National Audit Office

HM Revenue & Customs 2009-10 Accounts

Report by the Comptroller and Auditor General

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Summary

Scope of the audit

1 Section 2 of the Exchequer and Audit Departments Act 1921 requires the Comptroller and Auditor General (C&AG) to examine the accounts of HM Revenue & Customs (the Department) to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. The C&AG is also required by that Act to examine the correctness of the sums brought to account and to report the results to the House of Commons. The C&AG's audit opinion on the Trust Statement account and this report together satisfy that requirement.

2 We have examined the Department's activities and principal tax streams, and obtained evidence on the adequacy and operation of its regulations and procedure. This report sets out our overall conclusions from this examination, and our findings and recommendations in three areas which were a priority for the Department in 2009-10:

- the collection of PAYE (Part 2);
- debt management (Part 3); and
- Tax Credits (Part 4).

3 There are three broader issues that have influenced the Department's administration of tax in 2009-10:

- the **recession**, which has increased the value of tax debt to be recovered;
- the pressure on the Department to **increase efficiency** and **reduce its cost base**, which has required it to streamline many processes; and
- the **effectiveness of information systems** in providing information which enables it to manage tax collection effectively, for example by automatically linking a taxpayer's debts for all taxes. This is particularly important because the Department is increasingly adopting a customer **segmentation** approach, which identifies different types of taxpayer and adopts tailored approaches to communication and tax collection for each type. This requires sophisticated systems which provide a 'whole of customer' view of a taxpayer's position and the Department's interaction with them.

4 Our conclusions on the Department's overall management of the tax systems are based on our examination under Section 2 of the Exchequer and Audit Departments Act 1921, our value for money studies under the National Audit Act 1983, and consideration of the Department's Statement on Internal Control. Since our previous report on the Department's Accounts,[1] we have completed five value for money studies, resulting in the following reports:

- Review of errors in Guaranteed Minimum Pension payments (HC 878 of 2008-2009).
- Dealing with the tax obligations of older people (HC 961 of 2008-2009).
- HM Revenue & Customs' estate private finance deal eight years on (HC 30 of 2009-2010).
- Handling telephone enquiries (HC 211 of 2009-2010).
- The efficiency of National Insurance administration (HC 184 of 2010-2011).

5 We have begun work on two further value for money studies, to be published later in 2010, on the management of civil investigations, and working with tax agents. As part of a wider programme of work to validate the value for money savings reported by major government departments, we are undertaking a review of the Department's efficiency savings.

Conclusion

6 Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, we conclude that, in 2009-10, HM Revenue & Customs has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. This assurance is subject to the observations on specific aspects of the administration of taxes and tax credits in this report.

The collection of PAYE

7 In June 2009, the Department implemented a new National Insurance and PAYE Service (the new Service). This brought together its existing PAYE records with the National Insurance Recording System, allowing it to combine all information on individuals' employment and pension income in a single record for the first time.

1 *HM Revenue and Customs 2008-09 Accounts*, HC 464 Session 2008-2009.

The implementation of the National Insurance and PAYE Service

8 The introduction of the new Service has been difficult. The Department originally planned to implement it in June 2008 but this was twice deferred; first to complete aspects of its development and second to satisfy itself that the system infrastructure would meet operational demands. The Department estimates that as a result of the deferral it incurred a further £33 million of costs and was unable to realise £55 million of planned efficiency savings during 2008-09 and 2009-10. In addition, it estimates that changes to system requirements and implementation costs, including those to meet revised security guidelines, have added a further £78 million. The Department's latest business case now estimates the total cost of the project at £389 million, with expected savings of around £532 million over five years.

9 The re-phased implementation began in June 2009, with the full system functionality completed in April 2010 following the final software release. Although the initial implementation went well, problems in the quality of the Department's employment data and operation of the new Service have contributed to subsequent difficulties in processing:

- up to seven million potential over and underpayments of tax have yet to be processed as a result of delays in loading 2008-09 end of year returns onto the new Service. In addition, erroneous employment records have been generated due to the new Service's inability to match some of the end of year returns to existing records;
- work items (processing exceptions requiring manual review) were created at a much faster rate than the Department's operational team were ready to handle. To avoid breaching its 12.5 million capacity limit, the seven million potential over and underpayment items relating to the 2008-09 end of year processing were removed from the Department's new work management system. It now plans to begin the reconciliation of 2008-09 over and underpayments in August 2010; and
- significantly more amendments to tax codes were calculated than expected when the new Service first supported the annual generation of tax codes used by employers to calculate tax deductions from pay. The Department found that the new Service had the potential to generate up to 25 million coding notices, almost double the 13 million anticipated. A significant number of the amended codes were incorrect.

10 The Department only fully appreciated the extent of the data inaccuracies once the problem with the annual coding emerged in January 2010. It took action to prevent the notification of the majority of these codes to individuals and to ensure that none were issued to employers without checking and correction. Its recovery programme involved the review of over nine million records potentially at risk. It also deferred the automated reconciliation and clearance of the 2008-09 and 2009-10 end of year tax returns to carry out further checks on two million records that were potentially in error. The underlying problems with the new Service's functionality will only be fully rectified with further changes to the software supporting the annual coding and end of year reconciliation processes, which the Department intends to have in place for 2011.

11 The phased release of the new Service also meant that the functionality to support the automated reconciliation of individuals' PAYE records was not available to the Department between July 2009 and April 2010. Although it set up a process to manually work open cases going out of date, it was not able to work the bulk of the backlog of 18.2 million un-reconciled cases from 2007-08 and previous tax years affecting around 15 million people. Many of whom may not be aware that they have overpaid tax and are due a refund or, where they have underpaid, that they are liable to make further payments. The amounts involved are substantial, which early analysis suggests could in aggregate lead to tax repayments and recoveries of £3.0 billion and £1.4 billion respectively.

Action being taken by Department

12 The Department is undertaking a review of the annual coding exercise to identify lessons learned and further actions not addressed by its recovery programme. It has also launched a follow-up programme to stabilise the new PAYE service, including further modification to aspects of the computer system and operational practices, with the aim of balancing the delivery of the PAYE operational workload. It is considering a proposal to manage clearance of legacy open cases, those relating to 2007-08 and prior years, which predate the implementation of the new Service.

Recommendations

a **The Department has a programme underway to stabilise service delivery. It is examining the root causes of data quality issues in the new Service, their impact, and approaches to their resolution.** To minimise the risk of inaccurate or incomplete data entering the new Service, it should:

- review the systems for capturing and processing data before it enters the new Service and assess the scope for improving data quality through more stringent validation;

- review the standards for the quality of data submitted by employers and other stakeholders, take steps to educate and support them in their achievement, and identify those who persistently fail to comply for targeted follow up;
- set targets for the lead time allowed to clear critical work items taking account of the risks to the accuracy of employment data; and
- to minimise the impact of over and underpayments of tax identified through the end of year reconciliation process, set targets for the accuracy of tax codes issued to individuals and their employers.

b **The Department is proposing to review its PAYE operating model as part of its programme to stabilise the new Service. The uncertainty over the PAYE operating model and the backlog of open cases make it difficult for it to forecast the overall workload and the operational resources required to deal with it.** It is imperative that the Department stabilises the performance of the new Service so that work items are cleared promptly and, at the very least, are not carried over into the following tax year. The Department should also set a clear timetable for completing this work and clearing the backlog of open cases.

c **The Department previously planned to reach a steady state in the clearance of open cases by 2010 where open cases were cleared for each tax year and there were no backlogs for earlier years. Based on its latest plans, the backlog of open cases will take a further four years to clear.** The Department should:

- prioritise the clearance of cases where it believes the taxpayer has overpaid tax;
- examine the scope for accelerating the clearance of the backlog through the use of automated solutions rather than manual working; and
- re-assess the scope to identify and exclude underpayments of tax where recovery is unlikely to represent value for money.

Debt Management

13 Over the last year the Department's Debt Management and Banking Directorate (the Directorate) has increased the value of debt recoveries by £5.6 billion to £67.9 billion, despite the recession making debts more difficult to recover. At the end of March 2010 the total level of receivables[2] in the Department's accounts was £26.1 billion, compared to £27.7 billion as at 31 March 2009.

2 Receivables in the Trust Statement represent amounts due from taxpayers in respect of established liabilities at the end of the reporting period for which payment has not been received. Debt is passed to the Directorate at the point when payment is overdue.

14 The Department has continued to develop its approach to collecting debt. It has a range of activities underway including a number in response to recommendations we have previously made on improving debt management, such as the strengthening of risk profiling and managing debt through a single system. The Department has also introduced new payment methods and trialled the use of private sector debt collection agencies.

15 During 2009-10, it introduced a campaigns-based approach to debt collection in each of the major taxes. Each campaign is individually designed, tailoring and coordinating recovery actions to the Department's analysis of the debt and debtor behaviour, including the earlier identification of cases for enforcement. In 2009-10, as the new approach began to be rolled-out, campaigns collected £2.8 billion, representing less than 5 per cent of all debt collected in the year. The Department is extending the campaigns-based approach rapidly and plans to implement it across all taxes by October 2010.

16 The Department's evaluation of these initial campaigns suggests an improvement in the rates of collection and staff productivity compared with its traditional debt collection processes. However, the information currently available to management does not readily allow comparison of performance between campaigns or with the previous debt collection approach.

17 The Department's management information systems do not currently provide the necessary analysis of debt and customer behaviours to support the campaigns-based approach. It currently relies on ad hoc data analysis to support the planning and delivery of individual campaigns, but this does not allow it to analyse debt and monitor performance in real-time and thus limits its flexibility to reconfigure campaigns and redeploy resources where its risk assessment changes. It currently plans to implement enhancements to its information systems in 2011-12 to support its analysis of debtors and management of campaigns.

18 In addition to improving its approach to collection, the Department has continued to assist taxpayers by providing faster access to time to pay decisions. Between November 2008 and March 2010, its Business Payment Support Service agreed over 300,000 time to pay arrangements valued at some £5.2 billion. It has estimated that businesses are paying over 90 per cent of time to pay arrangements on time.

Recommendations

d **The Department has developmental work underway in a number of areas to further improve its management of debt.** It should continue with its plans and, in particular, press ahead with work to establish a mechanism to systematically measure the performance of campaigns. It should:

- establish a consistent set of measures, including their cost and effectiveness, to allow comparisons to be made across campaigns and over time. These measures should also link with the Department's new top-level debt management targets of the value of debt overdue by 30 and 90 days, and to the clearance of aged debt;
- set specific targets when planning individual campaigns. These targets can then be used to assess the performance of each campaign and of the campaigns-based approach; and
- introduce a process to assure the data supporting the set of measures.

e **The Department is extending the campaigns-based approach to embrace all of its debt collection activity. It is undertaking a number of initiatives to support the roll-out of the approach and produces detailed plans for each individual campaign.** To ensure that it can resource the larger number of campaigns appropriately, it should put together an overall plan showing the number and type of staff skills, training and management oversight required across all campaigns and regularly review this plan as campaigns are running.

