National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs, HM Treasury

The management of tax expenditures

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National Audit Office

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The management of tax expenditures

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

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This report examines the economy, efficiency and effectiveness of how the exchequer departments used their resources with regard to the design, administration, monitoring, evaluation and management of tax expenditures.

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Contents

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Key facts

£155bn
sum of the estimated costs of 'tax expenditures' in 2018-19 (tax reliefs supporting government objectives)

5%
real increase in summed estimated cost of tax expenditures, 2014-15 to 2018-19

£11bn
estimated 2018-19 cost of tax expenditures with published evaluations since 2015

362	number of tax expenditures (tax reliefs supporting government economic and social objectives)
111	number of tax expenditures that HM Revenue & Customs has costed
23	number of tax expenditures with a forecast cost of more than £1 billion in 2018-19
63	tax reliefs HM Treasury assessed for value for money as part of a monitoring exercise by 2019
15	number of tax expenditures with published evaluations since 2015

Summary

Introduction

1 The UK tax system had 1,190 tax reliefs as at October 2019. A tax relief reduces the tax an individual or business owes. There are two broad categories of tax reliefs: structural tax reliefs that are largely integral parts of the tax system and define the scope and structure of tax (such as the personal tax allowance); and non-structural tax reliefs where government opts not to collect tax to pursue social or economic objectives. Non-structural tax reliefs are often referred to as 'tax expenditures' and we use this description in this report. Examples include tax credits for companies' research and development (R&D) costs and income tax relief on pension contributions. Some tax expenditures simply reflect a policy choice by ministers to support particular groups or sectors (for example the housing market), while others are designed to incentivise behaviour. Some tax reliefs can be difficult to classify because they have more than one objective and include elements of both tax expenditures and structural reliefs.

2 Tax expenditures are an important part of public policy design. They cover most areas of government activity, including welfare, housing, business, food, education, health and transport. They can also make the tax system more complicated and less transparent, and they could pose risks to public finances because their costs can rise beyond expectations. Tax expenditures differ from public spending in that they reduce the amount of tax collected, rather than consume resources after tax is collected. However, they are similar in that both affect the public purse and can be used to pursue discrete policy objectives.

3 The UK had 362 tax expenditures in October 2019, with HM Revenue & Customs (HMRC) reporting the cost of 111. These tax expenditures had a combined estimated cost of £155 billion in 2018-19. Aggregating the cost of tax expenditures gives a sense of their scale, but it does not reflect the amount of tax that would be generated if tax expenditures were removed because some taxpayers would change their behaviour and there may be wider economic impacts.

4 Ministers propose policy changes to introduce or amend tax expenditures as part of the Budget. Parliament undertakes scrutiny of tax policy including tax expenditures as part of the Budget process and through the work of the Treasury Select Committee. HM Treasury and HMRC (the exchequer departments) are responsible for all aspects of the effective working of the UK tax system including tax expenditures. HM Treasury is responsible for strategic oversight of the tax system and HMRC is responsible for administering the system. The Accounting Officers of HM Treasury and HMRC are accountable to the Committee of Public Accounts for the economy, efficiency and effectiveness of the resources they use to discharge their responsibilities, including the work they carry out to manage tax expenditures.

5 Along with the Committee of Public Accounts, we have repeatedly raised concerns about the departments' management of tax reliefs. In our 2014 report, *The effective management of tax reliefs,* we found that neither department had frameworks or principles to guide their administration of tax reliefs. In 2016, we reported that while HMRC had developed internal guidelines for managing reliefs, staff did not understand they were compulsory. In 2018, the Committee of Public Accounts concluded that HMRC did not know whether a large number of tax reliefs were delivering value for money. HMRC and HM Treasury have responded to our recommendations by increasing their oversight of tax expenditures and actively considering their value for money. In 2019, HMRC informed the Committee that, whilst both HM Treasury and HMRC are responsible for advising ministers, the prime responsibility for advising ministers on the value for money of tax reliefs lies with HM Treasury.

6 In July 2019, the Office for Budget Responsibility (OBR) identified the costs of tax reliefs as one of four new fiscal risks to the public finances. The OBR was concerned that: the government did not know the full cost of tax reliefs; that tax reliefs lacked transparency and scrutiny; and added complexity to the tax system.

Scope of this report

7 This report examines the effectiveness of HM Treasury's and HMRC's use of their resources in the management of tax expenditures. Government spending is governed by HM Treasury's *Managing Public Money* but there is no equivalent guidance for tax expenditures. The rules governing the tax system are set out in legislation which Parliament scrutinises through the Finance Bill process. The exchequer departments provide information needed to support decision-making. How the exchequer departments monitor and evaluate tax expenditures informs government's understanding of the value for money of tax expenditures. In this report we examine how HM Treasury and HMRC manage tax expenditures overall and examine their oversight and administration across the lifecycle of tax expenditures, specifically:

- the number and cost of tax expenditures (Part One);
- design and monitoring of tax expenditures (Part Two); and
- the evaluation and review of tax expenditures (Part Three).

8 Under section 6 of the National Audit Act 1983, the Comptroller and Auditor General (C&AG) examines the economy, efficiency and effectiveness of the way that government departments use their resources in discharging their functions, including the management of tax expenditures. Our assessment is informed by deeper dives into how the departments used their resources to administer and oversee nine established tax expenditures and design three that were new or recently amended (**Figure 1** on pages 7 and 8). We have not set out to conclude on the value for money of specific tax expenditures. Our audit approach is set out in Appendix One and our evidence base in Appendix Two.

Figure 1

Case study tax expenditures covered in this report

We looked at tax expenditures which supported a range of objectives and had differing ages and cost

Description	Objective	When introduced	Cost 2018-19[1] (£m)
1 Zero rating of VAT on the construction and sale of new dwellings (residential and charitable buildings).	Support housing construction	Long-standing (40+ years)	*14,800*
2 Relief from inheritance tax on agricultural property.	Support continuity of farming business		*315*
Research and Development (R&D) reliefs:	Support research and development activity	Established (6 to 39 years)	
3 Small- and medium-sized enterprises			*2,515*
4 R&D expenditure credit[2]			*2,340*
R&D reliefs provide an extra deduction from companies' taxable income for R&D expenditure. Loss-making companies can receive a tax credit.			
5 Entrepreneurs' relief – reduces capital gains tax to 10% for sales of certain assets (for example, selling a business or shares in a business).	Encourage enterprise		*2,200*
6 Patent box – reduces the corporation tax rate to 10% for profits from patented inventions.	Support commercialisation of innovation, and attract and retain intellectual property		*1,150*
7 Film tax relief – film production companies can claim additional corporation tax relief for film production expenditure in the UK.[3] Loss-making companies can receive a tax credit.	Support UK film industry		*550*
8 Relief on employer National Insurance Contributions for employees under 21.	Encourage employment of under-21s	Recently established (3 to 5 years)	610
9 Relief on employer National Insurance Contributions for apprentices under 25.	Encourage apprenticeships		160
10 Enterprise investment scheme – a venture capital scheme that grants income and capital gains tax reliefs to individuals investing in small companies.	Encourage investment in companies with high potential growth	New or recently amended	*720*[4]
11 Relief on stamp duty land tax for first-time buyers (no duty or reduced rates on homes up to £500,000).	Support home ownership and first-time buyers		*520*
12 Structures and buildings capital allowance – companies carrying out capital works on non-residential buildings can make a deduction from profits over a 50-year period.[5]	Support business investment		–[6]

Figure 1 *continued*
Case study tax expenditures covered in this report

Notes

1 Most 2018-19 costs are projections based on previous years' actual data. Projections are shown in italics to distinguish from actuals.

2 R&D expenditure credit is mainly claimed by large companies, although it is available to small- and medium-sized enterprises in certain circumstances.

3 Expenditure must be on goods and services used or consumed in the UK to qualify for film tax relief.

4 Cost is the total of the income tax (£600 million) and capital gains (£120 million) elements of the tax expenditure.

5 Some capital allowances have elements of both structural reliefs (that is, they help define the boundaries and thresholds of the tax system) and tax expenditures. Tax expenditures are tax reliefs which government uses to encourage particular groups, activities or products in order to achieve economic or social objectives.

6 HM Revenue & Customs reports the total cost of all capital allowances rather than the cost of each allowance such as structures and buildings.

Source: National Audit Office

Key findings

The number and cost of tax expenditures

9 **Tax expenditures represent a large and growing cost to the Exchequer.** In July 2019, the OBR reported that the known cost of tax expenditures had risen in the past decade. Our analysis of latest data published by HMRC in October 2019 shows that, between 2014-15 and 2018-19, the cost of tax expenditures increased by 5% in real terms, from £147 billion to £155 billion (forecast). Twenty-three tax expenditures each costing more than £1 billion accounted for 92% of the total forecast cost in 2018-19. The largest tax expenditures were the reliefs on pension contributions, the reliefs from VAT on food and new dwellings, and the relief from capital gains tax on people's main homes (paragraphs 1.5, 1.15 to 1.17 and Figure 3).

10 **HMRC has committed to publishing more information on the cost of tax expenditures.** HMRC has calculated the cost of 111 of 362 tax expenditures. It plans to estimate the costs for more tax expenditures between 2020 and 2022, prioritising those tax expenditures it regards as higher risk (paragraphs 1.5, and 1.18 to 1.19).

11 **The number of tax expenditures presents government with a significant oversight challenge.** The International Monetary Fund states that tax expenditures require the same amount of government oversight as public spending. The scale of tax expenditures in the UK is larger than most other countries and it will be challenging to give tax expenditures the same amount of attention as spending. HMRC is improving its understanding of the different types of tax expenditures by categorising tax expenditures by purpose. Its initial work indicates that many are intended to incentivise behaviour. While HMRC's new categorisation is useful in understanding the broad types of tax expenditures, it is not sufficiently detailed to group those targeted at similar sectors or those with similar social or economic objectives (paragraphs 1.6, 1.7, 1.13, 1.14, 1.20 to 1.21 and Figure 4).

The design and monitoring of tax expenditures

12 The exchequer departments are improving their oversight of tax expenditures. In 2016 HMRC set up a central team to oversee its management of tax reliefs. The team identified the officials responsible for specific reliefs and established compulsory guidance. It introduced a framework to record information on reliefs in a consistent manner across the Department. In 2017, HM Treasury piloted monitoring of tax expenditures, prioritising those with specific policy objectives worth more than £40 million a year. By 2019 it had informally assessed whether 63 tax reliefs were value for money, as part of its policy-making process. The exchequer departments' monitoring processes are still in development, and not yet integrated with one another. They plan to develop a single framework for administering and reviewing tax expenditures, drawing on relevant UK and international good practice (paragraphs 2.9 to 2.14).

13 When designing tax expenditures, HM Treasury has not given enough consideration to how it will measure impact. When designing a new tax expenditure HM Treasury undertakes many of the activities that we would expect at this stage including consulting with relevant stakeholders. However, we did not find any cases among tax expenditures introduced since 2013 where government had set out plans for their evaluation at design stage, or triggers for evaluation if costs or benefits differed significantly from their forecasts (paragraphs 2.3 to 2.6 and Figure 9).

14 Some tax expenditures cost far more than government's published forecasts indicated. HMRC does not compare the actual costs of tax expenditures to the government's original published forecasts available to Parliament. HMRC told us that published forecasts are made on a different basis to the actual costs and a number of factors make meaningful comparison difficult. For example, the forecasts can include the impact on public finances of other changes to the tax system, other elements of tax revenue or wider economic impacts, which may not be directly comparable to the full cost of the tax expenditure. Even so, HMRC could take these factors into account to make meaningful comparisons, which would help it better understand costs. We compared forecast and actual costs for 10 tax expenditures, adjusting for differences as far as possible with the data available. The comparison indicated large differences for some tax expenditures:

- For five tax expenditures introduced since 2013, including three of the four largest, data indicated costs were generally in line with original forecasts.
- For the R&D expenditure credit, and four smaller tax expenditures introduced since 2013, data indicated costs exceeded forecasts by 50% or more.

It was more difficult to compare forecasts and actual costs for tax expenditures introduced before 2013. However, we found that the costs of three of our case study tax expenditures had grown from around £1 billion in 2008-09 to around £5 billion in 2017-18, much faster than the trends indicated in published forecasts (paragraphs 2.16 to 2.20 and Figures 10 to 12).

15 **HMRC has not fully investigated some large changes in costs.** Cost increases may indicate that a tax expenditure is working well, or that it is being used in ways not intended. However, this can be difficult to determine without a substantive assessment. HMRC had identified reasons for large changes in cost for all the established case study tax expenditures we looked at. However, it did not normally test how far the reasons explained cost movements, or compare its costs estimates with other data. Of the nine cases we looked at, HMRC checked cost changes against independent data for only agricultural property relief and R&D reliefs. For R&D reliefs, HMRC compared the total R&D companies had claimed in tax returns for UK and overseas activity, with national statistics on total UK (only) R&D activity. This comparison revealed that the R&D activity companies had claimed was rising more quickly, and in 2016-17 exceeded all UK R&D activity by 43%. HMRC is in the process of investigating the reasons for trends in data (paragraphs 2.17, 2.21 to 2.24 and Figure 13).

16 **R&D tax reliefs have been subject to increased levels of abuse.** HMRC does not hold data on tax lost from abuse and error for all tax expenditures. However, it has developed a single view of the 63 main compliance risks it faces. Six of these risks are specific to tax reliefs. Some of the other risks partly arise from tax reliefs, although HMRC's data do not show the significance of reliefs. Of the six tax relief-specific risks it has identified, the risks were increasing for three. The risk arising from the R&D tax expenditures was increasing the most. In 2017 and 2018 HMRC identified more tax at risk from poor-quality R&D claims, and from abuse by companies with a limited UK presence. In 2018 HMRC substantially increased its estimate of tax at risk from the R&D tax expenditures to a level which indicated further action was required. The time needed to train new staff and develop new systems has affected the pace of HMRC's response (paragraphs 2.25 to 2.27).

The evaluation and review of tax expenditures

17 **HMRC has formally evaluated only a minority of tax expenditures.** HMRC commissions and undertakes evaluations of few tax expenditures. Since 2015, HMRC has published evaluations of 15 tax expenditures, representing just 7% (£11 billion) of the aggregate forecast cost of tax expenditures in 2018-19. HMRC has evaluated only five of 23 tax expenditures costing more than £1 billion, and less than half of the large tax expenditures experiencing the fastest cost growth (paragraphs 3.2 to 3.4).

18 **HMRC's evaluations of tax expenditures suggest that their effectiveness varies widely.** Evaluations published since 2015 by HMRC have assessed the impact of 13 of the 15 tax expenditures covered. These evaluations found that seven of these tax expenditures (costing £3.6 billion in 2018-19) were having a positive impact on behaviour, and one (costing £1.4 billion) had had a mixed impact. However, five tax expenditures costing £5.2 billion had only a limited impact. Notably, a 2017 evaluation found that only 8% of people claiming entrepreneurs' relief in the previous five years said it had influenced their investment decision-making. The relief costs the Exchequer more than £2 billion a year (paragraph 3.6 and Figure 14).

