



House of Commons
Committee of Public Accounts

HMRC: Tackling the hidden economy

Fifty-fifth Report of Session 2007–08

*Report, together with formal minutes, oral and
written evidence*

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The Committee of Public Accounts

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Summary

There are no reliable estimates of the tax lost through the hidden economy but it could be over £2 billion a year and involve around 2 million people. HM Revenue & Customs (the Department) spent £41 million in 2006–07 on encouraging people and businesses into the formal economy, and detecting and imposing sanctions on those operating in the hidden economy. The Department achieved a return/cost ratio of 4.5:1 which should increase as recent initiatives achieve their full effect. Areas of risk include

- self-employed people, such as builders and decorators, who often receive cash payments;
- individuals who trade on the internet, and
- buy-to-let landlords.

Since 2003–04 the Department has detected some 30,000 hidden economy cases a year, a detection rate of only around 1.5%. The amount of tax from cases detected in the hidden economy has, however, increased by 13% in real terms since 2003–04. The return on the Department's investigations in 2006–07 was 5:1.

To increase detections, the Department has been making more use of data matching techniques. It also set up the Tax Evasion hotline in 2005 for members of the public to report suspicions of tax evasion. The hotline received over 120,000 calls in 2006–07 but progress in investigating cases has been slower than the Department expected. The Department completed 2,000 investigations compared with 5,500 planned, yielding additional tax assessments of £2.6 million compared with £32.5 million planned. Investigations of small businesses, businesses which should be registered for VAT but are not, and employers' compliance yield higher returns.

When the Department detects people in the hidden economy, it can impose a penalty of up to 100% of the tax owed. In most cases it either imposes a much lower penalty or waives the penalty. In 2006–07 the Department imposed penalties of £5 million, amounting to around 3% of the tax identified. Prosecutions rose to 69 cases in 2006–07. The Department did not receive much publicity on these cases, limiting their wider deterrent effect.

To encourage people to declare tax owed, the Department has run advertising campaigns, which have led to a further 8,300 registrations and should result in additional tax of £38 million over three years. In 2007, the Department introduced the Offshore Disclosure arrangements to encourage people holding overseas bank accounts to voluntarily disclose and pay any tax owed. This followed landmark rulings against several major financial institutions which required them to disclose to the Department details of around 400,000 bank accounts. Some 45,000 people came forward bringing in around £400 million at a cost of £6 million, a return of £67 for every £1 spent.

On the basis of a report by the Comptroller and Auditor General,¹ the Committee examined HM Revenue & Customs on the scale and nature of the hidden economy, encouraging people into the formal economy, detecting people in the hidden economy, and the Department's use of penalties and criminal investigations.

Conclusions and recommendations

- 1. In common with other tax authorities, the Department does not have robust estimates of the tax lost from the hidden economy.** A firmer estimate would help the Department judge the scale of the problem posed by the hidden economy and whether it is doing enough to tackle it. Given the difficulties in developing such estimates, it is important to capitalise on the work of others in this area. The Department should work closely with the European Commission in its project on undeclared work to develop an estimate for the UK.
- 2. The Department has not fully assessed the risks to tax from different sectors and groups in the hidden economy.** It should bring together information it currently holds in a structured way to identify the highest risks and gaps in coverage where further analysis is needed.
- 3. Through its Offshore Disclosure arrangements, the Department has succeeded in persuading 45,000 people to put their tax affairs in order, thereby raising £400 million in additional tax at a cost of £6 million.** The Department should devise similar schemes in other risk areas such as the home repair and improvement sector and buy-to-let landlords. Such schemes would involve obtaining information on groups of potentially non-compliant people or businesses through data matching and other sources, and using that information to secure voluntary disclosure.
- 4. Around 80% of those operating in the hidden economy are likely to owe relatively small amounts of tax, but the total tax at stake could be significant.** Methods which encourage groups of people to put their tax affairs in order, such as publicity campaigns and voluntary disclosure schemes have proved more cost-effective than formal investigation of individual cases. The Department should further publicise the benefits of joining the formal economy and how to do this. It should also use publicity campaigns should to encourage take up of further voluntary disclosure schemes.
- 5. The Department has detected some 30,000 hidden economy cases a year since 2003–04, a detection rate of around 1.5%, so the chances of getting caught appear minimal.** The Department could boost the detection rate by following the example of the Department for Work and Pensions and make more use of data matching techniques. Comparing tax records with information on businesses that pay business rates and on local authority licences for doormen, street traders and taxis could help identify those evading tax.
- 6. The Department has a large and growing backlog of Tax Evasion hotline cases awaiting investigation. It has not reached its target for completed investigations and it is not keeping pace with the caseload generated.** The Department should speed up the investigation of hotline cases by redeploying resources that are no longer required on investigating VAT missing trader fraud and suspicious activity reports. The Department should complete the 11,900 cases awaiting investigation and aim to complete a similar number of investigations each year.

7. **The Department makes higher returns on certain types of investigation, such as small businesses, businesses not registered for VAT, and employer compliance reviews.** Hotline investigations have also generated much higher returns than initially expected on such cases. The Department should concentrate more detection work in these areas. It should also increase the number of such cases reported to the hotline by focusing further advertising campaigns on these areas of risk.
8. **The Department has raised £27 million from investigating suspicious activity reports but expected to raise £74 million.** It expected to use the suspicious activity reports made to the Serious Organised Crime Agency under the Money Laundering regulations, to detect significant numbers of people with undeclared income. A court ruling in 2006 has restricted the information it can obtain in this way from solicitors and accountants. The Department should consider whether to seek alternative powers to strengthen this work.
9. **The Department can impose penalties of up to 100% of the tax detected but usually does not do so. The average penalty is only 3%.** When the new penalty regime comes into force, the Department should use the full range of penalties available, and track the number and value of penalties levied compared to the tax involved. It should also rigorously apply the penalty rules for those it detects who failed to come forward voluntarily under the Offshore Disclosure arrangements.
10. **In 2006–07, the Department abandoned 284 criminal investigations, roughly the same as the number it opened that year. Over a third of cases have been under investigation for more than one year.** Reducing the number of abandoned investigations and meeting its target for completing its investigations within a year would release resources that could be used to increase levels of other activities, such as prosecutions. The Department should improve its selection of cases by identifying the factors that lead to cases being abandoned. The Department should also manage more closely the progress of cases against its one year target and interim milestones.
11. **For every thousand cases detected only two are prosecuted. The Department achieves limited publicity on prosecutions reducing the deterrent effect.** In comparison the Department for Work and Pensions secures 60 prosecutions per thousand benefit fraud cases. The Department should double the number of prosecutions. It should also raise public awareness about the risk of detection and punishment by advertising the results of its work through, for example, its website and contacts with trade and professional organisations.

1 The scale and nature of the hidden economy

1. There are no reliable estimates of the tax lost through the hidden economy. But it could be over £2 billion and involve around 2 million people. The Department estimated losses of between £400 million and £500 million in VAT in 2001–02 from between 125,000 and 180,000 businesses that should have been VAT registered but were not. For other taxes, the Department has estimated losses of at least £1.5 billion involving 2 million ghosts and moonlighters. Ghosts are people who work in the hidden economy and pay no tax on their earnings. Moonlighters are people who pay tax on certain earnings but fail to declare other additional sources of income. The Department has no estimate of the number of employers who encourage or facilitate ghosts and moonlighters and evade employers' National Insurance contributions.²

2. In 2006, the Department employed the University of Bristol to produce firmer estimates of the amount of tax lost from the hidden economy. The Department subsequently decided not to take the work forward as the proposed methodology was unlikely to produce worthwhile results because a significant number of people would refuse to take part. The Department expects that regular comparison of tax records against external information sources will over time provide a better picture of the extent of the hidden economy and trends within it.³

3. Other tax authorities have also tried to estimate the amount of tax lost from the hidden economy, but so far none has found a reliable method. A survey by the European Commission in 2007 showed that across the 27 EU countries around 5% of people had undertaken undeclared work in the previous year. The UK was below the European Union average at 2%, and the results for each country varied from 1% to 18%. The method used tends to under-report the extent of undeclared work. The Commission is undertaking a study to identify the best methodology for providing comparable estimates of the amount of undeclared work across the EU.⁴

4. The Department believes that around 80% of those operating in the hidden economy are individually evading relatively small amounts of tax. It regards the self-employed as a high risk area, especially those trades where cash is commonly used for payment, such as building and decorating. New risks to tax revenue are emerging from those trading on the internet and from buy-to-let landlords failing to declare their income and capital gains. The very nature of the hidden economy means that the Department lacks a good understanding of the risks, and the scale of those risks across all sectors of the economy.⁵

5. The Department has undertaken various special projects on, for example, people holding offshore accounts who do not pay tax on their income or interest, barristers, nail

2 Qq 9, 45; C&AG's Report, paras 1.3, 1.5

3 C&AG's Report, para 5.3

4 C&AG's Report, paras 1.6 and 5.4; *Underdeclared Work in the European Union*, September 2007, European Commission

5 Qq 59–61; C&AG's Report, para 5.2

bars, and medical consultants who undertake non-NHS work on which they may not be paying tax. The Department has also sought to trace the owners of luxury yachts and vehicles who may not be declaring tax.⁶

6. When tackling the hidden economy, the Department uses both preventive measures to encourage people into the formal economy and other measures to detect, penalise and deter people from operating in the hidden economy. Some projects contain features of both approaches. Success depends upon maintaining a balanced programme of prevention, detection and deterrence.⁷

7. In 2006–07, the Department spent £41 million on its hidden economy work in 2006–07 and achieved an overall return of 4.5:1. It spent around £22 million on detecting and investigating cases, achieving a return of around £5 for every £1 spent, as well as creating a wider deterrent effect. The Department has only recently launched advertising campaigns and voluntary disclosure arrangements. Initial results indicate that these measures are achieving substantially higher returns than more traditional methods of detection.⁸