Tax Credits

Error and fraud

19 In 2009-10, the Department paid a net £27.3 billion in Child and Working Tax Credits to more than six million families. It estimates that error and fraud resulted in payments of between £1.95 billion and £2.27 billion being made to claimants incorrectly and between £0.20 billion and £0.31 billion not being paid to claimants due to error. The levels of error and fraud are material within the context of the £27.3 billion spent on tax credits. As this expenditure has not been applied to the purposes intended by Parliament and does not conform with the requirements of the Tax Credits Act 2002, the Comptroller & Auditor General has qualified his opinion on the regularity of the tax credits expenditure reported in the 2009-10 Trust Statement.

20 The Department has a target to reduce error and fraud to not more than 5 per cent of the value of finalised entitlement by March 2011. Because of the time lag in producing error and fraud estimates, the Department will not be able to assess if it has achieved this target until the summer of 2012. To provide a measure of its progress, it has set targets for the amount of error and fraud it needs to prevent each year. It calculated that it needed to prevent £650 million of error and fraud by the end of March 2010. It aims to prevent £1 billion of error and fraud by March 2011 and £1.4 billion by the time the awards for 2010-11 are finalised in July 2011.

21 In April 2009, the Department launched a new strategy for reducing error and fraud, targeting claims where error and fraud is most prevalent. This included improving support to claimants, new approaches to identifying and preventing error and fraud from entering the system, and enhanced risk assessments. There is evidence that the new approaches are beginning to deliver positive results. Taken together, the Department estimates that its interventions on individual awards led to a reduction of error and fraud of £569 million in 2009-10; this compares with £253 million in 2008-09. It is continuing to develop its measurement of intervention yield and strengthen its assurance activities to increase the consistency and accuracy of measurement.

22 In aggregate, the Department estimates it prevented error and fraud of £656 million, in excess of its target of £650 million. This estimate includes the Department's assessment of the impact of its communications (£30 million) and the wider deterrent effect of its interventions (£57 million) both of which are difficult to measure objectively.

Recovery of overpayments

23 The adjustment of tax credits awards at the end of each year to reflect claimants' actual circumstances can result in over and underpayments. While the annual level of tax credits overpayments continues to fall, the Department has been less successful in recovering the backlog of overpayments from previous years. At the end of March 2010, the amounts to be recovered by the Department had increased to £4.5 billion, of which £1.3 billion is being recovered by adjusting ongoing awards. Of the balance, £2.4 billion relating to awards that are no longer in payment has been passed to the Debt Management and Banking Directorate to be recovered directly and a further £0.8 billion is yet to be transferred, in some cases because the overpayment is disputed.

24 The Department's collection rate for tax credits debt is substantially lower than for tax debts. In 2009-10, direct recoveries were £202 million, less than 10 per cent of the total value of the £2.4 billion of tax credits debt with the Directorate. This is partly because of the financial difficulties which claimants face and their inability to repay, and partly because of the Department's debt collection priorities which have led the Directorate to focus its recovery action on higher value tax debts, rather than the comparatively lower value tax credits debt. The Department continues to work to identify and clear all of the debt which it is uneconomic to collect from its debt system.

Recommendations

f **The Department currently has little information to assess the relative vulnerability of each stage of the tax credits process to error and fraud.** To assist in the targeting and design of future interventions in those areas of greatest risk, it should undertake further analysis to understand the root causes of error and fraud and where and how these enter the system.

g **The accurate measurement of error and fraud prevented across the wide range of interventions is essential to assessment of the delivery of the Department's strategy.** The Department needs to put in place improved guidance and quality control procedures to improve the accuracy and reliability of intervention yields.

h **The Department is taking steps to improve its analysis of tax credits debt to give a better measure of the claimant's ability to repay. It will use this analysis to support the targeting of its collection of debt arising from the 2010 renewals process.** The Department should:

- set a clear timetable for extending its analysis of tax credits debtors' ability to pay to cover all debt currently identified for direct recovery;
- use this analysis to help it to identify those debts which are uncollectible or uneconomic to collect for write-off; and
- bring all remaining tax credits debt into active recovery by extending the campaigns-based approach to include debts outstanding from previous years.

Part One

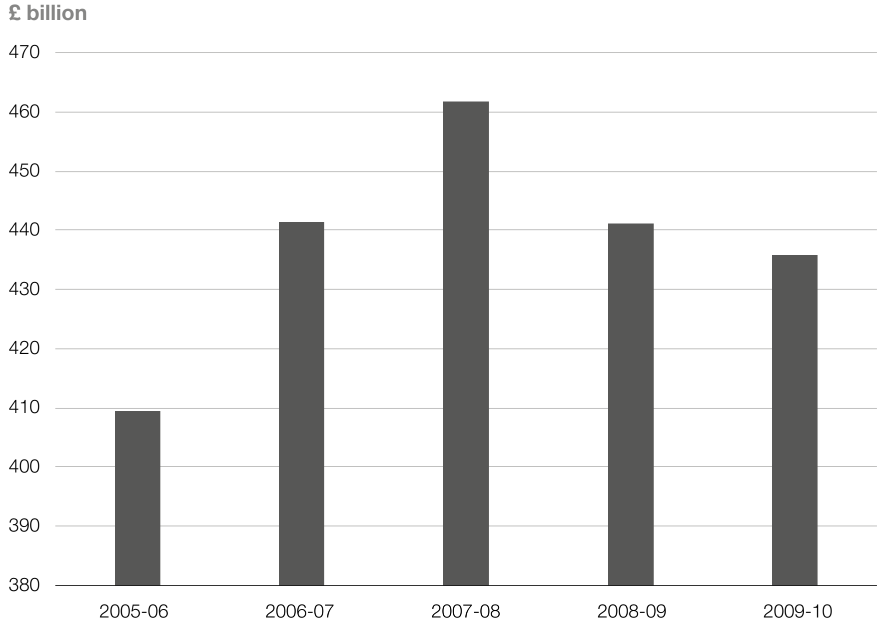
Introduction

Tax revenues in 2009-10

1.1 In 2009-10, total revenues accruing to the Department were £435.1 billion, £5.9 billion (1.3 per cent) lower than in 2008-09.[3] **Figure 1** shows the tax revenues reported in the Department's Trust Statement in the last five years.

1.2 **Figure 2** overleaf shows the changes in tax revenues between 2008-09 and 2009-10. The largest decreases in revenues were in Corporation Tax, Capital Gains Tax and Petroleum Revenue Tax. These were partly offset by increases in Hydrocarbon Oils Duties and Tobacco Duties.

Figure 1
Total revenue 2005-06 to 2009-10



Source: HM Revenue & Customs

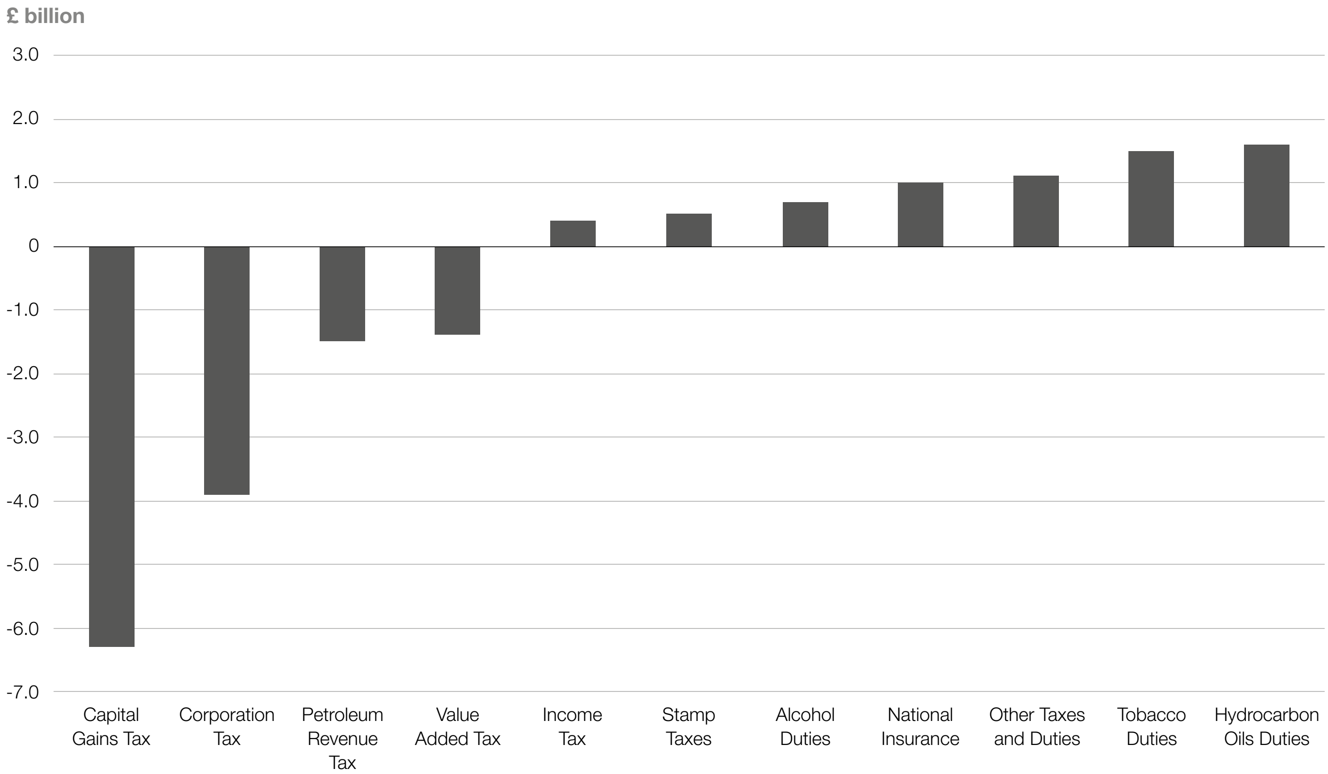
3 From 2009-10, tax credits expenditure is no longer classified in the Statement of Revenue & Expenditure between negative taxation and payments of entitlement. To ensure comparability with 2009-10, prior year revenue figures have been restated to exclude tax credits expenditure previously classified as negative taxation.

1.3 Accrued Revenue Receivable, the tax and duties relating to the financial year but not yet due to be paid, was £15.6 billion (24 per cent) higher at 31 March 2010 than at 31 March 2009. This reflects the improving economic situation. Although the economic downturn led to cash receipts for Income Tax being lower than in 2008-09, this was offset by the increase in accrued revenue receivable meaning that overall Income Tax revenue changed little. The reasons for the main changes in revenues are:

- **Capital Gains Tax: £6.3 billion (77 per cent) decrease.** The decrease is due to taxpayers having brought forward disposals in prior years to take advantage of temporarily lower rates, and to falls in asset values affecting the volume and value of disposals.
- **Corporation Tax: £3.9 billion (9 per cent) decrease.** The decrease is due to lower profits as a result of the economic downturn, mainly in the offshore sector, where production levels and gas and oil prices were lower, and in the financial sector.