19 **HM Treasury has developed internal, informal processes for assessing the value for money of tax expenditures.** HM Treasury reviews the tax system annually, including tax expenditures, as part of the Budget. In addition to this HM Treasury started a monitoring exercise in 2017 as a tool for collecting information and officials' views to help inform advice to ministers. HM Treasury's monitoring assessments have rated the value for money of 63 tax reliefs. HM Treasury told us these are internal, informal assessments that do not represent the formal view of the Department and should not be published because they are part of policy advice to ministers. We looked at monitoring templates for eight case studies and found that the assessments ask many of the questions we would expect, but that the quality of information underpinning the assessments was variable. HM Treasury was better placed to assess tax expenditures when it had information available from recent HMRC evaluations. In the case of the R&D expenditure credit HM Treasury based its assessment on an evaluation of the previous scheme aimed at large companies. HM Treasury undertakes limited quality assurance of its value-for-money assessments (paragraphs 1.22, 2.13, 3.7 to 3.12 and Figure 15).

20 **There is no formal documentation specifying explicitly the departments' accountabilities for the value for money of tax expenditures.** In 2014, HM Treasury set out its view on accountability for tax reliefs but it did not specifically consider accountability for value for money. In 2019, HMRC informed the Committee of Public Accounts that the broader question of the value for money of tax reliefs is the responsibility of HM Treasury, with HMRC providing relevant advice as part of the tax policy partnership in the normal way. Policy decisions on the value for money of tax expenditures are for Treasury ministers, who are ultimately accountable to Parliament for the tax system and policy. HM Treasury officials are accountable for providing ministers with high quality advice to make those decisions. HMRC officials also carry out administrative functions which influence the cost and impact of tax expenditures. For example, clear guidance, promoting take-up to target groups, action to tackle abuse and timely reporting can all help to improve value for money (paragraphs 1.8 to 1.13, 2.25 to 2.27 and 3.13 to 3.16).

21 **Public reporting has improved but does not yet provide the information necessary to assess the value for money of tax expenditures.** HM Treasury ministers are accountable to Parliament for the value for money of tax expenditures. As part of the legislative process the government publishes costings and 'tax information and impact notes' and ministers outline their aims to Parliament. However, government does not publish the information necessary for scrutiny of the value for money of existing tax expenditures. HMRC's statistical bulletin is much improved but still contains very limited information on the benefits achieved by tax expenditures, only limited commentary on their cost trends, and although HMRC included estimates for the number of claimants for the first time in January 2019, there is no trend data on the number of claimants. The bulletin does not explain how costs and benefits differ from the original published forecasts. Other countries have more comprehensive evaluation and reporting despite most having comparatively lower levels of tax expenditures (paragraphs 1.8, 2.5 to 2.7, 3.15, 3.17 to 3.20 and Figure 16).

Conclusion

22 At a forecast cost of £155 billion in 2018-19, tax expenditures represent an important means by which government pursues economic and social objectives. Evaluations show that their impact is not guaranteed, and many require careful monitoring. We have previously raised concerns about how effectively government is managing tax expenditures. Both HMRC and HM Treasury have responded to our recommendations by increasing their oversight of tax expenditures and actively considering their value for money.

23 While these steps are welcome, they are very much still in development. The large number of tax expenditures means it will take time to identify and embed good practices. Both departments need to make substantial progress and ensure sufficient coverage and rigour in the work they undertake on this matter.

24 On their own these improvements will not be sufficient to address value-for-money concerns unless the departments formally establish their accountabilities for tax expenditures and enable greater transparency. Lessons can be learned from other countries that have established clear arrangements for evaluating and reporting on tax expenditures. We look to HM Treasury and HMRC to follow suit by clarifying arrangements for value for money and improving the evaluation and public reporting of tax expenditures.

Recommendations

25 As the custodians of the tax system HMRC and HM Treasury are responsible for assessing the cost and impact of tax expenditures and communicating this to decision-makers. We recommend that:

HM Treasury should:

a **establish a framework for designing and administering tax expenditures that is commensurate with the large number of UK tax expenditures.** The framework should draw on 'Green Book' principles, international good practice and stakeholder views;

b **develop a robust methodology for assessing the value for money of different types of tax expenditures**, ensuring that assessments are quality-assured;

c **consider specifying time-periods or triggers for evaluation and review when designing each tax expenditure**;

d **each year review whether the objectives of tax expenditures still align with government objectives**; and

e **establish and document clear requirements for officials to report concerns about the value for money of tax expenditures to ministers**, for example by specifying accountability arrangements.

HMRC should:

f **further develop categorisation of tax expenditures** according to, for example, their objectives, scale, age and risks, in order to inform the allocation of administrative resources in proportion to the cost and impact that tax expenditures are intended to achieve;

g **identify and use independent data sources, where available, to further test reasons for movements in the cost of high-priority tax expenditures**;

h **develop a more systematic approach to the evaluation of tax expenditures to provide greater coverage**. We estimate that the external cost of commissioning evaluations of six tax expenditures a year would likely be between £1 million and £1.5 million. This estimate does not include the cost of HMRC's own internal costs, which could be significant;

i **develop an approach so that it understands and can report the differences between actual and forecast cost for tax expenditures it regards as high-priority in its published analysis**. In cases where it is not feasible to make a comparison for a high-priority tax expenditure, HMRC should explain why; and

j **include trend data on the number of beneficiaries of tax expenditures in published analysis**, where possible, and take account of this within commentaries.

Part One

The number and cost of tax expenditures

1.1 The UK had 1,190 tax reliefs as at October 2019. This part of the report examines:

- the different types of tax reliefs;
- oversight of tax expenditures and stakeholder concerns;
- how the number and cost of tax expenditures has changed over time; and
- understanding of the tax expenditures government needs to administer.

1.2 Part Two considers the design and monitoring of tax expenditures. Part Three considers their evaluation and review.

Structural reliefs and tax expenditures

1.3 Tax reliefs reduce the tax an individual or business owes. Some can also lead to a payment. There are two broad categories of tax reliefs: structural tax reliefs and non-structural tax reliefs, normally referred to as tax expenditures. Structural tax reliefs are largely integral parts of the tax system. These reliefs have various purposes including defining the scope of taxes and making taxes more progressive (such as the personal tax allowance).[1] Tax expenditures are reliefs where government opts not to collect tax to pursue social or economic objectives (**Figure 2**).

1.4 Tax expenditures are a diverse group, and can be large (such as tax relief on pension contributions), complex (such as some corporation tax reliefs) or small tax reliefs intended to recognise certain taxpayers (such as relief on war disablement benefits). Some tax reliefs can be difficult to classify because they have features of both tax expenditures and structural reliefs. The nature of tax reliefs means that they can have more than one objective, some incentivise behaviour, while others simply reflect a government policy choice to reduce the tax burden on particular groups or sectors.

1 A progressive tax is a tax that imposes a lower tax rate on low-income earners compared with those with a higher income.

Figure 2
Types of tax relief in the UK tax system

There are two main types of tax relief. HM Revenue & Customs (HMRC) reports costs for a minority of reliefs

Type	Definition	Example	Number	Number where HMRC reports cost estimates[2]	Aggregate 2018-19 cost of reliefs where HMRC reports estimates (£bn)
1 Structural reliefs	Define the boundaries and thresholds of the tax system.	Income tax personal allowance.	828	85	271
2 Tax expenditures	Encourage particular groups, activities or products in order to achieve economic or social objectives.	Relief on contributions to pension schemes.	362	111	155
Total			**1,190**	**196**	**426**

Notes

1 Costs are the value of the relief to the taxpayer. Costs will therefore change if tax rates are altered. The amount of tax revenue gained if reliefs were to be removed is likely to be lower than costs as taxpayers would change their behaviour in response and there may be wider economic impacts.

2 Most cost estimates for 2018-19 are projections based on previous years' actual data.

3 A relief may have tax expenditure and structural elements (that is, it can support government objectives and define the tax system). For example, most capital allowances are structural reliefs in that they replace company estimates of capital depreciation costs when calculating taxable profit, but the rates can be preferential where government wants to incentivise capital investment (for example investment in some oil and gas plant and machinery). HMRC allocates reliefs to the type (that is, tax expenditure or structural) it deems most dominant.

Source: National Audit Office and HM Revenue & Customs, *Estimated Costs of Tax Reliefs*, October 2019, and HM Revenue & Customs, *Estimated cost of structural tax reliefs*, October 2019

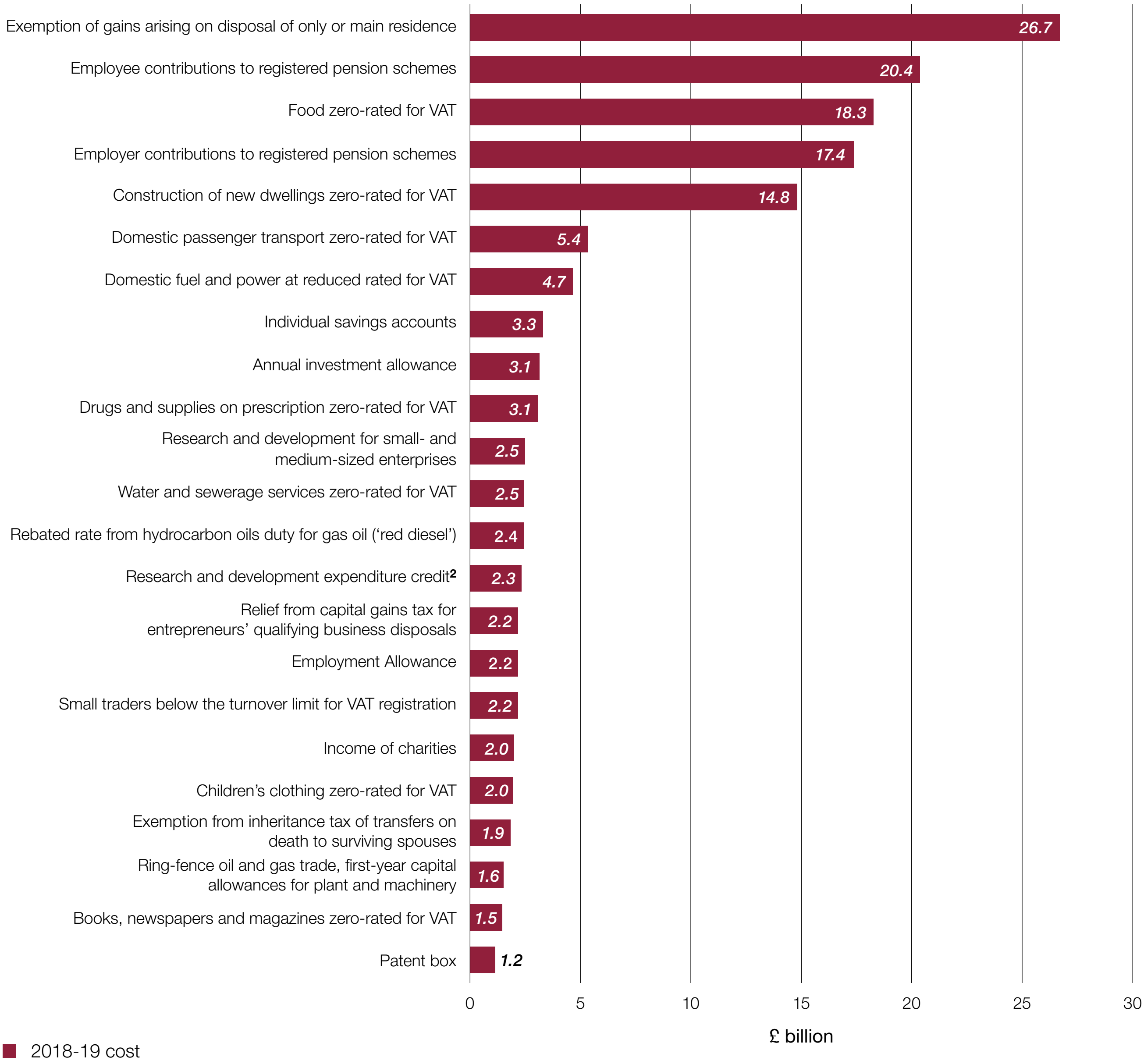
1.5 The UK had 362 tax expenditures in October 2019, with HM Revenue & Customs (HMRC) reporting the cost of 111. The combined cost of these was forecast to be £155 billion in 2018-19.[2] The combined cost does not represent the gain to the exchequer should tax expenditures be abolished. Revenue generated from abolishing a relief is likely to be lower as taxpayers change their behaviour and there may be wider economic impacts. Twenty-three large tax expenditures – each forecast to cost more than £1 billion in 2018-19 – accounted for 92% of the total forecast cost (**Figure 3** overleaf). The list in Figure 3 is dominated by tax expenditures that provide relief from capital gains on people's homes, relief on pension contributions, relief from VAT for certain goods and services, and reliefs to encourage saving and investment.

2 HM Revenue & Customs, *Estimated Costs of Tax Reliefs*, October 2019, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/837766/191009_Bulletin_FINAL.pdf.

Figure 3

Cost of the largest tax expenditures in 2018-19 for which estimates are available

The 23 largest tax expenditures had a forecast cost of £143 billion, 92% of the forecast cost of all tax expenditures. The top five cost £98 billion (63%)[1]



Notes

1 This Figure shows all tax expenditures with a cost of more than £1 billion for 2018-19. Most cost estimates for 2018-19 are forecasts as they are projections based on previous years' actual data. The exceptions are rebated rate from hydrocarbon oils duty for gas oil ("red diesel") and Employment Allowance where actuals are available. Projected values are italicised to distinguish from actuals.

2 Research and development expenditure credit is mainly claimed by large companies, although available to small- and medium-sized enterprises in certain circumstances.

3 Income of charities includes but is not limited to individual and company Gift Aid.

4 As shown in Figure 2, HM Revenue & Customs reports cost estimates for 111 of the 362 tax expenditures.

5 Tax expenditures are tax reliefs which government uses to encourage particular groups, activities or products in order to achieve economic or social objectives.

6 Individual values do not sum to the total due to rounding.

Source: National Audit Office analysis of data from HM Revenue & Customs, *Estimated Costs of Tax Reliefs*, October 2019

1.6 HMRC does not report the cost of 251 tax expenditures as it does not have sufficient information on their use. The amount of data HMRC collects on usage of tax expenditures varies. Taxpayers must specifically claim for some tax expenditures – including some that can result in payments, such as the research and development (R&D) reliefs. For others, such as VAT tax expenditures, data collected through tax returns are not sufficient to estimate costs with certainty and HMRC estimates the costs using sources such as national statistics. Additionally, some reliefs are designed so that people who do not owe any tax are not required to engage with the tax system to claim their relief.

1.7 The best available data indicate that the cost of UK tax expenditures is relatively high by international standards. Comparing the scale of UK tax expenditures with other countries is difficult because of differences in tax regimes, variations in definitions of what is a tax expenditure, and the absence of up-to-date data. However, in 2016, the International Monetary Fund reported data indicating the cost of tax expenditures in the UK was higher than most of 25 comparator countries (**Figure 4** overleaf).[3] The scale and large number of tax expenditures therefore presents a challenge to HM Treasury and HMRC (the exchequer departments) in terms of oversight.

The oversight of tax expenditures and stakeholder concerns

1.8 Ministers account to Parliament for tax policy decisions and policy objectives they seek to achieve by forgoing tax revenue. Parliamentary oversight of tax policy is exercised during the passage of the Finance Bill (the Budget), and the work of the Treasury Select Committee.

1.9 Ministers depend on the exchequer departments to oversee the tax system and provide technical advice and feedback. In practice:

- HM Treasury is responsible for strategic oversight of the tax system and seeks to design sustainable taxes, deliver responsive tax policy and business tax reforms, consistent with sound public finances. HM Treasury officials (explicitly the principal accounting officer) are responsible for considering the effectiveness of tax policies and providing evidence-based advice to ministers;
- HMRC is responsible for delivering tax policies and maintaining the tax system, alongside its duties to collect revenue due and tackling the tax gap; and
- the two departments work in a policy partnership. They share an analysis function, whose responsibilities include predicting the impact of changes to tax reliefs proposed in the Budget and producing statistics on tax reliefs and taxes in general.

