HM Revenue & Customs 2011-12 Accounts

Report by the Comptroller and Auditor General

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Amyas Morse
Comptroller and Auditor General
National Audit Office

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Summary

About this report

1 This report provides the findings and overall conclusion of work conducted under section 2 of the Exchequer and Audit Departments Act 1921, by which the Comptroller and Auditor General (C&AG) must assess the adequacy of the systems to assess and collect taxes.

2 This report forms part of our programme of audit work on HM Revenue & Customs (the Department). The programme includes our examination under section 2, our annual financial audit of the Department's accounts, and value-for-money studies which are the subject of separate reports to Parliament. Our work is designed to support effective parliamentary scrutiny of the Department's activities and to provide insight and make recommendations to help the Department meet its objectives.

3 The report is arranged in five parts:

- **The Summary** describes the scope of the audit and provides our overall conclusion and principal findings and recommendations in each area;
- **Part One** summarises the findings of relevant reports we have published in the last year and sets out some key facts and figures about revenue collected by the Department in 2011-12;
- **Part Two** covers progress in **stabilising the PAYE service** since the serious problems that emerged when the Department introduced the new National Insurance and PAYE service (NPS) system in 2009;
- **Part Three** covers the Department's performance in **managing tax debt**, including its progress in implementing a revised debt management strategy introduced in 2009-10; and
- **Part Four** examines the Department's progress in tackling error and fraud in respect of tax credits, and the effectiveness of its approach to managing debt arising from the tax credits system.

Scope of the audit

4 Section 2 of the Exchequer and Audit Departments Act 1921 requires the 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. This report meets that requirement, taken alongside the C&AG's audit opinion on the Department's *Trust Statement* account, which records the tax revenues the Department has collected.

5 The C&AG provides a separate audit opinion on the Department's *Resource Account*, which records the Department's running costs and other spending, most significantly its spending on tax credits. Before 2011-12, tax credit expenditure and related balances were reported in the *Trust Statement*. From 1 April 2011, these are reported in the *Resource Accounts* to reflect changes in accounting policy resulting from the government's 'clear line of sight' project to align departmental budgets and accounts. For ease of reporting, we have included our examination of tax credits in this report.

Wider work supporting the C&AG's conclusion

6 In forming his conclusion, the C&AG considers a range of work that complements his section 2 examination, including the results of our financial audit of the Department's accounts and the findings of value-for-money work. Relevant work by the NAO published in the last year, which is summarised in Part One, include reports published under the C&AG's section 2 powers and value-for-money reports.

Reports published under the C&AG's Section 2 powers

7 We published the *Renewed alcohol strategy: a progress report* in January 2012. We concluded that the Department had achieved its key financial objective in the first year of the strategy but had not disrupted the supply chain for alcohol diverted illicitly on to the UK market.

8 In June 2012, we published a report on the reasonableness of five large tax settlements that had been the subject of Committee of Public Accounts' scrutiny following our report on the Department's 2010-11 accounts. Our original report had concluded that the Department had not followed its normal governance processes in agreeing these settlements. Our June 2012 report found that all five settlements were reasonable and the overall outcome for the Exchequer was good, but expressed concerns about the processes through which the settlements were reached.

Value-for-money reports

9 We have published five reports in the last year that evaluated the value for money of the Department's activities. Of particular relevance to the C&AG's conclusion in discharging his section 2 responsibilities were our reports *The expansion of online filing of tax returns* (November 2011) and *The compliance and enforcement programme* (March 2012).

Conclusion

10 While recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, we conclude that in 2011-12 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 in this report and our other reports to Parliament.

Principal findings and recommendations

The PAYE Service (Part Two)

11 We have previously reported in last year's report on accounts the difficulties the Department faced in operating PAYE after introducing its National Insurance and PAYE Service (NPS) system.

Findings

12 **The Department is part way through its plan to stabilise the PAYE service.** It had many key activities to complete in 2011-12 to meet its target to be operating a normal PAYE service by March 2013. The Department:

- has met its target to process 6.7 million end-of-year reconciliations relating to the 2008-09 and 2009-10 tax years. The Department carries out end-of-year reconciliations on each taxpayer's record to determine whether the correct amount of tax has been paid;
- is on track to reconcile the 2010-11 and 2011-12 tax years by March 2013; and
- is also on track to clear outstanding reconciliations predating the introduction of NPS relating to tax years 2003-04 to 2007-08 by December 2012.

13 **Stabilising PAYE has come at a cost.** We reported last year on amounts of tax the Department decided to forego in order to keep workloads manageable. In 2011-12, it has remitted an additional £12.7 million relating to claims from taxpayers that it had failed to make proper and timely use of information available to it, bringing the total of those claims to £53.7 million. The Department originally estimated that it would cost £57.3 million to March 2013 to clear open cases and £23.6 million to stabilise PAYE. Its estimate for open case clearance remains unchanged although for stabilising PAYE this has reduced to £21.2 million.