Figure 2

Changes in 2009-10 tax revenues compared to 2008-09



Source: HM Revenue & Customs

- **Petroleum Revenue Tax: £1.5 billion (60 per cent) decrease.** The decrease is due to lower gas and oil prices, and lower production volumes.
- **Value Added Tax: £1.4 billion (1.8 per cent) decrease.** The decrease in revenue is due to the temporary reduction in the VAT rate from 17.5 per cent to 15 per cent from 1 December 2008 to 1 January 2010.
- **Tobacco Duties: £1.5 billion (19 per cent) increase:** The increase is mainly due to an increase in the duty rate, a fall in the amount of foreign travel and the euro exchange rate reducing the incentives for cross-border travel and fraud.
- **Hydrocarbon Oils Duties: £1.6 billion (6 per cent) increase:** The increase is primarily due to increases in the duty rate.

1.4 Receivables, amounts due from taxpayers but not yet paid, decreased by £1.6 billion (5.8 per cent) to £26.1 billion, reflecting the Department's improved performance in collecting debt.

The Department's objectives for 2009-10

1.5 Departmental Strategic Objectives (DSOs) set out for Parliament and the public what government departments will deliver in return for their funding. DSOs are underpinned by key indicators for measuring progress, against which Departments publish their performance. The Department has two DSOs for the Spending Review period 2008-09 to 2010-11:

- DSO 1: Improve the extent to which individuals and businesses pay the amount of tax due and receive the credits and payments to which they are entitled; and
- DSO 2: Improve customers' experiences of the Department and improve the UK business environment.

1.6 In its 2009-10 Business Plan, the Department set out four further enabling objectives, and the actions that it would take in 2009-10 to achieve all six objectives. The four enabling objectives were: improving professionalism; delivering an affordable and sustainable cost base; motivating and developing staff; and exploiting information and technology services.

1.7 In addition to these objectives, the Chancellor of the Exchequer sets out his strategic priorities for the Department in an Annual Remit letter. In his letter for 2009-10, the Chancellor acknowledged the progress the Department had made in setting its strategic direction with the new DSOs and 2009-10 Business Plan. He set the following priorities for the year:

- protecting tax revenues in the economic downturn by reducing debt, and tackling abusive avoidance, evasion and non-compliance;
- reducing tax credit fraud and error and improving the take-up of working tax credit;
- implementing the 'Modernising PAYE Processes for Customers' (MPPC) programme;
- implementing the remaining recommendations of the Poynter Review on data security; and
- achieving value for money savings by delivering workforce change.

1.8 As well as delivering the Chancellor's priorities in 2009-10, the Department had to fulfil its commitment to a 5 per cent year on year real terms reduction in funding over the period 2008-09 to 2010-11. It is aiming to deliver efficiency savings across its three principal areas of costs: staff, accommodation and IT. It reduced its staff from 84,000 to 69,300 in the two years to April 2010. As well as reductions in staff numbers, its plans for workforce change include redeploying staff, ensuring they have appropriate skills, and improving employee attendance and engagement. We are undertaking a review of the Department's savings as part of a wider programme of work to validate the value for money savings reported by major government departments.

1.9 The Department also continued with its Transformation Programme in 2009-10. The Programme includes expanding the take-up of online services, launching an integrated National Insurance and PAYE Service; improving the tools and processes used in compliance and enforcement; reducing the size of its estate; delivering retail banking to all government departments; and delivering a single government website for businesses. In 2010-11, the Department's strategy is to focus on understanding different groups of taxpayers and tailoring its engagement with them according to their willingness and ability to meet their obligations.

Changes in the Department's powers and scope

1.10 In 2009-10, there were two major changes affecting the Department's powers and scope: the formal creation of the UK Border Agency, and the start of a new penalty and compliance checking regime for the largest taxes. A new tax, the bank payroll tax, was also introduced in December 2009.

Powers Review

1.11 The Department's review of its powers, deterrents and safeguards (the Powers Review) started in 2005 following the merger of the Inland Revenue and HM Customs & Excise. The aim of the Powers Review is to modernise tax penalties, compliance checks, and the Department's investigative powers, and to align them across taxes.

1.12 The new penalties regime applies to returns due on or after 1 April 2009 for Income Tax, VAT, PAYE, National Insurance contributions, Corporation Tax, Capital Gains Tax and the Construction Industry Scheme. A new compliance checking framework also began for the largest taxes on 1 April 2009. This introduced new inspection and information powers, and aligned record-keeping requirements. It also aligns the time limits for compliance checks and claims to four years for these taxes. The penalty regime and compliance checking framework were extended to most other taxes and duties from 1 April 2010.

1.13 The Powers Review has also introduced measures to make debt collection more efficient, and simplified and harmonised the interest chargeable on late payment of tax.

UK Border Agency

1.14 During 2009, the UK Border Agency, an agency of the Home Office, took on statutory responsibility for protecting the UK's borders against illicit and harmful trade, with 4,841 of the Department's staff formally transferring to the new agency.

Bank payroll tax

1.15 Legislation in the Finance Act 2010 introduced a new bank payroll tax. The gross receipts are forecast to be £2.5 billion before taking into account the potential impact on other tax revenues. This tax is payable at a rate of 50 per cent by banks on banking employees' bonuses exceeding £25,000. The tax applied to all discretionary and contractual bonuses from the time of its announcement, on 9 December 2009, to 5 April 2010. Payment is due on 31 August 2010.

Part Two

The collection of PAYE

Introduction

2.1 In 2009-10, the Department collected £150.0 billion in Income Tax and £99.0 billion in National Insurance contributions (NICs), through Pay as You Earn (PAYE) and Self Assessment. Under PAYE, employers deduct Income Tax and NICs from employees' pay and pay it directly to the Department. This Part of our report considers the recent changes the Department has made to the computer systems to support the collection of PAYE.

The PAYE Process

2.2 Employers and pension scheme administrators (collectively referred to as employers) are responsible for administering PAYE schemes on behalf of the Department by ensuring that the correct amounts of tax and NICs are deducted from employees' earnings and paid over to the Department each month. The Department issues a tax code for each employee, so that employers can calculate how much tax to deduct. Tax codes are determined by individual taxpayers' circumstances and are revised to reflect relevant changes notified to the Department. While employers submit monthly returns of total deductions from employees and payments made to the Department, it is only when they submit their annual returns that they provide information on total earnings, tax deducted, NICs and statutory payments under each PAYE scheme and for individual employees. These enable the Department to update the individual's record and reconcile their earnings to the tax and National Insurance paid to identify any over or underpayments. **Figure 3** outlines the main stages in the PAYE process.

Figure 3
Key stages in the PAYE Annual Cycle

Annual Coding (prior to new tax year)

HMRC issues coding notices to both individuals and employers, based on latest known information.

Employers apply the new tax coding to individuals for the purposes of determining net pay and tax deductions.

Individuals contact HMRC with questions relating to their new tax coding.

In year processing

Employers deduct tax (using tax code) and National Insurance Contributions and pay these to HMRC.

The majority of employers make monthly payments.

Employers send HMRC information about employees starting or leaving.

HMRC updates its records for employee movements and provides employers with a tax code for new employees.

End of year returns

Employers send HMRC information about total amounts of tax and National Insurance deducted and paid over in the year, together with details of employment income and deductions by employee.

HMRC matches monthly deductions paid to the amounts declared in the End of Year returns.

HMRC collects any underpayments and repays any overpayments.

End of year reconciliation

HMRC matches returns for individuals to its records and reconciles their tax and National Insurance deductions with their employment income.

HMRC updates its records of pay and tax details and issues a revised tax coding notice, where necessary.

Where additional tax is payable, HMRC may adjust the tax code for a subsequent year to collect the balance through the PAYE system, or the individual can pay the amount in full immediately. HMRC repays any overpayments of tax.

Individuals may contact HMRC if they deem the tax paid in year to be incorrect.

Source: HM Revenue & Customs

The challenges of administering PAYE

2.3 We have previously reported on the challenges the Department faces in administering PAYE in the modern employment environment.[4] The Department's former PAYE computer systems were designed at a time when it was usual for people to have one source of employment and not change employer very frequently. The systems therefore structured records around employments rather than individual taxpayers, and these were held in 12 regional databases which were assigned to specific tax offices. Working patterns have changed, with many taxpayers having more than one job or frequently moving jobs (such as students), and the number of people with multiple sources of income (such as working pensioners) has increased. As the Department's records of some individuals' employments have become spread across more than one of its regional databases, it became increasingly difficult for it to bring together a complete picture of an individual's employments identifying all relevant sources of income, increasing the risk of people paying the incorrect amount of tax.

2.4 The challenges in processing PAYE have contributed to an increase in the volume of cases identified through the Department's end of year reconciliation process that require manual checking. 'Open cases' arise where the PAYE system identifies discrepancies in taxpayer records or where end of year returns are not matched to an existing record. Delays in clearing these records can mean delays in notifying taxpayers if additional tax is payable or refunds are due. At the end of March 2010, there were 18.2 million open cases relating to the 2007-08 and preceding tax years, affecting an estimated 15.4 million customers. The extent of over and underpayments of tax in this population can only be determined when the open cases are worked. However, early analysis by the Department suggests that around half of all these cases are likely to involve an over or underpayment of tax and in aggregate these may lead to repayments and recoveries of the order of £3.0 billion and £1.4 billion respectively.

The New PAYE Service

2.5 In June 2009, the Department implemented the new National Insurance and PAYE Service (the new Service) which involved a major upgrade to its PAYE systems, bringing together the National Insurance Recording System and its existing PAYE employment records to combine all information on individuals' employment and pension income. The new Service represents the final stage in a long term programme to modernise the collection of PAYE with the objective of improving the quality of processing, customer service and accuracy of tax collected, which began when online filing of employers' end of year returns started in 2005.

4 Report by the Comptroller and Auditor General, on *HM Revenue & Customs 2005-06 Accounts*, HC 1159, Session 2005-2006.

2.6 The new Service introduces a single record for an individual's PAYE pay and tax details irrespective of the number of sources of income they have, which should result in more accurate tax codes and reduce the likelihood of individuals over or underpaying tax. In addition, replacing 12 regional databases with a single national database allows the Department to deal with the majority of enquiries at first point of contact and to manage demand for operational services nationally rather than by region.

2.7 A key function of the new Service is its workflow management system, which allows the Department to identify processing exceptions for manual review by staff. For the first time, the new Service provides the Department with a national picture of such exceptions which it can prioritise and assign to the processing offices that have the capacity to deal with them.

2.8 The new Service also offers efficiency savings. In its business case the Department planned to reduce the number of staff engaged on PAYE processing by the equivalent of 2,034 full time posts. Overall, based on its revised business case, the Department expects to save around £532 million over five years, and to recover its investment of £389 million by 2013.

Delays in implementation

2.9 The Department originally planned to implement the new Service in June 2008 but deferred its implementation twice, first to October 2008 and then to spring 2009. The first deferral was to allow the Department to complete the development of key aspects of the system. The second deferral was caused by uncertainty about the system's ability to support expected volumes of transactions. The Department took the view that it was better to defer implementation again than to put the operation of PAYE at risk. As a consequence, end of year returns for the 2007-08 tax year were processed by the predecessor system rather than the new Service.