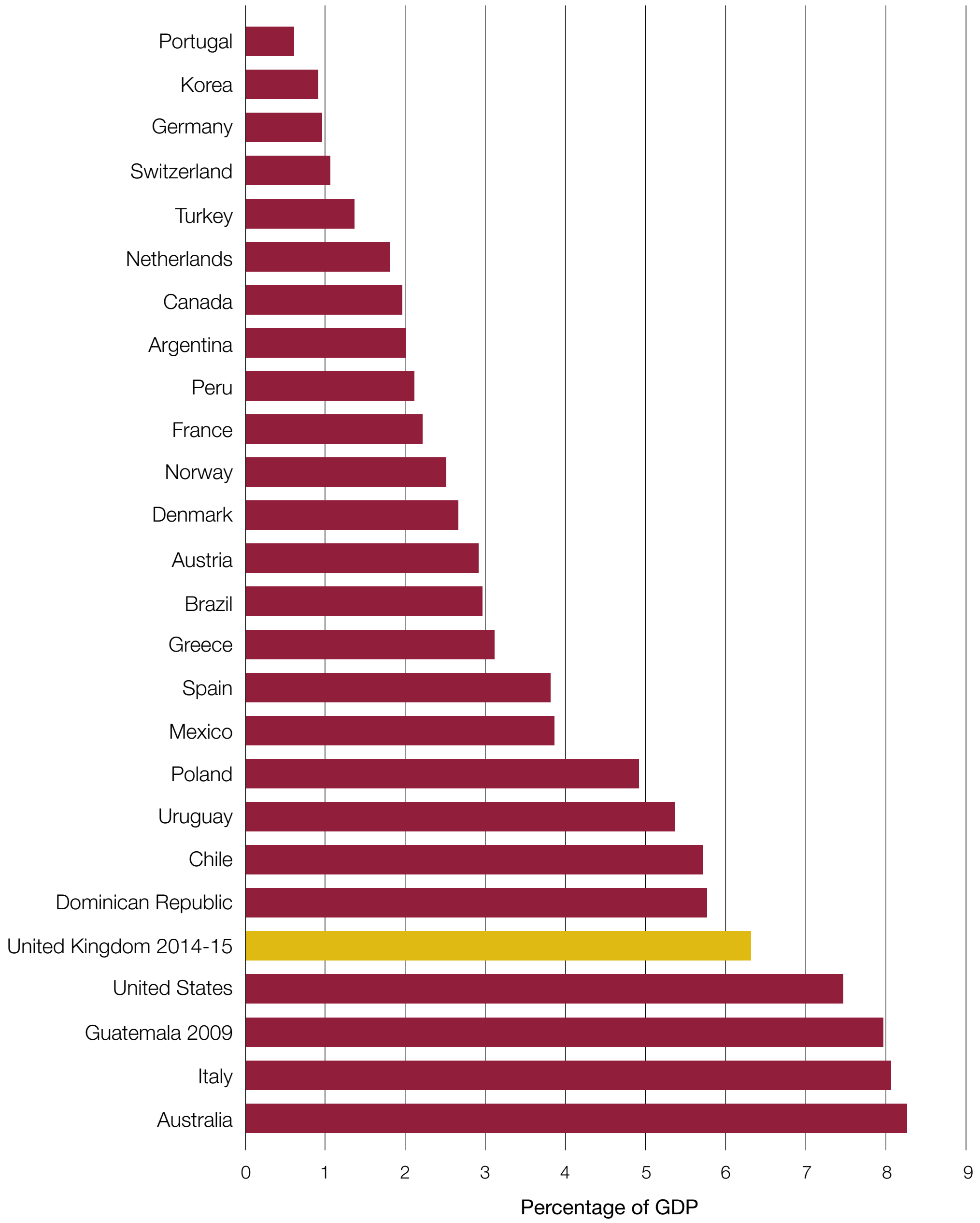
1.10 The Accounting Officers of HM Treasury and HMRC are accountable to the Committee of Public Accounts for the economic, efficient and effective use of their resources in discharging their responsibilities. The roles and responsibilities of the respective departments and that of ministers and Parliament are set out in **Figure 5** on page 19.

3 International Monetary Fund, *United Kingdom Fiscal Transparency Evaluation*, November 2016, page 24.

Figure 4

Cost of tax expenditures as a percentage of gross domestic product (GDP) in selected countries as reported by the International Monetary Fund (IMF) in 2016

Estimates presented by IMF indicate that revenue forgone in the UK from tax expenditures is high compared with other countries



Notes

1 Estimates are for 2010 unless otherwise stated.

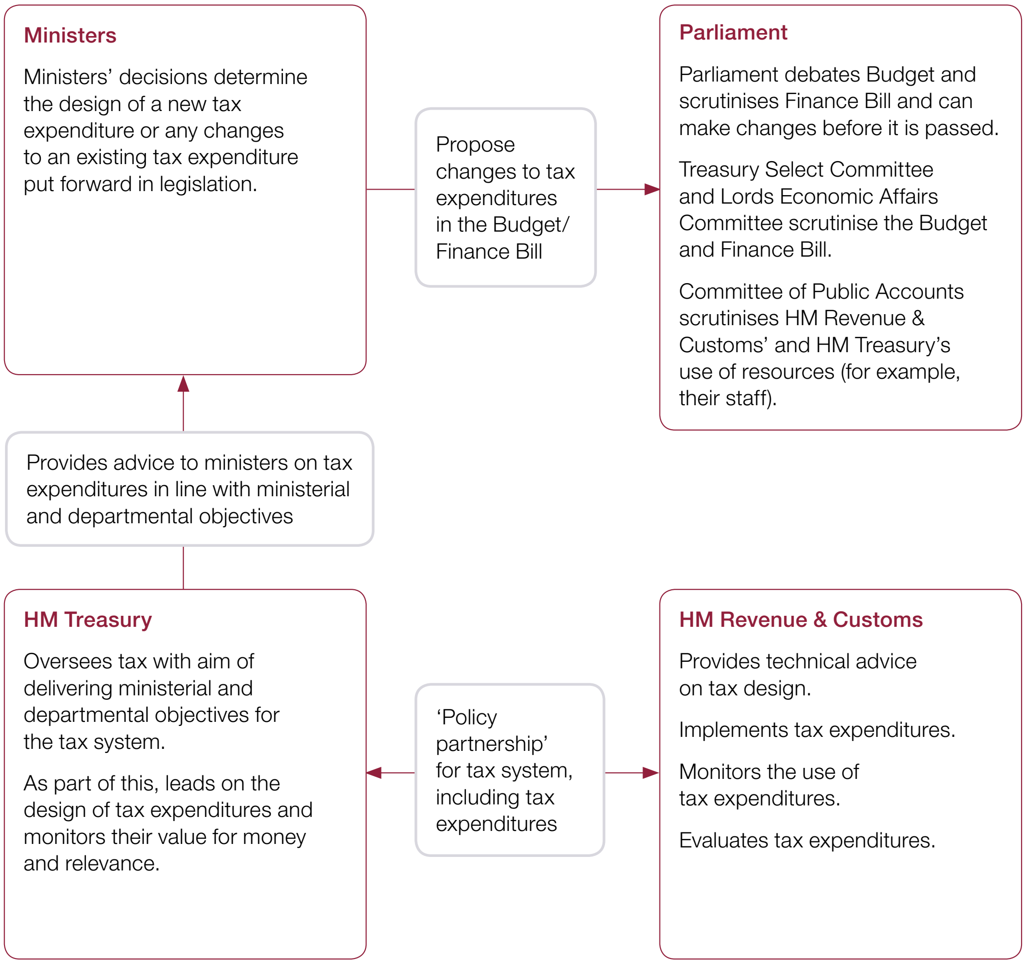
2 Comparisons between countries should be treated with caution due to the different approaches taken by different countries when reporting tax expenditures.

Source: International Monetary Fund, *United Kingdom Fiscal Transparency Evaluation*, 2016

Figure 5

Tax expenditures: roles and responsibilities

Parliament has an opportunity to consider all new tax expenditures



Source: National Audit Office

1.11 Accountability mechanisms and the way that Parliament checks and approves government spending and taxation differ. Tax rules must be enshrined in legislation to ensure taxpayers are obligated to comply. Parliament debates and approves all tax policies, including tax expenditures before they can take effect. Changes can only be achieved through legislation and there are no budget constraints, as the conditions to qualify for a tax relief are set out in law and must be applied equally to all taxpayers. In contrast Parliament considers government's spending plans twice a year, and a department has flexibility to transfer resources between its different activities without Parliament's approval.

1.12 There is no formal guidance for how tax expenditures should be administered. *Managing public money* guidance sets out accounting officers' responsibilities for their departments' use of resources, and how to dispense these responsibilities.[4] The guidance does not apply to tax expenditures as tax revenue forgone is not a resource of a department but a decision to forgo tax made by a minister. The rules governing the tax system are set out in legislation which is scrutinised through the Finance Bill process.

1.13 Since 2014, both the National Audit Office and the Committee of Public Accounts have reported several times on the management of tax reliefs by HMRC and HM Treasury. In our November 2014 report, *The effective management of tax reliefs*, we found that neither HM Treasury nor HMRC had established frameworks or principles to guide their management of tax reliefs.[5] In 2016, we reported that HMRC had developed guidelines for managing reliefs but HMRC staff we spoke to did not understand they were compulsory.[6] Most recently, in 2018, the Committee of Public Accounts concluded that HMRC did not know whether a large number of tax reliefs delivered value for money.[7] HMRC and HM Treasury have responded to our recommendations by increasing their oversight of tax expenditures and actively considering their value for money. In 2019, HMRC informed the Committee that, whilst both HM Treasury and HMRC are responsible for advising ministers, the prime responsibility for advising ministers on the value for money of tax reliefs lies with HM Treasury.

1.14 A range of stakeholders, including the International Monetary Fund (IMF) and the Office for Budget Responsibility (OBR), have expressed concerns about the large number of tax expenditures and their impact upon the UK's public finances. In 2019, the OBR identified the cost of tax reliefs as one of four new fiscal risks to the UK.[8] The OBR expressed concern that the government did not know the full cost of tax reliefs; that tax reliefs lack transparency and adequate scrutiny; and add complexity to the tax system. The IMF states that governments should give tax expenditures the same amount of attention as public spending.[9] Appendix 3 sets out a timeline summarising stakeholder concerns and HM Treasury and HMRC's actions to improve management and transparency.

4 HM Treasury, *Managing public money*, July 2013, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/742188/Managing_Public_Money__MPM__2018.pdf.
5 Comptroller and Auditor General, *The effective management of tax reliefs*, Session 2014-15, HC 785, National Audit Office, November 2014.
6 Comptroller and Auditor General, *HM Revenue & Customs 2015-16 Accounts, Report by the Comptroller and Auditor General*, July 2016.
7 HC Committee of Public Accounts, *HMRC's performance in 2017-18*, Sixty-Sixth Report of Session 2017–2019, HC 1526, November 2018.
8 In its *Fiscal risks report,* July 2019, OBR set out its four new fiscal risks as: a no-deal Brexit; output gap mismeasurement; the higher cost of tax reliefs; and discretionary fiscal loosening.
9 International Monetary Fund, *How to notes: Tax Expenditure Reporting and Its Use in Fiscal Management. A Guide for Developing Economies,* March 2019.

Changes in the number and cost of tax expenditures

1.15 In July 2019, the OBR reported that the known cost of tax expenditures had risen in the past decade.[10] Our analysis of data published by HMRC, including the latest data published in October 2019, shows that, between 2012-13 and 2018-19 the estimated cost of tax expenditures increased in real terms from £126 billion to £155 billion (forecast).[11] The forecast cost of tax expenditures in 2018-19 is equal to 7.3% of gross domestic product (GDP).

1.16 The rate of growth has slowed in recent years, increasing in real terms by £8 billion (5%) from £147 billion in 2014-15.[12] The overall number of tax reliefs has been relatively stable recently. The government added 14 new tax reliefs (including seven tax expenditures) and removed four tax reliefs (all tax expenditures) between 2017 and 2019. The government has also made changes to extend or restrict 47 other tax reliefs.

1.17 Between 2014-15 and 2018-19 corporation tax tax expenditures grew at a faster rate than other tax expenditures (£2.6 billion, 57%), driven by the research and development reliefs (combined cost up by £1.7 billion). The cost of VAT tax expenditures grew most in absolute terms (£5.6 billion, 11%), due mainly to the relief on new dwellings (up £4.6 billion). The cost of the tax expenditures that can apply to either income tax or corporation tax declined the most (£5.5 billion, 54%) (**Figure 6** overleaf).

1.18 In November 2018, the Committee of Public Accounts recommended that HMRC improve its understanding of the cost of those tax reliefs where it does not already have that information.[13] Some existing cost estimates are also incomplete. For example, HMRC's cost estimates for some inheritance tax, income tax and capital gains tax expenditures do not include the use of these tax expenditures by trusts – which are arrangements used frequently in tax planning.

1.19 It will take time to improve information on the total cost of tax expenditures. In April 2019 HMRC committed to reducing the number of un-costed tax reliefs and said that it would focus on the 251 tax expenditures where costs are currently unavailable. It has set up a project that will run in two stages over several years. The first stage will involve a comprehensive review of currently available data to provide indicative estimates for tax expenditures. The second stage will identify tax expenditures where HMRC would need to collect or buy additional data to estimate costs. HMRC intends to publish some new estimates in 2020 and expand coverage in 2021 and 2022. HMRC will prioritise higher-risk tax expenditures.[14]

10 Office for Budget Responsibility, *Fiscal risks report*, July 2019.

11 In Comptroller and Auditor General, Tax Reliefs, Session 2013-14, HC 1256, National Audit Office, April 2014 we reported that the cost of tax expenditures was £101 billion in 2012-13. The figure of £126 billion reflects subsequent revisions by HMRC to its cost estimates for 2012-13 and an adjustment to convert the estimates to 2018-19 prices. As shown at Figure 2, HMRC currently costs 111 of 362 tax expenditures. Most recent data is in HMRC, *Estimated Costs of Tax Reliefs*, October 2019.