14 **To operate PAYE successfully, the Department must be in a position to manage the work generated during the year.** Day-to-day management involves manually dealing with in-year changes to taxpayer records triggered by taxpayers and work items, which are generated automatically by the Department's NPS system. The Department estimates that without further automation, around 20.5 million work items would arise annually although it can only action around 13.5 million work items manually. To deal with the volume of work items, it has prioritised those that affect a taxpayer's end-of-year tax position, identified items that are duplicated elsewhere and managed the production of others. In 2011-12, it has undertaken an exercise to look at ways of automatically reducing or eliminating some of these work items and it is in the final stages of getting approval for a project to take this work forward.

15 **The Department has started a pilot to prepare for the full roll-out of 'Real Time Information' (RTI).** With RTI employers and pension schemes (collectively called employers) must report employee's income tax and National Insurance deductions as they pay them rather than at year-end. The timetable for full implementation is challenging and driven by the Department for Work and Pensions' timetable for rolling out Universal Credit from October 2013. The Department plans to test the system in a pilot that started in April 2012. At 31 May, 209 PAYE schemes covering 1.5 million individual records were using RTI. By October 2013, all employers and pension providers will be required to use it. The Department has examined ways to improve data quality, which is vital to the successful operation of RTI, and there are signs of improvement. The Department has yet to decide how far it will use RTI to improve the PAYE service and will use the pilot to inform this work.

Recommendations

16 **The Department should continue its work to understand the risks and tax effects of each work item.** This will assist in reducing the volumes created to a manageable level. It will also help it to prioritise their clearance, knowing the risks to the accuracy of data, levels of customer contact and the operation of the PAYE process.

17 **The Department must complete its current review of its PAYE operating model, considering the impact of RTI.** Without clarity on the future operating model, it is difficult for the Department to forecast the overall workload and the operational resources required. The Department will still have to undertake an end-of-year reconciliation of each taxpayer's record as employers will not report all data monthly under RTI. The Department needs to decide, taking account of emerging findings from the RTI pilot, on which changes notified under RTI it should update on taxpayer records in real time and whether it can carry out any of the work currently performed at the reconciliation stage earlier.

Tax debt management (Part Three)

18 **The value of tax debt at 31 March 2012 under active management stood at £13.3 billon, compared with £15.0 billion in the previous year.** During 2011-12, the Department continued to collect a significant amount of overdue tax – £37.9 billion compared with £33.3 billion in 2010-11.

19 **There has been a large increase in the amount of tax liabilities that the Department decided not to pursue ('remitted'), especially for income tax, over the last two years.** The Department 'remits' the liability when it decides not to pursue it, for reasons such as hardship or value for money. The Department remitted £756 million of income tax in 2011-12. The increase results from: the decision to increase temporarily the amount under which an underpayment is not pursued from £50 to £300 as part of its PAYE stabilisation process, the increased volumes of cases being reconciled over this period, and the recording by the new NPS systems of all underpayments below the amount not pursued as revenue losses which were not recorded previously.

20 **The Department has made progress in implementing the debt management strategy it introduced in 2009-10.** It is now using a campaign approach to group debts by characteristics such as their value, and pursues them through a set of tailored and time-limited actions. This has increased the amount of debt the Department can collect. However, presently it lacks the detailed cost information that would allow it to assess the value for money of different collection approaches.

21 **The Department has delayed implementing one key element of its debt management strategy – to tailor debt action to each taxpayer's characteristics and past behaviour – from April 2011 to October 2012.** This delay was due to the government's moratorium on IT projects in 2010 and the civil service recruitment freeze, which meant the Department could not recruit the specialist analysts it needed. The Department also cannot easily link together the debts from different tax streams owed by a single taxpayer because of a long-standing limitation in its IT systems. Linking of debts tends to occur only when the Department initiate court action or other enforcement proceedings.

22 **The Department has increased its use of debt collection agencies, which between them collected £111.3 million of debt in 2011-12.** This represents about £70.5 million more than the Department estimates it would have collected had it not employed such agencies to deliver additional capacity. The Department started using agencies in response to the Committee of Public Accounts' recommendations in its 2008 report on debt management.

Recommendations

23 **The Department should identify the full cost of each of its debt collection activities to evaluate their cost-effectiveness and decide how best to allocate future resources.** The Department is trying to better understand costs but, while it can identify the cost of using debt collection agencies, it does not yet know the full cost of its other activities.

24 **The Department should continue to prioritise its work to undertake full risk profiling and customer segmentation of its debt balance, as recommended by the Committee of Public Accounts in its 2004 and 2008 reports.** The Department has delayed implementing this until October 2012 as a result of the government-wide moratorium on new IT projects and civil service recruitment freeze of 2010.

