investigation each year but this figure has never been achieved and the coverage in the last year for which figures are available, the year to 31 October 1979, was only 2.5%. For company accounts the coverage was a mere 0.25%.

7. In those cases selected 82% of the businesses concerned were found to have understated their profits. The additional tax recovered from those cases selected for detailed examination where it was not appropriate to seek interest and penalties was £14.1 million in the year ended 31.10.1979. The yield from cases where interest and penalties have been sought has also increased considerably: the total charge raised (including interest and penalties) has risen from £14 million in the year ended 31.10.1976 to £40 million in the year ended 31.10.1979.

8. These figures do not include those of Enquiry Branch where the yield has increased by 60 per cent in the last two years as the investigation of cases in Districts yields a greater flow of appropriate cases.

9. The Department is presently engaged in further re-deploying resources to release more of the most highly trained Inspectors on to the detailed investigation of company accounts. This exercise will at best achieve only a 1% coverage of companies - yet may reduce the coverage of non-company investigations to 2.3%, levels which are not considered adequate by either the Department or the Public Accounts Committee. Essentially it is additional resources that are required both of Inspectors who can investigate non-

company accounts and of fully trained Inspectors to work in the company field and at Enquiry Branch.

#### OPERATION OF PAY-AS-YOU-EARN

10. For the employee and director, tax is largely gathered through PAYE, a system which greatly depends on employers to deduct tax correctly and forward it to the Collector, and to supply information needed for the assessment of the individual taxpayer. On the Revenue's part, this generates the type of work traditionally carried out by the clerical and executive grades: coding, assessment and repayments, filing and linking information from different sources, explaining methods of operation to employers, liaising with other tax offices and collection offices, making further written enquiries, and so on. It is arguable whether enough resources have ever been devoted to these important tasks, but is undeniable that attention to them is declining as staff cuts work their way through to offices.

11. For example, employers are supposed to make a yearly return of the fringe benefits and expense allowances given to any employee liable for tax on them (broadly, those earning at a rate in excess of £8,500 a year). In practice, a high proportion of these forms P11D are never sent back, and the Department lacks resources to get them in. Those which are sent back are all too rarely verified though they are often incorrectly completed. A common omission is amounts reimbursed by the employer for private motoring expenses such as petrol. Even when there is a figure for petrol, it is unlikely to be checked by the tax office. The yield from taxing company cars and other benefits could be greatly increased if there were enough staff to ensure that P11Ds were sent back and completed correctly.

12. Another example of PAYE abuse arises through using employers as agents to collect tax on employees' earnings. Inevitably this leads to mistakes - and equally inevitably, some employers cannot resist the temptation to hold on to the tax deducted from employees' earnings, falsifying returns to conceal this. The evidence is that such irregularities are on the increase: between 1965 and 1973, just a quarter of visits to employers to check on PAYE operations threw up something unsatisfactory - but in the year ending 31st October 1980, more than half of such visits showed something wrong. Part of this growth reflects the better selection of cases to investigate, but much of it must be put down to increasing fraud by employers. The response to this has been to expand the number of staff involved in PAYE audit and to form six "Audit Groups" to tackle larger employers with nationwide operations. Currently an employer can expect to be visited once every 21 years and when the expansion programme is completed this figure should be halved but it will still be a long way from the once every five years regarded as ideal by the Board of Inland Revenue. Unless far

more resources are devoted to curbing fraud among employers, the system is in danger of breaking down.

#### HOONLIGHTING AND CASUALS

13. Perhaps the most intractable problem faced by western economies is the growth of the "cash sub-economy", the world of weekend and evening jobs settled in untraceable cash payments. Certainly no country has yet found the solution to this problem, but there is much which could be done to curb it.

14. For example, one large area of abuse is in household repairs and improvements - plumbing, electrical repairs, building, roofing and decorating. These services are often advertised in newspapers newagents' windows and by circulars - usually contacted only by telephone number. Given the resources, such subterfuges could be penetrated - and once it is established that a particular individual is in business part-time, the normal procedure for dealing with the self-employed should be adequate.

