

TAXREP 42/04

The Small Business Council's review of the informal economy

**Response dated 27 August 2004 from the Tax Faculty of the Institute of
Chartered Accountants in England & Wales
to the Small Business Council's review of the informal economy,
published on 30 July 2004**

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INTRODUCTION

1. The Tax Faculty of the ICAEW is pleased to contribute to the Small Business Council's (SBC) review of the informal economy.
2. The following document sets out who we are, some general comments on the review, including the scope of our contribution; and detailed responses to the questions asked by the SBC.

WHO WE ARE

3. The Institute of Chartered Accountants in England and Wales is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
4. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).
5. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter **TAXline** to more than 11,000 members who pay an additional subscription.

COMMENTS ON THIS REVIEW

7. We are pleased to contribute to this review, but we are concerned about the short time which has been allowed for it. The SBC announced its review on 30 July and asked for responses by 27 August. This allows only four weeks and coincides with the summer holiday period. This seems unnecessarily short, and is insufficient for representative bodies such as ourselves to seek members' views or prepare an in-depth response. We see no reason why the consultation period should not be in accordance with the Government's Code of Practice on consultation which specifies a minimum period of three months. We hope the SBC will take this into account when formulating policy based on responses to its questionnaire.
8. Our comments, given below, are based on anecdotal evidence and on the experiences of members who have done pro bono work for advice agencies such

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as TaxAid. They are also based on our knowledge of the tax system and of the help and information which is available from the Inland Revenue. We do not have any statistical evidence or research data on the informal economy.

9. Lord Grabiner QC's report on the informal economy in March 2000 made a number of recommendations for incentives and sanctions to encourage businesses to 'come clean'. These included the setting up of the Inland Revenue's confidential helpline, the requirement to register for NIC within three months or face a penalty, and the new offence of fraudulent evasion of tax.
10. We published our response to the Grabiner Report as TAXREP 18/00 and a copy is attached. A summary of our response which was published on our website is as follows:

This representation argues that the Grabiner Report on the black economy should not be implemented without further consultation, on the grounds that it is 'shoddy, hurried and untroubled by lack of evidence to support its proposals'.

The Report was produced in a mere three months. The lack of detailed analysis, the absence of serious evidence to support most of its conclusions and an apparent indifference to the likely effect of some of the proposals destroys Grabiner's credibility as a serious basis for legislation.

Despite its fundamental flaws the Chancellor of the Exchequer has announced that the Government will implement Lord Grabiner's report without any public consultation. The Tax Faculty warns this is a dangerous decision and we urge the Chancellor to think again.

11. Given our concerns about this report and the proposed measures which were introduced, we believe it is essential that a full analysis is published as to how effective these measures have proved to be in practice and whether they have succeeded in combating the informal economy. We would suggest this as an area which the SBC might fruitfully explore.
12. We would be interested to know whether any work has been done on how these recommendations were taken forward, how effective they proved to be, and whether they could be made more effective. We would suggest this as an area which the SBS might fruitfully explore.
13. Our comments on the questions raised by the SBC are given below, following the numbering in its questionnaire. We have only answered those questions where we are able to give informed comments. Comments on the benefits system or job market, for example, are beyond our remit.

14. RESPONSES TO QUESTIONS ABOUT THE INFORMAL ECONOMY

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Q1 Can you give examples of types of businesses or business sectors that are particularly prone to operating within the informal economy?

Q2 Do those businesses or business sectors have any common characteristics? For example, are they labour intensive or seasonal in nature?

It is difficult to generalise, but certainly at the small business end of the scale, those in the informal economy are often cash-based and/or working from home (ie they do not have a separate office or workshop). They are often one-man-bands and do not employ others. They may be carrying on the undeclared activity in addition to other work. Examples might be: taxi and mini cab drivers; despatch riders and couriers; builders and decorators; cleaners and gardeners; window cleaners. (This is not intended to be an exhaustive list, and of course we recognise that many in these trades are fully compliant.)

An important category is those who do not choose to be self-employed, but who are told by their 'employer' that they must deal with their own tax. Correctly, they may be employees, and the employer should operate PAYE. These individuals have little choice in the matter if they want the work, but they may not understand what being 'self-employed' means. A further group is those who are carrying on a self-employed activity according to tax law, but who do not see themselves as traders – an example would be foster carers, who often view themselves as performing a social service and do not realise they have to register with the Inland Revenue (though most should now be covered by the new tax exemptions).

Another situation is where the trader is relying on an adviser, and that adviser gives incompetent or unscrupulous advice about how tax matters should be dealt with. The trader and adviser may be colluding, or the trader may simply be the victim of bad advice. The adviser could be professionally qualified, or unqualified. We have no data as to how widespread this situation is, but it is of particular concern to bodies such as the ICAEW, which seeks to uphold high professional and ethical standards of its members.

Q5 Does the existence of the informal economy support or undermine the formal economy? If so, please explain how.

The fact that some traders in a business sector are evading tax means that those who are compliant are at an unfair disadvantage. If evasion is seen to be relatively easy, or even acceptable, it discourages compliance in others. It is difficult to see how the informal economy could support the formal economy.