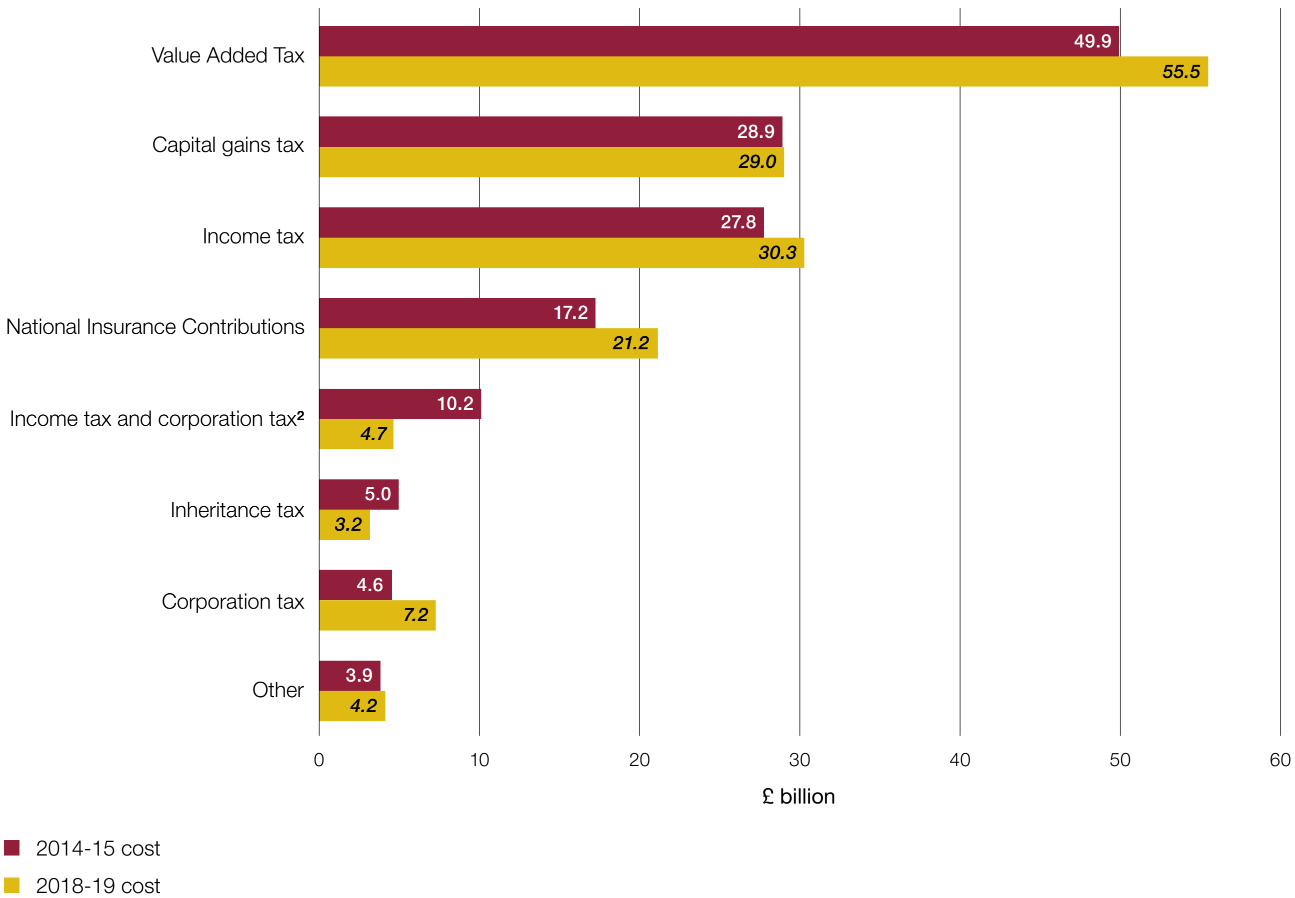
12 HM Revenue & Customs, *Estimated Costs of Tax Reliefs*, October 2019, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/837766/191009_Bulletin_FINAL.pdf.

13 See footnote 7.

14 Letter from HMRC Chief Executive to the Chair of the Committee of Public Accounts, April 2019, available at: https://www.parliament.uk/documents/commons-committees/public-accounts/Correspondence/2017-19/Letter-from-Sir-Jonathan-to-Chair-in-response-to-report-on-HMRC's-Performance-in-17-18-recommendation-13-and-4-190430.pdf.

Figure 6
Cost of tax expenditures (where known) by tax

The cost of tax expenditures (where known) is increasing in real terms for most taxes



Notes

1 All costs at 2018-19 prices.

2 Three tax expenditures can reduce income tax or, if used by companies, corporation tax.

3 Values are calculated by aggregating the estimated cost of individual tax expenditures. For many tax expenditures, the 2018-19 estimates are projections based on previous years' actual data. 2018-19 values are therefore shown in italics.

4 The estimated costs of reliefs do not reflect the amount of tax that would be generated if these tax expenditures were removed as it does not take into account behavioural change or wider economic impacts.

5 Costs shown are for the 111 tax expenditures HM Revenue & Customs reports costs on. As shown in Figure 2 there are 362 tax expenditures in total.

6 Tax expenditures are tax reliefs which government uses to encourage particular groups, activities or products in order to achieve economic or social objectives.

Source: National Audit Office analysis of data from HM Revenue & Customs, *Estimated Costs of Tax Reliefs*, October 2019

Understanding the tax expenditures government needs to prioritise

1.20 In 2019, HMRC completed a provisional classification of tax expenditures into three sub-categories, reflecting the broad type of outcome that they are designed to achieve (**Figure 7**). This work provides a basis on which to assess the scale of oversight that may be required for each broad class of tax expenditure. For example, tax expenditures intended to incentivise behaviour may require more detailed assessment than those designed to benefit a specific group. The absolute cost, and change in the cost of a tax expenditure, will also affect the level of scrutiny that is appropriate.

1.21 While HMRC's categorisation is useful in understanding the broad objectives of tax expenditures, it is not sufficiently detailed to group tax expenditures targeted at similar sectors or those with similar social or economic objectives. Such analysis is important for HM Treasury to monitor the combined effect of tax forgone alongside spending, for example grant funding to business and business tax expenditures. In January 2020, we reported that the cost of tax expenditures supporting business exceeds the cost of direct business support grants.[15]

1.22 HM Treasury reviews the tax system, including tax expenditures, annually as part of the Budget. This process can result in more tax expenditures being introduced than the number that are removed, depending on ministerial objectives and priorities for the tax system. In 2011, the Office of Tax Simplification (OTS), which reports to the Chancellor of the Exchequer, conducted a review of 155 tax reliefs and made recommendations that 47 be abolished on the basis that they were either time-expired, there was no ongoing policy rationale, the value was negligible, or the administrative burden outweighed the benefit (Appendix 3). The OTS said at the time that there was clearly scope to simplify a number of the remaining 883 reliefs but such work would logically be part of wider projects reviewing specific taxes or the ways specific taxes affect particular sectors.[16] Since 2011, OTS has considered specific tax reliefs as part of the wider reviews it has conducted, such as of particular taxes or events that affect taxpayers.

Figure 7
HM Revenue & Customs' (HMRC's) categorisation of tax expenditures

HMRC's provisional classification shows that most tax expenditures are to incentivise behaviour or benefit a specific group

HMRC classification	Approximate percentage of the total of 362 tax expenditures (%)	Example
To incentivise a specific behaviour	40	Relief on contributions to pension schemes.
To benefit a specific group	40	Zero rating of VAT on new dwellings.
To serve a social purpose	20	Zero rating of VAT on food.

Source: National Audit Office and HM Revenue & Customs

15 Comptroller and Auditor General, *Business support schemes*, Session 2019-20, HC 20, National Audit Office, January 2020, paragraph 6.
16 Office of Tax Simplification, *Review of tax reliefs final report,* March 2011.

Part Two

The design and monitoring of tax expenditures

2.1 As government auditors, we expect to see evidence of HM Revenue & Customs (HMRC) and HM Treasury (the exchequer departments) effectively using their resources to manage tax expenditures. In 2014 we set out the characteristics of an effective system (**Figure 8**).

2.2 This part of the report considers the progress that HMRC and HM Treasury have made in improving how they use their resources in their oversight of tax expenditures, with a particular focus on the design and monitoring of tax expenditures. Part Three considers the evaluation and review of tax expenditures.

HM Treasury's design of tax expenditures

2.3 In the run-up to each Budget or fiscal event, officials advise ministers on a variety of tax measures including the design of new tax expenditures and the reform of existing tax expenditures in line with ministerial objectives and HM Treasury's responsibility to ensure a sustainable tax system. Tax expenditure proposals can be made within the context of wider policy changes to the tax system or spending measures.

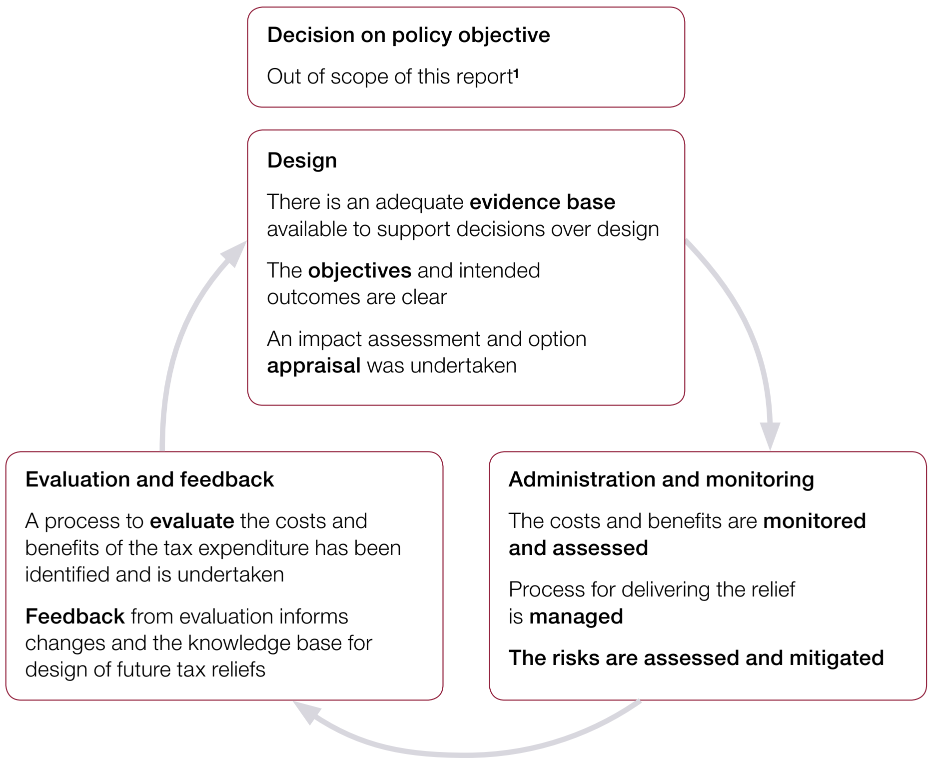
2.4 To understand the design process, we reviewed HM Treasury's approach to designing and revising three tax expenditures. We found that HM Treasury had considered most of the factors we would have expected (**Figure 9** on page 26). HM Treasury had considered a range of options to deliver policy objectives for two of our case studies and considered value for money for all three. It did least well in articulating clear objectives for what the tax expenditures should achieve and how they would be measured and evaluated.

2.5 Following the design or revision of a new tax expenditure, the exchequer departments normally publish 'tax information and impact notes' (TIINs). We reviewed TIINs for significant tax expenditures introduced since 2013 and found the gaps in coverage for our three case studies were repeated.[17] The TIINs set out objectives in general terms and did not provide baselines against which the benefits could be measured. None of the TIINs set out criteria for evaluating or reviewing the tax expenditure, such as triggers if costs or benefits differed significantly from their forecasts.

17 In total we identified 14 new tax expenditures introduced since 2013, which each cost more than £50 million a year by 2018-19. We identified TIINs for 11 of these.

Figure 8

Characteristics of an effective system to design, manage and evaluate tax expenditures



Note

1 The Comptroller and Auditor General does not comment on the merits of policy objectives.

Source: National Audit Office

2.6 HM Treasury normally conducts a public consultation on the introduction of a tax expenditure at the design stage, unless it considers doing so will have adverse market implications. It is not always feasible for the exchequer departments to test for the behavioural impact of a new or revised tax expenditure given the difficulty of isolating the impact of a tax expenditure from other potential influences such as the economic environment.

2.7 The exchequer departments have also published 'policy costings' for the measures in each Budget since 2011.[18] These are helpful to Parliament in scrutinising costs. They contain information on the level of detail and behavioural assumptions behind estimated costs, although this has reduced over the years. The Chartered Institute of Taxation, the Institute for Fiscal Studies and the Institute for Government, who represent key users of TIINs and policy costings, report that the level of detail has reduced over the years.[19]

18 The Office for Budget Responsibility scrutinises each of the government's costings of individual tax and annually managed expenditure policy measures to decide whether to certify them as 'reasonable and central' estimates. It also assigns an uncertainty rating for each costing, and explains the reasons behind those that it deems are highly uncertain.

19 Jill Rutter et al, *Better Budgets: Making tax policy better*, Chartered Institute of Taxation, Institute for Fiscal Studies, Institute for Government, 2017, p. 33.

Figure 9

Issues considered by HM Treasury during design of our three case studies of new or recently amended tax expenditures

For our three case studies, HM Treasury had considered most of the factors we would expect

	First-time buyers' relief from stamp duty land tax	**Structures and buildings capital allowance (SBA)[1]**	**'Risk to capital' condition for venture capital schemes relief**
Context	Part of a package of housing measures	Part of a package with other changes to capital allowances to support business investment	One option in a package of options to encourage high-risk business investment following the 'Patient Capital Review'[2]
Issue			
Objectives set out	Yes in general terms (not SMART)[3]	Yes in general terms (not SMART)	Yes in general terms (not SMART)
A range of tax options (for example, different rates of relief)	Yes	No for SBA, but yes for other options in the package	Yes
Compared to spending alternatives	No but part of a package with spending measures	No	Yes
Estimated costs/impacts for the options	Yes	Yes for package as a whole	Yes
Value for money	Yes	Yes	Yes
Confidence in estimates[4]	Yes	Yes	Yes
Differential impacts on different sectors, regions and types of people	Yes	Yes	No
Risks of rewarding behaviour that would have occurred anyway	Yes	Yes	Yes
Risk of the measure being abused/different legal interpretations	Yes	Yes	Yes
How well the measure or a similar measure had, or had not, worked in the past	Yes	Yes	Yes
HM Revenue & Customs' administration costs quantified	Yes	Yes	No
Practical implementation issues	Yes	Yes	Yes
How it will be evaluated	No	No	No

Notes

1 Capital allowances have both structural and tax expenditure elements.

2 For risk to capital condition we have assessed whether the issues were considered for the overall package of options HM Treasury was considering. The largest venture capital scheme is the enterprise investment scheme.

3 SMART objectives are those which are: specific, measurable, achievable, relevant and time-bound.

4 'Confidence in estimates' refers to whether there has been consideration of how certain the forecasts are and/or how sensitive they are to changes to underlying assumptions.

Source: National Audit Office analysis of HM Treasury documents

Administration and monitoring of tax expenditures

2.8 HMRC administers most tax expenditures as part of its wider administration of each tax stream. It manages some tax expenditures separately where they require specialist knowledge or involve significant payments to taxpayers, such as research and development (R&D) reliefs. As well as ensuring compliance with the rules, HMRC is responsible for monitoring costs and benefits and evaluating tax expenditures. In 2014 we found some good practice but also inconsistency and fragmentation in how HMRC managed reliefs, with insufficient information-sharing on risks, costs and benefits.[20] In 2016, we encouraged HMRC to approach each tax relief in a way that is in proportion to its risk.[21]

2.9 HMRC has implemented all four of the recommendations relating to tax reliefs in the National Audit Office's 2016 report.[22] Specifically, they set up a small central team in 2016 to improve management of tax reliefs, including tax expenditures. The team introduced a process for tax reliefs and helped to coordinate its use. By 2019 the team had finalised a complete list of all tax reliefs for the first time and identified staff with lead responsibility for each tax relief.

2.10 The team has established compulsory guidance and has developed a framework of questions based on good practice to help staff with lead responsibility for tax expenditures. This framework is designed to capture information on reliefs in a consistent manner across the Department. The framework covers most of the areas we would expect to see including costs, public awareness and promotion of the tax expenditure, and arrangements for monitoring and evaluation.

2.11 The framework does not provide adequate guidance for all the risks affecting tax expenditures, including risks of abuse; overlap with spending programmes; and identification of the resources needed to administer the tax expenditure effectively. However, when we looked at nine tax expenditures in more detail we found that HMRC had considered risks to tax revenue in each case.