2.10 The Department revised its business case to reflect the impact of its decision to defer implementation of the new Service and other project changes. It estimates that as a result of the deferral it incurred a further £33 million of costs and was unable to realise £55 million of planned efficiency savings during 2008-09 and 2009-10. In addition, it estimates that changes in system requirements and implementation costs, including those to meet revised security guidelines, have added a further £78 million to the cost of the project.

2.11 Following the second deferral, the Department made significant changes to the way the PAYE modernisation programme was governed. It recruited a new programme director, introduced a new programme governance structure, changed the risk and stakeholder management processes, and appointed consultants to provide assurance on specific aspects of the new Service. To reduce the risk to implementation and minimise the disruption to PAYE processing, the consultants advised that the timetable for the implementation should be broken down into more manageable stages. The Department therefore chose a phased approach based on three system releases, with the aim of delivering the maximum functionality in the first release.

2.12 The first release in June 2009 delivered core PAYE functionality which included the creation and maintenance of taxpayer and employment details, tax code calculations and aspects of end of year processing. It also involved the migration of data into the new Service and the transfer of users to the new system. Two further phases in November 2009 and April 2010 completed the release of the system software, including more complex functionality for end of year reconciliations and real time management information.

2.13 One consequence of the decision to phase the implementation of the new system and defer the end of year reconciliation functionality was that, between June 2009 and April 2010, the Department did not have the system capability to work the backlog of 18.2 million un-reconciled cases from previous tax years. Although it set up a process to manually work open cases relating to 2003-04 before the statutory deadline for their clearance passed.

2.14 The Department's decision to defer the implementation of the new Service from October 2008 to June 2009 was justified. Aside from the concerns around the capacity to support the expected volume of transactions, there is further evidence to suggest that the system was not ready for implementation in October 2008. At the time the decision was taken in June 2008 to defer implementation, the Department understood that system software was fully developed and ready for implementation. However, subsequent system and business testing in the run-up to implementation identified over 4,600 defects in the system software and 109 omissions from the original specification. The resolution of these issues within the revised timetable placed additional demands on the programme, although all identified system omissions and all but 57 of the lower priority defects were resolved prior to the system being implemented in June 2009.

2.15 The Department assessed the severity of these remaining defects in terms of their impact on customers and on the operation of the system. In the light of this analysis it decided to proceed with the implementation rather than delay it any further. It introduced manual workarounds to address these known weaknesses until the required enhancements to the system could be implemented in the later releases. It estimated that these workarounds would delay its planned redeployment and release of up to 500 operational staff.

2.16 The Department planned and tested the transfer of data to the new Service through a series of trials, before migrating all data in June 2009. The data transfer involved the alignment of 54.3 million live taxpayer PAYE records across the 12 regional databases into 45.4 million distinct customer employment records on the new database.

2.17 The integrity of the information held on individual employments was not validated prior to migration. While the Department accepted that further work to update and correct some employment data in the period following implementation would be required, it assumed that the exceptions processes it had put in place would be sufficient to correct data inaccuracies as it received up to date information from employers. However, evidence from the initial operation of the new Service suggests that the Department did not fully appreciate the extent of risk from data inaccuracies or its implications for the delivery of PAYE.

Operation of the New Service

Roll-out of the New Service

2.18 The implementation of the new Service was a significant undertaking, involving the progressive roll-out to 650 locations and 23 business units across the country over several months and the transfer of 28,500 staff onto the system. The Department also delivered a training programme for all system users in advance of the new Service's implementation and established arrangements to ensure that teams had technical support and guidance through the transition.

2.19 The initial implementation went well with the new Service operating as intended and staff being able use its online functions without any major issues. The Department's transition team, which was established to support staff through the initial implementation period and respond to any issues arising from live operation, was disbanded several weeks ahead of schedule. It was only later that the Department began to experience difficulties with the late running of the processing of 2008-09 returns, a build up in work items, and the problems with 2010-11 annual coding. These issues are considered in the following paragraphs.

Processing 2008-09 Returns

2.20 Delays in loading and reconciliation of end of year returns have prevented the processing of over and underpayments of tax for the 2008-09 tax year. The Department had planned to process the returns for the 2008-09 tax year in the summer of 2009, but software problems prevented posting of 2008-09 data to the new Service until November 2009. In previous years, end of year processing would usually start in April and be largely complete by October.

2.21 As the full system functionality, including the capability to automatically clear certain reconciling items, would not be available until April 2010, the Department had intended to work these items manually. However, when the Department was able to run the reconciliation of 2008-09 returns in mid-December, it identified in excess of seven million over and underpayments. Because of the delays in processing, it had effectively lost the opportunity to work these cases and make any necessary corrections to its PAYE data before it was due to run the 2010-11 annual coding exercise. As a consequence, in January 2010, it decided to defer the reconciliation of these items until the automatic clearance capability was available. These items will now be processed from August 2010, although it is not yet clear how many cases will clear automatically and how many will be left for manual working.

2.22 In addition to contributing to the delays in finalising the 2008-09 tax year, the problems in matching end of year returns with employment data led to the system generating erroneous employment records. This is because, unlike the predecessor system, the new Service automatically creates an employment where it receives information it cannot match to an existing record. In some instances, most notably when an occupational pension is reported to the Department for the first time, the new Service will create a work item which has to be examined promptly to safeguard against subsequent errors in processing. However, in most instances, the creation of a new employment is not flagged as a work item in the new Service. This means that erroneous employments could have been created in the new Service which were not identified for further review.

Managing Work Items

2.23 The new Service's work management system identifies exceptions and other actions (work items) arising from PAYE processing which require resolution by operational staff. Unlike its predecessor system, the new Service allows management to prioritise work items and allocate staff according to national priorities. There are currently almost 150 different types of work items relating to a range of exceptions, for example:

- discrepancies between employers' records and those held on the system;
- discrepancies arising on the validation of tax details;
- over and underpayments of tax outside system tolerances; and
- where it automatically creates a new employment, for example, on receipt of an end of year return for an employment not previously identified on the system.

2.24 In the period up to December 2009 the Department found that work items were being created at a much faster rate than it was able to work. There was a risk that the 12.5 million capacity for open (unworked) items in the work management system would be breached. This risk materialised when the Department eventually processed 2008-09 returns data on the new Service generating an additional seven million items. This led it to remove these items from the work management queue and reschedule them for processing in August 2010. Following this, the total number of open work items has fallen to, and has stayed within the range of 6 to 8 million, and within the capacity of the work management system.

2.25 Not all exceptions identified by the new Service are flagged as work items. In May 2009, the Department introduced a mechanism which allows it to prevent certain lower priority exceptions from entering the work item queue. The Department does not have a precise figure, but estimates that approximately 10 million lower priority exceptions in the period up to March 2010 were prevented from entering the work item queue. The Department estimates that half of the exceptions relate to the initial transfer of data into the system.

2.26 Accurate employment data is fundamental to the effective working of the new Service. The delay in clearing some of these work items increases the risk of inaccurate employment data in the system. In certain circumstances these inaccuracies could potentially lead to errors in tax codes being operated by an employer, or errors in repayments or demands for payment being issued by the Department.

2010-11 Annual Coding

2.27 In January 2010, the Department began to issue annual coding notices for the 2010-11 tax year, informing individuals and their employers how much tax-free income they are entitled to. This was the first time that the new Service had supported annual coding, and the Department had previously estimated that it might issue around 13 million coding notices to individuals, approximately 10 per cent more than in previous years. In the event, the Department found that the new Service had produced significantly more amended tax codes than expected, with the potential to generate up to 25.8 million coding notices, almost double the amount anticipated. A significant number of the codes generated were incorrect.

2.28 The Department was not fully aware of the extent and nature of the errors in coding notices until it started to receive more calls to its contact centres. Individuals were reporting that they had received coding notices containing incorrect allowances, or relating to jobs held years before or jobs never held, and duplicating previous notices. At its peak, the Department received over 18,000 telephone calls per day relating to erroneous coding notices. The errors affected taxpayers in groups with more complex tax affairs, including those with more than two jobs and many pensioners. The errors arose where the Department's and employers' records did not match, and to a lesser extent from processing failures which led to notices being generated for invalid employments and incorrect coding calculations.

2.29 In January 2010, the Department established a recovery programme to identify and prevent the issue of any further incorrect coding notices to individuals and ensure that corrected coding notices were issued to employers in time for the 2010-11 tax year. At that point it had already issued 3.2 million coding notices that were at risk of being incorrect to 2.3 million individuals, but was able to stop a further 3.8 million individuals from receiving a coding notice at risk of being incorrect by intervening to prevent their despatch pending investigation. It also launched a programme of communications with stakeholders.

2.30 The Department reviewed the 45 million employment records on its database and identified 9.3 million records potentially at risk of error. It took steps to ensure that no codes for these customers were issued to employers before they had been checked and, if necessary, corrected. It also prioritised the clearance of records identified as being at risk. By the end of March 2010, it had reviewed 6.6 million records, either through an automated process or, where automated repair was inappropriate, by manual investigation. Where an error in coding was identified a corrected notice was issued to the employer in advance of the new tax year. At its peak, in addition to the 1,600 already dealing with work items, the Department diverted a further 2,400 staff away from its usual operations supporting personal tax customers to assist in the recovery programme.

2.31 For those employments where a notice was not issued, it asked employers to operate the previous year's code until advised otherwise. The Department has reviewed all at risk cases and is nearing completion of its programme to issue revised coding notices where required.

End of Year Processing

2.32 In the light of the errors in annual coding, the Department recognised that data inaccuracies could lead to further errors in processing and work items. It was concerned that any further errors in data could adversely affect the end of year reconciliation. As a precaution it performed further scans of the database to identify any records where the now known data issues could affect the end of year reconciliation. At the end of June 2010, the Department had identified a further two million records at risk and needing review. It plans to start its bulk processing of the end of year reconciliation for 2008-09 returns in August 2010, after these potentially erroneous records have been identified and corrected or excluded from the end of year reconciliation.

Accuracy of Processing

2.33 The new Service offers the Department the potential to raise processing accuracy due to the increased proportion, around 90 per cent, of work items being cleared automatically under the new Service, compared with around 70 per cent in the former PAYE system. The Department's quality monitoring shows that in 2009-10 it achieved an overall accuracy rate of 95.3 per cent in processing PAYE work items against a target of 96.5 per cent. This compares with 96.2 per cent achieved in 2008-09.

2.34 The principal reason for the failure to achieve the target was a fall in the accuracy of manual processing, which fell to 80 per cent for the year as a whole compared to a target of 89 per cent. The Department considers this dip is mainly because of the scale of the culture shift required for staff to adjust to new ways of working and follow the new processing guidance. In the period following the implementation of the new Service, the accuracy of manual processing fell to its lowest level of 71.8 per cent in November 2009, before returning to 84.1 per cent by March 2010, in line with the level achieved prior to the new Service's implementation. This improvement is partly explained by the prioritisation of specific work items to support annual coding recovery.

