

W. R. **CONFIDENTIAL**

PRIME MINISTER

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

Tax Evasion

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

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

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

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

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

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

no

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3 July 1981

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PRIME MINISTER

*See note on next page
The work would create
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c. Mr. Walters
Mr. Wolfson
Mr. Ingham
Mr. Hoskyns
Mr. Duguid

*Mr. Ingham
Government
not*

TAX EVASION

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

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

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

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

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

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

4. Other considerations are:

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

Men - I feel the work would stop - i.e. we should get less tax because of no V.A.T from cash expenditure

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

/ proposals

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

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

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*for Econ
P.S.*

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

10 DOWNING STREET

From the Private Secretary

6 July 1981

COUNTERING TAX FRAUD AND EVASION

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

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

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

L. P. LANKESTER

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

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B/C:- Mr Walters
Mr Hoskyns
Mr Wolfson

29 June, 1981

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

Countering Tax Fraud and Evasion

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

J. P. LANKESTER

A J Wiggins, Esq
HM Treasury

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

Qs 4750-66

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

Qs 4767-8

Q 4764

Qs 4714-5

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

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

"THE BLACK ECONOMY"

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

C&AG's
Report
(Volume 3)
Para 136

Qs 4619-22

Qs 4658-60

Qs 4619,
4641

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

Q 4728

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

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

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

TOBACCO PRODUCTS DUTY

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

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

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