2.12 We held a workshop with HMRC staff to understand how they used the framework and to identify possible areas for development. Staff with lead responsibility for tax expenditures told us that the framework helped them manage tax expenditures. However, some of these staff said that the framework did not change what they did in practice as they considered they were already effectively managing their tax expenditures. Other staff said that following the framework helped to maintain knowledge of tax expenditures.

20 Comptroller and Auditor General, *The effective management of tax reliefs*, Session 2014-15, HC 785, National Audit Office, November 2014.

21 Comptroller and Auditor General, *HM Revenue & Customs 2015-16 Accounts, Report by the Comptroller and Auditor General,* National Audit Office, July 2016.

22 See footnote 21.

2.13 HM Treasury has also improved its monitoring of tax expenditures. It has developed a monitoring template to ask officials to review whether prominent tax expenditures are achieving their objectives, informally assess their value for money, and consider the case for reform. Following International Monetary Fund (IMF), National Audit Office and Committee of Public Accounts concerns, HM Treasury piloted a monitoring template in 2017 for 40 tax reliefs costing more than £40 million with specific policy objectives. In its process of providing ministerial advice, HM Treasury expanded coverage so that by early 2019 it had assessed 63 tax reliefs. HM Treasury told us the framework is a tool for collecting information and officials' views to help inform advice to ministers. The quality of these assessments is considered in Part Three.

2.14 HM Treasury has not integrated its monitoring with HMRC's. HM Treasury's current monitoring template does not cover the design of tax expenditures and, of the 57 questions in HMRC's framework, only eight address design. As of October 2019, the departments reported that they were developing a single framework. HM Treasury was considering what it could learn for how it appraises new tax expenditures from its 'Green Book' guidance on appraising spending proposals and from international comparisons.[23]

2.15 Neither HMRC nor HM Treasury differentiates between management of tax policy as a whole and tax reliefs, meaning that it is not possible to set out the precise amount of resources working on tax expenditures. HM Treasury reports that around 200 of its staff work on tax policy overall.

Monitoring and forecasting the cost of tax expenditures

2.16 Accurate forecasting of future costs is inherently difficult, particularly for new tax expenditures. Government's published forecasts are prepared by HMRC and scrutinised by the Office for Budget Responsibility (OBR) in its role as the government's official forecaster.[24]

2.17 Increases in cost can indicate that a tax expenditure is working well. Conversely, increases can also mean that a tax expenditure is being used in ways not intended. Economic growth, inflation, policy changes and changes to underlying tax rates can also have an effect. It is important that the exchequer departments understand the reasons for changes in costs but these are often hard to determine without a substantive assessment. Such assessments would ideally include comparisons of expected and actual costs. However, HMRC does not compare the government's original published forecasts for new tax expenditures to their actual costs.

23 HM Treasury, *The Green Book: Central Government Guidance on Appraisal and Evaluation*, 2019. Available at https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-governent.

24 In order to carry out its statutory duties, OBR has a legal right of access to information and analysis across the public sector. For tax matters this includes HMRC, where officials are required to produce any analysis, including draft forecasts, that the OBR requires to fulfil its remit.

2.18 HMRC told us that costs in its official statistics can appear to be very different from published forecasts because they are prepared on a different basis. For example, published forecasts assess the impact on public finances and can reflect:

- reductions in the cost of other tax expenditures where taxpayers are expected to switch to a new and more generous tax expenditure;
- the expected wider economic impacts of a new tax expenditure; and
- the expected impact on public finances of related policy changes made at the same time.[25]

Forecasts are calculated on a National Accounts Basis, while the official statistics are generally on an accruals basis (they represent the effects on the tax liabilities for each year, not receipts in each year).[26]

2.19 We compared government's published forecasts with costs in official statistics for nine new tax expenditures adjusting for differences as far as possible with the data available.[27] These comparisons indicate that estimates for five tax expenditures, including the three largest, were broadly in line or within government forecasts (**Figure 10** on page 30). However, the comparisons also indicate that the costs of four tax expenditures could be more than original forecasts by around 50% to 150%. We also found that the cost of the R&D expenditure credit (primarily claimed by large companies) phased in from 2013 was higher than internal government forecasts (**Figure 11** on page 31).[28] The exchequer departments do not report large differences in expected and actual costs.

2.20 It was more difficult to compare the costs of established tax expenditures with published government forecasts because projections cover a maximum of five years. However, three of our case studies introduced before 2013 had published forecasts covering longer periods as a result of several policy changes The combined cost of these three tax expenditures increased from around £1 billion in 2008-09 to around £5 billion in 2017-18, much faster than any published forecasts suggested.[29] Since 2008-09, their costs have grown by between 245% and 625% (**Figure 12** on pages 32 and 33). Economic growth will have contributed to the cost increases.

25 Government forecasts the impact of new tax expenditures on public finances but HMRC subsequently monitors and reports the total cost of taxpayers using the tax expenditure. These can be very different. For example, when a taxpayer moves from an existing to a more generous new tax expenditure. The forecast cost of the new tax expenditure is based on the change in the level of relief provided to the taxpayer; actual cost is based on the total level of relief the new tax expenditure provides.

26 Under the National accounts basis, costs represent time-shifted cash.

27 We identified 13 new tax expenditures introduced since 2013 which had published forecasts and each cost more than £50 million a year by 2018-19. We excluded from our analysis four of these tax expenditures because forecasts either included the impact of taxpayers moving from a less generous relief or included wider policy changes (paragraph 2.18). We identified internal government forecasts for another tax expenditure – the R&D Expenditure Credit – costing more than £50 million a year by 2018-19. We analysed this separately (Figure 11).

28 The TIIN for the new scheme did not set out its full forecast cost.

29 Part of the growth in the cost of the R&D scheme for small- and medium-sized enterprises in recent years has been due to data revisions. As explained in Figure 12, HMRC has corrected gaps in data for 2015-16 to 2017-18 but data for earlier years have not been corrected. We have shown an increase in the period to 2017-18, as data for 2018-19 on a receipts basis is not yet available for the research and development scheme for small and medium enterprises.

Figure 10

Comparison of government's estimates of actual costs with published forecasts for nine tax expenditures introduced since 2013

Comparison indicates actual costs exceed forecasts for several tax expenditures[1]

	Cumulative for period covered by forecast				
	Forecast (£m)	Actual (£m)	Actual less forecast (£m)	Actual less forecast (as a percentage of forecast) (%)	Period covered
Employment allowance[3]	7,245	7,000	-245	-3	April 2014 – March 2018
Patent box	2,800	2,805	5	0	April 2013 – March 2017
Relief on employer National Insurance Contributions for employees under 21	2,010	2,320	310	15	April 2015 – March 2019
Air passenger duty children's exemption	295	695	400	136	May 2015 – March 2019
Stamp duty land tax first-time buyers' relief	685	680	-5	-1	November 2017 – March 2019
High end TV[4,5]	215	*574*	*359*	*167*	April 2013 – March 2018
Relief on employer National Insurance Contributions for apprentices under 25	335	350	15	4	April 2016 – March 2019
Theatre[4,5]	80	*208*	*128*	*160*	September 2014 – March 2019
Video games[3,4]	75	116	41	55	April 2014 – March 2017

Notes

1 Government forecasts are prepared by HM Revenue & Customs and scrutinised by the Office for Budget Responsibility. Government prepares forecasts to show the impact on public finances of new tax expenditures. Actuals are the costs of taxpayers using tax expenditures. With the data available to us we have not been able to identify to what degree differences in approach would affect the differences between actual and forecast cost shown above.

2 Figure covers new tax expenditures introduced since 2013 which i) had published forecasts, ii) cost more than £50 million by 2018-19 and iii) where we could make indicative comparisons.

3 Forecasts for Employment allowance and High-end TV include the forecast impact of changes made to the schemes after they were introduced. The assumptions underpinning these forecasts (such as the assumed economic growth rate) will differ from the assumptions underpinning the initial forecasts of the schemes' costs.

4 Actuals are on accruals basis except for High end TV, Video games and Theatre which are on a receipts (that is, cashflow) basis. The values on an accruals basis represent the effects on the tax liabilities for each year, not receipts in each year.

5 For High end TV, period includes 2017-18, where costs are provisional and thus values are in italics. For Theatre, period includes 2017-18 and 2018-19, where costs are provisional and thus values are in italics. Non-italicised values are all final.

6 Tax expenditures are tax reliefs which government uses to encourage particular groups, activities or products in order to achieve economic or social objectives.

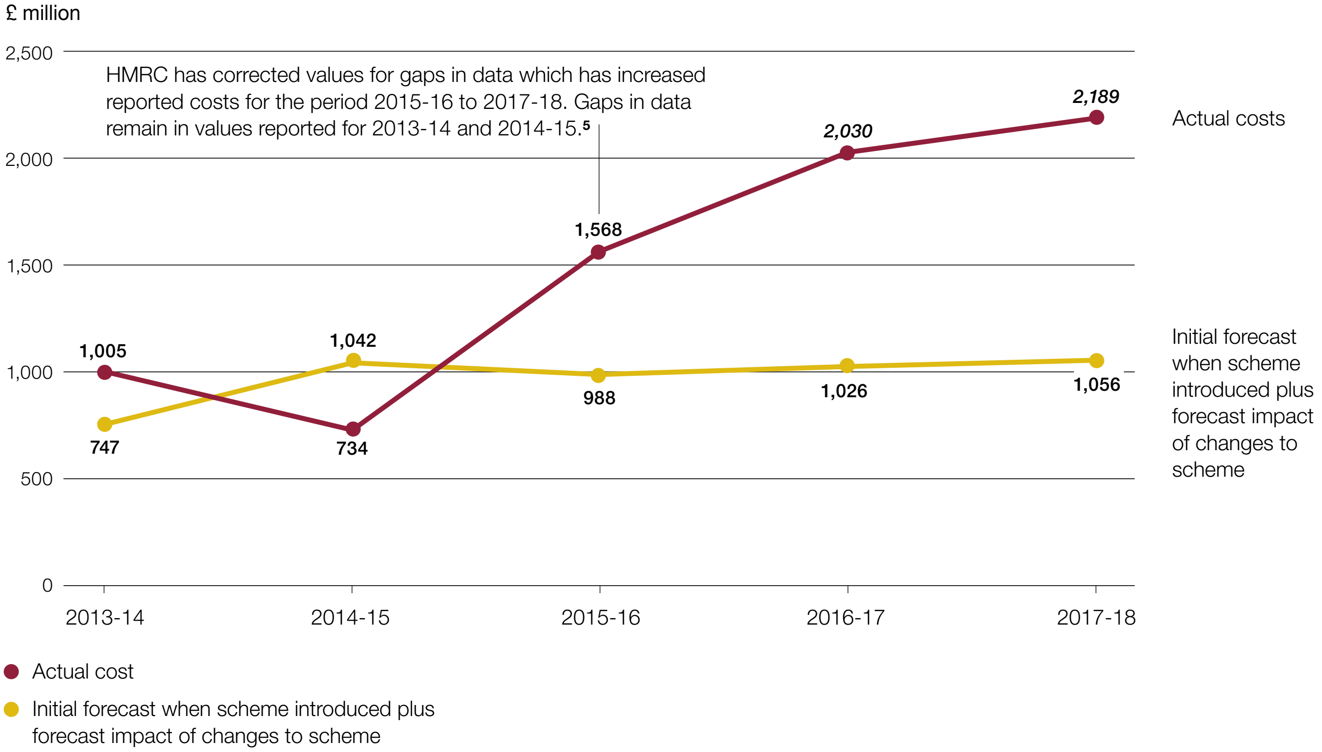
7 Forecasts are for the nominal costs of tax expenditures. Actuals also shown on a nominal basis.

Source: National Audit Office

Figure 11

Costs compared with forecast for the research and development (R&D) expenditure credit

The cost of this tax expenditure has been much higher than forecast since 2015-16. Across the period 2013-14 to 2017-18 costs exceeded forecasts by £2.7 billion (55%)



Notes

1. All costs in 2018-19 prices. Costs are on a receipts (that is, cashflow) basis and thus differ from those shown in Figure 13, which are on an accruals basis. Receipts data have not yet been produced for 2018-19. Values for 2016-17 and 2017-18 are provisional, and are italicised to distinguish from final values.
2. The research and development expenditure credit is a tax expenditure to support research and development activity. It is primarily claimed by large companies, although available to small- and medium-sized enterprises in certain circumstances. It was introduced in April 2013 but large companies could continue to use the old scheme for large companies until March 2016. Forecasts and actuals for the period up to 2015-16 are totals for both schemes.
3. Forecasts from 2015-16 include the forecast impact of three changes made to the research and development expenditure credit after it was introduced. The assumptions underpinning these forecasts (such as the assumed economic growth rate) will differ from each other and from the assumptions underpinning the initial forecast of the scheme's cost.
4. Costs over this period have increased due to cuts in the corporation tax rate. Not all the cuts in corporation tax were reflected in the cost forecasts for the scheme.
5. In 2018, HM Revenue & Customs identified that it had been under-reporting the total costs of both the R&D expenditure credit (and its predecessor scheme for large companies) and the R&D scheme for small- and medium-sized enterprises by around £550 million. HMRC has corrected values from 2015-16. Values for earlier years are understated.

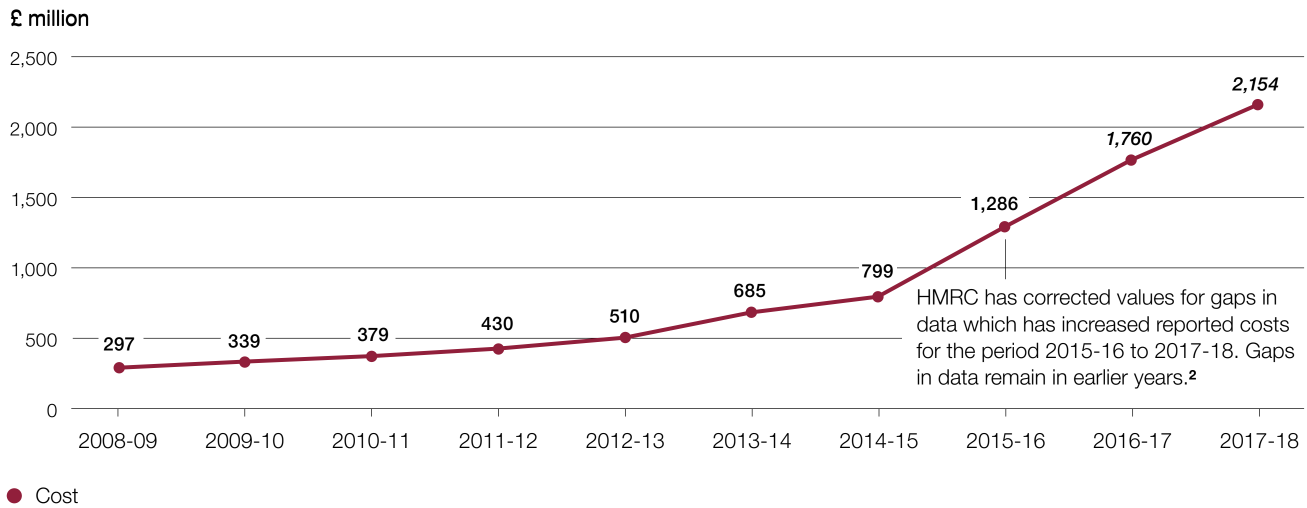
Source: National Audit Office

Figure 12

Cost of three case study tax expenditures since 2008-09

The costs of these three tax expenditures are much higher than in 2008-09

Research and development relief for small- and medium-sized enterprises[2]