6 Qq 17–19, 52, 72, 76, 102–107; C&AG's Report, para 1.9

7 C&AG's Report, paras 11–13

8 C&AG's Report, paras 11–13, 3.2, 3.5, Figure 1

2 Encouraging people into the formal economy

8. In recent years the Department has used publicity campaigns to encourage people who may otherwise have operated in the hidden economy to register and pay tax. The Department estimates that some 8,300 people registered for tax due to these campaigns. It estimates that these newly registered people will pay tax of around £38 million over three years, providing a return of £19: £1 on expenditure of £2 million.⁹

9. Some of those operating in the hidden economy think the Department could make more use of campaigns to inform people of the benefits of working in the formal economy and make clearer what is likely to happen to them if they come forward voluntarily. Some of those operating in the hidden economy are concerned whether they can afford to pay the tax owed, not realising that the Department will allow time for them to pay. The European Commission has identified opportunities for Member States to make more use of advertising campaigns to highlight to the public the risks of employing someone in the hidden economy. The Department recognised the need to do more to raise awareness of the risks of operating in the hidden economy.¹⁰

10. In 2004, our predecessors pointed to the growing threat of fraud involving offshore accounts.¹¹ In 2006 and 2007 the Department won landmark rulings against a number of major financial institutions that required them to disclose details of UK resident offshore account holders who may owe tax. As a result, the Department received details of around 400,000 bank accounts and introduced the Offshore Disclosure arrangements to encourage these people to come forward voluntarily to disclose and pay all tax owed. The Department fixed the penalty at a lower level than would normally be the case to encourage people to take advantage of the scheme. Two weeks before the closing date, the Department had received 10,000 notifications. With further publicity the number rose to 64,000. Of these, 45,000 people paid over £400 million in tax and penalties. The project cost the Department £6 million, thereby achieving a return: cost ratio of £67:£1.¹²

11. The Department is now contacting people who it believes may owe tax but who chose not to come forward. If they owe tax, the Department intends to impose higher penalties than for people who came forward voluntarily under the arrangements. It will also consider whether to refer the most serious cases for prosecution.¹³

9 C&AG's Report, paras 2.7–2.8

10 Qq 46, 114; C&AG's Report, paras 2.9, 4.13, 4.15

11 Committee of Public Accounts, *Tackling fraud against the Inland Revenue*, First Report of Session 2003–04, HC 62

12 Qq 46, 92, 94; C&AG's Report, paras 2.15, 2.16

13 Q 93; C&AG's Report, para 2.16

3 Detecting people in the hidden economy

12. Since 2003–04, the Department’s hidden economy teams have detected some 30,000 cases a year. This represents a detection rate of around 1.5%, based on the 2 million people estimated to be in the hidden economy. The Department recognised that the number of detections needs to increase. It plans to redeploy some investigation staff to hidden economy work, having put considerable effort and achieved some success in reducing VAT missing trader fraud in recent years.¹⁴

13. Over the four year period to 2006–07, the amount of tax the Department detected in its hidden economy investigation work increased by 13% in real terms to £145 million. The Department’s return on detecting and investigating hidden economy cases in 2006–07 was £5 for every £1 invested. It achieves highest returns of 15:1 on investigating businesses which should be registered for VAT but are not.¹⁵

14. In 2004, our predecessors recommended that the then Inland Revenue expand the remit of its anti-fraud hotline—which covered employers and PAYE—and publicise its existence.¹⁶ In November 2005, the Department set up a confidential Tax Evasion hotline allowing members of the public to report suspicions of evasion on income tax, corporation tax, capital gains tax, inheritance tax, VAT and National Insurance contributions. People can also report suspicions through the Department’s website by completing an online form.¹⁷

15. Between February and April 2006, the Department advertised the hotline extensively to encourage members of the public to report their suspicions of self employed people operating in the hidden economy, such as hairdressers and taxi drivers. The Department launched a more limited radio campaign in February 2007 targeted at employers who do not pay over the tax they deduct from employees on their payroll. In total, the Department spent £4.5 million on advertising the hotline.¹⁸

16. In 2006–07, the Tax Evasion hotline received around 120,000 calls from the public. The Department completed around 2,000 investigations compared with 5,500 planned. The Department had to spend additional effort on handling three times more calls than expected and evaluating the information received. Around half the calls lack relevant information or, following risk assessment, are found not to merit further action. By the end of March 2007, the Department had completed investigations on almost 2,000 of the 19,800 cases on which it had produced intelligence packages, and had a further 1,500 investigations underway. 11,900 cases awaited investigation (**Figure 1**). The Department continues to receive around 7,000 calls a month.¹⁹

14 Qq 10–11, 15–16, 114; C&AG’s Report, paras 1.5, 3.2. VAT missing trader fraud is where fraudsters register for VAT, buy goods VAT free from another EU Member State, sell them on at VAT inclusive prices and then disappear without paying the VAT due.

15 Qq 11, 47–49; C&AG’s Report, paras 3.4, 3.5

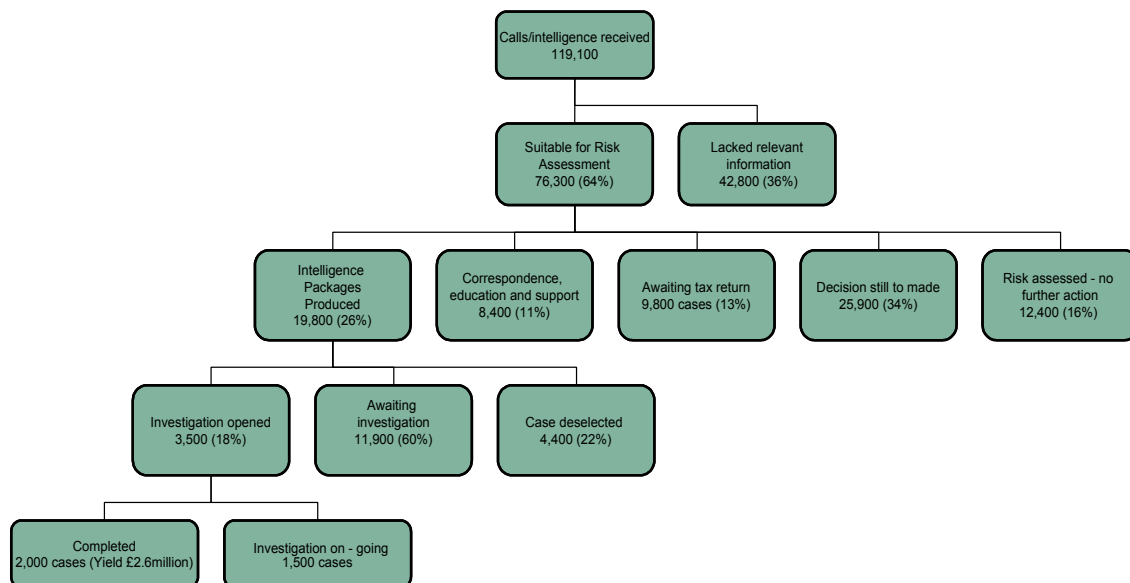
16 Committee of Public Accounts, *Tackling Fraud against the Inland Revenue*

17 C&AG’s Report, para 3.7

18 C&AG’s Report, para 3.8

19 Qq 12–13, 34–38, 55; C&AG’s Report, paras 3.8–3.10

Figure 1: Progress as at 31 March 2007 on Hotline calls received during 2006–07



Source: C&AG's Report, *HM Revenue & Customs: Tackling the Hidden Economy (HC 341, Session 2007–08)*

17. The Department assessed that £2.6 million of tax was due from completed hotline cases in 2006–07 against an estimate of £32.5 million. The lower number and different mix of cases investigated caused this shortfall. Most of the information received by the Department has been on ghosts and moonlighters where the tax at stake is lower than for cases involving small businesses and employers. This may be because the Department's advertising of the hotline concentrated mainly on self-employed people operating in the hidden economy rather than employers.²⁰

18. The average amount of tax achieved per case has been higher than estimated. For example, the average amount of tax achieved on employers' cases was over £23,000 compared with the £10,500 estimated. The Department intends to undertake more employer compliance reviews as it has only completed an insignificant number; 14 cases compared to the 2,600 expected (**Figure 2**). The continued slow progress in dealing with hotline cases means that the additional tax in 2007–08 fell well below its original estimate of £77 million.²¹

20 Qq 51–52; C&AG's Report, paras 3.8, 3.11

21 Qq 38, 51–52; C&AG's Report, para 3.11

Figure 2: Hotline cases completed in 2006–07

	Estimated Numbers of cases	Cases Achieved	Estimated average amount of tax	Average achieved	Estimated tax assessed £million	Total tax achieved £ million
Registration of ghosts and moonlighters	2,100	1,823	£790	£890	1.7	1.6
Employer compliance reviews	2,600	14	£10,540	£23,170	27.2	0.3
Small business investigations	800	146	£4,630	£4,730	3.6	0.7
All cases	5,500	1,983	£5,940 (weighted average)	£1,330 (weighted average)	32.5	2.6

Source: C&AG's Report, *HM Revenue & Customs: Tackling the Hidden Economy (HC 341, Session 2007–08)*

19. The Department has been making more use of data matching to detect people in the hidden economy by linking the various data it holds on taxpayers and comparing it with third party information such as Yellow Pages. It is some way behind the Department for Work and Pensions which carries out regular bulk data matching exercises to detect errors and fraud in benefits. In a pilot project, the Department is using specialist computer software to analyse various internal and external information sources. This work has identified over 300,000 cases of suspected ghosts and moonlighters. The Department plans to conduct further work in 2008–09 on up to 20,000 cases, with potential tax of £26 million. This work is experimental and at an early stage of development. The Department could make more extensive use of information available on, for example, those paying business rates on their premises, and local authority licences for doormen, street traders and taxis. It could also make more use of vehicle licensing data held by the Driver and Vehicle Licensing Authority, such as by identifying owners of high value cars and commercial vehicles who may not be declaring their income.²²