2.35 The Department estimates that PAYE processing errors resulted in £132 million of underpayments (compared to £114 million in 2008-09) and £238 million of overpayments (£96 million in 2008-09).

Action being taken by Department

2.36 The Department is undertaking a review of the annual coding exercise to identify lessons learned and further actions not addressed by its recovery programme. The review examines the root causes for the problems; their impact on customers; compliance with established process and policies; the governance process and its application; and the financial impact of cost overruns, delayed benefits and recovery costs.

2.37 The Department closed its PAYE modernisation programme in June 2010. In its place it has launched a successor programme to stabilise the PAYE service delivery. The Programme's three key elements and their objectives are:

- Operational Delivery: to maintain the balanced delivery of the PAYE operational workload, including recovery, to minimise stakeholder impacts and implement working practice changes that optimise the use of resources;
- Stabilisation: to ensure the successful and complete recovery for all PAYE business events, and identify and implement, in 2010-11, solutions that eliminate the root causes of PAYE processing errors; and
- Enhancement: to enhance Personal Tax Group operations to permit a flexible and balanced delivery to customers.

2.38 The Department has set up a project to manage clearance of legacy open cases, those relating to 2008-09 and predating the new Service implementation. Due to the difficulties encountered in implementing the new Service, it has resumed work on open cases in June 2010, focusing on overpayments, but only expects to clear 1.2 million cases by March 2011. It is considering the options available to clear larger numbers of open cases by a combination of automated clearance and manual working. It is also exploring the option of not working lower priority cases, although it will continue to give priority to cases where a customer has potentially overpaid tax.

Part Three

Debt Management

Introduction

3.1 In his July 2009 remit letter to the Accounting Officer, the Chancellor of the Exchequer stated that "during the economic downturn it is vital that HMRC focus on safeguarding the flow of revenue to the Exchequer." He asked that "steps be taken to actively manage and reduce the £27.7 billion stock of tax debt over the year."

3.2 In November 2008 we reported[5] that the Department needed to improve its debt management by: strengthening risk profiling; managing debt through a single system; linking and pursuing together debts owed by an individual taxpayer on different taxes; using more innovative methods for communicating with customers; and improving the efficiency of its telephone centre operation. Our Report on the Department's 2008-09 Accounts[6] also highlighted the growth in tax debt and the need for the Department to actively manage debt in the face of the increased risk of default by tax debtors during the recession. The Department has developmental and other work underway, and this part of the Report examines the steps it is taking in revising its approach to debt management.

2009-10 performance

3.3 At the end of March 2010, the receivables[7] balance in the Department's Trust Statement was £26.1 billion, compared to £27.7 billion as at 31 March 2009. **Figure 4** shows key collection statistics for 2009-10 and 2008-09. The Department did not have a formal debt performance target for 2009-10. We have previously recommended that the Department should measure the value of debt overdue by 30 and 90 days in line with a standard debt management industry performance indicator. It has now introduced a target based on such measures:

> *In 2010-11, to reduce the proportion of tax debt remaining by 8 per cent at 30 days and 13 per cent at 90 days compared with 2008-09.*

Overall performance will be measured based on the aggregate of performance on Corporation Tax, PAYE and Self Assessment debts. VAT debt will be covered by the new measure following its transfer to the core debt management system.

5 *HM Revenue & Customs Management Of Tax Debt,* HC 1152 Session 2007-2008.
6 *HM Revenue & Customs 2008-09 Accounts,* HC 464 Session 2008-2009.
7 Receivables in the Trust Statement represent amounts due from taxpayers in respect of established liabilities at the end of the reporting period for which payment has not been received. Debt is passed to the Directorate at the point when payment is overdue.

Figure 4
Debt collection in 2009-10 compared to 2008-09

	2009-10 (£b)	2008-09 (£b)
Total revenue	435.1	441.0
Collection		
Debt passed to the Directorate for collection	86.5	83.0
Debt cleared by the Directorate	86.4	78.7
Cleared by:		
Collected	67.9	62.3
Revenue losses written-off or remitted	6.3	4.6
Amendments, cancellations and other adjustments	12.2	11.8
Receivables balance in the Trust Statement		
Receivables balance as at 31 March	26.1	27.7
Provision for doubtful debt	10.9	11.2
Net receivables balance as at 31 March	15.2	16.5

Source: HM Revenue & Customs

3.4 The Department's Debt Management and Banking Directorate (the Directorate) is responsible for the pursuit of debt. In 2009-10, £86.5 billion of debt was passed to it, an increase of £3.5 billion over the previous year. It collected £67.9 billion, £5.6 billion more than in 2008-09.

3.5 Not all debt passed to the Directorate is collected:

- The Department writes-off tax which cannot be collected, for example where the taxpayer cannot be traced or becomes bankrupt. It also has the discretion to remit (not to pursue) tax, for example on the grounds of hardship. In 2009-10, the Department wrote-off or remitted £6.3 billion as revenue losses. This is £1.7 billion higher than in 2008-09 because of a special exercise to clear aged irrecoverable debt and the impact of an increase in insolvency levels following the economic downturn.
- Some tax liabilities passed to the Directorate are cleared from the debt system without collection or having been written-off as a revenue loss. This can occur where debts are subsequently amended or cancelled as further information is received to confirm a taxpayer's final liability, for example where an estimated liability is revised by information contained in a tax return. In 2009-10, the Department cleared £12.2 billion of tax as result of amendments and cancellations.

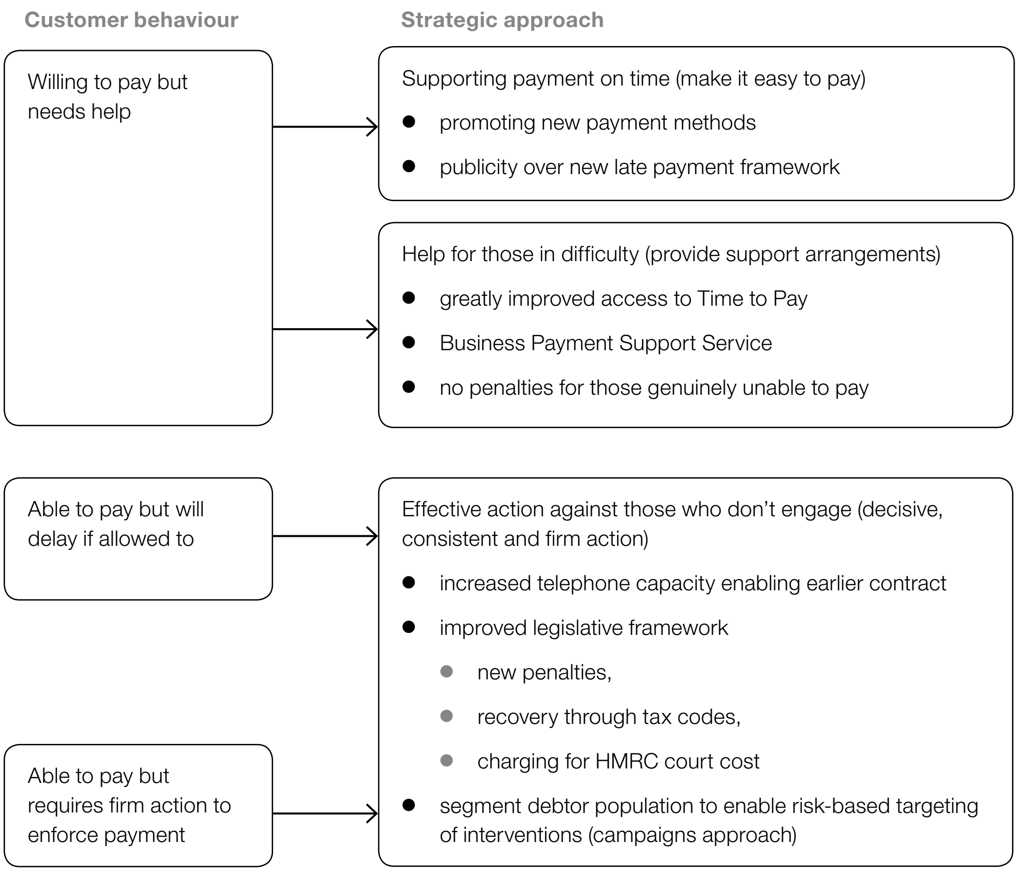
3.6 The Department's provision for doubtful debt at 31 March 2010 of £10.9 billion included estimates for those debts that may be subsequently written-off or remitted and for other clearances resulting from amendment or cancellation.

Improving debt management

The Debt Management Strategy

3.7 During 2009-10, the Department began to implement a revised debt management strategy based on the segmentation of customers according to risk and previous behaviours, and tailoring and targeting its collection activities to increase the likelihood of recovery and to improve the speed of collection and reduce costs (**Figure 5**). Previously the Directorate followed a standard debt collection process with automated debt reminders being initiated in the individual tax systems before being passed to the Directorate for pursuit through telephone calls, in writing and through visits. This approach to debt collection was generally adopted regardless of the type of debt, with limited differentiation by value and risk of non-payment.

Figure 5
Components of the Debt Management Strategy



Source: HM Revenue & Customs

3.8 The principles of the revised strategy are to: help prevent taxpayers getting into debt by supporting them better before their tax liabilities become overdue, and tailoring communications with them so that any queries are resolved and debt is paid without the need for further multiple contact. As part of this revised approach, the Department is improving its debt collection processes through:

- developing a better understanding of taxpayer behaviour;
- adopting a campaigns-based approach;
- improving its information systems;
- developing its channels of customer contact, particularly telephony; and
- improving the quality of its information on debt balances.

Better understanding of taxpayer behaviour

3.9 To better understand taxpayer behaviour and ability to pay, the Department is building its capacity to identify, link and analyse each taxpayer's debts, previous behaviours (payment history) and the actions taken to collect previous debts. This will allow it to build up a historic profile of each taxpayer, across all debts, and to assess their ability to pay, risks of non-payment and insolvency, and which debt pursuit actions are likely to be most effective.

3.10 To date the Department has had to resort to ad hoc interrogations of its debt management system to support this analysis. This approach is inflexible and costly. The Department is developing its capability to routinely analyse debt balances and debtor behaviours. It aims to have this enhanced analytical capability in place for 2011-12.

The campaigns-based approach

3.11 During 2009-10, the Department introduced a campaigns-based approach to debt collection across the major taxes. A campaign is an individually designed, time limited set of actions taken on a particular tax stream's overdue debts. The debt recovery actions for each debt in a campaign are tailored to its nature, previous debtor behaviours and the resources available to undertake the work (**Figure 6** overleaf). The Department planned the campaigns to ensure it had sufficient capacity to take appropriate recovery actions at the time they would be most effective. This included planning the number of debts included in the campaign to ensure that subsequent actions could be sustained through the campaign.