Film tax relief[3]

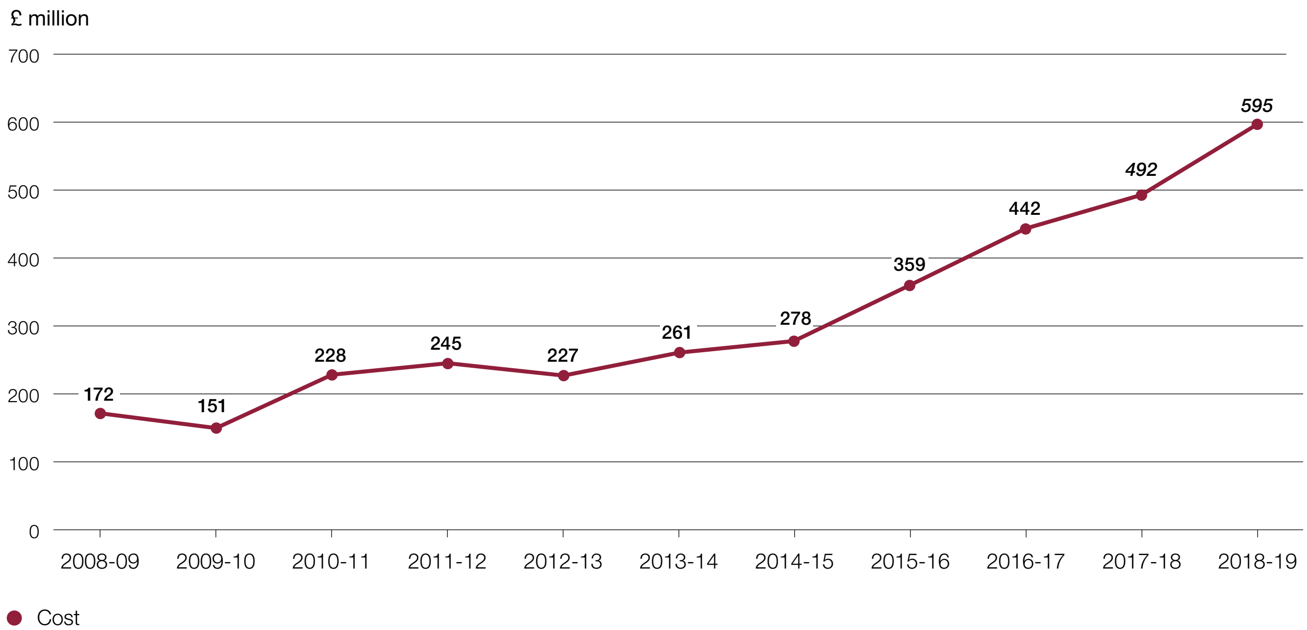
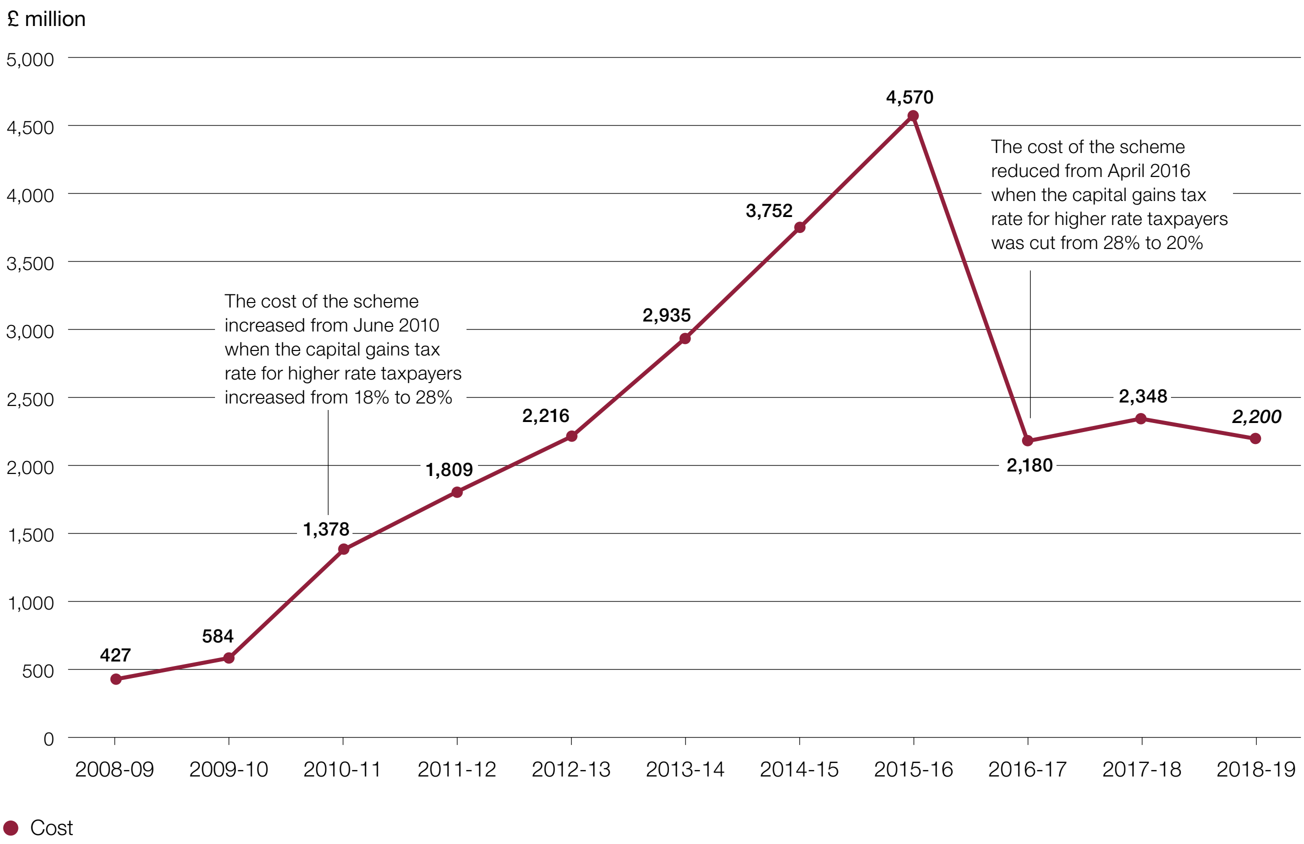


Figure 12 *continued*

Cost of three case study tax expenditures since 2008-09

The costs of these three tax expenditures are much higher than in 2008-09

Entrepreneurs' relief[4]



Notes

1 All costs at 2018-19 prices.

2 R&D relief for small- and medium-sized enterprises – this tax expenditure is to support research and development activity. Costs are on a receipts basis and thus differ from those shown in Figure 13, which are on an accruals basis. Receipts data has not yet been produced for the R&D scheme for 2018-19. Values for 2016-17 and 2017-18 are provisional, and have been italicised to distinguish from actuals. In 2018, HM Revenue & Customs identified that it had been under-reporting the total costs of both the R&D scheme for small- and medium-sized enterprises and the R&D expenditure credit (and the predecessor scheme for large companies) by around £550 million. HMRC has corrected values from 2015-16 to 2017-18. Values for earlier years are understated.

3 Film – this tax expenditure is to support the UK film industry. Costs are on a receipts (that is, cashflow) basis and thus differ from those shown in Figure 13, which are on an accruals basis. Values for 2017-18 and 2018-19 are provisional and have been italicised to distinguish from actuals.

4 Entrepreneurs' – this tax expenditure is to encourage enterprise. The relief reduces capital gains tax to 10% for sales of certain assets. Costs are on an accruals basis. Costs before 2014-15 do not include the costs of trusts claiming the relief. Value for 2018-19 is a projection based on previous years' actual data, and has been italicised to distinguish from actuals.

5 For all three tax expenditures, policy changes (such as changes to make schemes more generous) will have contributed to the cost increases shown.

Source: National Audit Office

Investigation of movements in cost

2.21 In July 2019, the OBR questioned whether government adequately scrutinises tax reliefs to control their cost.[30] We tested HMRC's understanding of changes in cost for our nine case studies of established tax expenditures. The costs of five had increased by more than 30% in real terms over the past four years, and the costs of another had increased by more than 30% since its introduction in 2016-17. The cost of one case study tax expenditure was broadly flat and two showed reductions in the period (**Figure 13**).

Figure 13

Case study tax expenditures – cost and HM Revenue & Customs' (HMRC's) understanding of cost movements

Costs have changed significantly for seven case studies

Tax expenditure	Cost in 2014-15[1,2] (£m)	Cost in 2018-19[3] (£m)	Percentage cost change 2014-15 to 2018-19 (%)	HMRC's understanding of cost movements[4]	Costs checked to other data[5]
VAT relief for new dwellings	10,238	*14,800*	*45*	✗	No
Entrepreneurs' relief from capital gains tax[6]	3,752	*2,200*	*-41*	✔	Internal
Research and development (R&D) reliefs for:					
Small- and medium-sized enterprises	1,404	*2,515*	*79*	✔	External
R&D expenditure credit[7]	1,790	*2,340*	*31*	✔	External
Patent box	697	*1,150*	*65*	✔	No
Film tax relief	327	*550*	*68*	✔	No
Relief on employer National Insurance Contributions for employees under 21	574 (2015-16)	610	6 (since 2015-16)	✔✔	No
Relief on employer National Insurance Contributions for apprentices under 25	83 (2016-17)	160	93 (since 2016-17)	✔	No
Agricultural property relief	356 (2015-16)	*315*	*-12* (since 2015-16)	✔✔	External

Notes

1 All costs at 2018-19 prices. Costs are on accruals basis. Accruals represent the effects on the tax liabilities for each year, not receipts in each year.

2 For the two reliefs from National Insurance Contributions, values are for the first year the schemes were in operation. For agricultural property relief, 2015-16 value shown as HMRC used a different costing approach in 2014-15.

3 Most 2018-19 costs are projections based on previous years' actual data. Projections – and percentage changes based on projections – are shown in italics to distinguish from actuals.

4 ✔✔ = good, ✔ = some, ✗ = none.

5 Shows whether HMRC gets assurance about its cost estimates by comparing to other data it holds or reported by third parties.

6 The relief reduces capital gains tax to 10% when entrepreneurs sell certain assets. The cost of the relief has reduced since 2014-15 because the capital gains tax rate for higher rate taxpayers was reduced from 28% to 20% from April 2016.

7 R&D expenditure credit is mainly claimed by large companies, although available to small- and medium-sized enterprises in certain circumstances.

Source: National Audit Office

30 Office for Budget Responsibility, *Fiscal risks report*, July 2019, pages 95 and 110. Available at: https://obr.uk/frr/fiscal-risks-report-july-2019/

2.22 HMRC had identified reasons for cost changes for each case study but it did not normally test how far its reasons explained the cost movements. HMRC provided quantitative analysis to support its reasons in only one case. For agricultural property relief, HMRC had compared cost trends to death rates for those liable to inheritance tax. HMRC told us that it was not possible for it to carry out quantitative analysis for all our nine case studies because, for example, it could not separate out different factors affecting costs or there was no suitable external data for comparison.

2.23 HMRC's understanding of cost changes appeared insufficient for the four largest case study tax expenditures, given their cost and the scale of change. We identified several reasons for HMRC's limited understanding: treatment of tax expenditures as structural tax reliefs; data quality; insufficient comparisons with other data, such as tax returns or official statistics; and not quantifying the actual impacts of policy changes. The four tax expenditures were:

a **Zero-rated VAT on construction of new dwellings. The cost of this tax expenditure increased by 80% between 2012-13 and 2018-19, reaching a forecast cost of £14.8 billion.** HMRC carried out limited analysis because it views this long-standing tax expenditure as close to being a structural relief as it is an established part of the housing market and would be difficult to remove. HMRC is not able to gather cost from tax returns because, as with other VAT reliefs, taxpayers neither apply for the tax expenditure nor disclose it on tax returns. Instead, HMRC estimates the cost of this tax expenditure using national statistics on the number and price of new dwellings, meaning that estimates of the revenue forgone are determined by the value of house-building. HMRC has not identified other data sources it can use to make comparisons.

b **The two research and development (R&D) reliefs. Combined forecast cost £4.9 billion in 2018-19.** HMRC's understanding of cost movements was limited by inaccurate data and because it is investigating apparent differences with trends in other sources**.** In 2018, HMRC identified that it had been under-reporting the costs of R&D reliefs by £550 million due to an error. HMRC has compared its data from tax returns on the R&D activity companies claimed to have undertaken in the UK and overseas, with national statistics on total UK (only) R&D activity.[31] This comparison showed that the R&D activity companies had claimed to have undertaken rose from 82% of all UK R&D activity in 2013-14 to 143% in 2016-17 (latest year for which data are available).[32] HMRC had not completed its investigation of the reasons for the increase as at January 2020. It considered that reasons for the increase were likely to include: the introduction of the R&D expenditure credit scheme from 2013-14, which enabled large loss-making companies to make claims; data corrections from 2014-15; the increasing generosity of the R&D reliefs; and increasing awareness of the R&D reliefs. Abuse and poor-quality claims have also increased costs.

31 Companies can claim for some overseas expenditure under the scheme.
32 HM Revenue & Customs, *Research and Development Tax Credits Statistics*, October 2019.

c **Entrepreneurs' relief. The cost of this tax expenditure reached £4.6 billion in 2015-16 and then halved to £2.2 billion in 2016-17.** HMRC has a partial but improving understanding of movements in cost. HMRC has identified the two main factors driving movements. It has analysed these factors with the aim of improving future forecasting, but it has not quantified their impact on reported costs. The two main factors were the lifetime limit on individual entrepreneurs, which had increased three times, pushing up costs; and changes in the main capital gains tax rate. Changes in the rate had first increased and then reduced the value of the relief to entrepreneurs.

2.24 In July 2019, the OBR concluded that the cost of tax reliefs was poorly understood. In particular, it said that HMRC was unable to offer it any explanation for why the cost of R&D tax reliefs or entrepreneurs' relief had been rising or why the cost of entrepreneurs' relief then halved in a single year.[33] Since July 2019 HMRC has been working to better understand factors affecting the cost of the R&D reliefs and entrepreneurs' relief.

Managing abuse and error

2.25 Abuse and errors increase both the cost of tax expenditures and the resources that HMRC needs to administer them. Those tax expenditures which result in payments, such as R&D reliefs, are attractive to fraudsters as well as those that make legitimate claims. HMRC does not hold data on tax at risk from abuse and error for all tax expenditures.[34] However, it has developed a single view of the 63 main compliance risks it faces across its business. Six of these risks are specific to tax reliefs. Some of the other risks partly arise from tax reliefs. HMRC's data do not show the significance of reliefs to these risks.

2.26 Of the six risks specific to tax reliefs, HMRC estimates the tax at risk was increasing for three, with a risk arising from R&D tax expenditures increasing the most. In 2018 HMRC substantially increased its estimate of tax at risk from R&D tax expenditures to a level indicating that further action was required.

33 Office for Budget Responsibility, *Fiscal risks report*, July 2019, pages 5 and 110. Available at: https://obr.uk/frr/fiscal-risks-report-july-2019/
34 Tax at risk is HM Revenue & Customs' measure of ongoing risks to tax revenue.

2.27 Between 2017 and 2018 HMRC's new centralised R&D team identified that the scheme for small- and medium-enterprises was subject to four significant compliance issues. HMRC addressed an attempted fraud. It also began investigating an artificial avoidance scheme. The two other issues will take time to address for reasons within and outside HMRC's control, meaning that tax will continue to be lost.