Personal tax credits (Part Four)

25 **The C&AG has qualified his regularity audit opinion on the Department's 2011-12 *Resource Accounts* because of material levels of error and fraud in payments of personal tax credits.** The overall level of error and fraud in 2010-11 (the latest year available) indicates that payments of between £2.08 billion and £2.46 billion were made to claimants incorrectly because of error and fraud. Further amounts of between £170 million and £290 million are not being paid to claimants due to error.

26 **The Department did not achieve its target to reduce the level of tax credits error and fraud to no more than 5 per cent of entitlements.** The estimated level of error and fraud in payments made in 2010-11 was between 7.5 per cent and 8.8 per cent, (compared to between 7.0 per cent and 8.6 per cent in 2009-10). Based on the midpoint of 8.1 per cent, the Department did not meet its objective, set in July 2008, to reduce levels of error and fraud to no more than 5 per cent by 2010-11.

27 **The Department considers it is on track to meet its target to achieve £1.7 billion through its interventions to prevent and detect error and fraud in tax credit awards for 2011-12. However, it has overstated some of its achievements.** The Department had recorded over £1.5 billion of impacts from its interventions, at 31 March 2012, and is projecting losses prevented will total over £1.7 billion by the end of July 2012. Our review indicates that there are some inaccuracies and inconsistencies in the recording of these losses causing the Department to overstate achievement.

28 The relationship between the Department's estimate of the levels of error and fraud and the proxy losses prevented from its in-year interventions is not clear. Losses prevented increased by £223 million between 2009-10 and 2010-11, but the Department's estimate is that the level of error and fraud increased by approximately £200 million between these years.

29 The Department met its target to reduce tax credit debt to £4 billion at 31 March 2012. The Department has reduced the gross level of tax credits debt from £4.7 billion at 31 March 2011 to £4 billion at 31 March 2012. Much of this can be attributed to remitting debt during 2011-12 of £1.7 billion including remissions of inactive debt over three years old. This is consistent with the recommendations made by the Committee of Public Accounts that the Department write off debt where there is a value-for-money case for doing so.

30 The Department's large debt remission in 2011-12 has tackled some long-standing balances but much of the remaining tax credit debt is old and unlikely to be recoverable. The Department estimates that £2.3 billion of the £4 billion tax credit debt shown as outstanding at 31 March 2012 is unlikely to be recovered. It has inadequate management information on the age profile and recoverability of this debt.

31 The Department's campaigns approach has had limited success in collecting tax credits debts more promptly. The Department's plans to manage personal tax credits debt more actively have met with some limited success, and it faces challenges in improving its collection rate given its obligations not to cause hardship through its approach to debt recovery.

Recommendations

32 The Department needs to undertake an investigation into the results of the error and fraud analysis programme for 2010-11. The results indicated an unexpected increase in the level of error and fraud in finalised awards, which the Department needs to understand and use to revisit its strategy.

33 The Department needs to improve the accuracy of calculating and recording the outcome of its interventions to tackle error and fraud in tax credits awards. It needs to ensure that it accurately captures and reports any claimed losses prevented and better understands the link between these results and the levels of error and fraud in tax credits awards.

34 The Department should analyse its remaining balance of tax credits debt to see whether it can recover individual debts. Much of the debt balance of £4 billion recorded at 31 March 2012 is old and unlikely to be collectable. The Department needs to prepare a robust analysis of the age and collectability of debt and collect what is value for money to do so before it considers writing it off.

System-wide recommendations and observations

35 There are broad themes that link our recommendations on PAYE, debt management and tax credits and recommendations made in our 2011-12 value-for-money work. These themes also apply to other aspects of tax administration not directly covered in this report, and we recommend that the Department seeks to apply the lessons covered in this report more widely across the full range of its activities.

36 The Department should:

- **improve its analysis of the costs and benefits of its interventions, such as debt campaigns, and initiatives to reduce tax credits error and fraud;**
- **use better understanding of risks, such as risk profiling of taxpayers, to prioritise and target its activities; and**
- **be clearer, before implementing significant structural changes, about what its future operating model will be. It should set out how its business will be changed by the implementation of RTI and Universal Credit, for example.**

37 The Department's vision for 2015 is to create a tax administration that is more efficient, flexible in its response to customers and more effective in bringing in revenues. This will be challenging as the Department faces a great deal of change during the period. Whilst it has a Business Plan, a customer-centric strategy and a change programme which is seeking to coordinate delivery of major projects, the Department does not have an organisation-wide operational strategy. This strategy would set out how it will deliver tax administration in the future, supported by planning of resources, communications with customers and changes to working practices. It would help the Department to establish the interdependencies between projects and develop an integrated response. The strategy would also help address and mitigate some of the operational difficulties outlined in this and our other recent reports.