20. Under the Money Laundering Regulations, organisations are required to make suspicious activity reports to the Serious Organised Crime Agency if they know or suspect that a transaction involves money laundering. In 2004, the Department received additional Spend to Raise funding to use these reports to increase the number of people it detects who may have a source of income they are not declaring.²³

21. From April 2004 to March 2007, the Department completed 7,150 investigations involving over £27 million in tax, compared with £74 million expected. The Department had expected to generate significant numbers of cases from information obtained from solicitors and accountants. A court ruling in 2006 confirmed, however, that solicitors and accountants can only disclose client information in limited circumstances. As a result, the

²² Qq 17, 21–23, 53–54, 69–73; C&AG's Report, paras 3.17, 3.18

²³ Qq 39–42; C&AG's Report, para 3.13

Department has been able to obtain far less information than originally expected. It has not considered whether it should seek new powers as a consequence.²⁴

22. The Department's hidden economy teams also receive referrals from the National Minimum Wage team which investigates whether employers are complying with the legislation. Of its 4,200 investigations in 2006–07, the National Minimum Wage team referred 580 cases where it suspected employers may be paying employees' cash in hand. The Department accepted that it should provide feedback to the national minimum wage team on what has happened on these cases and whether the information was useful.²⁵

24 Qq 43, 56–57, 109, 112; C&AG's Report, para 3.14

25 Qq 32, 58; C&AG's Report, para 3.15

4 Penalties and criminal investigations

23. When the Department detects people operating in the hidden economy, it can charge interest for late payment and impose a civil penalty of up to 100% of the tax owed. The Department can reduce the penalty where the offence is not serious and where the person makes a complete and voluntary disclosure of the amount owed and cooperates with the Department's enquiries. It may also decide not to charge interest or impose a penalty where only a small amount of tax is involved or the person does not have the funds to pay a penalty.²⁶

24. The Department rarely uses penalties available to their full extent. In 2006–07, it imposed penalties totalling 3% of the total tax identified of £161 million. The Department also charged interest of around 3% of the total tax identified. It appears that in over half of the cases the Department imposed no sanction.²⁷

25. As a result of the Department's Review of Powers, Deterrents and Safeguards, a new penalty regime is being introduced through the Finance Act 2008. For tax periods from April 2008, penalties will be based on the amount of tax understated, the nature of behaviour that gives rise to the understatement and the extent of disclosure by the taxpayer. Where people have made genuine errors and taken reasonable care, the Department will not levy a penalty. In cases where people have not taken reasonable care, the Department will impose a penalty of up to 30% of the amount of tax owed. Where people have deliberately evaded tax, the Department will impose a penalty of up to 70%. Where people have deliberately evaded tax and concealed their income, the Department will impose a penalty of up to 100%.²⁸

26. The Department considers criminal investigation of hidden economy cases with a view to prosecution, where it believes the tax involved exceeds £10,000 and the case has other features, such as being a second offence or involving a professional person who advises on tax matters. The number of hidden economy prosecutions has increased but there remains very little chance of someone in the hidden economy being prosecuted. In 2006–07, there were 69 prosecutions, equivalent to two cases prosecuted for every thousand cases detected. In contrast, the Department for Work and Pensions secures 60 prosecutions per thousand cases for benefit fraud. In recent years the Department has deployed most of its 2,000 criminal investigation staff on VAT missing trader fraud because of the large amounts of revenue involved. Around 50 investigation staff have tackled hidden economy cases. The Department now plans to devote more resources to hidden economy cases, focusing on more complex cases.²⁹

27. The Department abandoned 284 criminal investigation cases in 2006–07, roughly the same as the number of cases it opened that year. The Department abandons cases if:

26 Q14; C&AG's Report, para 4.2

27 Q14; C&AG's Report, para 4.3

28 Qq 14, 91

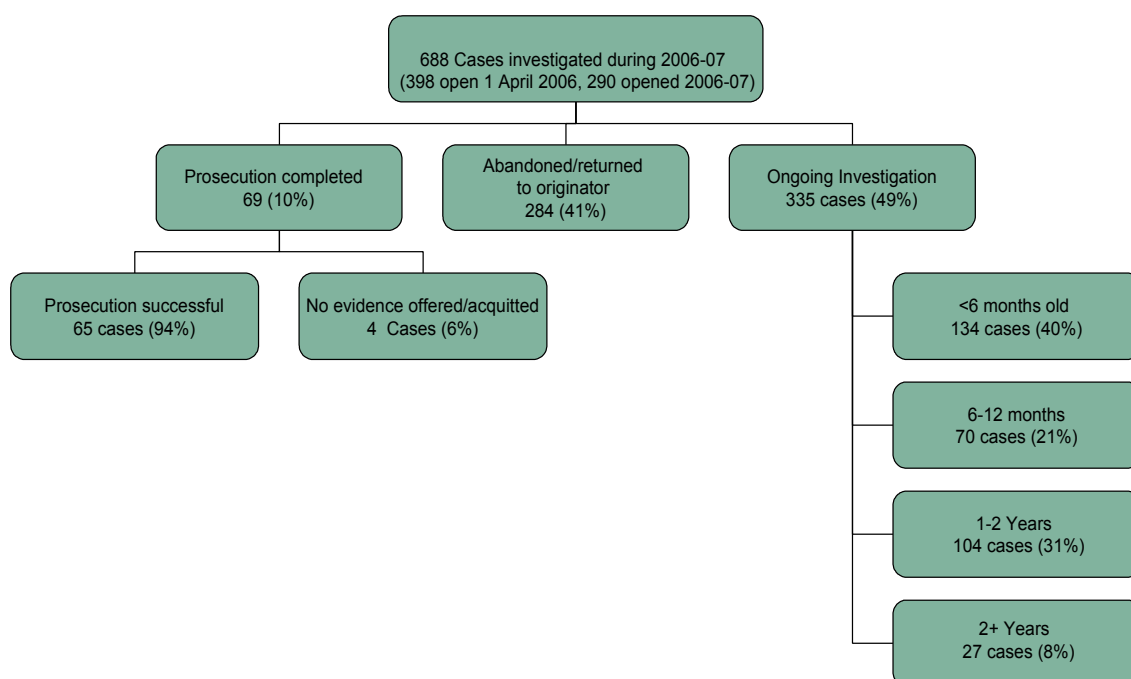
29 Qq 16, 27, 68, 85, 93; C&AG's Report, para 4.9

- there is either insufficient evidence to refer the case for prosecution;
- there is little tax at risk; or
- further investigation of the case would not be in the public interest.

Overall the turnover in completing cases appears to be slowing down. The Department expects hidden economy criminal investigations to be completed within one year but over a third of cases have been open for longer, and 8% for over two years (**Figure 3**).³⁰

28. In 2006–07 the average cost of a prosecution was £30,000, exceeding the average amount of tax detected of £11,260. The Department estimated that the average cost was around three times more than the cost of benefit fraud prosecutions which it considered to be generally more straightforward as it is easier to establish the amount defrauded.³¹

Figure 3: Criminal Investigations and prosecutions in 2006–07



Source: C&AG's Report, *HM Revenue & Customs: Tackling the Hidden Economy (HC 341, Session 2007–08)*

29. Obtaining widespread publicity of successful prosecutions is important for successful prosecutions; more people will be deterred from joining the hidden economy. While the Department obtains regional media coverage, it has found it difficult to generate national media coverage. It recognised the need to do more to increase the deterrent effect.³²

30 C&AG's Report, paras 4.11 and 4.12

31 Qq 15, 63–64; C&AG's Report, para 4.10

32 Qq 15, 114; C&AG's Report, para 4.10

Formal Minutes

Monday 10 November 2008

Members present:

Mr Edward Leigh, in the Chair

Mr Paul Burstow
Mr Nigel Griffiths
Keith Hill

Mr Austin Mitchell
Mr Don Touhig
Mr Alan Williams

Draft Report (*HMRC: Tackling the hidden economy*), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 29 read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Fifty-fifth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Wednesday 12 November at 3.30 pm.]

Witnesses

Wednesday 11 June 2008

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Mr Dave Hartnett CB, Acting Chairman, **Mr Mike Norgrove**, Director Central Compliance and **Ms Naomi Ferguson**, Director Local Compliance, HM Revenue and Customs

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HM Revenue and Customs

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Thirty-second Report	Reducing the cost of complying with regulations: The delivery of the Administrative Burdens Reduction Programme, 2007	HC 363 (Cm 7453)
Thirty-third Report	Ministry of Defence: Major Projects Report 2007	HC 433 (Cm 7453)
Thirty-fourth Report	Increasing employment rates for ethnic minorities	HC 472 (Cm 7453)
Thirty-fifth Report	Housing Market Renewal: Pathfinders	HC 106 (Cm 7453)
Thirty-sixth Report	HM Treasury: Making Changes in Operational PFI Projects	HC 332 (Cm 7493)
Thirty-seventh Report	Ministry of Defence: Leaving the Services	HC 351 (Cm 7453)
Thirty-eighth Report	Nuclear Decommissioning Authority—Taking forward decommissioning	HC 370 (Cm 7453)

Thirty-ninth Report	Preparing to deliver the 14–19 education reforms in England	HC 413
Fortieth Report	Department of Environment, Food and Rural Affairs: Management of Expenditure	HC 447 (Cm7493)
Forty-first Report	Department of Health: NHS Pay Modernisation: New contracts for General Practice services in England	HC 463
Forty-second Report	Preparing for sporting success at the London 2012 Olympic and Paralympic Games and beyond	HC 477 (Cm 7453)
Forty-third Report	Managing financial resources to deliver better public services	HC 519 (Cm 7493)
Forty-fourth Report	The roll-out of the Jobcentre Plus office network	HC 532 (Cm 7493)
Forty-fifth Report	Reducing the risk of violent crime	HC 546
Forty-sixth Report	The procurement of the National Roads Telecommunications Services	HC 558
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Forty-eighth Report	The supervision of community orders in England and Wales	HC 508
Forty-ninth Report	Making grants efficiently in the culture, media and sport sector	HC 641
Fiftieth Report	Preparations for the London 2012 Olympic and Paralympic Games	HC 890 (Cm 7453)
Fifty-first Report	Revenue and Customs Prosecutions Office	HC 601
Fifty-second Report	Protecting consumers? Removing price controls	HC 571
Fifty-third Report	Reducing passenger rail delays by better management of incidents	HC 655
Fifty-fourth Report	Compensating victims of violent crime	HC 251
Fifty-fifth Report	HMRC: Tackling the hidden economy	HC 712
First Special Report	The BBC's management of risk	HC 518 (Cm 7366)
Second Special Report	Evasion of Vehicle Excise Duty	HC 557 (Cm 7366)
Third Special Report	BBC Procurement: The BBC Trust's response	HC 1118

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 11 June 2008

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Mr Philip Dunne
Mr Ian Davidson
Nigel Griffiths

Mr Austin Mitchell
Dr John Pugh
Geraldine Smith

Mr Tim Burr, Comptroller and Auditor General, and **Ms Jane Wheeler**, Director for Revenue & Customs Value for Money Reports, National Audit Office, gave evidence.