15. It has been suggested that one feature of the UK tax system which encourages taxpayers not to declare spare-time earnings is the relative infrequency that tax returns are sent out - "If they don't ask, I won't tell". The Revenue is known to be considering reducing the number of returns sent out as an economy measure, which can only accelerate this trend. Indeed, it would make sense to send returns more often to people with readily marketable skills coupled with judicious notes about the penalties for not declaring earnings.

16. Another well-known area of abuse is that of earnings from casual evening or weekend work in pubs, clubs, restaurants, garages and the like. If people with such casual jobs tell their part-time employer that they have no other source of earnings, then no tax need be deducted from the casual earnings so long as they are below a certain threshold (£26.50 a week in 1980-81). Unless these casual earnings are voluntarily declared on the tax return, they are effectively tax-free - even if the casual concerned has other earnings to which they should be added for tax purposes.

17. Tax offices should already have the information to track down this type of abuse. The employer concerned will claim the wages paid out as a trading expense, to be deducted from his receipts before arriving at his taxable profit. When the employer pays casual employees without deducting tax, the tax office can ask for a list of the casuals on form P38. In practice, P38s are often not sent out or followed up, due to lack of staff. When they are, it

may take time to trace the casuals concerned - their tax affairs are outside the tax office's area. If the names turn out to be false, then it needs further efforts to ensure that correct names are submitted. Faced with diminishing staff numbers, it is hardly surprising that most tax offices fail to bother with the procedure at all.

18. The P38 procedure will not cope with casuals who are paid out of cash takings, without a claim against business receipts. In theory, such abuses should be picked up on visits to business premises by PAYE audit staff and Inspectors investigating the business accounts. It should be obvious - if such visits are made in the normal working hours of the business - that the numbers of staff working do not tally with the records. However, there are insufficient resources for visits by either group to be a real threat.

#### DIRECTORS

19. The taxation of directors provides particular problems for the Inland Revenue, because they are so closely involved in the running of their companies. It is not always easy to detect payments and other benefits drawn from company funds by directors until long after the period concerned, by which time the company may have ceased to exist. Ensuring the correct operation of the PAYE system as promptly as possible is essential if directors are to pay their fair share of tax.

20. Unhappily, this is another area of work which can be set aside when the pressure is on to clear other arrears. A sample of ten per cent of director cases in a selection of tax offices showed that 45 per cent had the potential to yield significant amounts of tax if pursued - and seven out of ten clearly had been neglected. The survey concluded that directors' returns were subject only to superficial examination. One tax office managed to produce £ $\frac{1}{2}$  million of extra tax simply by making sure that directors filled in the correct returns - accepting the answers without question.

21. The Department has recognised these difficulties by encouraging the formation of "Director Groups" in Districts to specialise in the problem, and by collating relevant material in a Directors' Handbook. The new Inspector (S)(T) will direct much compliance work in Districts and should be able to encourage a more thorough approach to director cases. But these measures will only be pious resolve if there are not the resources at all levels to implement them.

### INFORMATION PROVIDED TO TAX OFFICES

22. Tax offices are sent a good deal of information by banks, buildings societies and other savings institutions, so that they can check that taxpayers are declaring all their sources of income. For example, banks currently send tax offices details of any account which yields more than £150 interest during a tax year. The amounts above which details of interest must be returned have recently been vastly increased to cut staff - reducing the flow of slips which are often the source of information about undeclared income. But even with this reduced flow, slips are often set aside for more pressing work - inevitably leading to loss of tax.

23. It is clearly important that there should be sufficient resources to process all information received in tax offices. But it is also worth asking whether more information could be profitably sought. For example, random checks on all interest paid out by a limited number of institutions each year would detect and deter those who conceal investment income by spreading it around in order to keep below the well-known limits governing the issue of information slips.

### SPECIAL OFFICES

24. The Special Offices first established in 1976 - are able to look at any area where the Revenue is at risk and bring to the task of countering avoidance and evasion an intensity of approach which it is not always possible to adopt in the District Offices. In the event they have been highly effective. For example, an investigation of practices in the Smithfield Meat Market started by Special Office and handed over to the local District now produces an estimated £300,000 profits per annum. Very substantial settlements have been made in individual cases and there has been considerable success in countering losses of tax in particular industries. For instance, the regulation of PAYE in Fleet Street produces additional tax estimated at £2m per annum. In addition they have gathered information for Districts and other Head Office agencies which have enabled them to bring into charge significant additional amounts of tax.