Part One

Departmental performance in 2011-12 and the C&AG's work on the Department

1.1 This part of the report discusses:

- tax revenues in 2011-12;
- the UK-Switzerland tax agreement; and
- summarises the work we have published on the Department's activities.

Tax revenues in 2011-12

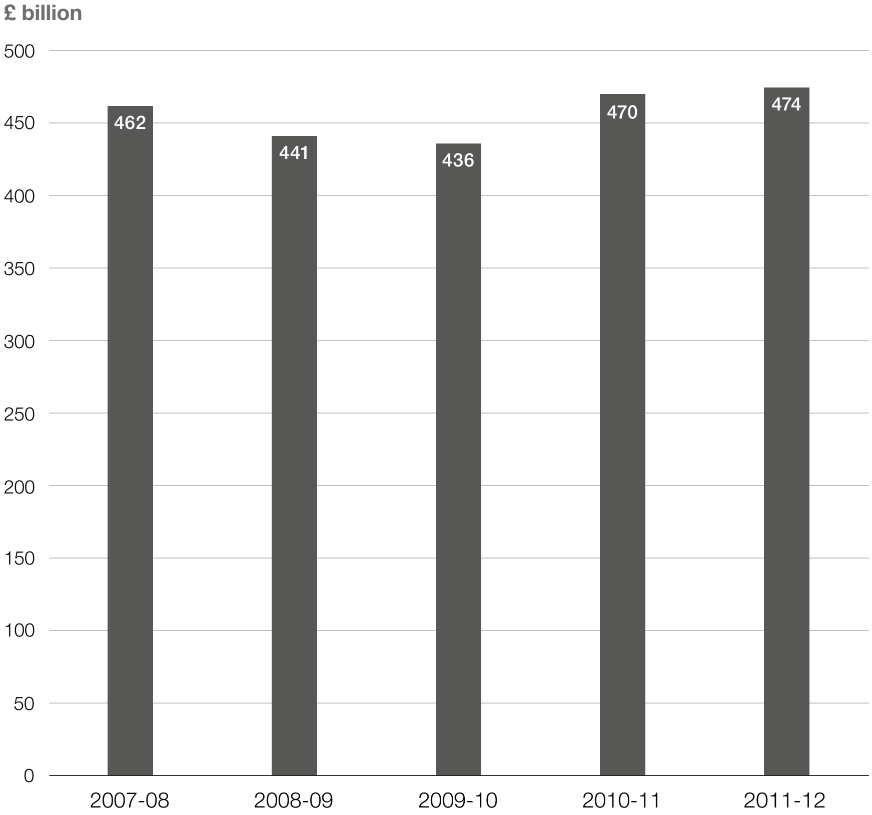
1.2 In 2011-12, total revenues accruing to the Department were £474.2 billion, £4.5 billion (0.96 per cent) more than in 2010-11. **Figure 1** shows the tax revenues reported in the Department's *Trust Statement*[1] in the last five years. The *Trust Statement* reports the revenues and expenditure, and assets and liabilities related to taxes and duties.

1.3 **Figure 2** on page R14 shows the changes in tax revenues between 2010-11 and 2011-12. Tax revenue has continued to recover from the effects of the recession in 2008-09 and 2009-10. VAT revenue has increased by £9.3 billion, largely due to the rate increase from 17.5 per cent to 20 per cent and increases in revenue from the oil, gas and business services sectors. Revenue from corporation tax has decreased as a result of turbulence in the financial sector, partly offset by increased revenue from offshore companies because of higher oil and gas prices. Tax revenues for income tax and National Insurance have fallen from 2010-11. This is largely because the previous year's figure includes an overestimate of self-assessed income tax liabilities, which has been corrected in the current year. Other taxes and duties have risen as a result of rate rises for tobacco duty, alcohol duty, air passenger duty and insurance premium tax.

1 *HM Revenue & Customs annual report and accounts 2011-12*, July 2012; *HM Revenue & Customs annual report and accounts 2010-11*, HC 981, July 2011; *HM Revenue & Customs 2009-10 accounts,* HC 299 July 2010; *HM Revenue & Customs 2008-09 Accounts,* HC 464, July 2009; *HM Revenue & Customs 2007-08 Accounts,* HC 674, July 2008.

Figure 1
Total revenue 2007-08 to 2011-12

Total revenue in 2011-12 was £474.2 billion, £4.5 billion more than in 2010-11



NOTES
1 The total revenue figure for 2010-11 varies from the published accounts because of changes in accounting policy as a result of the government's 'clear line of sight' project to align departmental budgets and accounts.
2 Total revenue figures for the years 2007-08 and 2008-09 vary from those published in the respective Trust Statement Accounts, which include tax credits as negative taxation within revenue for those years.
3 Total revenue in 2007-08 and 2008-09 excludes revenue from fines and penalties.