Ms Paula Diggle, Treasury Officer of Accounts, was in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

HM REVENUE & CUSTOMS: TACKLING THE HIDDEN ECONOMY (HC 341)

Witnesses: **Mr Dave Hartnett CB**, Acting Chairman, **Mr Mike Norgrove**, Director Central Compliance, and **Ms Naomi Ferguson**, Director Local Compliance, HM Revenue & Customs, gave evidence.

Q1 Chairman: Good afternoon. Welcome to the Public Accounts Committee where today we are considering the Comptroller and Auditor General's Report on *Tackling the Hidden Economy*. We welcome back to our Committee Dave Hartnett, who is the Acting Chairman of HM Revenue & Customs. You have been Acting Chairman for some time now, have you not?

Mr Hartnett: I have, Chairman, nearly seven months.

Q2 Chairman: Is it not about time you became the Chairman?

Mr Hartnett: There is a competition for the Chairman.

Q3 Chairman: How long is this competition going to take?

Mr Hartnett: I do not know. It is being organised by the Cabinet Office rather than by HMRC.

Q4 Chairman: And is your hat in the ring?

Mr Hartnett: Ah, that is a very unfair question to ask, if I may say so. That is a secret.

Q5 Chairman: It was not meant unkindly, Mr Hartnett.

Mr Hartnett: No, I realise that.

Q6 Chairman: We are very fond of you really.

Mr Hartnett: I know.

Q7 Chairman: But you have been Acting Chairman for some time.

Mr Hartnett: Hopefully doing a decent job as well.

Q8 Chairman: Would you like to introduce your colleagues?

Mr Hartnett: Of course, Chairman. To my right is Naomi Ferguson, who is the Director responsible for our national network of offices dealing with compliance, and to my left is Mike Norgrove, who is the Director responsible for compliance strategy.

Q9 Chairman: Now, Mr Hartnett, you think, do you, that there are two million people in the hidden economy? That is what the report tells us. Is that right? You do not know, obviously, but is that a rough guesstimate that we can have some confidence in?

Mr Hartnett: There are up to two million. Chairman, as you say, it is very hard to have confidence in a figure.

Q10 Chairman: If that is a figure that we can have some confidence in why do you only investigate 28,000 of them?

Mr Hartnett: Because we have lots of other areas of work where we think there is significant risk as well, and we apply our resource to this.

Q11 Chairman: But 28,000 out of two million—your chances of being caught are virtually nil, are they not?

Mr Hartnett: I think that is not right because we are getting better and better at catching people. If you compare 2003/04 to 2006/07, we have increased the yield by 13% and we have increased the number of people coming in from the hidden economy to—

Q12 Chairman: I am sure you have increased your yield from such a low base. It would be difficult not to. Anyway, I will leave that point. You have got this telephone hotline. It is mentioned in 3.10, is it not, but why do you not investigate all these cases? It seems to be very successful. People ring up all the time.

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Mr Hartnett: People do ring up very regularly indeed. We have one case of a wife who has phoned up 68 times about her husband.

Q13 Chairman: I know the feeling, Mr Hartnett!

Mr Hartnett: And we have looked at him every time and we have not found a basis on which to investigate. I did not say that just to create mirth, Chairman. It is to illustrate that we get an awful lot of information on the hotline and it is really important for us to risk-assess it properly, not to trouble people where there is no reason to trouble them, and so we use a filtration process to deliver packages for our people to investigate where we think there is solid evidence.

Q14 Chairman: We have discussed how you investigate so few of these people. Now let us discuss for a moment, Mr Hartnett, what happens when you actually catch them. You could, of course, impose a penalty of 100% of the tax, could you not, but in fact on average you only impose 3%, so virtually there is no chance of being caught and if you are caught you are going to be asked to pay back 3% of the tax you owe? It is not much of a deterrent, is it?

Mr Hartnett: The penalty regime is changing. The old regime had a maximum of 100% irrespective of the quality of the issue. This will change in the Finance Act 2008, so that where there is genuine error, where people have taken reasonable care, the penalty will normally be nil because people who have taken reasonable care clearly want to be in the system. For people who have got things wrong without taking reasonable care the penalty will be up to 30%, up to 70% for something that is very deliberate, and up to 100% where it is deliberate with concealment.

Q15 Chairman: Let us now look at the prosecutions, shall we? Our friends in the Department for Work and Pensions are prosecuting 60 cases per thousand benefit fraud cases. You are only prosecuting two cases per thousand hidden economy cases. I am not suggesting that you should rise to the level of 60 per thousand but two per thousand is very low, is it not? This is a tiny chance of being prosecuted if you are in the hidden economy. These are people deliberately evading paying tax.

Mr Hartnett: I think there are three important factors here. The first is that the Department for Work and Pensions generally know the precise amount by which they have been defrauded. That might not be true if there is organised crime involved but generally they know that so a prosecution can be much more straightforward. If you are prosecuting for income or profits where you require lots of witnesses to quantify the amount, that is a lot harder, and we have a policy of using prosecution as a deterrent. But that then gets me to the second issue, which is that despite having a very talented communications and marketing team in HMRC we do find it very difficult to get media attention for our prosecutions. We get good attention in the regions but not much nationally, and that makes it much harder to have a deterrent effect. The third element

is this: we have 2,000 staff in our Criminal Investigation Directorate.¹ In the last few years their principal focus has had to be missing trader fraud because of the sheer scale of the numbers involved, and they have done very well with prosecutions there recently. We have got a much broader spread of need for criminal investigations.

Q16 Chairman: I was not asking about the publicity. This is a fact contained in paragraph 4.9 of the report, two cases per thousand. This is a low number.

Mr Hartnett: It is a low number and we do have plans to increase it when we can apply the skilled resource to it.

Q17 Chairman: You have had various successful schemes like the Offshore Disclosure Scheme, have you not? That was quite successful in bringing people out of darkness into light. What other similar schemes are you going to use in the future to try and tackle the hidden economy, particularly at the upper end of the scale?

Mr Hartnett: We have got several things going on. We have got more than 20 projects. We are trying to do the same with builders and decorators and the like by matching publicly available information, maybe advertisements in the *Yellow Pages* or elsewhere, with our databases. That tends to be at the lower end. At the upper end of the scheme we have a project looking at barristers, for example 57 barristers who were in the hidden economy at some time in recent years.

Q18 Chairman: What, barristers doing legal work in this country perfectly normally are not paying any tax at all?

Mr Hartnett: Not paying any tax.

Q19 Chairman: Right at the lower end of the Bar? I was once an impoverished barrister.

Mr Hartnett: I hope you will not mind if I check. There are barristers, medical consultants, who have a job in addition to their remuneration from the NHS, and something we touched on when I was last here which is broadly at the upper end, we have a rich source of information at the minute about people who have hidden their wealth in Lichtenstein, so we are ploughing that field as well right now, and there are many others.

Q20 Mr Dunne: Mr Hartnett, you are at the moment in the process of looking at your national office network in order to meet your Gershon targets and so on.

Mr Hartnett: Yes.

Q21 Mr Dunne: I had a meeting this morning, as it happens, with two of your staff members to discuss the closures in the Welsh Borders where the offices in Shrewsbury, Hereford and Ludlow are all expected

¹ Note by witness: 2,000 figure includes operational and business staff, referred investigation teams dealing with frontier casework, accountants etc as well as fully trained investigators.

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to be closed, or at least the personnel relocated, apart from contact centres. I do not know the precise breakdown in Hereford and Shrewsbury but in Ludlow you have the local compliance team which will cease to operate from Ludlow. What impact will this have on catching people in the hidden economy if you are moving your personnel to more centralised locations where they are further away from the activity you are trying to stop?

Mr Hartnett: The crucial issue, Mr Dunne, is this: once upon a time we identified people in the hidden economy and other individuals or corporates to investigate by local knowledge. Today that is not right. Today data matching done by machines is probably the best source of information we have, and you can do that data matching anywhere in the UK, for Ludlow or for anywhere else. We have increased the yield from investigation work. We are increasing the skills of our people and we believe that having this work done in a smaller number of centres than in the past is more effective. Maybe I can bring in Naomi. She is responsible for this.

Ms Ferguson: I very much echo what David has said about the use of technology to increase the risk rating of the companies that we look at or the individuals that we know or who we are looking for. We can target our resources more effectively. We are also creating some different ways of working. Traditionally we have perhaps gone out with an individual to investigate a company on its premises. We will still do that but some of that is not effective for us and is quite a burden on the customer and we believe we can do some of that remotely. We have been trialling some of that very effectively.

Q22 Mr Dunne: What proportion of the 28,000 cases that the Chairman referred to are detected electronically rather than through other means?