25. Despite the recommendation that there should be a network of Special Offices covering all Inland Revenue Regions only six presently exist, the latest being London No.2 office (only recently brought up to strength) and Sheffield opened in July 1980. However the yield from the first four is quite spectacular:

Year ended 30 September 1977	- (3 offices)	£6.4 million
Year ended 31 October 1978	- (4 offices)	£11.6 million
Year ended 31 October 1979	- (4 offices)	£14 million
Year ended 31 October 1980	- (4 offices)	£20 million

Cases presently under investigation by the Special Offices are



likely to bring in tax of more than £80 million (a once and for all figure).

26. These very positive results and the evidence which has been provided of the value of indentifying different methods of investigating a person's or a group of persons tax affairs must be foundations to be built on not an end in themselves. It is evident that in London alone there must be almost unlimited potential for tax investigators and there is virtually no coverage of the North East with Liverpool, the South West and Wales with Bristol and Cardiff and Eastern England. The existing offices provide only the barest minimum liaison with local districts and can only be seen as a semblance of a national network. This contact with local tax districts is considered to be a key feature of Special Office work and largely justified the setting-up of the second London office - but even two offices are stretched to the limits with nearly 250 districts to cover. In regions where no Special Office exists liaison is impossible. It is manifest that the network is grossly inadequate and there is a clear case for expansion.

27. What has governed the rate of setting up the existing offices and prevents further expansion is the present manpower policies which force the Department to choose between maintaining the existing resources on traditional work rather than creating new Special Offices. The resources required are highly skilled and scarce Inspectors of Taxes, the numbers of which have remained pretty constant over recent years. What is needed is a relaxation of the manpower constraints to expand the stock of these highly skilled specialist staff and enable the Department to set up further Special Offices over a period of years without taking resources which are already overstretched on the highly productive work. Whether one is thinking in terms of taking more graduate recruits or training more in-service staff an early start needs to be made as training is a lengthy process. Such growth will be very modest in terms of the total size of the Revenue (each Special Office has less than 20 staff) but it will add significantly to the Department's experience and effectiveness in countering avoidance and evasion. In our view it is wrong to say that additional Special Offices can only be justified if savings in staff are made elsewhere. Particular in this area staff savings bring with them very high risks of revenue loss. Although the Special Offices have been highly effective in the evasion and avoidance field it must be stressed that the most cost effective use of valuable trained resources is in the local District Offices where £250 million was added to returned profits for the year ended 31st October 1979 as a result of the examination of accounts and computations submitted to the Department.

#### CONCLUSIONS - MANPOWER

28. It would be easy to dismiss the Associations' claims as simply a demand for more staff and an attack on the Government's policy

of reducing the size of the Civil Service, but this would be a far too simplistic approach. The concern of the Associations is that the Inland Revenue Department should be properly equipped to carry out the tasks that Parliament has given it to do. Criticism of the Department over its failure to tackle the Black Economy may well be properly directed but it cannot be effective in carrying out its tasks if it does not have the resources to do so.