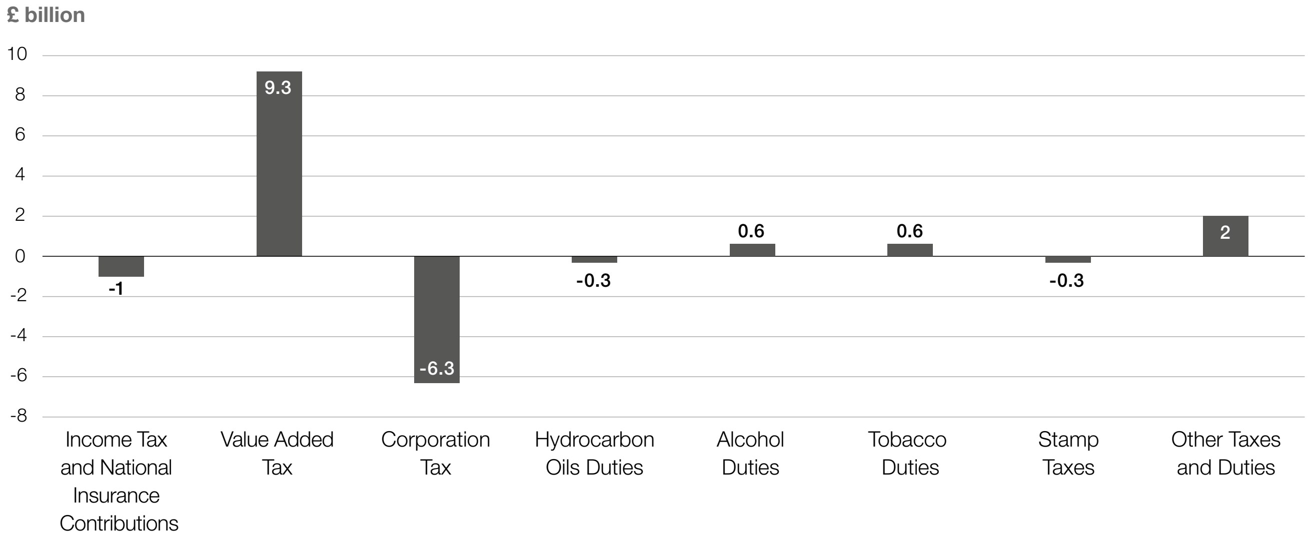
Source: HM Revenue & Customs

UK-Switzerland tax agreement

1.4 On 6 October 2011, the UK and Swiss governments signed an agreement to tackle offshore tax evasion. The agreement aims to settle the past tax liabilities of UK individuals who hold Swiss assets through a one-off payment covering liabilities and will also establish a new withholding tax to collect future amounts due. Those who have already paid their tax can instruct their banks to disclose their details in order not to suffer the one-off levy. Any person under current investigation, or subject to a previous relevant investigation, cannot benefit from the clearance of past tax liabilities and there will be no clearance of past liabilities for those involved in criminal attacks on the tax system or for anyone whose Swiss assets are the proceeds of non-tax crime.

Figure 2
Changes in 2011-12 tax revenues compared with revenue in 2010-11

VAT has increased by £9.3 billion between 2010-11 and 2011-12



Source: HM Revenue & Customs

1.5 The agreement is expected to come into force in 2013, once both countries have completed the necessary parliamentary steps. Subject to the agreement coming into force the Swiss authorities, for the relevant Swiss paying agents, will make an up front payment of 500 million Swiss francs in anticipation of monies due once the agreement starts to operate fully. This has been disclosed in the 2011-12 Trust Statement accounts.

Summary of NAO publications in the last year

1.6 Against the background above, in 2011-12 we published the following reports.

Reports published under the C&AG's section 2 powers

1.7 In January 2012, we published the *Renewed alcohol strategy: A progress report*[2] in response to parliamentary interest in the issue of alcohol duty fraud. The Department estimated that evading alcohol duty could have cost the taxpayer over £1 billion in 2009-10, and that fraud was on the rise. Our report concluded that the renewed strategy to deal with alcohol fraud was more comprehensive than what went before. Also the Department achieved its key financial objective in the first year of the strategy, achieving £433 million of financial benefits against a target of £390 million. However, we found that the Department was not working successfully with industry to disrupt those who were illegally diverting duty-unpaid alcohol back into the UK market. We also found there was a low level of criminal sanctions against those committing fraud. The Department has no explicit objective in its strategy to increase the number and impact of criminal investigations and prosecutions.

2 Comptroller and Auditor General, *Renewed alcohol strategy: A progress report,* Session 2010–2012, HC 1702, National Audit Office, January 2012.