Ms Ferguson: For the majority of that we will use our technology. These days we would not normally keep statistics that would allow us to say it is a certain percentage.

Q23 Mr Dunne: But broadly speaking is the majority collected in that way or is it in a small number of cases?

Ms Ferguson: All my cases in the hidden economy area will come through our Risk and Intelligence Service which means we will have run them through that IT kit.

Q24 Mr Dunne: Why do you call the department “Local Compliance” if it is not locally conducted?

Mr Hartnett: That is historic, not very historic. It goes back three or four years when that was the approach. We will find a new name when we have finished changing the organisation.

Q25 Mr Dunne: Chairman, if you will allow me, I must make a plea for you to consider, as I mentioned to your officers today, retaining office premises in rural locations where I think you will find they are cheaper to maintain and occupy than in city centre locations, which is, I fear, what may be happening in our region.

Mr Hartnett: Mr Dunne, the plea is noted and some of your colleagues have made similar pleas to us, but one thing I would say very quickly if I may. It may seem cheaper. Given what we have to do some of the larger centres we are developing look as though they are going to be cheaper overall, better value overall, and produce more as well but we would be happy to talk about that on another occasion.

Q26 Mr Dunne: Thank you. Turning to an aspect of the report which is very much focused on, I am amused to see ghosts operating in the economy; one of the thrusts of your investigative work that has been brought to my attention is to seek to increase the yield from VAT registered businesses where there perhaps has not been full recovery. I have had representations from the trade association representing leisure centres, SpoRTA, which represents 120 leisure trusts across the country, most of which are legacy transfers from local authorities into independent trusts. At the moment there is considerable anxiety amongst these groups that you are seeking to target VAT recovery inappropriately, and this arises in relation to the supply of services which are, let us say, a membership subscription which is mixed, both exempt supply of membership of a swimming pool or a gymnasium and a standard rate supply such as membership of a spa. The attitude that has been taken by the Revenue thus far is that you should apply full VAT across all such mixed supply and that is in contrast with all the advice that the trusts have been receiving. They submitted a case to you in January through PricewaterhouseCoopers looking for a decision on this and have had no response at all nearly six months later. This is causing considerable anxiety in this sector because the consequence, if you were to get your way in this (and there is apparently some £20 million or so at stake according to your calculations), would be that if you were to apply three years’ worth of penalties most of these trusts, which have no reserves as a rule, would cease to operate.

Mr Hartnett: Let me say several things. We have indeed heard from PricewaterhouseCoopers. They spoke to me. I do not think it is as long ago as January. The second thing is that I would be very happy to sit down with SpoRTA if they have significant representations to make that are not already made, but I think, Mr Dunne, you touch on one of the most difficult areas of VAT. This is not particularly a SpoRTA issue but it is partial exemption for a trader or an organisation that is registered for VAT. It is one of the areas that I think is both technically difficult and where, if I may say so—and this is again not a comment about SpoRTA—traders sometimes take the benefit of the doubt. We regard it as one of our major risk areas in relation to VAT but on the particular issue I would be very happy, with Mike and/or Naomi, to sit down and talk to them.

Mr Dunne: I would appreciate that and I will follow that up if I may, Chairman. These are organisations which are social enterprises. There is not a question of any kind of fraud or personal gain coming out of

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this. It is a question of whether they can, for example, meet the Government's recently announced aspirations for swimming for all. If we do not have any sports facilities we certainly will not have any swimming.

Q27 Mr Mitchell: How many staff are employed on this kind of work? You mentioned 2,000 inspectors. The report says 1,270. How many is the actual number dealing with this area?

Mr Hartnett: Let me just clarify the 2,000, Mr Mitchell. The 2,000 are roughly the total number of staff in our Criminal Investigation Directorate.² The work on the hidden economy that is covered in this NAO report involves about 1,270/1,300 of our people and we have had 50 staff in our Criminal Investigation Directorate³ engaged in the work as well.

Q28 Mr Mitchell: How does that compare with the numbers which you gave us in the earlier inquiry investigating the financial affairs of large companies?

Mr Hartnett: It is a smaller number.

Q29 Mr Mitchell: Much smaller?

Mr Hartnett: We have about—and I am doing this from memory so I will correct it if I need to—1,700 people in the Large Business Service. We also have people in our special civil investigations. We have an international team working on large companies. I would say that at least twice as many work on the affairs of large companies.

Q30 Mr Mitchell: But the return on those investigations on large companies must be more than twice as much as the return on pursuing piddling VAT matters or barrow jobs in the hidden economy.

Mr Hartnett: Of course, but the difficult issue is this: if we were to abandon work on the hidden economy—

Q31 Mr Mitchell: I am not saying that, but there is a need surely for more staff on the bigger projects and less on this?

Mr Hartnett: Our difficulty is that if we were to reduce the number here the people who are really good at their job but who would become available could not necessarily do big corporate work and, second, we have to be active in the area of the hidden economy to protect the integrity of the tax system, because if there was a perception that we were inactive or less active then I think the hidden economy would grow.

Q32 Mr Mitchell: How far are your efforts co-ordinated with those in other departments involving potential fraud, people not paying the minimum

wage, for instance, people involved in social security fraud who might well be doing barrow jobs at the same time? How far do the efforts of those departments or agencies co-ordinate with yours?

Mr Hartnett: We do the compliance work in relation to the national minimum wage, for example, but we are very joined up indeed with the Department for Work and Pensions. The head of that department and I recently agreed to set up a joint rapid reaction team to deal with, in particular, the effects of organised crime in relation to the hidden economy and in other areas of benefit and tax fraud, so we are very joined up.

Mr Mitchell: So if I am prosecuted for not paying the minimum wage in the Mitchell drive-in bar and brothel—

Chairman: What did he say?

Q33 Mr Mitchell: It is just an idea. We have got an election coming up. If I was prosecuted for that your lads would shortly follow.

Mr Hartnett: Yes. Where we prosecute we often do so jointly with our colleagues in the Department for Work and Pensions because there is benefit fraud too.

Q34 Mr Mitchell: I was a little surprised at some of the figures in the report because I think the English have got the well-known habit of snitching on each other. We all hate each other so much we are anxious to turn in our neighbours for fun and profit, or even where there is no profit at all. I see that, while that is a major source of information, and you have 120,000 calls to the tax evasion hotline, and I know that people doing barrow jobs often snitch on each other, you are not very good at investigating those.

Mr Hartnett: I think this goes back to what I was trying to say to the Chairman. I am not sure whether snitching is a particular English disease or not but there are undoubtedly callers to our evasion hotline who think that by simply calling the line, whatever they say, accurate or inaccurate, they can cause pain to somebody.

Q35 Mr Mitchell: Oh, yes, of course, but you have 120,000 calls and only 2,000 investigations completed. That is a very small proportion.

Mr Hartnett: Because there are plenty of investigations in hand. That is the number completed.

Q36 Mr Mitchell: 5,500 planned. Again, that is not a high proportion.

Mr Hartnett: It would be fair for us to say that we have been a bit disappointed with the quality of some of the calls, which has made it hard for us to justify starting an investigation. I venture to suggest, if I may, Mr Mitchell, that you would be pretty fed up with us if you had a stream of calls from constituents who said that they knew they had been shopped by the next door neighbour, there was no substance to it but we had started an investigation.

² Note by witness: 2,000 figure includes operational and business staff, referred investigation teams dealing with frontier casework, accountants etc as well as fully trained investigators.

³ Note by witness: Have had 50 in the past but currently under that figure.

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Q37 Mr Mitchell: It is not a question of reporting on the next door neighbour because you do not tell them who has reported.

Mr Hartnett: Absolutely, we do not.

Q38 Mr Mitchell: But it must be a fertile source of information about people evading VAT or doing barrow jobs.

Mr Hartnett: It is a fertile source and what we have found is that the figures for 2007/08 are not audited so are not accurate yet and you will excuse me: I am not going to offer anything to you today, we will write when we have got them audited, but they do show a much higher level of success in terms of yield than for 2006/07.

Q39 Mr Mitchell: I see that you are working on suspicious activity in bank accounts under the money laundering regulations. That is surely not what they were intended for. I am not being critical but that is not what the money laundering legislation was intended for.

Mr Hartnett: The money laundering legislation provides suspicious activity reports which go into the—

Q40 Mr Mitchell: Is that in respect of overseas transfers or is it any suspicious activity?

Mr Hartnett: Anything like that at all. There can be huge amounts of money involved and there can be comparatively small amounts of money involved, and they come to us through a central point.

Q41 Mr Mitchell: Do they all come to you?

Mr Hartnett: All that look as though they have a relevance for taxation come to us, but the majority of them are not necessarily about the hidden economy. On missing trader fraud that I was talking about earlier on we get a huge number of suspicious activity reports where the banks, for example, have become very good and actually say on suspicious activity reports sometimes, “This looks like missing trader fraud”. They are not giving a professional or an expert opinion but it is a helpful steer. Suspicious activity reports transcend the whole range of our work.

Q42 Mr Mitchell: So you get the reports and then you send investigators in to find out what the tax liabilities are in all cases?

Mr Hartnett: We risk-assess the issue in all cases.

Q43 Mr Mitchell: I see that you were defeated in trying to get the same information from accountants and solicitors. Were you getting information from accountants and solicitors before that or not?

Mr Hartnett: I think we had received some. I am not sure that it is right to say—and I say this only to be perfectly accurate—that HMRC was defeated. I think lawyers and accountants took the case generally about the money laundering rules, and one of the things we were looking forward to was receiving reports from family lawyers, for example, about hidden monies that emerge in divorce cases and the like.

Q44 Mr Mitchell: Before this legislation, of course, accountants were one of the major factors arranging money laundering through shell companies and all that kind of business, so they certainly know it is going on. I would have thought that they were well worthy of investigation. Why will you not do an estimate? We found the same problem, did we not, on the large companies? We do not know how much tax is lost through offshore accounts or whatever. Why can you not do an estimate in this which is a much less important area?

