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

PRIME MINISTER

INLAND REVENUE MANPOWER AND THE BLACK ECONOMY

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

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

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

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

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

Margaret O'Mara

(N.L.)
10 November 1983

(approved by the Chancellor
and signed in his absence)

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

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



10 DOWNING STREET

From the Private Secretary

Prime Minister

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

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

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

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10 DOWNING STREET

From the Private Secretary

15 November 1983

Inland Revenue Manpower and the Black Economy

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

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

Andrew Turnbull

Miss Margaret O'Mara,
HM Treasury.

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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.*

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3 July 1981

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PRIME MINISTER

*See note on next page
The work would create
less income
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the CMI duties
Government please
not*

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

TAX EVASION

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

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

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

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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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1 July 1981

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attached

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THE BLACK ECONOMY

A report by the CPRS

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September 1982

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CHAPTER 1 - INTRODUCTION

Structure of report

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

Definition

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

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

- a. The full-time self-employed window-cleaner who earns enough to be liable for income tax but is unknown to the Inland Revenue: he is a 'ghost'.

- b. The ambulance driver, paying tax on his regular income, who also undertakes building work in his spare time, and avoids tax on his income from that source: a 'moonlighter'.

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

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

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

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

The two faces of the black economy

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

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

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

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

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

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

A way forward

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The size of the black economy

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

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

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

-the amount of currency in circulation;

-the value of transactions in the economy.

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

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

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

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

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

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

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

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

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

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

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

Could we find out more?

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

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

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

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

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

CHAPTER 3:

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

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

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

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

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

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

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

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

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

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

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

Dynamic effects

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

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

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

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

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

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

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

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

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

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

National statistics and economic policy

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

Social effects

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

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

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

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

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

Conclusions

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

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

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

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

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

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

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

CHAPTER 4: HARNESSING THE ENERGIES OF THE BLACK ECONOMY

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

The tax and benefits systems

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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CHAPTER 5: ENFORCEMENT AND MONITORING

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

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

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

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

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

Present Enforcement Work

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

The Inland Revenue's Enforcement Work

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

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

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

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

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

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

DHSS Fraud Work

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

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

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

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

Deterrence

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Moonlighter declarations

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

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

Exchange of information between Departments

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

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

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

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

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

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

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

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

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

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

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

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

Co-ordination of PAYE and national insurance work

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

- 600 Inland Revenue PAYE Auditors look at tax deduction

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

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

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

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

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

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

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

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

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

Overlap of Fraud Work by DE and DHSS

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

Monitoring the Effects of Enforcement

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

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

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

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

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

CHAPTER 6: SUMMARY AND LIST OF RECOMMENDATIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

Recommendations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ANNEX A: STUDIES OF THE SIZE OF THE BLACK ECONOMY