Q7 Do businesses operate within the informal economy primarily to avoid or evade tax?

We would distinguish here between avoidance and evasion – the loss of tax due to the existence of the informal economy is evasion, not avoidance.

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The evasion of tax is certainly a major reason why businesses do not declare their income or comply with other requirements, and some do this deliberately.

However, many very small business drift into the informal economy because they are deterred by the red tape involved in regulatory matters, or are baffled by how the tax system works. This is particularly the case where it is not their choice to be self-employed. The longer they leave it, the more frightened they become about making the first step to sort things out. To that extent, the requirement to register for NIC within three months of starting a business merely aggravates the penalty culture which will not necessarily encourage taxpayers to come forward and regularise their affairs.

Q10 Does the complexity of keeping formal records or other regulatory requirements deter businesses from acting within the formal economy?

Q11 Does a person's level of literacy or numeracy have an effect on their decision to operate in the informal economy

Yes, regulatory requirements are one factor which can deter people from complying. Poor literacy or numeracy, and also language difficulties, can compound the problem.

As noted above, a person does not necessarily make a decision to operate in the inform economy – they may drift into it, or have it thrust upon them.

Q12 What factors motivate businesses to move from the informal to the formal economy?

A frequent motivating factor is that a person wants to do something which requires him to tell a government body about his recent activities. For example – taking a job where PAYE will be operated; claiming tax credits or welfare benefits.

It is perhaps stating the obvious to say that often, a person will fear or suspect that the revenue authorities are soon going to find out about his activities, and before this happens, decide to take the initiative and sort things out.

Sometimes people start to regularise their affairs once they come across a source of advice to help them do it. They may become able to afford an adviser (which perhaps they could not, at the start of the business).

Q13 What hurdles do businesses face when trying to enter into the formal economy?

Most small businesses need specialist advice to help them negotiate their tax and other regulatory requirements. The availability of affordable advice and good public information is therefore crucial.

Fear is a factor which deters some small businesses from entering the formal economy – fear of how much their arrears might be, or of the sanctions which the revenue authorities will apply. For this reason, those in the informal economy may not wish to

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approach the revenue authorities directly, but via a third party, who can estimate the liability and act as mediator. This can be a problem if they cannot afford to pay an adviser, and cannot find a source of free advice.

Once a business has approached the tax authorities and regularised its position, it can face a considerable bill for arrears. There may not be funds to pay this. Whilst we do not condone non-compliance, it seems counter-productive that a business should be helped and encouraged to enter the formal economy, and find itself with an unmanageable debt. We do not advocate an amnesty, but some flexibility is needed in recovering such debts, if the intention is to keep the business going.

Q14 Would an increased awareness of the practical and legal benefits of the formal economy encourage informal businesses to legitimise?

We do not know whether the practical and legal benefits of being within the formal economy are a key factor in encouraging businesses to legitimise. We suspect, however, that the fear of what might happen if they do not legitimise is often a more powerful motivator than the positive benefits which may accrue.

Q15 Would better information or training on how to operate within the formal economy encourage informal businesses to legitimise?

Clear information on the regulatory requirements is certainly an advantage. There is good information on the Inland Revenue and other government websites, and in their published guidance, but it could be improved. It also needs to be readily accessible.

We would also make the point that information and training, however good, can only go so far to explain a complex system. The complexity of the underlying tax system is one reason why businesses find it hard to understand what is expected of them.

Q16 Should government departments focus on encouraging businesses to legitimise or should they concentrate on forcing businesses to comply with tax/regulation?

We see no reason why government departments should choose to concentrate on one or the other of these – it is important that they should do both.

Q17 Does the fear of penalties discourage businesses to legitimise?

Yes, in some cases, fear of penalties is a deterrent. Equally significant are fear of other sanctions (such as prison) and of tax arrears.

Q18 Are you aware of any sources of advice to help businesses become legitimate?

Those who can afford it can seek professional advice. An accountant or tax adviser will assist a business to become legitimate, provided the client is prepared to make full disclosure. An adviser may assist in negotiating a settlement if necessary.

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Those who cannot afford to pay for professional advice have fewer sources of help available. The Inland Revenue's confidential helpline will explain what is needed to legitimise. Their Business Support Teams provide useful training, but are aimed more at new businesses rather than ongoing ones who are in arrears.

Charities such as TaxAid and TaxHelp for Older People use qualified tax specialists to give free advice, and some practitioners are prepared to give pro bono assistance. Local small business groups may be able to help. However, other advice agencies such as the CAB tend not to be equipped to advise on tax issues other than straightforward ones.

Q19 Do you have any suggestions as to what would encourage or enable businesses to become legitimate?

The tax rules affecting small businesses are extremely complex. We have called for simplification many times over recent years, yet the system has instead become even more complicated. Businesses will be more likely to legitimise their activities if they can understand easily the tax they are required to pay.

In this regards, the Tax Faculty has identified ten tenets which, if followed, would make for a better tax system. These are listed below.

12. THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

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7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160