Mr Hartnett: I am sorry; I do not understand the question.

Q45 Mr Mitchell: Why can you not give us figures estimating the amount of fraud that is going on? You cannot really know the scale of the problem you are dealing with unless you provide estimates of the people who are not paying VAT, fiddling employment, doing ghost work in the economy. These are all very bald estimates.

Mr Hartnett: They are the best we can manage with the hidden economy about which necessarily we know so little. Our best shot has been that it is upwards of £1.5 billion a year.

Q46 Mr Mitchell: Finally, I see that the European Commission is trying to push us to advertising now. That seems fairly sensible in the sense that when you have advertised it has produced a quite substantial return. Are you intending to use that?

Mr Hartnett: We used it, Mr Mitchell, in relation to the Offshore Disclosure Initiative. I can give you some figures which are rough and ready but you will see the point. We were unable to advertise for a long time in relation to the Offshore Disclosure Initiative, which had its first point by which people had to do things on 22 June 2007, and with a relatively short time to go—two weeks—we had about 10,000 people come forward. After advertising and correspondence then became more vigorous another 54,000 people came forward in two weeks, and I think that makes your point on the power of advertising.

Q47 Mr Bacon: I would like to ask the NAO to clarify a point on figure 5 on page 19. Am I right to understand that what the “Hidden Economy Teams—VAT” bar on the left is saying is that the return in terms of added revenue was roughly 15 times the cost of the team that did that?

Ms Wheeler: Yes.

Q48 Mr Bacon: Mr Hartnett, there is very clearly a big variation between the VAT team producing very high returns and some of the others producing much lower ones. The hotline is the lowest of all, presumably because it is about twice the cost and that presumably takes account of the 68 calls from—I will not describe her as your lady friend, but you know what I mean.

Mr Hartnett: I do not know this lady.

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Q49 Mr Bacon: The lady whom you referred to. That is incorporated into that figure of the yield being only twice the cost; is that right?

Mr Hartnett: I think that is right, but if you compare on this bar chart the large bar for VAT and the smaller bar for income tax and national insurance next to it, I think that brings out a great truth about these figures. VAT is on turnover and income tax is on profit or income, and it is hard to think of a business where the whole turnover is profit, so that second bar is going to be much lower.

Q50 Mr Bacon: That brings me to the question I wanted to ask about this. It refers to this in paragraph 3.8, that you have got particular groups who are more likely to be in the hidden economy, such as hairdressers, trades involved in the home. Two very obvious trades in the home are cleaning and gardening. Generally speaking—and we are not talking about landscapers at the Chelsea Flower Show—these are people at the very low end of the income scale. They are just scraping along to some extent and so although they might be liable for tax that they are not paying it probably is not a lot, whereas, shall we say, people running large market stalls every week are effectively retailers but out on the street with an awning over them. They are not paying any income tax or any VAT at all. Most people would say that morally it is quite different even though they are both failing to observe the obligation to pay some tax. Do you, in the way you look at this and in the way you pursue them, simply allocate the resources on the basis of where the yield will come or do you take into account what one might call a sort of social factor, that many of the people at the bottom end of the income scale who are scraping along are not exactly people whom you ought to be hot after anyway?

Mr Hartnett: The key is this: we want to apply our skilled resource to risk. We have to apply it across the hidden economy, so we will investigate some of the less wealthy people you describe, but a market trader, a cleaning organisation, something like this, that we identify as operating without paying tax is much more likely to get pretty immediate attention from us than someone with a much smaller income that you describe.

Q51 Mr Bacon: If you look at paragraph 3.8 it says you did focus on self-employed people, although the yield, over the page in paragraph 3.11, is much higher for small businesses and employers. Why target the self-employed when the employers, even relatively small ones, produce much, much better yields?

Mr Hartnett: Well, the self-employed are small businesses, and quite often we do not know. Let me give you one or two examples. Through our data matching we identified somebody providing a Rolls Royce hire service. They were not smart new Rolls Royces, they were older ones, but had not cost a lot. We are into that individual now for a sum of about £350,000.

Q52 Mr Bacon: Owed to you?

Mr Hartnett: Owed to the Exchequer. Mr Mitchell mentioned a trade he might take up one day, but nail bars are part of the fashion trade and we are finding those quite astonishing. We are finding an awful lot of them are not known to us and we have nail bar investigations involving over a million pounds,⁴ and the important thing is here informing our risk assessment all the time; we are learning more and more about different sectors. I agree with you, however; only 14 cases in relation to employer compliance reviews are insignificant, and that is one of the reasons, probably the crucial reason in Naomi's area, that we have brought together in single management function the employer compliance teams working in this area and those looking at the self-employed and others as well.

Q53 Mr Bacon: You mentioned data matching. In paragraph 3.17 it is very clear that your work on data matching is somewhat embryonic. In fact, it says: "This work is experimental and is at an early stage of development and subject to further testing", and "In time the Department intends to provide an organisation wide data matching service to detect people and businesses not complying . . .". The Department for Work and Pensions, it says in the next sentence, carries out regular bulk data matching exercises. Why are you so much behind them? Surely the techniques for data matching, with huge groups of data of either taxpayers or benefit recipients or pension recipients, must be very similar?

Mr Hartnett: To a point they are, but we are looking at much more complicated techniques to identify risk. I wanted to say to Mr Dunne earlier on in terms of data matching that the way to envisage it is as a great big hopper, and today we can throw much more into the hopper than we have ever been able to do in the past, and I am very proud of this on behalf of HMRC. We are regarded in the world tax community as probably the most innovative in tax administration, but it is right to say it is embryonic because we are putting much more data together than ever before.

Q54 Mr Bacon: But the hopper analogy surely also applies to DWP. What is different about them which enables them to be much better at it in the sense that already they can do regular bulk matching, which is what you are not doing?

Mr Hartnett: I think that is right but only to a point. It is much more straightforward for DWP than it is for us because we are looking at a whole range of trades, and at lots of people doing many different things.

Q55 Mr Bacon: In paragraph 3.9 it says, "Of the 19,800 cases where the Department has produced intelligent packages, 3,500 had been opened, of which almost 2,000 had been completed generating additional tax of £2.6 million". You have a pretty big backlog there. How are you going to deal with it?

⁴ Note by witness: We are investigating a number of nail bars but at this stage less than a million in tax recovered.

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Mr Hartnett: It is not necessarily a backlog; we will have risk-assessed these packages and be taking the ones that look most productive first.

Ms Ferguson: This is not a backlog. Think of this as stock in hand, work in progress. Obviously the report was written at a point in time and since then we will have taken up some of the cases that were sitting as stock in hand waiting to be taken up, and, indeed, have taken more up following that, so those cases will now have been worked, and we have moved on to other ones.

Q56 Mr Bacon: On page 21, and this is really a question about how you do your estimates and how you come up with your figures, the sentence that caught my eye was where it said: “The continued slow progress in dealing with cases means that the Department is likely to raise up to £7 million in additional tax in 2007-08 compared to its original estimate of £77 million”. Now, that is an enormous difference. Who comes up with these numbers? That is out by a quantum of ten?

Mr Hartnett: I agree. We have professional analysts doing this work for us, but this goes back to one of Mr Mitchell’s observations: we expected to have a very rich source of data from accountants and lawyers, we planned on that basis as the money laundering rules were brought in, and then the obligations of accountants and lawyers were changed from what was first envisaged, and we thought we would have a very rich seam of very substantial cases.

Q57 Mr Bacon: This is because of the court case?

Mr Hartnett: Yes.

Q58 Mr Bacon: Lastly in paragraph 3.15, “The national minimum wage team”—this is the investigation team—“does not . . . receive feedback on what has happened to [the cases it has looked at] or whether the information was useful in following up cases”. It is hard to think of a way more quickly to demoralise folk than to ask them to give you information as an investigation team and then not to tell them what you have done with it or whether it was useful. How can you get more feedback?

Mr Hartnett: The only thing I want to say, before bringing in Naomi, is that our investigators, our teams, are anything but demoralised.

Ms Ferguson: They would normally get feedback at the point where we undertake the risk assessment. What the NAO picked up on, and were right to do so, is that sometimes we are not very good at tracing all the way through to the end outcome. It is something I will pick up with the teams because you are right, it can certainly help. I know locally individuals will do it but I think we should think about how systemically we can provide that feedback.

Q59 Dr Pugh: Your estimate for the number of people involved in the hidden economy is 2 million but we have been trying to get some picture of what these people are like. Have you any feeling, on that two million, how many are big problems, in other

words owe a huge amount of taxation, or are the vast bulk of them small time offenders, the gardeners, the hairdressers and so on?

Mr Hartnett: The picture is rather more the second you paint than the first.

Q60 Dr Pugh: And in percentage terms?

Mr Hartnett: That is very difficult. It is like guessing the complete unknown.

Q61 Dr Pugh: Well, suppose I were to say that 80% of the people you are looking at you think are small time offenders rather than big time?

Mr Hartnett: That would be a very fair start.

Q62 Dr Pugh: 69 cases ended up in prosecutions in 2006/7 and it cost on average £30,000 I think per case per prosecution. Can you give us some idea of what the breakdown in cost is of that £30,000, if that is the figure? If it costs you £30,000 to prosecute somebody and you are only looking at recovering £11,000 taxation, I think these were the figures in the report, and you clearly will not get all of that back as a result of prosecution, you could almost make the case saying it is hardly worth doing apart from its deterrent effect on other people, and you may not be encouraged to do it on those sorts of figures. Of that £30,000 you are paying to prosecute somebody, in a sense, what are you paying for? Is that lawyers’ fees?

Mr Norgrove: That includes lawyers’ fees, yes, and our own staff time is included in that.

Q63 Dr Pugh: How does that compare with a DWP prosecution, because obviously they can be very expensive too?

Mr Norgrove: Ours would be considerably more expensive than theirs.

