



PROJECT BRIEFING

Self-employment Underreporting in the UK

Overview

UK tax administration (HMRC) has faced public demand for more efficient service delivery and greater accountability.

Driving much of this is the existence of the "tax gap" – defined as the difference between the amount of tax due to the Exchequer and the amount actually collected in any given year.

Historically, widespread evidence of self-employment underreporting has been found in tax audits and empirical studies*.

*Slemrod (2007), Hurst (2010), Schuetze (2010), Engström and Holmlund (2006)

Challenge

The self-employed are recognised as a group of potential non-compliant individuals due to the unavailability of third party reporting (*PAYE vs Self-Assessment*). The project uses calculations to estimate:

- How much self-employed people underreport their income?
- The characteristics of the self-employed that influence non-compliance?

Analysis

Econometric analysis was undertaken using data from the Living Costs/ Food Surveys 2010-12, with a sample of households with two married adults.

$$\ln C_{ij} = Z_i \alpha_j + \beta_j \ln Y_i' + \gamma_j SE_i + \eta_i$$

C_{ij} represents food consumption
 Z_i is a vector of households characteristics
 Y_i' represents reported income
 SE_i is a dummy variable capturing self-employment status



The Engel curve was estimated for food expenditure for both self-employed and employed to produce estimates of income underreporting. Assumptions were made that the self-employed report their income correctly and food expenditure is correctly reported by both groups.

Results



Calculations indicated that self-employed underreported their income by an average of 19.6%

Previous studies using PW Analysis:

Authors-Pub	Country	Year	Estimate SE underreporting
Pissarides and Weber (1989)	UK	1982	55%
Lyssiotou et al. (2004)	UK	1993	28%
Schuetze et al. (2002)	Canada	1990	11-23%
Johansson (2005)	Finland	1994-1996	17-40%
Engström & Holmlund (2006)	Sweden	1999-2001 and 2003-2004	30%
Hurst (2010)	US	1980-2003	30%

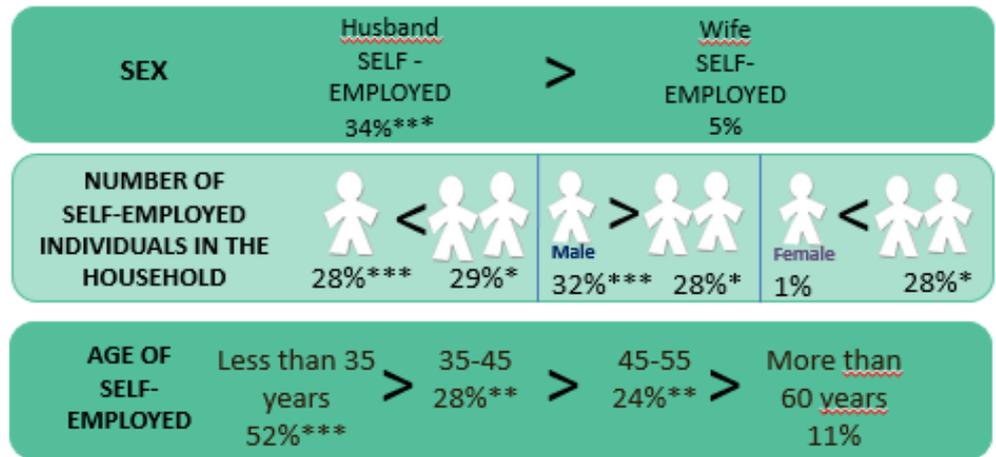
Findings

Is it underreporting?

The model was tested further to investigate whether the income-gap obtained using this approach can indeed be linked to underreporting by testing other plausible explanations that might cause a systematic gap between groups.

Other alternative explanations behind this gap were successfully ruled out which enforces the argument that it does in fact measure hidden income by the self-employed, for example by suppressing income or inflating business expenses.

Characteristics of non-compliance (% income underreporting)



Conclusions

- Non-compliance by self-employed households (more than 25% of income from self-employment) is estimated to be on average 28%.
- The link between the estimated income-gap and underreporting was investigated by testing other alternative explanations of the gap. The gap cannot be explained by differing preferences between the two groups, including savings behaviours, financial constraints and measurement error.
- Self-Employment underreporting varies by sex, age, and region which helps inform about the factors that correlate with non-compliance.
- The results are consistent with the behaviours found in previous studies, experiments and research conducted using audit data.



Find out more: -

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