1.8 Our report recommended that the Department should:

- improve the quality, depth and analysis of performance information used to support its strategy;
- produce and publish credible estimates of the tax gap for beer and wine;
- improve the effectiveness of its work with industry to reduce the volume of beer at risk of diversion into illicit markets; and
- set an objective to increase the number and impact of criminal investigations and prosecutions.

1.9 In June 2012, we published a report[3] on the reasonableness of five large tax settlements that were subject to scrutiny by the Committee of Public Accounts following our report on the Department's 2010-11 accounts. Our original report[4] had concluded that the Department had not followed its normal governance processes in agreeing these settlements. Our follow-up report found that all five settlements were reasonable and the overall outcome for the Exchequer was good, but expressed concerns about the processes through which the settlements were reached.

Value-for-money reports

1.10 We have published five value-for-money reports in 2011-12, each of which is summarised below. The reports focus on issues that are key to the Department's ability to operate with reduced resources.

1.11 *Pacesetter: HMRC's programme to improve business operations.*[5] The Department's Pacesetter programme aims to improve its business processes. We found that the programme had improved productivity through new ways of working. We recommended that the Department should prioritise applying Pacesetter to the areas of greatest potential benefit and do more to integrate the programme with its wider change and cost reduction plans.

1.12 *Reducing costs in HMRC*[6]. The Department must generate cumulative cash savings of £1.6 billion in its running costs between 2010-11 and 2014-15. We found that while the Department has a clear vision for how it will look in 2015 and knows its main running costs, there were gaps in its understanding, such as on the link between costs and values. It must address these gaps to create the conditions to achieve value for money over the next four years. The Department agreed with this and we will follow up its progress in 2012-13.

3 Comptroller and Auditor General, *Settling Large Tax Disputes,* Session 2012-13, HC 188, National Audit Office, June 2012.
4 *HM Revenue & Customs annual report and accounts 2010-11*, HC 981, July 2011.
5 Comptroller and Auditor General, *Pacesetter: HMRC's programme to improve business operations,* Session 2010–2012, HC 1280, National Audit Office, July 2011.
6 Comptroller and Auditor General, *Reducing costs in HMRC*, Session 2010–2012, HC 1278, National Audit Office, July 2011.

1.13 *The expansion of online filing of tax returns*[7]. We found that the Department was on track to deliver the programme to time and budget, and that there was evidence that the Department was achieving savings as a result. We recommended that it should collect more detailed cost information to assess whether it had maximised the benefits of using online returns.

1.14 *Core skills at HMRC*[8]. We concluded that the Department could get better value for money if it directed its £96.5 million investment in skills more systematically at business priorities. Staff skills would have been a factor in the improvement of business results, although there is not a direct evidential link between business results and training and development activity. We recommended that it should take a more strategic and informed approach to its investment, aligning skills needs and training more clearly with business objectives and holding business areas to account for performance.

1.15 *HMRC: The compliance and enforcement programme.*[9] We found that the programme had helped the Department to substantially increase tax yield to March 2011, achieving net additional yield of £4.32 billion. We recommended that the Department could better achieve value for money from its investment in compliance work by developing a fuller understanding of the impact of projects and helping people to use new technology by providing the right training at the right time.

1.16 We are currently examining four subject areas. Three of these look at the three principal commitments under the Department's change programme. These are to improve customer service, to reduce its operating costs and to re-invest money from its efficiency savings to generate increased tax revenue. The fourth will further analyse and evaluate the effectiveness of the Department's actions to reduce tax credits error and fraud, following up and expanding on Part Four of this report.

7 Comptroller and Auditor General, *The expansion of online filing of tax returns,* Session 2010–2012, HC 1457, National Audit Office, November 2011.
8 Comptroller and Auditor General, *Core skills at HMRC,* Session 2010–2012, HC 1595, National Audit Office, December 2011.
9 Comptroller and Auditor General, *HMRC: The compliance and enforcement programme,* Session 2010–2012, HC 1588, National Audit Office, March 2012.

Part Two

The PAYE service

2.1 Pay As You Earn (PAYE) is the Department's largest tax collection process. In 2011-12, it collected £151.8 billion in income tax and £101.6 billion in National Insurance contributions, of which nearly 90 per cent was collected through PAYE. There are approximately 39 million individuals with an active PAYE employment record, including 10 million receiving pension income, administered through 2.1 million PAYE schemes. Each year the Department processes around 60 million returns for separate employments and pensions. In June 2009, the Department implemented the new National Insurance and PAYE Service (NPS) system to replace its former PAYE computer system. It brings together individuals' tax records into a single taxpayer record. The Department encountered significant difficulties in administering PAYE after implementing NPS, which we covered in our report on the Department's 2010-11 accounts.[10] The Committee of Public Accounts has also been critical of the roll-out.[11] The Department committed to stabilising the PAYE Service by the end of March 2013, and has also begun a programme to improve the PAYE service through capturing information from employers in real time.