Figure 6
The campaigns-based approach compared to the traditional debt collection approach

Traditional approach	Campaigns-based approach
The pursuit process follows a predictable sequence and is the same for all customers.	The pursuit process is tailored to the nature of the debt and the customer's characteristics and past behaviour. A customer who has never been in debt before is subject to a different approach to a customer who never pays until threatened with enforcement.
The content of letters and phone calls is the same for all customers.	The content of letters and phone calls are tailored, as above.
The length of time between interventions is consistent and predictable.	The length of time between interventions is generally significantly faster paced than before and is aligned with the Department's new debt collection targets at 30 and 90 days, but again is tailored depending on the customer's past behaviour.
Sometimes significant intervals between the Department saying it will take action and it carrying out the action.	The sequence of actions takes place and escalates more quickly than previously.
Limited reference is made to the customer's payment behaviour and its consequences.	Letter and telephone contact make customers aware of the consequences of their actions: • emphasise the customer's responsibility to pay on time or contact the Department before the due date if they cannot do so; and • letters are designed to prompt high levels of immediate payment or inbound phone contact.
No set time to conclude debt pursuit activity.	Campaigns have an end date by which time the Department aims to have worked all cases to a conclusion.

Source: HM Revenue & Customs

3.12 The Department will measure the success of campaigns by the achievement of successful outcomes, which are collecting the debt, agreeing an instalment arrangement, or cancelling, correcting or writing-off uncollectible debt as appropriate. Its evaluation of the performance of the first completed campaigns suggests improvements in debt collection performance and in staff productivity. For example, the initial Self Assessment campaign collected 85 per cent of the debt balance compared to 57 per cent over the same period the previous year, and used 64 staff compared to some 260 staff in 2008.

3.13 The measures used to support the evaluation of the initial campaigns vary between taxes and, in some instances, are based on data captured locally by the collection offices running them. As a result, the information available to management does not readily allow full comparison of performance between campaigns or with the previous debt collection approach.

3.14 The Department commissioned a more in-depth evaluation of the first campaign on Self Assessment Income Tax. This identified the key success factors of the campaign as: effective capacity planning to maintain the campaign; proactive performance management; and the training and coaching of staff. It identified the main challenge for the Department as replicating these drivers of success when implementing and embedding new ways of working across 6,000 debt collection staff spread across 80 offices.

3.15 In 2009-10, as the new approach began to be rolled-out, campaigns collected £2.8 billion, representing less than 5 per cent of all debt collected in the year. The Department is extending this approach rapidly in 2010-11. Since April 2010, it has run campaigns across all major tax collection systems: PAYE, Corporation Tax, Self Assessment and Value Added Tax. By October 2010 it plans to extend the approach to cover new and legacy debt across all taxes. From June 2010, it has also established specialist debt offices to process revenue losses and to monitor time to pay arrangements.

Improving debt management information systems

3.16 The Department's ability to improve its productivity and flexibility is constrained by the limitations of its information systems. The Department's core debt management system supports a number of functions: the recording of debtors' financial data, letter production, telephony, and workflow management. The fully integrated design of the system makes it more difficult for the Department to separate such debt collection functions to manage customer contact more flexibly, as required under a campaigns-based approach. The system offers some capability to analyse debtor behaviour and to prioritise interventions, but this too is limited.

3.17 The Department is improving its ability to link individual taxpayer debts across tax streams, by incorporating VAT debt currently held on a separate system into its main debt management system. This will allow it to build up a more complete picture of a taxpayer's indebtedness to the Department, prior behaviours and ability to pay. It had originally planned this transfer for October 2010 but this is now scheduled for April 2011 following a reassessment of system requirements and to mitigate risk.

3.18 To maximise the potential of a campaigns-based approach, the Department needs to assess regularly a debtor's financial position and response to particular interventions. Currently, this analysis is performed by specialists working with limited data drawn from the debt management system. The inability to analyse debt in real time limits the Department's capability to reconfigure campaigns and reallocate resources. The Department plans to introduce enhanced analytics and campaign management systems from April 2011, but recognises that there are risks to the timely delivery of these systems.

3.19 To support the campaigns-based approach, the Department has increased the number of telephone staff and extended telephone call centres' opening hours to pursue debt. Between August 2009 and March 2010, eight sites, with 880 staff were reallocated into telephone-based debt pursuit. The Department also intends to replace the current telephony system by 31 December 2010 to allow automated switching between inbound and outbound calls and therefore automatically respond to changing volumes of inbound calls throughout the day.

Ensuring the debt balance represents collectible debt

3.20 As stated in paragraph 3.5, not all debt included in the debt balance falls to be pursued. To help ensure debt collection activity is directed at debt that is legally due, the Department aims to introduce revised processes to identify and remove debts from the debt balance that should not be pursued and, where possible, prevent these items being created. **Figure 7** gives examples of some of the causes of uncollectible debt and the actions being taken to prevent it.

Providing support to debtors

3.21 The Department is also providing support to debtors by making it easier for them to pay and, in some cases, allowing them more time to pay.

Making it easier to pay

3.22 The Department has introduced new payment methods to enhance customer choice and convenience. In November 2008 it introduced payment by credit card and debit card. It is enhancing the ability to pay by direct debit and piloting the collection of small non-income tax debts by adjusting a taxpayer's PAYE tax coding.

Figure 7

Some causes of uncollectible debt and actions taken to prevent it

Potential cause of uncollectible debt	Actions being planned and taken
New companies registered or new employee schemes set up but with no data from taxpayer to indicate activity or having any employees. Penalties and charges automatically issued.	• Identify companies with no activity and make the associated tax record dormant, issuing appropriate notification to the company. • Identify employer schemes where there is no activity and flag the tax record to prevent automatic penalties and charges being issued.
Time lags with data can mean that determinations or penalties are sometimes raised even when companies, employer schemes or self-employment had ceased operation – some of which might have already been notified to Companies House or the Department.	• Investigating ways of linking data feeds from Companies House to the Corporation Tax system to ensure timely notification of company changes and update details when a company is dissolved. • Improve handling of company cessation notifications within the department.
To encourage taxpayers to file overdue returns, the Department can raise its own assessments of the tax due. The assessment shows as a debt, which may subsequently be revised downwards once a return is filed with the actual tax liability.	• Issue guidance to explain the impact of tax assessments raised by wider Enforcement and Compliance staff and how they can work with the Directorate to minimise uncollectible debt.

Source: HMRC Uncollectible Debt Project

Allowing more time to pay under the Business Payment Support Service

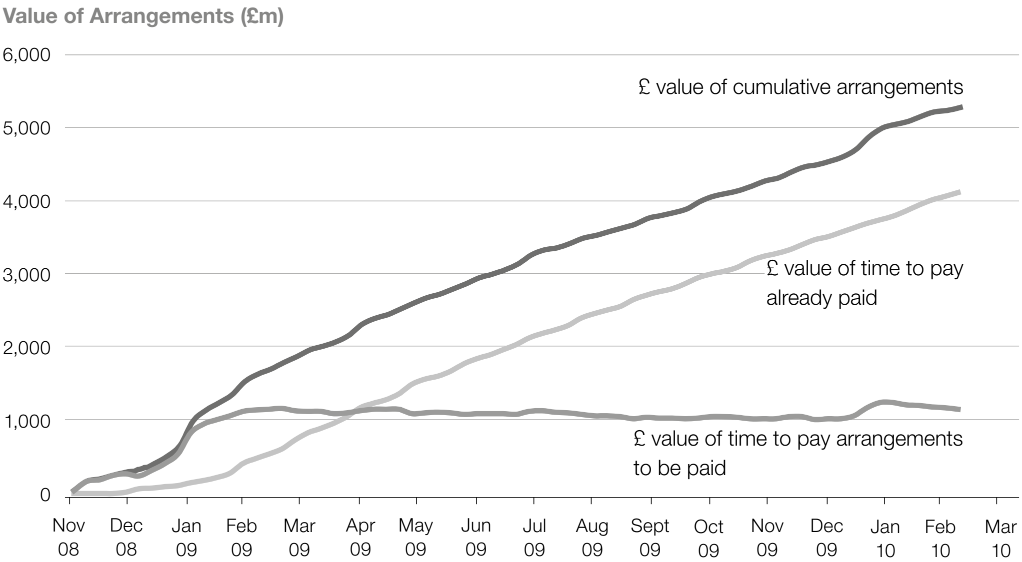
3.23 The Department can grant taxpayers more time to pay their debts where this improves the likelihood of the tax ultimately being collected and is cost-effective. To help businesses in temporary financial difficulty during the recession to gain faster access to time to pay decisions, the Department launched its Business Payment Support Service in November 2008.

3.24 Between November 2008 and March 2010, the Department has agreed over 300,000 time to pay arrangements valued at some £5.2 billion. As **Figure 8** shows, between March 2009 and March 2010 the value of arrangements to be paid remained relatively steady at just over £1 billion.

3.25 The Department's debt systems do not allow it to monitor separately rates of default for the Business Payment Support Service. However, it has conducted four separate reviews of time to pay arrangements over the duration of the scheme and estimated that businesses are paying over 90 per cent of arrangements on time.

3.26 The Department's review of time to pay arrangements also suggests the service has not been subject to abuse by businesses; visits to over a thousand businesses identified only eleven cases where it now considers support granted under the service was inappropriate.

Figure 8
Value of cumulative and net Business Payment Support Service time to pay arrangements (to March 2010)



Source: HM Revenue & Customs

Enhancing capacity and capability

3.27 In our 2008 report on Debt Management,[8] we recommended that the Department "explore the benefits and risks of … using private debt collection agencies to collect some types of debt". In May 2009, the Department launched a small scale trial to establish the feasibility and impact of using agencies to give it additional capacity and capability to recover debts. The trial was also designed to identify private sector expertise in handling certain types of debt which the Department could then use.

3.28 The trial used two separate agencies to work sample packages of debt. The Department wrote to customers at the start of the process to inform them that their debt was to be passed to a debt collection agency. The Department estimates that around 14 per cent of the debt to be passed to the agencies was cleared as a result of this initial letter.

3.29 The Department's subsequent evaluation of the trials concluded that they were a success and that agencies have the necessary capabilities to collect a significant level of tax debt that would not otherwise be recovered across a range of taxes. The cost of recovering debt varied significantly. The larger Self Assessment packages achieved a greater return – between £4.40 and £6.10 per pound spent – than the smaller packages of Pay As You Earn and National Insurance debt.

3.30 The Budget on 22 June 2010 announced that the Department will continue the use of private sector debt collection agencies following the trials.

8 *HM Revenue & Customs Management Of Tax Debt*, HC 1152 Session 2007-2008.

Part Four

Tax Credits

Introduction

4.1 Child and Working Tax Credits (tax credits) offer financial support to more than six million families, supporting around 10 million children. Tax credits form part of the personal tax system. The Department accounts for this expenditure in its Trust Statement for taxes, duties and other revenues and related expenditure. It spends around £27 billion on tax credits each year. **Figure 9** compares tax credits paid in 2009-10 with the previous year.