- **Abuse of the relief by companies with a minimal UK presence is expected to continue to 2022-23, and possibly beyond, partly because of the time to consult and change legislation.** The abuse began after legislation was changed in 2012 removing a cap which had sought to ensure that companies claiming payments through the R&D scheme had not been arranged solely for this purpose.[35] In early 2018, HMRC identified that overseas entities were routing non-UK expenditure through UK entities they had established with the purpose of accessing R&D payments. The October 2018 Budget proposed reintroducing a cap from April 2020. The departments consulted on the cap in 2019.[36] If the cap is introduced from April 2020 as proposed, companies will have until 2022-23 to make claims under existing rules for accounting periods beginning in the 12 months before April 2020.[37] HMRC estimates that the proposed cap will save the Exchequer £45 million a year.

- **The time needed to fund and train new staff and develop systems has slowed HMRC's response to poor-quality claims.** Poor-quality claims are the main cause of lost tax. They have been an issue since the scheme was introduced with, for example, companies or their agents claiming for non-allowable spending. HMRC has sought to improve quality by, for example, providing better guidance. HMRC has used funding provided by the November 2017 Budget to increase the number of compliance staff in its R&D team. The new staff are expected to be fully trained by the end of 2020, and will continue to build up experience for a considerable period after that. Following the increased assessment of tax at risk in 2018, HMRC is also exploring opportunities to improve its systems and processes for risk-assessing claims and preventing incorrect payments, which is likely to require both legislative change and funding.

35 The cap limited the payments a company could receive in a year to its total PAYE and National Insurance Contributions payments.

36 New cap – set at three times a company's PAYE and NICs liability – seeks to strike a balance between limiting abuse and not disadvantaging legitimate claims.

37 Change will affect accounting periods which commence on or after 1 April 2020. Claims can be submitted up to 24 months from the end of a company's accounting period.

Part Three

The evaluation and review of tax expenditures

3.1 How HM Revenue & Customs (HMRC) and HM Treasury (the exchequer departments) evaluate and report tax expenditures is a necessary condition for informing ministers' decisions and enabling public scrutiny. In this part of the report we assess the adequacy of:

- the exchequer departments' approach to evaluating tax expenditures;
- arrangements for assessing value for money and acting on this; and
- arrangements for public reporting.

Evaluating the impact of tax expenditures

3.2 Evaluating tax expenditures is an important means of assessing the impact of the forecast £155 billion of tax revenue forgone.[38] Nevertheless, HMRC has evaluated only a small minority of established tax expenditures.

3.3 Since 2015, HMRC has published evaluations covering just 15 established tax expenditures costing around £11 billion in 2018-19 (7% of the known cost of tax expenditures).[39] Two tax expenditures costing more than £1 billion a year (gift aid and entrepreneurs' relief) had been evaluated more than once. Many of the other costliest tax expenditures, or those growing at a fast rate, have not been evaluated. In total HMRC has evaluated:

- none of the 10 largest tax expenditures;
- five of the other 13 tax expenditures costing more than £1 billion a year; and
- three of 11 tax expenditures costing between £50 million and £1 billion a year with cost increases of more than 30% in real terms between 2012-13 and 2016-17.

38 £155 billion is the aggregate forecast cost of 111 tax expenditures in 2018-19. As shown in Figure 2, HMRC reports cost estimates for 111 of the 362 tax expenditures. As explained at paragraph 3, aggregating the cost of tax expenditures gives a sense of their scale, but it does not reflect the amount of tax that would be generated if tax expenditures were removed because some taxpayers would change their behaviour and there may be wider economic impacts.

39 Fourteen tax expenditures were covered by evaluations HMRC had commissioned. HMRC publishes all externally commissioned research, which includes any commissioned research that contributes to evaluation of tax expenditures. The other tax expenditure was evaluated by HMRC. HMRC does not have a central record of all the tax expenditures where it has undertaken an evaluation. HMRC does not report a cost for one of the 15 tax expenditures evaluated and thus £11 billion is the aggregate cost of 14 tax expenditures.

3.4 The cost of evaluations is not large compared to the value of tax expenditures. Evaluations HMRC commissions typically cost between £50,000 and £250,000. We estimate that since 2015 HMRC has spent around £2 million on evaluations of tax expenditures. This estimate does not include the cost of HMRC staff in overseeing evaluations, which could be significant.[40]

3.5 Two factors have limited the number of evaluations HMRC has commissioned of tax expenditures:

- HMRC has a central research budget (£2 million in 2019-20). Proposals to evaluate tax expenditures must compete against proposals covering HMRC's wider business and HM Treasury priorities.
- HMRC considers some tax expenditures to be difficult to evaluate because, for example, they have multiple or unclear objectives, or objectives which are difficult to assess, such as reducing the risk of taxpayers behaving in a particular way.

3.6 HMRC's evaluations indicate that the impact of tax expenditures can vary widely. The evaluations HMRC has published since 2015 have assessed the impact of 13 of the 15 tax expenditures covered.[41] The evaluations found that seven of these tax expenditures (costing £3.6 billion in 2018-19) were having a positive impact on behaviour, one (£1.4 billion) had a mixed impact, and the other five (£5.2 billion)[42] had a limited impact (**Figure 14** on pages 40 and 41).

HM Treasury's assessments of the value for money of tax expenditures

3.7 HM Treasury has responded to National Audit Office (NAO), Committee of Public Accounts and International Monetary Fund (IMF) concerns about its oversight of tax expenditures by establishing a monitoring exercise for them, beginning in 2017. The exercise includes an assessment of their value for money and represents an important step in improving HM Treasury's management of tax expenditures.

3.8 The number of tax reliefs for which HM Treasury has collated informal value-for-money views from officials has increased from around 40 in 2017 to 63 in 2019. In 2019, it brought together the results of its value-for-money assessments for the first time.

40 HMRC does not separately record staff time spent on overseeing evaluation from staff time spent on analysis of taxes and tax expenditures, meaning that it is not possible to set out the precise amount of resource and associated cost to overseeing evaluations.

41 The other two tax expenditures – agricultural property relief (cost in 2018-19, £315 million) and business property relief (£480 million) – were covered by a single evaluation. The evaluation considered issues such as awareness among target groups but did not conclude on the impact of the tax expenditures.

42 The £5.2 billion figure is based on four tax expenditures with cost estimates. The fifth does not have a cost estimate.

Figure 14

HM Revenue & Customs' (HMRC's) evaluations concluding on the impact of tax expenditures

Evaluations commissioned or undertaken by HMRC found evidence that seven of 13 tax expenditures were having a positive impact on behaviours[1]

	Tax expenditure[2]	Year published	Estimated cost 2018-19[3] (£m)	Key finding	Impact on behaviour
1	Video games relief	2017	*115*	There were several ways the relief had helped developers start new games and get them to the market place. The relief was welcomed by the video industry but had yet to reach its full impact.	Positive
2	Enterprise investment scheme – income tax	2016	*600*	The schemes were generally working as intended in terms of how investments were used (for example, bridging finance gaps), and 60% of investors said their proposed investment would either definitely or probably not have taken place without the schemes.	Positive
3	Enterprise investment scheme – capital gains tax		*120*		
4	Venture capital trusts – income tax relief on share subscriptions		*160*		
5	Venture capital trusts – income tax relief on dividends		*60*		
6	Venture capital trusts – relief on capital gains tax		*15*		
7	Research and Development (R&D) relief for small- and medium-sized enterprises[4]	2015	*2,515*	Each £1 of relief provided stimulated £1.53 to £2.35 of additional R&D spending. HMRC did not test or adjust results for abuse of this tax expenditure (paragraph 2.26).	Positive
8	Gift aid	2016	*1,350*	Of individuals eligible to add gift aid, 20% always did, 50% sometimes did and 30% never did. Improving awareness could help to reduce gift aid claims among ineligible donors and increase claims among eligible donors.	Some
9	Relief on employer National Insurance Contributions for employees under 21	2018	610	A third of employers viewed the savings from the reliefs as very or fairly significant. However, in isolation neither tax expenditure has had a significant impact on workforce planning or decisions about hiring.	Limited
10	Relief on employer National Insurance Contributions for apprentices under 25		160		
11	Entrepreneurs' relief	2017	*2,200*	The tax expenditure had limited impact on those who claimed it. For example, of those surveyed who had claimed entrepreneurs' relief in the previous five years, only 8% said that the tax expenditure had influenced their decision at the point of investment.	Limited

Figure 14 *continued*

Evaluations concluding on the impact of tax expenditures

Tax expenditure[2]	Year published	Estimated cost 2018-19[3] (£m)	Key finding	Impact on behaviour
12 Employment allowance	2015	2,200	The allowance was having limited impact on business decisions; 27% of employers claiming the allowance had or intended to use it for a specific purpose, such as more spending on staffing. Only 22% of these said that spending only happened, or would only happen, because of the allowance, with another 7% saying the allowance had or would increase spending they would have otherwise made.	Limited
13 Business asset rollover relief[2]	2015	Cost unavailable	There were relatively few cases where the relief appeared to have a major influence on the business behaviour and tax planning of claimants.	Limited

Notes

1 The evaluation of the R&D relief for small- and medium-sized enterprises was undertaken by HMRC. All other evaluations were commissioned by HMRC from external organisations. Evaluations are available through HMRC's Estimated Costs of Tax Reliefs, October 2019 (second document on this web page www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs, tab Non-statistical information on impacts of tax reliefs).

2 Where a tax expenditure has been covered by more than one evaluation, most recent evaluation shown. The 2015 evaluation of business asset rollover relief also covered entrepreneurs' relief.

3 Most costs are projections for 2018-19 based on previous years' actual data. Projections are shown in italics to distinguish from actuals.

4 The assessment also covered the previous scheme for large companies. It generated a single additionality ratio covering both tax expenditures. At January 2020, HMRC was finalising a second assessment of the tax expenditure for small- and medium-sized enterprises, which should reflect some of the changes since 2015 to make it more generous.

5 Tax expenditures are tax reliefs which government uses to encourage particular groups, activities or products in order to achieve economic or social objectives.

Source: National Audit Office

3.9 The assessments are intended to be light-touch but nonetheless cover many of the areas that we would expect to see. In addition to asking HM Treasury 'owners' of tax expenditures to assess value for money, monitoring templates ask for assessments of whether, for example, a spending alternative is available for a tax expenditure.

3.10 HM Treasury officials had informally assessed the value for money of eight of our case study tax expenditures as part of its monitoring exercise. The types of evidence and analysis varied, with HM Treasury only reporting a cost–benefit ratio for three **(Figure 15** overleaf**).** In the examples of our case studies, HM Treasury was best placed to assess value for money where HMRC had evaluated the tax expenditure's impact, as was the case for both National Insurance Contributions reliefs and entrepreneurs' relief. However, the number and scope of HMRC evaluations limits the analysis that HM Treasury is able to draw upon. For two of our case studies (patent box and agricultural property relief) HM Treasury did not have quantitative evidence to inform its assessment of value for money. In the case of the research and development (R&D) expenditure credit, the only quantitative evidence was an evaluation of the previous version of the scheme for large companies.

Figure 15
Evidence used to assess value for money

Quality of evidence HM Treasury used varied across our case study tax expenditures

Case study	Consideration of deadweight and avoidance[1]	Consideration of spending alternative	Comparison of cost to forecast	Quantitative evidence for cost–benefit ratio	Quantitative evidence for outcomes/ behaviour change	Quantitative evidence for value-for-money assessment
Entrepreneurs' relief	✔✔	✔	✔	✗	✔✔	✔✔
Relief on employer National Insurance Contributions for employees under 21	✔✔	✔	✔✔	✗	✔✔	✔✔
Relief on employer National Insurance Contributions for apprentices under 25	✔✔	✔	✔✔	✗	✔✔	✔✔
Film tax relief	✔	✔	✗	✔	✔	✔
Research and Development relief – small- and medium-sized enterprises	✔	✔	✗	✔✔	✔✔	✔✔
Research and Development relief – large companies[4]	✔	✔	✔	✔✔	✔✔	✔✔
Patent box	✔	✔	✔✔	✗	✗	✗
Agricultural property relief	✔	✔	✔	✗	✗	✗

Notes

1 'Deadweight' is where the tax expenditure is paid when behaviour sought would have occurred anyway.

2 ✔✔ = good, ✔ = some, ✗ = none.

3 One of our case studies – VAT on relief on new dwellings – had not been assessed.

4 Quantitative evidence was from the previous version of the scheme.

Source: National Audit Office

3.11 There are aspects where the monitoring process lacks maturity. Although HM Treasury asks the owners of tax expenditures to make informal assessments on value for money, they do not possess a shared definition of this and assessments are not quality-assured. HM Treasury told us that the monitoring exercise had helped to improve the strategic approach it takes by providing advice to ministers on tax expenditures as a whole.

3.12 HM Treasury's assessments of tax expenditures contain information which could strengthen Parliament's scrutiny of them, including whether HM Treasury regards these expenditures as delivering value for money. However, HM Treasury told us its assessments of value for money should not be published because they are informal assessments and do not represent the official position of the Department and are also part of the policy-making process and therefore confidential.

Responsibility for acting on value-for-money concerns

3.13 HM Treasury's value-for-money assessments help inform policy decisions about whether a tax expenditure should be reformed. Decisions about whether to amend a tax expenditure are a matter for ministers, who may need to consider a wider range of factors including wider government objectives, the priorities of each fiscal event, and levels of Parliamentary support and public perception.

3.14 HM Treasury does not use its value-for-money assessments to inform administrative action HMRC could take to improve the effectiveness of tax expenditures. These administrative solutions could, for example, include HMRC promoting tax expenditures more actively to target particular groups and improving the accessibility and understandability of guidance. Additionally, HM Treasury could use the value-for-money assessments to identify the characteristics of tax expenditures which are good and poor value for money, to better inform design, risk assessment and monitoring.

3.15 In 2014, HM Treasury set out its view on accountability for tax reliefs but it did not consider specifically accountability for value for money.[43] In 2019, HMRC informed the Committee of Public Accounts that the broader question of the value for money of tax reliefs is the responsibility of HM Treasury, with HMRC providing relevant advice as part of the tax policy partnership in the normal way.[44] Policy decisions on the value for money of tax expenditures are for Treasury ministers, who are ultimately accountable to Parliament for the tax system and policy. This includes decisions on the effectiveness of tax policy, including on the value for money of tax reliefs. HM Treasury officials are accountable for providing ministers with high-quality advice to make those decisions, including value-for-money considerations, in line with their objectives and those of the Department.

43 HM Treasury, *Treasury Minutes: Government responses on the Sixty-First report (Session 2013-14) and the First to the Seventh reports from the Committee of Public Accounts: Session 2014-15*, Cm 8938, September 2014, page 12.

44 HM Treasury, *Treasury Minutes: Government response to the Committee of Public Accounts on the Sixty-Fourth to the Sixty-Eighth reports from Session 2017-19*, CP 18, January 2019, page 11; and Public Accounts Committee, *Oral evidence: HMRC Standard Report 2018-19*, HC 28, October 2019, Q88.

3.16 The respective roles and responsibilities of the exchequer departments for tax expenditures are not specified in publicly available documentation. HM Treasury's accountability systems statement and single departmental plan refer to its accountability to Parliament for the use of its resources, its role in structuring and delivering taxes, and the need to work closely with other government departments in undertaking this. These documents do not, however, define the role in relation to tax reliefs explicitly, which the different departments currently perform.