2.2 This part of the report covers how the Department:

- plans to achieve a stabilised PAYE service by the end of March 2013; and
- is preparing to roll-out Real Time Information.

The National Insurance and PAYE service

2.3 Employers currently pay PAYE deductions for all their employees to the Department monthly based on tax codes from the Department. However, employers only provide detailed information on the deductions made for each employee after the end of each tax year. The Department then reconciles the tax due with the payments received throughout the year to ensure employees have paid the correct amount of tax. This sometimes results in under or overpayments of tax, for example where employee circumstances have changed in-year. **Figure 3** overleaf shows the PAYE process.

10 *HM Revenue & Customs annual report and accounts 2010-11*, HC 981, July 2011.
11 HC Committee of Public Accounts, *HM Revenue & Customs: PAYE, tax credit debt and cost reduction,* Fifty-eighth Report of Session 2010-12, HC 1565, December 2011.

Figure 3
Key stages in the PAYE annual cycle

Four main activities take place annually within the PAYE system

Annual coding	In-year processing	End-of-year returns	End-of-year reconciliation
Before the tax year	During the tax year	After the tax year	
HM Revenue & Customs issues coding notices to both individuals and employers, based on latest information. Employers apply the new tax coding to individuals to determine net pay and tax deductions. Individuals contact HM Revenue & Customs with questions relating to their new tax coding.	Employers deduct tax (using tax code) and National Insurance contributions and pay these to HM Revenue & Customs. Employers send HM Revenue & Customs information about employees starting or leaving. HM Revenue & Customs updates its records for employee movements and provides employers with a tax code for new employees.	Employers send HM Revenue & Customs information about total amount of tax and National Insurance deducted and paid over in the year, together with details of employment income and deductions by employee. HM Revenue & Customs matches monthly deductions paid to the amounts declared in the end-of-year returns.	HM Revenue & Customs matches returns for individuals to its records and reconciles their tax and National Insurance deductions with their employment income. HM Revenue & Customs updates its record of pay and tax details and issues a revised tax coding notice, where necessary. Where additional tax is payable, HM Revenue & Customs 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. HM Revenue & Customs repays any overpayments of tax.

Source: National Audit Office

2.4 NPS structures PAYE records around the individual rather than the employer or pension scheme as under the previous PAYE system, bringing together all of an individual's sources of income. The benefits of this are to:

- increase the number of individuals starting the year on the correct tax code, reducing the number of over and underpayments identified at the end of the tax year;
- increase the Department's ability to complete its end-of-year reconciliation of taxpayers' records automatically;

- allow the Department to focus its manual processing on clearing exceptions caused by unexpected data or missing information, or where processing is overly complicated or not cost-effective to automate; and
- increase taxpayers' certainty in their tax affairs that they are paying the right amount of tax throughout the year, regardless of changes in their employment.

2.5 We, and the Committee of Public Accounts, have previously reported in detail on the difficulties encountered in how PAYE operates after the Department introduced NPS.[12] The Department's phased release of NPS meant that it could not automatically reconcile individuals' PAYE records until April 2010. This led the Department to defer its reconciliation of approximately 39 million taxpayer records for 2008-09 until September 2010. This delayed clearing these records and the identifying under and overpayments of tax by over a year. Problems in the quality of data transferred from the predecessor system led to it having to suspend production and issue of annual tax codes in January 2010.

Plans to stabilise the PAYE service

2.6 The Department plans to stabilise the PAYE service by the end of March 2013, where the Department would be dealing with only three open tax years at any point in the year (Figure 3). Over 12 months the Department would:

- reconcile taxpayer accounts for the previous tax year;
- make some in-year adjustments to reflect changes in circumstances, thereby keeping taxpayer accounts up to date; and
- calculate and issue correct tax codes for the following tax year.

2.7 The Department intends to achieve this by:

- clearing the 6.7 million outstanding end-of-year reconciliations for 2008-09 and 2009-10 by March 2012;
- clearing outstanding reconciliations predating the introduction of NPS relating to the 2003-04 to 2007-08 tax years by December 2012; and
- completing end-of-year reconciliations for both the 2010-11 and 2011-12 tax years by March 2013 by accelerating the processing timetable.