Q64 Dr Pugh: Twice? Three times?

Mr Norgrove: I could not hazard a guess but our cases are considerably more complex and take longer, so I would say it is a factor of at least three but I would be guessing.

Mr Hartnett: If I could come in, there is a figure here for DWP prosecution as an indication but ours would be higher because a comparable figure would not be just a hidden economy figure, it would be all-our prosecution work, and some of our cases are some of the biggest and most complicated cases in the country.

Q65 Dr Pugh: In terms of the cases you take to completion as opposed to those you prosecute over, have you compared them head to head with DWP? Are they proportionately again more expensive?

Mr Hartnett: I am not quite sure what you mean.

Q66 Dr Pugh: Well, DWP will close an investigation at a certain point and it will then have cost so much; you will close an investigation at a certain point and it will cost so much; so I am wondering what the head-to-head comparison looks like?

Mr Hartnett: Cost yield for us is much higher.

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Q67 Dr Pugh: When you prosecute, or make a decision to go for prosecution, what kind of threshold needs to be crossed? Do you need to be looking at a substantial sum for recovery, or do you just simply need to know there is an offence there and there is no other way of resolving it?

Mr Hartnett: Can I return to the previous question? When I say cost yield is much higher I mean that our yield for cost is higher; I do not mean the cost is higher.

Q68 Dr Pugh: Of course, yes.

Mr Hartnett: We look at number of things. We have a very clear criminal investigation policy,⁵ which is on our website, which ranges from the nature of the offence through to the role of the individual. A judge or a lawyer involved in tax is much more likely to be referred for⁶ prosecution by us for tax fraud than someone who is not in that sort of special position, but we do look at monetary levels as well. I was saying to the Chairman earlier on that some of our criminal prosecution work is quite complicated and that complication does not necessarily depend on the amount of money involved, so we have set ourselves a sort of working threshold of £10,000 to consider criminal investigation but we will come below that where it is appropriate because we have to provide deterrence across the whole system.

Q69 Dr Pugh: Going on to the subject of data matching which has been raised already, you can only do that within a database and, clearly, it is a question of what is in your database, or, to put it a different way, it depends on what your database is linked to. Are you linked up to any other databases? For example, the DWP one?

Mr Hartnett: We provide datasets to DWP; they provide datasets to us.

Q70 Dr Pugh: On individuals?

Mr Hartnett: No, on groups, but our basic database is all taxpayers, all payers of national insurance, all claimants of tax credits. When we are doing data matching we try to put all our databases for individuals into the hopper, if I can keep describing it as that, with third party information as well, to see what links come out.

Q71 Dr Pugh: I want to follow up a point made by Mr Dunne about the abolition of local tax offices. One thing local tax offices will have is local knowledge, and you obviously are putting your money on some data matching exercise and quite clearly, if you do all your effort in that direction, that will be hopefully where you pick up the prosecutions, or whether the case is for further investigation, but clearly it is not an either/or, is it? You can do both. You can have local knowledge

where you will find out about that nail bar that does not appear to be paying any taxation, and you will also be able to do the data matching as well?

Mr Hartnett: Well, to a point --

Q72 Dr Pugh: Well, the nail bar is not going to be on your database but it may well be recognised by the local tax office.

Mr Hartnett: That is the key issue, and we are much more likely—and more effectively and more cheaply—to pick up the nail bar by analysing the Yellow Pages or other advertising material and finding electronically that the nail bar is not on our database, than by waiting for one of our people to walk past it.

Q73 Dr Pugh: So do you get many referrals from the local office?

Mr Hartnett: Nothing like as much. We used to be dependent on that for cases and dependent on information, perhaps, from the banks as well. Today we are matching electronically, we might match a thousand nail bars or try and match a thousand nail bars to our databases in five minutes, or something like that.

Q74 Dr Pugh: We will look for some evidence of that in the fullness of time. I once went to the police headquarters in Liverpool where they were concerned with migrant workers and the agencies that employed them, and they found the most successful way of tracking where things were going wrong was to look at people's tax affairs, but whereas in this establishment I looked at, you had the police sitting there with their computers, DWP sitting there with their computers and Customs people, Inland Revenue were not playing at all and were standing aloof from the whole process, although they could be extraordinarily useful to it. Has that attitude changed?

Mr Hartnett: With great respect it was not an attitude. Parliament has set us very strict rules of confidentiality and we cannot simply pass information across unless there is a statutory gateway or some other authority. We want to co-operate with others. The gangmasters' licensing work, which is where a lot of these immigrants work, we are a big collaborator in now, and we are allowed to do that and it is very successful.

Q75 Dr Pugh: If somebody comes to you to work on your house and they say: "I can do it for a lot less if you pay me cash in hand", and they explain to you very clearly that their reasons are they do not wish to pay tax, is the customer committing any kind of offence?

Mr Hartnett: I cannot think of a statutory tax offence that the customer is committing. I am not a lawyer, but I imagine a lawyer might be able to make a case for it being a conspiracy.

Q76 Dr Pugh: Lastly, there are certain areas, the entertainment industry, building sites, landlords and so on, which obviously are key evasion type areas and we are all very familiar with them. Do you have

⁵ Note by witness: We have a criminal investigation rather than prosecution policy as HMRC are no longer a prosecuting authority.

⁶ Note by witness: We have a criminal investigation rather than prosecution policy as HMRC are no longer a prosecuting authority.

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dedicated teams that specialise within specific areas that know, say, the entertainment industry pretty well?

Mr Hartnett: Yes, we do. We have specialist teams dealing with television, dealing with footballers, dealing with all sorts of other entertainers. We have a specialist scheme for the construction industry, and we have people who are absolute experts in dealing with compliance risk in the construction industry.

Q77 Mr Davidson: Can I clarify this, please? How much is £2 billion in the estimated cost worth in terms of a penny in income tax? Is that tuppence? A penny? A ha'penny? How much is raised by a penny on income tax?

Mr Hartnett: I do not think I know the answer, as I sit here.

Q78 Mr Davidson: That is reassuring, because the NAO assured me you would!

Mr Hartnett: I am embarrassed.

Q79 Mr Davidson: I am sure you can tell us, just to try and relate to it what the price is. On the question of publicity, you mentioned earlier on 57 barristers and a number of medical consultants and, indeed, if you were able to tell us that they were all Oxbridge public schoolboys then that would confirm all my prejudices at one time, but are you producing lists of the 57 barristers? Can you send us lists, for example, of these people who have committed such an offence?

Mr Hartnett: We have our own lists but I am back to where I was with Dr Pugh earlier on, that we cannot publish those because people are entitled to confidentiality.

Q80 Mr Davidson: Why?

Mr Hartnett: Because we have strict confidentiality rules.

Q81 Mr Davidson: But they have committed an offence?

Mr Hartnett: Yes.

Q82 Mr Davidson: It is similar to a butcher, say, selling duff sausages or a landlord selling a pint that is short. So people who cheat their income tax have anonymity?

Mr Hartnett: Everybody is entitled to confidentiality about their taxation affairs unless that confidentiality is lifted by statute or publicity for the prosecution or something like that.

Q83 Mr Davidson: So these 57 upholders of the law, who have been breaking it by cheating on their tax, are guaranteed anonymity?

Mr Hartnett: Unless we refer them for prosecution.⁷

Q84 Mr Davidson: How many of them will you prosecute?

Mr Hartnett: I do not know at the moment.

Q85 Mr Davidson: What sort of decision would be taken? What is the process by which you decide whether or not to prosecute?

Mr Hartnett: Well, we would look very carefully at whether any were involved in delivery of the tax system, were advising on tax. We are more likely to prosecute when someone is doing that; we look at the amounts of money involved; we look at whether it was a first offence and at whether there were any aggravating features. If someone, for example, was charging their fees out under a false name we would take that very seriously indeed.

Q86 Mr Davidson: Can you let us know how many were prosecuted of those 57?

Mr Hartnett: Of course.⁸

Q87 Mr Davidson: It just strikes me as being unfair here. If one of my constituents was caught, say, stealing £5 from a post office, they would undoubtedly be prosecuted and there would be consequences of publicity, yet if a barrister steals several hundred by avoiding his tax, then there is no publicity and he is allowed to carry on regardless. It does seem a trifle unfair, does it not?

Mr Hartnett: I can understand where you are coming from but we cannot prosecute everybody. We do that selectively.

Q88 Mr Davidson: Moving on to medical consultants, I think you said these are people working in the private sector on the side and not declaring their income. Can you tell us the hospitals they have been working for? Is there a pattern?

Mr Hartnett: Same answer, I am afraid. That is taxpayer confidential information.

Q89 Mr Davidson: But I am not asking about the particular taxpayer. Is there a pattern whereby a particular hospital, a private hospital, has a whole string of consultants?

Mr Hartnett: Not that we are aware of.

Q90 Mr Davidson: So, as far as you are aware, there is no deliberate path? It is down to the dishonesty of particular individuals?

Mr Hartnett: Were we to discern a deliberate pattern we would take a very serious view of that, and we have not so far.

Q91 Mr Davidson: It seems as if this is an offence, particularly in the upper areas, where people can get away without any stain on their character and there is virtually no penalty at all. What would be the level of charge levied on the barristers?

Mr Hartnett: As I was explaining earlier on, it depends whether they had taken reasonable care and made a mistake; it depends whether they were not taking reasonable care. It is hard to think they had taken reasonable care and failed to tell us about

⁷ Note by witness: HMRC are not a prosecuting authority

⁸ Ev 12.

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themselves. It would then depend on whether it was deliberate and whether there was some concealment, so it could be anything up to 100%.

Q92 Mr Davidson: Can I turn to the question of offshore jurisdictions and the issue of the amnesty and so on? Can you clarify whether people that you catch after the amnesty will be worse off than if they had come forward as part of the amnesty?

