National Audit Office

REPORT BY THE
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Reducing Costs in HM Revenue & Customs

Key facts

£3.5bn
HMRC's annual running costs in 2010-11, the baseline year

£1.6bn
target total reduction in running costs over the four years to 2014-15

£7bn
a year of additional tax revenues to be generated by 2014-15 from re-investing £917 million

£8.3 billion	target for cumulative savings in Tax Credits, Child Benefit and other welfare entitlements in 2011-15
£40.5 billion	2010-11 spending on Tax Credits, Child Benefit and other welfare entitlements
£1.6 billion	target for cash savings in running costs over the four years to 2014-15, amounting to 25 per cent in real terms
£3.5 billion	HMRC's running costs, excluding depreciation, in 2010-11
£468.9 billion	tax revenues collected by HMRC in 2010-11
£917 million	target for savings to be re-invested over four years in tackling tax non-compliance
£7 billion	target of additional tax revenue to be generated annually by 2014-15 from re-investing in tackling non-compliance (in addition to an extra £13 billion a year already included in HMRC's baseline)

Summary

1 Reducing the budget deficit is a Government priority. The 2010 Spending Review announced significant spending reductions across government. HM Revenue & Customs (HMRC) will contribute to reducing the budget deficit in two ways: by spending less and increasing tax revenues. In 2010-11 it spent £3.5 billion in running costs and £40 billion mainly on Tax Credits and Child Benefit, and it raised £469 billion in tax revenues.

2 HMRC aims to create a more efficient, flexible and effective tax administration that focuses on customer needs. It has committed to reducing running costs by 25 per cent in real terms by 2014-15, which amounts to cumulative cash savings of £1.6 billion (Figure 3 on page 14). Over this period, HMRC will re-invest £917 million of these savings to tackle tax evasion and avoidance and bring in additional tax revenues of £7 billion a year by 2014-15. HMRC is also required to reduce expenditure on Child Benefit and Tax Credits by £8.3 billion over the period. Its other main priorities are to reduce tax credit error and fraud by £2 billion a year; stabilise its National Insurance and PAYE Service; and reform the PAYE system.

3 Securing value for money from cost reductions involves more than just implementing planned cuts. Uniform top slicing of budgets or indiscriminate cost-cutting can leave an organisation at risk of building up higher costs in future. Expenditure cuts can generate long term efficiency savings only through fundamental reform of existing practices, such as restructuring an organisation to focus more tightly on service delivery, and by changing behaviours to raise awareness of the need for cost control.

4 This is one of a series of National Audit Office reports on how government departments are implementing their cost reductions and we expect to report at regular intervals over the Spending Review period. The first was on the Department for Work and Pensions. This report sets out HMRC's cost reduction proposals within its wider change programme (Part One); assesses HMRC's approach to identifying and assessing cost reduction measures (Part Two); and examines HMRC's plans for implementing cost reductions (Part Three). Our examination is based on the Department's plans at May 2011. Appendix One summarises our audit methodology.

5 This report is also part of a wider programme of audit we conduct on HMRC. The programme includes our annual audit of HMRC's accounts and examination of its systems for assessing and collecting taxes, and value for money studies and other work either across government or focusing on the Department. In devising our programme we have regard to the NAO's three strategic themes of cost-effective service delivery, financial management and informed government. Recognising the Department's challenge of creating a more efficient, flexible and effective tax administration, we seek to provide objective insight on how HMRC is:

- transforming its performance and improving compliance among taxpayers and benefit and tax credit claimants using its customer-centric approach; and
- achieving value for money by delivering a lower sustainable cost base while increasing revenues.

6 In undertaking this study, we took account of this broader programme of work, including our validation of HMRC's Spending Review 2007 efficiency savings, and our reports on HMRC's PaceSetter programme to improve business operations and on the Department's accounts.

Key findings

Cost reduction within a broader vision of strategic change

7 The first stage to achieving large scale cost reductions is to define a target operating model that is, in effect, a vision of how an organisation will look in the future given its objectives. Such a model should be refined through regular iteration as the analysis of information develops. By drawing on an analysis of the cost and value of existing activities and comparing these to the model, an organisation can then start to prioritise where it uses its resources and identify those areas to be trimmed.