4.2 Tax credits were introduced in April 2003 as part of wider reforms of the tax and benefits system, to relieve child and in-work poverty. Child Tax Credits provide families with children with financial support based on the number of children and any disabilities they may have. They are available to those aged 16 or over, whether working or not, who are responsible for at least one child. Working Tax Credits support working people by topping-up earnings; the amount depends on factors such as age and the number of hours worked, with additional support for eligible childcare costs or where a member of the household is disabled.

Figure 9
Tax credits overview

	2009-10 (provisional)	2008-09
Families benefiting[1]	6.1 million	5.9 million
Entitlements paid, net of overpayments recovered in the year[2]	£27.3 billion	£24.1 billion
Final value of awards[3]	Not yet known	£23.6 billion

NOTES
1 Figures represent the average number of families benefiting from tax credits.
2 The Department makes a final assessment of awards after the end of the year when the claimant's actual income and circumstances are known.
3 Actual information for 2009-10 will be available in May 2011, after awards have been finalised.

Source: HM Revenue & Customs

4.3 The tax credits scheme is designed to be flexible and to react to the changes in claimants' circumstances. Awards are initially assessed and paid on a provisional basis and then adjusted at the end of year once claimants' actual circumstances are known, giving rise to over and under payments (**Figure 10**). The process is complex, however, and claimants have not always understood their obligations to tell the Department when their circumstances change and to report their actual income and circumstances at the end of the year. Claimants also make genuine errors in their applications which result in incorrect awards, for example because they misunderstand what should be reported as income, or calculate childcare costs incorrectly.

4.4 We reported on tax credits in our Report on the Department's 2008-09 Accounts, and in earlier years. Our examination of tax credits in 2009-10 builds on the work we have undertaken in previous years and in this chapter we report on the Department's progress in:

- reducing error and fraud; and
- recovering tax credits overpayments.

Figure 10
Tax credits process

Application and award	Change in circumstances	Annual renewal	Recovery of overpayments
Claimant requests, completes and submits application form, based on current circumstances and estimated income for the year. HMRC captures and validates application, calculates provisional award and issues award notice to claimant. The provisional award goes into payment.	Claimant reports a change in circumstances by phone or in writing. HMRC applies security checks and seeks to verify information provided, prior to recording changes and calculating revised award. The revised award goes into payment.	Claimant provides information on income and circumstances for the year. HMRC calculates actual entitlement for the year and issues final award notice to claimant, including details on any over and under payment. HMRC uses the same information to calculate the provisional award for the following year and issues award notice.	For ongoing awards: HMRC recovers any overpayment against a previous year's award by offsetting these against the following years' awards. For terminated awards: HMRC seeks direct recovery from the claimant in cash. Claimants are given time to pay in cases of temporary financial difficulty.

Source: HM Revenue & Customs

Reducing error and fraud

4.5 In July 2008, the Department announced a target to limit tax credits error and fraud to no more than 5 per cent of the value of finalised entitlement by March 2011. The Department's latest estimate, based on finalised awards for 2008-09, indicates that error and fraud resulted in between £1.95 billion and £2.27 billion (8.3 per cent to 9.6 per cent of the final award). This compares with between £1.65 billion and £1.93 billion (8.3 per cent to 9.7 per cent) in 2007-08[9]. In addition, the Department estimates that error led to between £0.20 billion and £0.31 billion (0.8 per cent to 1.3 per cent of the final award) not being paid to claimants (**Figure 11**).

Figure 11

HM Revenue & Customs' estimates of error and fraud

	2008-09	2007-08 Restated[3]	2006-07
Value of finalised awards	£23.6 bn	£19.9 bn	£18.2 bn
Error and fraud favouring the claimant[1] (Overpayments)			
Estimated Range[2]			
Percentage	8.3%-9.6%	8.3%-9.7%	7.2%-8.4%
Estimated Range			
Value	£1.95 bn-£2.27 bn	£1.65 bn-£1.93 bn	£1.31 bn-£1.54 bn
Error favouring HMRC[1] (Underpayments)			
Estimated Range[2]			
Percentage	0.8%-1.3%	1%-1.6%	1.3%-2.1%
Estimated Range			
Value	£0.20bn-£0.31 bn	£0.20 bn-£0.32 bn	£0.24 bn-£0.39 bn

NOTES

1 The Department estimates levels of error and fraud based on the examination of a random sample of 4,165 finalised awards under its annual Error and Fraud Analysis Programme. As awards for 2009-10 are not due to be finalised until July 2010 and in some cases later, the Department will not be able to complete its error and fraud analysis of these awards until early 2011.

2 The estimated percentages show the central ranges of error and fraud as a percentage of finalised tax credits entitlement, rather than the midpoints. The Department publishes Child and Working Tax Credits Error and Fraud Statistics each year from where further details may be obtained: http://www.hmrc.gov.uk/stats/personal-tax-credits/menu.htm.

3 Figures restated to reflect actual rather than projected results.

Source: National Audit Office analysis of HM Revenue & Customs' data

9 The estimate of error and fraud in 2007-08 has been revised to reflect actual rather than estimated results, following the completion of its examination of all cases in its Error and Fraud Analysis Programme. As a result, the Department's previous estimate for overpayments of between 7.9 to 9.2 per cent has been revised to between 8.3 to 9.7 per cent. Similarly, its estimate of underpayments has been revised from 0.8 to 1.4 per cent to between 1.0 to 1.6 per cent.

4.6 The levels of error and fraud are material within the context of the £27.3 billion spent on tax credits. As this expenditure has not been applied to the purposes intended by Parliament and does not conform with the requirements of the Tax Credits Act 2002, the Comptroller & Auditor General qualified his opinion on the regularity of the tax credits expenditure reported in the 2009-10 Trust Statement.

4.7 As we have reported previously, the Department's estimates of error and fraud are based on an examination of finalised awards and exclude the costs of identify theft cases, which are measured separately and dealt with by its specialist Organised Fraud Team. The Department estimates that the work of this team has identified, and prevented, fraudulent awards amounting to £106 million during 2009-10 (£32 million in 2008-09). Most of the increase in the value of fraud prevented is attributable to improved targeting of higher risk applications.

The strategy for reducing error and fraud

4.8 The Chancellor's annual remit letter to the Accounting Officer in July 2009 stated that the increase in tax credits error and fraud was disappointing, illustrating the scale of the challenge facing the Department to reduce the level of error and fraud to 5 per cent by March 2011. He asked the Department to urgently revisit its strategy for meeting the target to ensure that the right interventions in the right quantities were being made to bring achievement of the target on track.

4.9 In April 2009, the Department launched a new strategy to reduce the level of error and fraud in tax credits. It also brought its tax credits processing and compliance teams together under the same management to make best use of its resources in delivering the strategy.

4.10 The new strategy is based on getting a better understanding of tax credits claimants and their behaviours to support a tailored approach to reducing error and fraud. It includes:

- better support to claimants by providing help with the application process and when reporting changes of circumstances;
- preventing error and fraud by identifying non-compliance at the earliest opportunity and responding appropriately; and
- tackling non-compliance through improving risk management processes and tools to maximise the impact of compliance interventions.

Another aspect of the strategy is to improve professionalism by ensuring that staff working on tax credits have the right skills to do the job.

Better support to claimants

4.11 The Department has offered more support to claimants to help them get their claims right by assisting them through the claim and renewals process and by contacting existing claimants to confirm that information held is accurate. In 2009-10 it contacted nearly half a million claimants to confirm the accuracy of its information as part of its 'health check' programme, focusing on those categories of claim where error and fraud is most prevalent – childcare costs and declaration of partners. The Department estimates these interventions to confirm the accuracy of information held have prevented £36 million of error and fraud. Other support activities prevented a further £3 million of error. It is now extending its interventions to focus on other elements of claims, including overstated working hours, non-allowable disability claims, and ineligible children.

Preventing Error and Fraud

4.12 The Department has increased its focus on preventing error and fraud from entering the system at the application, change of circumstances and renewals stages. Primarily, it undertakes pre-award checks of data provided, to confirm its accuracy before it enters the system. Additionally, since December 2009, it has introduced new checks to ensure that the details provided by claimants are correct before the claims are processed ('check now, then pay'). In 2009-10, pre-award checks prevented £173 million of error and fraud from entering the tax credits system. In 2010-11, the Department is extending its checking of changes of circumstances reported to contact centres to cover a wider range of risk categories as well as extending its checking of annual renewals.

Tackling Non-Compliance

4.13 The Department continues to identify tax credits claims for compliance and other enquiries based on specified verification and risk scoring criteria applied at the time awards are processed. The majority of awards checked through these processes are identified using risk scoring and profiling techniques and examined post payment by comparing tax credits data to other systems and targeting specific areas of concern including income discrepancies. As a consequence of these improved risk management processes, £356 million of error and fraud was identified in the system in 2009-10. In these circumstances the Department will correct the awards and take steps to recover any overpayments.

4.14 Taken together, the Department estimates that its interventions on individual awards led to a reduction of error and fraud of £569 million in 2009-10, this compares with £253 million in 2008-09 (**Figure 12** overleaf).

Figure 12
HM Revenue & Customs' Error and Fraud Interventions 2009-10

	2009-10		2008-09	
Interventions	**Number (thousand)**	**Impact (£ million)**	**Number (thousand)**	**Impact (£ million)**
Better Support to Claimants[1]	524	40	38	5
Preventing Error and Fraud[1]	104	173	57	96
Tackling Non-Compliance[1]	653	356	28	152
Total	**1,281**	**569**	**123**	**253**

NOTE
1 Each category includes an amount arising from interventions undertaken by the Compliance, Operations and Customer Contact Directorates.

Source: HM Revenue & Customs and National Audit Office

4.15 The Department continues to impose a financial penalty when it concludes that there has been a deliberate attempt to over-claim, or where the claimant has been negligent and provided the wrong information. In 2008-09 the Department introduced a new penalty regime which aimed to align the penalty with the seriousness of the underlying claimant behaviour, distinguishing between genuine mistakes for which there is no penalty, failure to take reasonable care, and deliberate error. During 2009-10, 1,221 penalties were raised, amounting to £1.8 million.

Measuring performance

4.16 The measurement of error and fraud through the Department's Error and Fraud Analysis Programme can only begin after awards are finalised several months after the end of each financial year and cannot therefore provide management with the real time information it needs to assess progress towards its 5 per cent target.

4.17 We have previously recommended that the Department should develop its performance reporting to obtain information that allows it to monitor progress sooner. The Department has now developed proxy indicators to allow it to track progress in reducing error and fraud through the year. The proxy indicators measure the amount by which each award is reduced as a result of the Department's interventions as well as an assessment of the wider deterrent effect. Its interim targets are to achieve £650 million in yield by the end of March 2010, £750 million by July 2010, £1 billion by the end of March 2011 and £1.4 billion by the end of July 2011. The Department continues to monitor its range of interventions to ensure that it can meet its overall target for reducing the level of error and fraud.