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

- macroeconomic
- microeconomic
- informed guesswork

Macroeconomic Methods

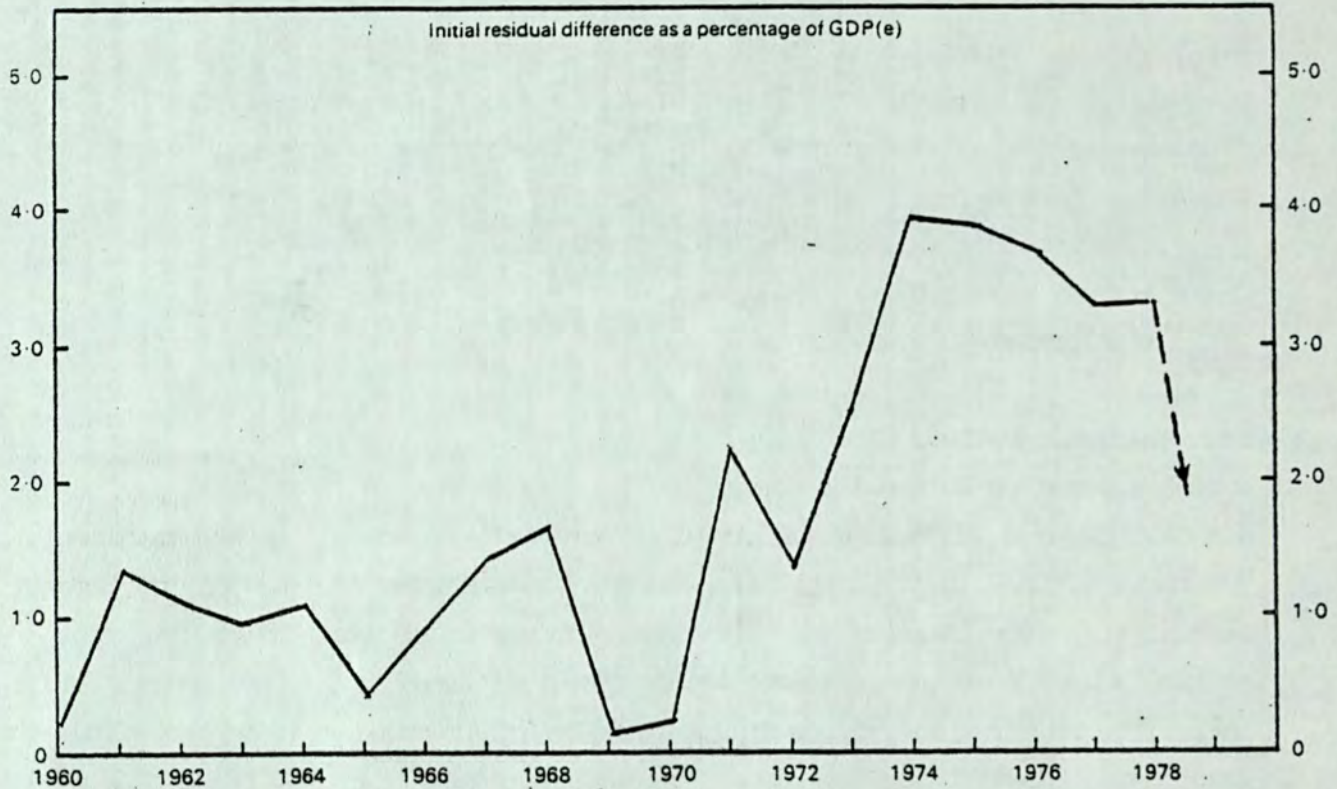
Estimate based on National Accounts

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

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

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

Figure A1: Initial Residual Difference (CSO Estimates)



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

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

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

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

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

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

The 'big bill' method

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

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

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

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

The transaction method

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

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

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

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

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

'Cash in the money supply' estimates

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

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

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

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

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

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

An Econometric Method

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

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

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

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

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

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

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

Is the black economy counter-cyclical?

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

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

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

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

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

A.27 These movements are to be compared with -

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

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

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

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

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

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

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

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

Micro-economic methods

Expenditure and income of individual households

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

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

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

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

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

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

Income-Expenditure discrepancies for the self-employed

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

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

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

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

Inland Revenue 'Guesstimates'

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

TABLE A.2

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

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

Conclusions (ii) Is the black economy getting bigger?

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

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

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

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

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

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

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

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

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

- PAYE Audit - to check that employers correctly operate the PAYE system and deduct tax and national insurance contributions; yield £20 million, 400 staff, ratio 4:1;

- Special offices - mainly to investigate areas of widespread evasion and avoidance where large amounts of tax are at risk (eg employment in Fleet Street of casual labour under fictitious names); yield £29 million, staff 102, ratio 19:1;

- Enquiry Branch - to investigate cases where there is a large amount of evasion or serious fraud; yield £23 million, staff 144, ratio 13:1;

- Board's Investigation Office - mainly concerned with administering a special scheme for collecting tax from sub-contractors.

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

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

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

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

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

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

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