8 **HMRC established a clear vision for the Spending Review period but has not yet developed a sufficiently defined operating model.** Its vision – to become more efficient, more flexible in dealing with customers and more effective in collecting tax revenues – set the context for the Spending Review settlement. HMRC also used its customer-centric strategy as a framework for assessing its proposals. In developing its plans, it specified operational priorities; tax revenue targets; and levels of business performance and customer service in some areas, such as PAYE, and dealing with calls and correspondence from customers. Much of its focus was on the impact of reducing costs on its ability to collect tax revenues, reflecting the key role of maximising tax revenues in reducing the budget deficit. HMRC has since developed a performance framework which defines expectations for some indicators in 2011-12. It has not though assessed or quantified the desired increase in levels of customer compliance, and how that might affect its cost base. Analysis of intended business performance and levels of customer compliance would provide a basis for assessing the overall cost base needed, and a framework for evaluating the changes that are needed.

9 HMRC's cost reduction measures and Change Programme involve wide ranging changes that, taken together, carry significant risks. HMRC has reported savings of some £1.4 billion since 2005. It now plans to implement 54 change projects, of which 24 are intended to reduce running costs by £964 million over four years. It is seeking to deliver further cost reductions of £647 million through savings in the provision of IT services, improvements in productivity, reduced sickness absence and headcount reductions by business areas. The size and shape of HMRC will change substantially as it reduces staff numbers by 10,000; redeploys, retrains and recruits 9,000 staff; significantly reduces the number of offices; re-organises corporate services; and implements major changes in approach in the Enforcement and Compliance and Personal Tax business areas. Its recent experience of implementing the new PAYE system emphasises the importance of robust strategies to mitigate the risks.

Understanding costs and value

10 Identifying and prioritising cost reductions requires a detailed knowledge of where costs are being incurred, the factors driving costs and the value of activities. Departments should have a good understanding of the distribution and profile of costs and the links between costs and the delivery of value. Information on business costs enables rational choices about what to stop, what to change and what to continue. Without this information, cost reductions are less likely to lead to efficiency savings.

11 In assessing potential cost reductions, HMRC had good information on the different costs it incurs, but had a limited understanding of the link between the cost and value of its activities. HMRC undertook a systematic approach to identifying cost reductions, drawing upon previous experience and work with the Cabinet Office to benchmark its costs. It had a good understanding of staff, estates and IT costs, and Corporate Services had good unit cost information, for example on IT. However, HMRC had limited information on the cost of its end to end processes, the cost of servicing different customer groups, and on the links between costs and value, which restricted its ability to assess long term efficiency gains. HMRC is improving its data on the cost of key activities and customer interactions, and has introduced a requirement for teams to assess whether savings are affecting operational performance.

12 HMRC's cost reduction proposals involve much uncertainty. It is preparing full business cases for the 24 projects to deliver £964 million of running cost reductions. This will enable HMRC to refine its estimates of the funding needed and the potential savings, and build greater confidence in the planned level of reductions. Further, some of the assumptions that underpin proposed savings of £412 million have not been fully tested, including planned reductions in sickness absence and the roll out of the PaceSetter programme. Our July 2011 report found that while the PaceSetter programme had led to some improvements in efficiency, the extent of these was not clear.

13 There is no contingency in HMRC's cost reduction plans. HMRC has developed plans that meet its cost reduction target but has made no allowance for under-delivery or slippage, and currently has no reserve of proposals on which to draw. It will be crucial, therefore, that HMRC delivers the expected trajectory of savings. HMRC expects business areas to live within their annual budgets while maintaining performance and has also developed governance arrangements to identify early signs of under-delivery. While it can point to its past performance in reducing costs, there remains the risk that measures to compensate for any shortfall could involve short-term non-sustainable cost reductions that could have an adverse impact on customer experience or business performance.

Delivering cost reductions

14 By following a step-by-step process of change, an organisation should be able to restructure its activities without disrupting ongoing service delivery. A change programme will typically involve a suite of projects and initiatives to re-structure existing processes, a communications strategy to convince and assure staff of the need for change, and a measurement system to monitor progress and evaluate impact.