Mr Hartnett: Let me be a little picky, first, if I may; we have not had an amnesty. We charged a lower penalty than we would otherwise have done and, if people have not come forward and we now detect them, we are looking for a much larger penalty and are investigating, with a view to referring for prosecution some who have failed to come forward as well.

Q93 Mr Davidson: But you are only prosecuting some? I hear the same sort of caveats apply. I am just trying to assess whether or not on the balance of risk it is worth somebody thinking, "Well, they won't catch me and if they do catch me the penalties are so low it is worth a chance". What evidence can you put forward that would convince me you are applying a regime which would frighten people into coming forward rather than continuing? You are making a cold-blooded calculation as to whether it is a risk worth taking.

Mr Hartnett: Let me make two points. In our experience a relatively small number of people consciously take the risk. Some do and some pay huge penalties, some go to gaol for taking the risk, but tax administration in the United Kingdom is dependent on others besides HMRC, it is dependent on accountants and lawyers, for example, and certainly the accountants and lawyers I have dealt with over the years are pretty vigorous in advising clients not to take the risk, because although we are selective in our referrals for prosecution⁹ we do prosecute, and I think the total number of prosecutions we are involved in each year is something around 1,000.¹⁰

Mr Norgrove: In total, yes.

Q94 Mr Davidson: Can I clarify this point about not taking the risk? Presumably all of those who had their offshore accounts, the sole purpose of which was to avoid tax, as I understand it, were well aware they were taking the risk that they would be caught at some stage or another?

Mr Hartnett: Not at all, no. Of the 64,000-ish who came forward to tell us they may have an issue, something like 45/46,000 then came forward with a disclosure, we are looking at the gap between that at the minute, and of those who came forward, a number of thousands, had no tax to pay either because the amounts involved were small or there were other reasons why there was no tax to pay. So I think it is wrong to say that everyone—and I am not sure you were saying this—with an offshore bank account is fiddling their tax.

Q95 Mr Davidson: Can I clarify the question of the amounts involved being small? I think there was a £2,500 cut-off point. If you had had that amount of income in the United Kingdom you would have been taxed on it, would you not?

Mr Hartnett: People came forward with £25, Mr Davidson, despite the cut-off. People were worried about being caught.

Q96 Mr Davidson: Even on £25 there actually would have been something to pay?

Mr Hartnett: Depending. We found some older people who had nothing to pay.

Q97 Mr Davidson: No other income? Right. Can I just ask about the co-operation you have had from British Overseas Territories? Are you satisfied that all of those are providing as much assistance as they ought?

Mr Hartnett: I think that, compared with a few years ago, we get excellent co-operation.

Q98 Mr Davidson: And you have no issues with jurisdictions such as Jersey, Guernsey, the Cayman Islands, and so on? Anything you ask for, you receive?

Mr Hartnett: We have more trouble with Liechtenstein today than we have with British Overseas Territories.

Q99 Mr Davidson: I understand that, but we have more pull perhaps with Overseas Territories than we do with Liechtenstein. Can I ask about money laundering and so on? If somebody is caught with money and a criminal record and so on, the money would be confiscated but, in those circumstances, how do you investigate their tax affairs? My understanding is if somebody is prosecuted you then have the opportunity to go back several years, but if they say nothing at all and just give the money up then you do not have the opportunity to go back six years or so. Is that correct?

Mr Hartnett: That is news to me, I have to say. There are cases, they go back a few years but I think they bring the point out, where people caught fiddling their taxes have burnt the cash, the cash no longer exists, but we have still taxed them on the best estimate of what they have destroyed, and, depending on the precise circumstance of the situation you describe, if it was income from trade we would want to tax it whether someone had received it or not.

Q100 Mr Davidson: And in what circumstances do you have the opportunity to go back in previous years?

⁹ Note by witness: HMRC are not a prosecuting authority.

¹⁰ Note by witness: This includes tax credit prosecutions.

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Mr Hartnett: For direct taxes¹¹, if there is—and this is about to change—negligence or fraud, we can go back twenty years. That is about to change so that for negligence we can go back six years, but for fraud we can still go back for twenty.

Q101 Mr Davidson: So that in any situation where somebody was, maybe, caught with a large bundle of cash, if it was forfeited under the criminal legislation and so on that would give you the opportunity to go back twenty years, would it?

Mr Hartnett: Yes, provided we can find a source to tax it. If someone simply had a big bundle of cash, the big bundle of cash could come from a bank robbery, we would not be seeking to tax that if we knew that is what it was, but if they were a trader we would want to tax it.

Q102 Mr Mitchell: In paragraph 5.4, the Australian Taxation Office is targeting people and using data matching techniques to identify people in cash-based businesses who lead a wealthy lifestyle, such as owning luxury cars and boats which appear unsupported by the income declared. Why do you not do that?

Mr Hartnett: We do.

Q103 Mr Mitchell: On what sort of scale?

Mr Hartnett: We are constantly looking for information about the registration of yachts and smaller boats; our compliance people might wander around a harbour and take a note of all the larger sized boats and trace them, and, if I may put it somewhat colourfully, into the hopper it goes so that we can match it. Helicopters, planes—

Q104 Mr Mitchell: So does your information come from the snitching line—

Mr Hartnett: No, not for this.

Q105 Mr Mitchell: —or does it come from inspection?

Mr Hartnett: We will seek to obtain information mainly from harbour masters, from buying commercially available data—all sorts of things like that.

Q106 Mr Mitchell: So if my constituents ring up and tell you I am leading an extravagant lifestyle on MPs' pay—

Mr Hartnett: I am going to believe them!

Q107 Mr Bacon: You just mentioned tax inspectors wandering around harbours, which conjures up a marvellous image. Will they be looking like a caricature of the Man from the Ministry, or are they wandering around in sailing gear, or are they in bowler hats?

Mr Hartnett: We do not do bowler hats and umbrellas any more, and I hope they are relaxed and doing a good job and doing it really professionally.

Q108 Mr Bacon: You did not answer my question.

Mr Hartnett: Well, I do not think they will be dressed as matelots with striped shirts! They would stand out.

Q109 Mr Davidson: Coming back to the question of the court case you mentioned where the responsibilities of lawyers and accountants were changed. Have you sought a change in legislation that would put you back to the situation where you thought you were?

Mr Hartnett: Mr Davidson, the court case was not with us, it was a court case brought by the professional bodies, and I think reversing it would take us into the very difficult area of legal professional privilege, and whilst we do get involved in issues around the issue of professional privilege I think it is owned by the Ministry of Justice so it would have to start there. Maybe it is another Department but I think that is where it is.

Q110 Mr Davidson: That was a “no”, then?

Mr Hartnett: That was a helpful no.

Q111 Mr Davidson: I just want to be clear.

Mr Hartnett: We cannot go back in there. It was not us, and I do not think we have an option to take a case in this area.

Q112 Mr Davidson: No, sorry, I am not saying take the case. It is a question of whether or not there are powers that you would like that you have not got that you have asked the system to consider giving you. That is what I am seeking to clarify.

Mr Hartnett: We are in the middle of the Government legislating modern powers for HMRC. The two old Departments had quite different powers; we are neither levelling up or down. We have consultation with all sorts of people. We are trying to provide a new suite of powers, but dealing with that issue is not part of it.

Q113 Chairman: Mr Hartnett, has a builder or tradesman ever said to you: “This will cost you so much, Guv, but if you gave me cash I can do it cheaper”?

¹¹ Note by witness: Currently the regimes are different for direct and indirect tax. In both cases if there is fraud we can go back 20 years. If we have negligence, we can go back 20 years in direct tax cases. If we do not have negligence or fraud in a direct tax case then we can go back 6 years. In indirect taxes there aren't negligence penalties, only penalties for error. With the new aligned time limits, which we expect to come into after 1 April 2010, we will be normally be able to go back 4 years for direct tax and VAT. Where tax is lost due to a failure to take reasonable care for direct tax, we will be able to go back 6 years rather than the current 20. Where tax is lost deliberately, or due to a failure to notify HMRC of liability to tax or use of a disclosable avoidance scheme, we will continue to be able to go back 20 years for direct taxes and VAT.

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Mr Hartnett: The last time it happened I paid by cheque.

Q114 Chairman: But in the real world we know this goes on all the time. Do you have an opinion on this? Do you think that above a *de minimis* level we should be required to pay by cheque or by card for such services?

Mr Hartnett: Can I just go at a slight tangent for a second to be helpful? The former Commissioner of the Internal Revenue Services in the United States believed fervently that, over a threshold of maybe \$5,000, anyone paying cash for services, whatever the circumstances, professional or private, should deduct tax and account for it to the IRS. Now, that feels to me like a pretty horrific prospect in terms of compliance costs for citizens and the like. I am firmly in the camp that believes we need to get better at

detection, deterrence and at raising awareness, and some of our help lines and hotlines are going in that direction. That would be my personal opinion of the way forward.

Q115 Mr Bacon: Mr Hartnett, I hate to miss an opportunity to ask you about how the settlement with EDS is going? The quarterly payments?

Mr Hartnett: I have had meetings in the last two or three weeks with both EDS and our lawyers. It continues, Mr Bacon, I am afraid, not to go as well as we had hoped. I think EDS probably feel they are not winning the contracts that they planned to win, but both I in the past and Mr Gray have said that our patience is not infinite, and that is where we stand at the minute.

Chairman: Thank you, Mr Hartnett. That concludes our hearing.

Supplementary memorandum from HM Revenue and Customs

In question 17, the Chairman was discussing particular schemes used by the Department to tackle the hidden economy. Mr Hartnett gave the example of 57 Barristers who were in the Hidden Economy at some time in recent years.

Questions 84–86 (Mr Davidson): *asked what action the Department would take in these cases. In particular, he asked for a note detailing how many of the 57 have been prosecuted.*

The project that identified 57 barristers as failing to notify has not, at this time, led to any prosecutions although the 36 cases that have been settled so far under civil proceedings have generated yield from tax/national insurance, interest and penalties amounting to some £605,000 The remaining cases are ongoing.

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