4.18 In 2009-10, the Department estimated that it had prevented error and fraud of £656 million, in excess of its target of £650 million. In addition to the estimated £569 million arising from interventions undertaken during the year, it included assessments of the impact of its communications (£30 million) and the wider deterrent effect of its interventions (£57 million, a 10 per cent uplift of the yields arising from interventions) both of which are difficult to measure objectively.

4.19 The Department is continuing to develop its measurement of intervention yield and strengthen its assurance activities to increase the consistency and accuracy of measurement. It recognises that it faces a challenge to measure the impact of the increased number of interventions delivered across a wider range of staff, including those in operations and customer contact centres, rather than by compliance specialists. The Department's own quality assurance activities have identified scope for improving the accuracy of its measurement of interventions through improved training and guidance.

Recovering tax credits overpayments

4.20 Overpayments and underpayments are an inherent feature of the tax credits regime because payments are based on claimants' income for the previous year. Claimants' final entitlement, based on their actual income and circumstances in the year, is calculated only after the end of each year.

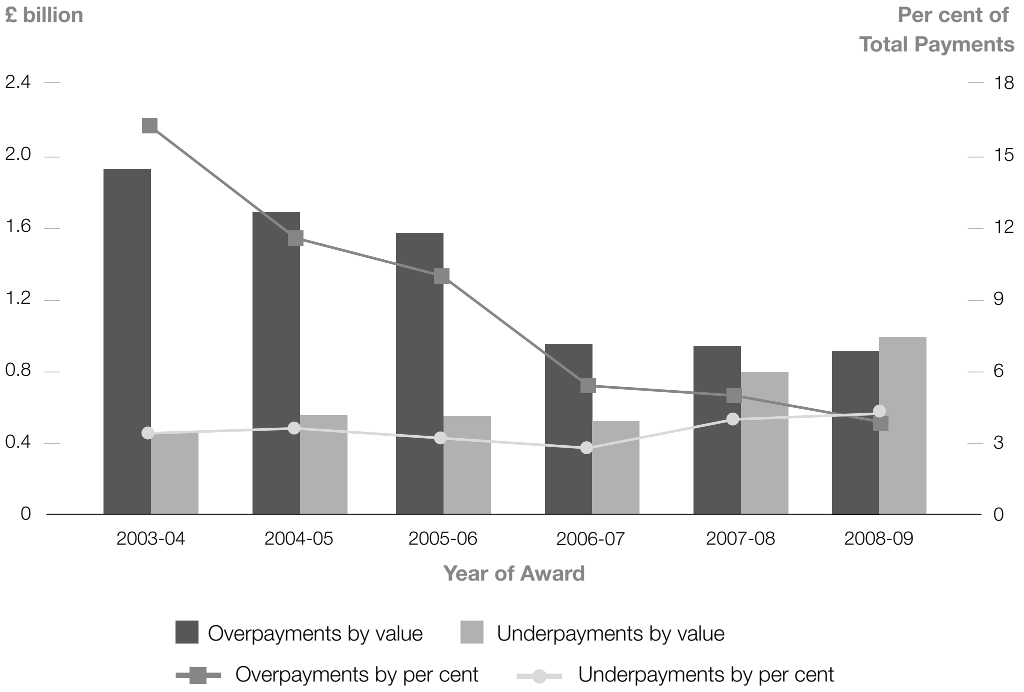
4.21 The Department has sought to minimise the level of overpayments and hence the amounts that have to be recovered. In 2008-09, overpayments caused by adjustments to awards were £917 million, continuing the reduction in overpayments since the measures announced in the 2005 Pre Budget Report took effect (**Figure 13** overleaf). The principal measure reducing overpayments was the April 2006 increase in the level of income rises disregarded on finalisation of awards, from £2,500 to £25,000.

4.22 Underpayments have, over the last three years, risen from £525 million to £992 million and are now at a level greater than overpayments. The increase in underpayments at year ends results from the decision to withhold arrears of underpayments until after the entitlement has been confirmed as a result of the awards finalisation process.

4.23 The overall level of tax credits debt has increased gradually in recent years. At the end of March 2010, the Department had £4.5 billion of overpayments to be recovered, compared with £4.4 billion at March 2009.

Figure 13

Tax credits overpayments and underpayments to 31 March 2009



NOTES

1 In accordance with the Department's normal approach, this figure excludes remissions and overpayments recovered in the year they were made.

2 Tax Credits awards for 2009-10 are not all due to be finalised until the end of January 2011. The Department will publish overpayment statistics for these awards in May 2011.

Source: HM Revenue & Customs

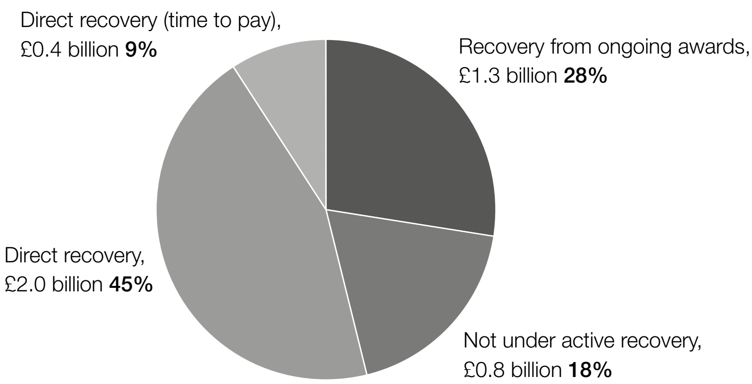
4.24 The Department recovers tax credits overpayments in two ways. If the overpayment relates to an ongoing award, recovery is made by reducing the level of payments in the following year (cross-year recovery). This adjustment is made automatically when the award for the subsequent year is calculated, subject to limits designed to protect low income families. Where claimants' circumstances have changed, resulting in them either receiving a new award, for example because they have a new partner, or no tax credits at all, the Department passes the debt over to its Debt Management and Banking Directorate (the Directorate) for recovery (direct recovery). These recoveries are either through lump sum payments or by agreed time to pay arrangements, where the Department allows claimants to make repayments in instalments over a 12 month period. It may also allow extended time to pay or defer collection in cases of temporary financial difficulty.

4.25 Of the £4.5 billion tax credits debt at 31 March 2010, £1.3 billion was being recovered through cross-year recovery from ongoing awards. A further £2.4 billion was with the Directorate for direct recovery, of which £0.4 billion (17 per cent) was being recovered under time to pay arrangements, whilst £2 billion was awaiting further recovery action. The remaining £0.8 billion was not being actively recovered either because collection had been suspended as claimants had disputed the overpayments or because overpayments related to awards that had not been finalised (**Figure 14**).

4.26 Although overpayments have fallen since the early years of the scheme, the levels of debt clearances are still insufficient to reduce the overall stock of tax credits debt. In 2009-10, the Department cleared £1 billion of tax credits debt. This included £372 million recovered from ongoing awards and £437 million cleared by remissions (debts waived where claimants have no means to pay) and write-offs (where debts cannot be recovered). Direct recoveries were £202 million, less than 10 per cent of the total value of the £2.4 billion of tax credits debt with the Directorate.

4.27 In 2009-10, the Department ran its first campaign for the direct recovery of debt identified as part of the 2009 annual renewals process. However, the start of the campaign was delayed with only half of planned debt recovery actions taking place before the end of March 2010. As a consequence, work on the campaign is continuing. The Department has taken steps to improve its analysis of debts by the household's ability to pay, and will use this approach in targeting its debt identified by the 2010 renewals process.

Figure 14
Tax credits debt at 31 March 2010 by method of recovery



Source: HM Revenue & Customs

Uncollectible debt

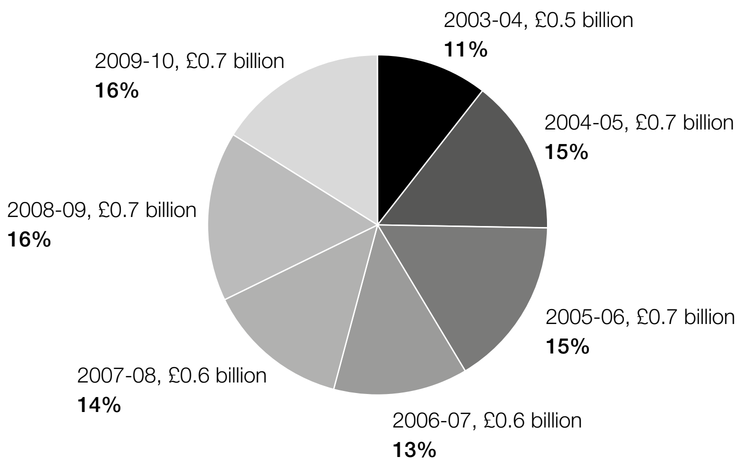
4.28 Over two thirds of tax credits debt is more than two years old (**Figure 15**). The Department's inability to make substantive progress in clearing the stock of tax credits debt relating to the early years of the scheme increases the uncertainty of its eventual collection. Since April 2003, the Department has written off £1.7 billion of tax credits overpayments and it currently estimates that the collection of a further £2.5 billion is doubtful.

4.29 The Department may remit tax credits debts where the cost of collection exceeds the value of the debt. It is also proposing to write-off and remit some debts which are difficult to enforce and which have not been actively pursued, and has recently remitted those cases processed outside the tax credits computer system which led to annual renewals not being managed in strict accordance with the Tax Credits Act 2002. Last year we reported that it initially proposed to remit £235 million of debts in the categories described. However, work to ensure that only appropriate debts were included within the categories as well as resource constraints has meant that clearance has been delayed.

4.30 Due to debt system constraints, the Department has only had limited analysis of the composition of tax credits debt under direct recovery in terms of ability to pay or when collection action was last taken. Its current work to improve its analysis of tax credits debtors' ability to repay should allow it to identify more clearly those cases which are uncollectible or uneconomic to collect for write-off.

4.31 The Department has rejected calls for a general amnesty on historical debt on the grounds that it must ensure equity and fairness to both the taxpayer and those tax credits claimants who have been paid the correct amount or have repaid overpayments.

Figure 15
Tax credits debt by year of award



Source: HM Revenue & Customs

Strategy for recovery of tax credits debt

4.32 In 2009-10, the Department prepared a Tax Credits Debt Tactical Delivery Plan, which was designed to reduce tax credits debt. The plan included objectives to reduce the amount of tax credits debt by £0.2 billion to £4.3 billion by March 2011, and reduce the level of tax credits debt going forward. During 2010-11, it is working to:

- stem the creation of debt by reducing the amount of error and fraud entering the system and by better understanding and measuring the impact of other interventions that reduce overpayments;
- develop a more active approach to engaging with claimants with a tax credits debt and support Debt Management and Banking in its 2010 Debt Campaign; and
- review and write-off uneconomic and unenforceable debts where there is no possibility of collection by March 2011.

4.33 In the longer term, alternative methods of recovery will be considered, including:

- working with the Department for Work and Pensions to trial the voluntary recovery of small overpayments from certain benefits; and
- extending the recovery of debts from ongoing tax credits awards to include any debts the claimant may have from previous awards. However, this will not be possible without a modification to the tax credits computer system; the soonest this can start to be developed for implementation is 2011-12.