Reporting on the costs and benefits of tax expenditures

3.17 Parliament can need information provided by HM Treasury and HMRC to hold ministers accountable for the value for money of tax expenditures. As part of the legislative process the government publishes costings and 'tax information and impact notes' (TIINs) and ministers outline their aims to Parliament. In response to recommendations made by us and by the Committee of Public Accounts since 2014, HMRC has made a series of improvements in its public reporting of tax expenditures. These included providing links to the evaluations HMRC has published on tax expenditures.

3.18 HMRC's latest (October 2019) published bulletin covering tax expenditures is much improved. HMRC listed all 362 tax expenditures for the first time. The bulletin also provided descriptions for all tax expenditures; and some analysis, supported by limited commentary, on movements in costs for the largest tax expenditures. For the largest tax expenditures, costs are provided in nominal terms, and as a percentage of nominal gross domestic product (GDP) to control for the effects of inflation and economic growth.[45]

3.19 Overall, however, the information publicly available to Parliament on the costs and benefits of tax expenditures is not sufficient for it to assess their value for money. Economic and social objectives are not explained for each tax expenditure and there is no comparison of costs and benefits to published forecasts. Commentaries on changes in cost tend to be descriptive and do not cross-refer to impact, or the number of claimants, which is reported for the most recent year where data are available.

3.20 Some other countries have more comprehensive evaluation and reporting of tax expenditures, despite comparatively lower levels of tax expenditure. HM Treasury has carried out a review of practices in five other countries as part of its work to consider how it could improve its oversight of tax expenditures. These countries all do more than the UK to evaluate and report on tax expenditures (**Figure 16**). Most have clear parameters to review the ongoing case for tax expenditures and to evaluate and to report on their performance publicly. Particular good practice includes:

- regular evaluations of tax expenditures against an established framework;
- regular and detailed public reporting on tax expenditures; and
- mechanisms to review the ongoing value of tax expenditures such as time limits.

45 HM Revenue & Customs, *Estimated Costs of Tax Reliefs*, October 2019, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/837774/191009_Bulletin_FINAL.pdf.

Figure 16

International case examples

Some countries prepare more comprehensive reports on tax expenditures, and have a more systematic approach to evaluation

Netherlands

Applies a standard set of questions to facilitate the introduction of new tax expenditures. Questions include whether the same goals can be achieved through other policy instruments.

Reviews established tax expenditures – both the ministry of finance and the spending department can be involved.

Results of the reviews are set out in the budget memorandum.

Budget memorandum also outlines plans for the next reviews of tax expenditures.

Germany

Legal obligation to report on tax expenditures to parliament every two years.

Applies a standard evaluation framework with four core areas:

- target accuracy;
- cost-efficiency;
- necessity; and
- sustainability.

Had externally evaluated 82% of tax expenditures (by value) by November 2019.

France

Annual budget document sets out the total cost of tax expenditures for three years, with latest cost split by government function (for example, economy).

Includes a list of evaluations of reliefs in budget documents.

Evaluations can be internal or carried out by the court of auditors.

Ireland

Publishes an annual report on tax expenditures summarising the fiscal impact of the range of tax expenditures and the results of reviews of individual tax expenditures.

Has established a framework for evaluating new and existing tax expenditures. For existing tax expenditures the framework covers: relevance; cost; impact; and efficiency.

Allows for flexibility in how framework is applied to reflect nature and scale of the tax expenditure. More thorough evaluations are recommended for more costly tax expenditures.

Guidelines specify:

- the tax system should only be used where there are demonstrable market failures and where a tax-based incentive is more efficient than direct expenditure; and
- all tax expenditures should be time-limited, making them subject to review every 3–5 years, depending on cost.

Canada

Prepares a comprehensive report intended to facilitate the analysis of federal tax expenditures.

Report covers:

- costs – both estimates of actual costs and forecasts for future years;
- summary of each tax expenditure, including a brief description, its objectives, historical information, and references to spending programmes relevant to the policy area; and
- evaluations and analytical papers assessing the impact of specific tax expenditures.

Source: National Audit Office analysis

Appendix One

Our audit approach

1 This report examined the economy, efficiency and effectiveness of how the exchequer departments used their resources with regard to the design, administration, monitoring, evaluation and management of tax expenditures.

2 In this report we examine the exchequer departments' management of tax expenditures across different stages of their lifecycles, specifically:

- the number and cost of tax expenditures (Part One);
- design and monitoring of tax expenditures (Part Two); and
- the evaluation and review of tax expenditures (Part Three).

See **Figure 17**.

Figure 17
Our audit approach

The objective of departments

HM Treasury: design sustainable taxes, benefits and pensions, consistent with sound public finances.

HM Revenue & Customs (HMRC): collects revenues due and bears down on avoidance and evasion.

How this will be achieved

HMRC and HM Treasury (the exchequer departments) are responsible for: advising on design; managing; administering; and monitoring tax expenditures.

Our study

We examined the effectiveness of the exchequer departments' management of tax expenditures across all stages of their lifecycles.

Our evaluative criteria

Government has full knowledge of the number and cost of tax expenditures.

Government designs and monitors tax expenditures effectively.

Government evaluates and reviews all tax expenditures.

Our evidence
(see Appendix Two for details)

We **conducted** nine case studies of established tax expenditures, and three of those which had been recently designed or revised.

We **analysed** tax expenditure cost data.

We **held a series of meetings** with officials at HMRC and HM Treasury.

We **drew on existing National Audit Office evidence**.

We **consulted** with stakeholder groups.

We **reviewed** published policy documents, guidelines and evaluations.

We **reviewed** strategic documents provided by the departments.

Our conclusions

At a forecast cost of £155 billion in 2018-19, tax expenditures represent an important means by which government pursues economic and social objectives. Evaluations show that their impact is not guaranteed, and many require careful monitoring. We have previously raised concerns about how effectively government is managing tax expenditures. Both HMRC and HM Treasury have responded to our recommendations by increasing their oversight of tax expenditures and actively considering their value for money.

While these steps are welcome, they are very much still in development. The large number of tax expenditures means it will take time to identify and embed good practices. Both departments need to make substantial progress and ensure sufficient coverage and rigour in the work they undertake on this matter.

On their own these improvements will not be sufficient to address value-for-money concerns unless the departments formally establish their accountabilities for tax expenditures and enable greater transparency. Lessons can be learned from other countries that have established clear arrangements for evaluating and reporting on tax expenditures. We look to HM Treasury and HMRC to follow suit by clarifying arrangements for value for money and improving the evaluation and public reporting of tax expenditures.

Appendix Two

Our evidence base

1 We conducted our examination of tax expenditures between April and November 2019. Our audit approach is outlined in Appendix One.

2 We conducted case studies of nine established tax expenditures. We selected these expenditures based on criteria including: relevance to government objectives; cost; cost increase in recent years; whether action has been taken on abuse in recent years; and whether a tax expenditure has been covered by previous National Audit Office (NAO) work. The nine tax expenditures we selected on this basis were:

- Research and Development tax reliefs for small- and medium-sized enterprises;
- Research and Development expenditure credit (primarily claimed by large companies);
- Entrepreneurs' relief on Capital Gains Tax;
- Zero-rated Value Added Tax on the construction of new dwellings;
- Relief on employer National Insurance Contributions for employees under 21;
- Relief on employer National Insurance Contributions for apprentices under 25;
- Film tax relief;
- Agricultural property relief from Inheritance Tax; and
- Patent box relief.

3 For each tax expenditure, we assessed the effectiveness of the management of the tax expenditure by HM Revenue & Customs (HMRC) and HM Treasury, considering issues such as monitoring arrangements, cost forecasts, management of risks such as abuse, and consideration of the impact of the tax expenditure. We undertook these assessments through a series of structured meetings with HMRC and HM Treasury officials and reviewed documents.

4 In addition, we conducted further case study examinations of three more recently designed or revised tax expenditures: first-time buyers' relief from stamp duty; structures and buildings capital allowance; and the 'risk to capital' condition for venture capital schemes relief. These tax expenditures were selected based on criteria including their age, the amount of revenue forgone, and the extent to which their success was dependent upon behavioural change. For each of these case studies, we conducted a series of meetings with HMRC and HM Treasury officials and reviewed documents.

5 The case studies tell us how HMRC and HM Treasury had designed and administered the selected tax expenditures. However, the basis for selecting the case studies means they do not provide representative evidence on the way they design and administer all tax expenditures. We carried out other methods which were relevant to the population of tax expenditures.

6 We conducted a number of pieces of analysis of the costs of tax expenditures. This analysis examined factors such as the extent to which costs had changed against their original baseline forecasts. Where we have converted nominal costs to 2018-19 prices, we have used the gross domestic product (GDP) deflator.[46]

7 The National Audit Office's operations management team ran a workshop with HMRC officials examining the maturity of the processes introduced by HMRC's central tax reliefs management team. We examined tax information and impact notes for recent tax expenditures, assessing issues including how thoroughly they set out expected costs and benefits and how these would be measured and evaluated.

8 We interviewed a range of organisations and individuals with an interest in tax expenditures:

- British Chambers of Commerce;
- Professor David Connell, Senior Research Fellow, Centre for Business Research, University of Cambridge;
- Department for Business, Energy & Industrial Strategy;
- Federation of Small Businesses;
- Institute of Economic Affairs;
- Institute for Fiscal Studies;
- Institute for Government;
- Office for Budget Responsibility;
- Office of Tax Simplification; and
- Resolution Foundation.

46 HM Treasury, National Statistics, *GDP deflators at market prices, and money GDP,* December 2019 (Quarterly National Accounts), January 2020.

9 In addition, the Chartered Institute of Taxation held a day-long informational workshop for us, in which we discussed issues related to each of our case study tax expenditures.

10 We consulted throughout different stages of the study with Kim Scharf, Professor of Economics, Head of the Economics Department at the University of Birmingham and Editor of *International Tax and Public Finance*.

11 We conducted a series of meetings with HM Treasury officials.

12 We reviewed a range of documents related to the overall management of tax expenditures by HMRC and HM Treasury.

13 We reviewed practices in other countries and verified these practices with international counterparts and published sources.

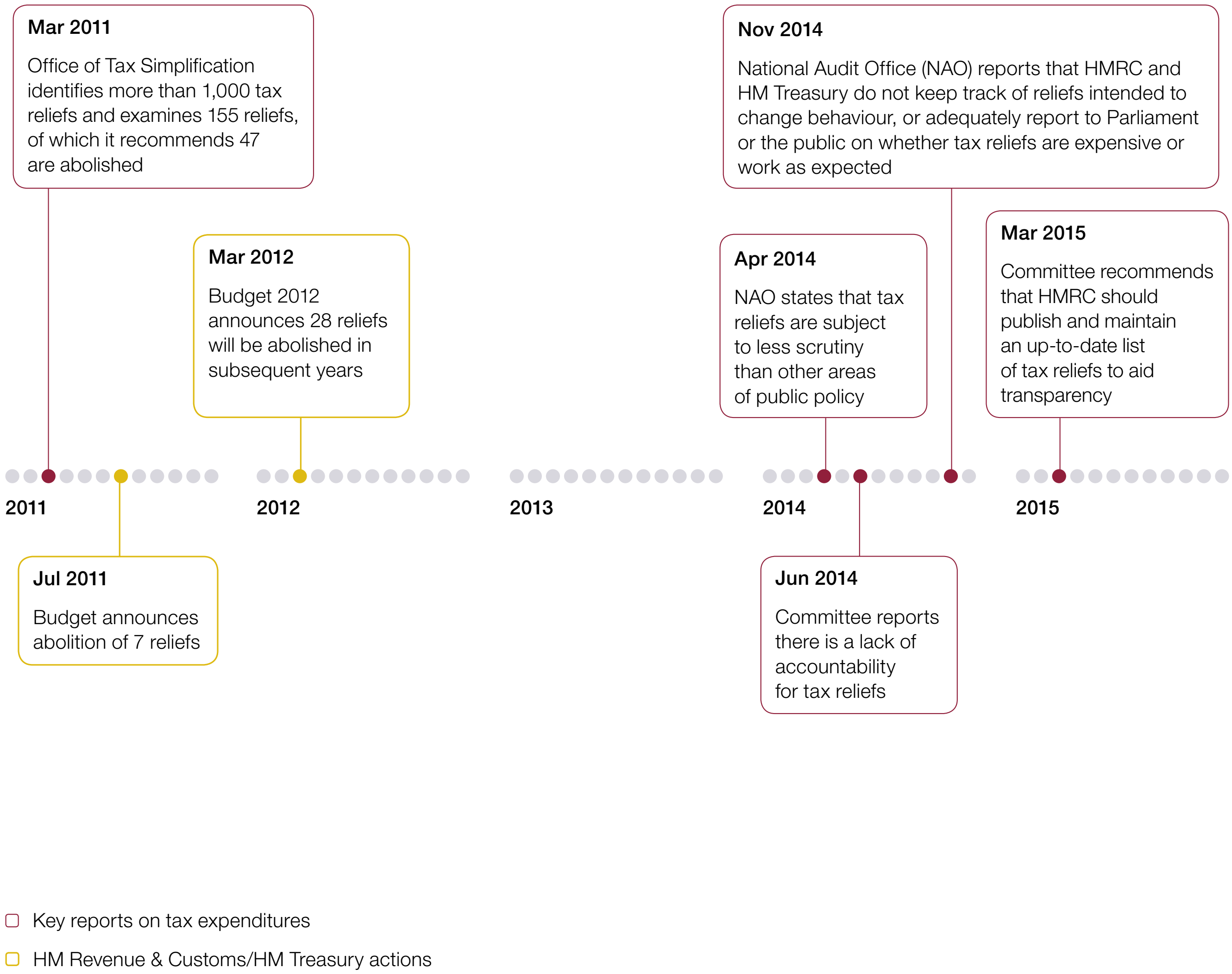
Appendix Three

Key reports covering tax reliefs and HMRC and HM Treasury's response

1 **Figure 18** is on pages 52 and 53.

Figure 18
Timeline of key events

HM Revenue & Customs (HMRC) and HM Treasury have responded to some of the concerns raised by us, the Committee of Public Accounts (the Committee) and other stakeholders



Source: National Audit Office

2016

Feb 2016
HMRC launches a central tax reliefs team

Jul 2016
NAO recommendations include that HMRC should provide a central role to oversee the management of tax reliefs and make good-practice guidance for administering tax reliefs compulsory

Nov 2016
International Monetary Fund (IMF) concludes that UK lacks control over the size of tax expenditures, which are relatively high by international standards

Dec 2016
HMRC begins to improve its public reporting of tax reliefs

2017

Jan 2017
Institute for Government, Institute for Fiscal Studies, and Chartered Institute of Taxation call for enhanced scrutiny and challenge of tax policy-making including tax reliefs

2017
HM Treasury pilots new template for assessing tax reliefs – applied to 40 tax reliefs costing more than £40 million

2017
HMRC introduces a framework to improve the management of tax reliefs. Framework to be compulsory for all tax expenditures

2018

Nov 2018
Committee recommends that HMRC takes greater responsibility for the value for money of tax reliefs and improves its understanding of uncosted reliefs

Nov 2018
HM Treasury develops its template. It was used to assess 63 tax reliefs

2019

Apr 2019
HMRC commits to reducing number of un-costed reliefs

Jul 2019
The Office for Budget Responsibility findings on tax reliefs include that: government does not know the overall cost of tax reliefs; there is a lack of systematic evaluation of them; and tax reliefs add to complexity

Oct 2019
HMRC, for the first time, has a complete list of all tax reliefs. This enabled HMRC to include tax expenditures in its annual tax reliefs bulletin for the first time

2019
HMRC's framework has been completed for all tax expenditures

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