15 HMRC has established comprehensive governance arrangements to deliver cost reductions; recognised the need to improve staff engagement; and is developing information to monitor progress. It has established a central team and programme management infrastructure; assigned responsibilities for delivery across business areas; and is developing a wide range of management information to monitor progress and identify early signs of slippage or under-delivery. HMRC has also developed plans to improve staff engagement and a communications strategy to keep staff informed of the changes taking place.

16 HMRC has begun to implement its cost reduction proposals. 2011-12 is a crucial year when HMRC is planning to spend £136 million (43 per cent of its investment funds for the four years) on implementing cost reduction projects. While it is often effective to spend early in a change programme to achieve greater benefits later, it carries a risk because HMRC does not expect full business cases for all projects to be ready until late summer 2011 and it can carry forward each year only limited amounts of any underspending. It has introduced a fast-track process to release funds for some projects in advance of full business case approvals; and started its organisational re-design.

17 HMRC recognises the main delivery challenges but has yet to assess the dependencies between projects and the critical path for delivery. It has identified management capacity, staff capability and its flexibility to redeploy staff as factors crucial to delivering its Change Programme. The challenges are most clearly illustrated in the Personal Tax business area, which is introducing significant changes and reducing staff numbers by 34 per cent by 2015. HMRC is developing arrangements to manage these risks, including a portfolio plan and a comprehensive workforce plan to manage staff redeployment. It has not, though, yet fully established the dependencies between projects and the critical path for delivering cost reductions and the wider Change Programme.

Conclusion on value for money

18 HMRC faces a significant challenge in reducing running costs by £1.6 billion over the next four years, at the same time as reducing welfare payments by £8.3 billion, increasing tax revenues and improving customer service. Delivering these commitments requires a clear vision; a good understanding of cost drivers; and a coherent and well informed plan. HMRC has established a clear vision for 2015 but it has not sufficiently defined the business performance and customer service it intends to achieve. While it knows its main running costs, it does not have a good understanding of the link between costs and value, and there is uncertainty and a lack of contingency in its cost reduction plans. It has put in place many of the necessary arrangements for delivering its cost reductions, although it has yet to develop a full understanding of the dependencies between projects and the critical delivery path. It is important that HMRC addresses these gaps to create the conditions to achieve value for money over the next four years.

Recommendations

19 Our recommendations are designed to help HMRC secure value for money in achieving its cost reduction commitments.

Cost reduction within a broader vision of strategic change

a **HMRC has not yet developed a detailed operating model needed to support its vision.** In defining how to achieve its vision, HMRC should extend its Performance Framework to define its expectations for all performance indicators up to 2015. This would include assessing the potential for reducing costs and increasing revenue from a positive shift in customer compliance and improvements in business performance; for example, in the accuracy of processing. In the interim, business areas should define models of how they will operate in the future.

Understanding costs and value

b **HMRC had limited information to assess fully the opportunities for cost reductions or the impact of cost reductions on business performance.** It should:

- analyse the link between the cost and value of its activities, to strengthen its ability to assess whether cost reductions are delivering efficiency savings; and
- draw on its initiatives to improve the quality of cost data to assess the potential for further structured cost reductions.

c **There is no contingency in HMRC's cost reduction plans, which increases the risks of under-delivery.** HMRC faces significant challenges in delivering the Change Programme while maintaining business performance and implementing operational priorities. Drawing on its experience in delivering change programmes, it should:

- ensure its governance arrangements are working effectively to provide early sight of under-delivery;
- reassess that it has the necessary programme management skills to deliver the projects; and
- start to identify a pool of additional proposals that it could draw on if required.

Delivering cost reductions

d **HMRC has not developed a detailed understanding of the dependencies between projects, but it has begun work on these issues.** It should:

- evaluate the dependencies between projects; the sequencing of projects needed to achieve cost reductions and realise benefits; and identify a critical path for delivery;
- evaluate the practical implications of delivery and assess the potential overlap between different projects and business areas;
- periodically test the overall deliverability of its plans; and
- after one year, review its programme and risk management arrangements to ensure that they remain fit for purpose.