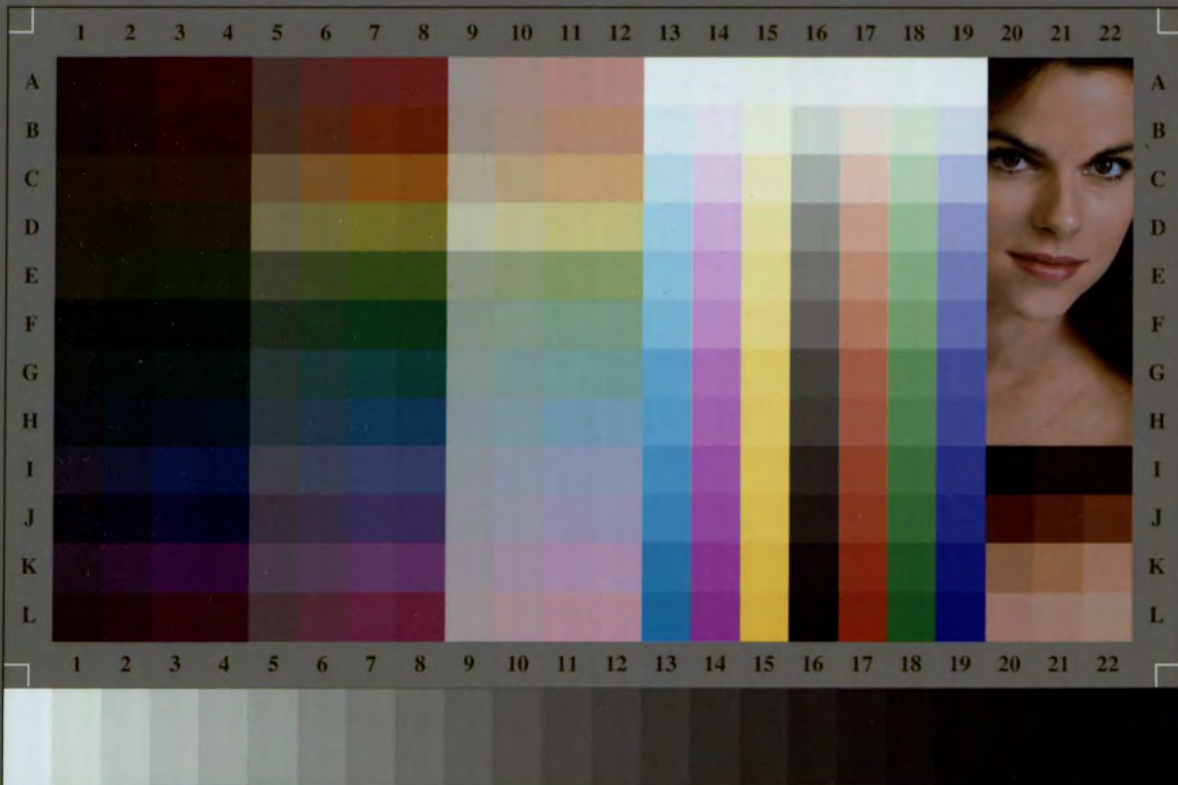
29. The Department has already made a very substantial contribution to the reduction in Civil Service manpower and no doubt where genuine savings can be made by fiscal or management means it will continue to do so - but this cannot be an end in itself. In its 8th Report of the 1979-80 session the Committee of Public Accounts (para.23) said: "At a time when the Government are seeking substantial reductions in public expenditure, we think it particularly important to guard as far as possible against avoidable losses of revenue." - and the leading article of 8 March 1980 in Taxation: "At the present time pressure is being exerted to reduce the cost of Government agencies ..... This is wholly commendable but if it results in a real fall in net revenue the whole exercise is self-defeating. Where increased expenditure ..... does result in a greater yield from tax collection common-sense must prevail at the expense of political dogma."

30. A few staff in each tax office devoted to tackling the black economy could ensure that each major area of evasion is tackled in turn - swinging the spotlight round in a random fashion. The gains of one year's searches will of course feed through into succeeding years while the beam moves on to cover new fields. But the one inescapable fact is that it is a matter of sufficient staff. There is a need for more Inspectors for Tax Districts and Special Offices, together with the necessary clerical support and also for clerical and executive resources to deal with the presently neglected areas of work outlined in this paper.

31. In particular we ask:

- (a) In any current or future manpower exercises the Inland Revenue should not be required to make savings simply to contribute to an arbitrary reduction in Civil Service numbers especially when to do so would put at risk the revenue yield.
- (b) Genuine manpower savings should be allowed to be re-deployed, where practicable, into an increased effort in the battle against evasion and avoidance.
- (c) Arbitrary ceilings on the numbers of staff in certain grades should be removed to allow controlled expansion of the Special Office network.

- (d) Since for many years the Department has suffered a chronic shortage of fully trained Inspectors, and given that it takes five years to train them, the bid to the Civil Service Commission should be allowed to be increased so that an adequate supply of such officers will become available in the future. Similar increases in the number of internal selections for full training should be permitted where suitable candidates are available.
- (e) Where suitable candidates are available there should be further selections of TOSHG for technical training to enable an expansion of non-company investigations to proceed.



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