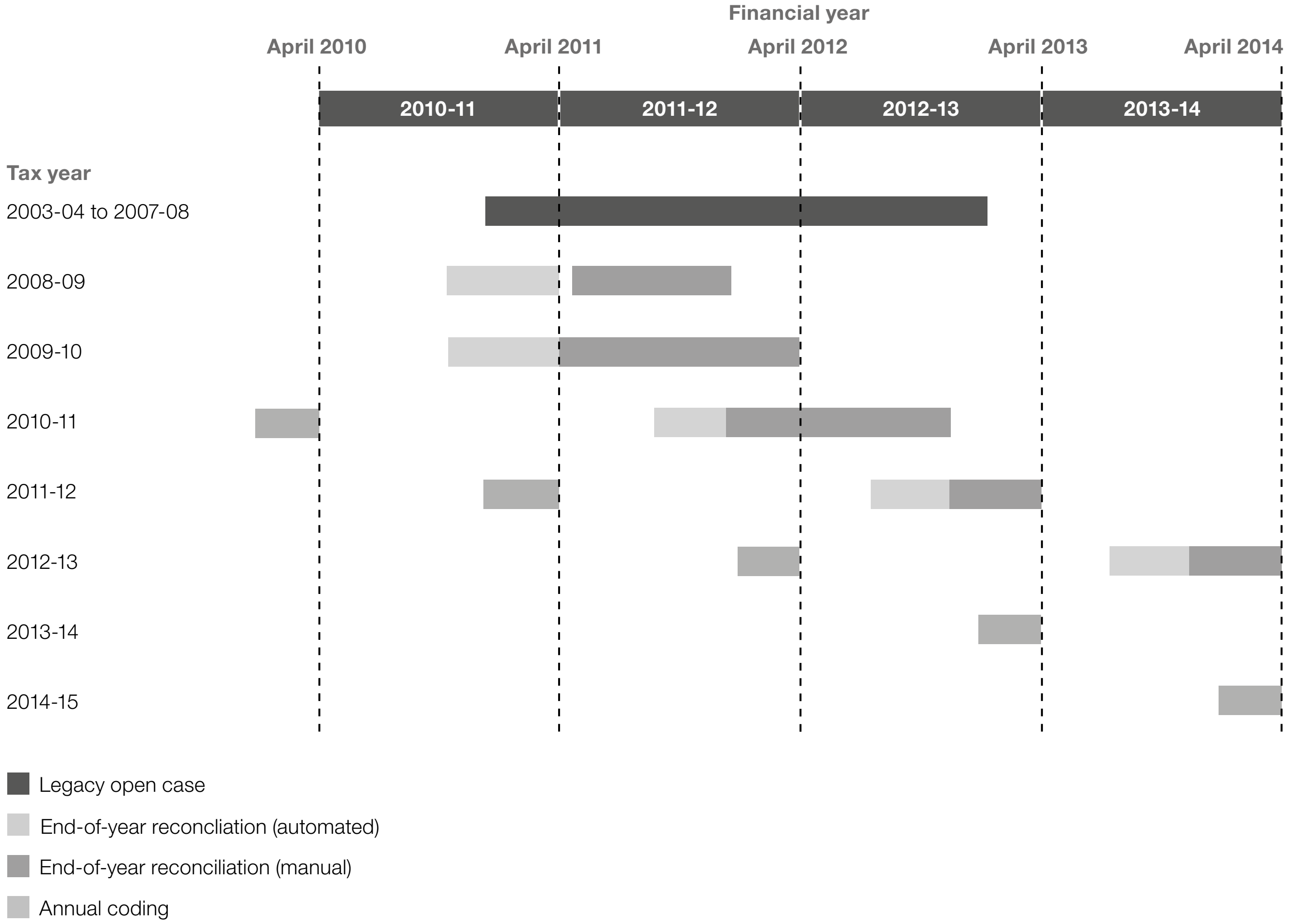
2.8 **Figure 4** overleaf illustrates the Department's planned timetable to deliver a stabilised PAYE service by 2013.

2.9 The Department originally estimated that it would cost £57.3 million to March 2013 to clear open cases and £23.6 million to stabilise PAYE. Its estimate for open case clearance remains unchanged although for stabilising PAYE this has reduced to £21.2 million.

12 *HM Revenue & Customs annual report and accounts 2010-11*, HC 981, July 2011.

Figure 4
PAYE stabilisation timeline

The Department had many key activities to progress during 2011-12



NOTES

1 In 2010-11, the Department completed the majority of annual coding for 2011-12 and end-of-year reconciliations for 2008-09 and 2009-10 where all information for automated reconciliation was available, in addition to processing 2007-08 underpayments from legacy open cases. In 2011-12, the Department planned to complete the manual end-of-year reconciliations for 2008-09 and 2009-10, progress the clearing of legacy open cases and start the end-of-year reconciliation for 2010-11.

2 In-year PAYE processing is a year-round activity and is not represented in the diagram.

Source: National Audit Office

Processing end-of-year reconciliations

2.10 The Department met its target to complete the end-of-year reconciliation of the 2008-09 and 2009-10 tax years by March 2012 (paragraph 2.7). It started these reconciliations in September 2010, completing the automated stage on target by March 2011. In 2011-12, it manually reconciled 6.7 million records. The exercise identified 5.6 million overpayments, amounting to £1.9 billion, and 1.1 million underpayments, amounting to £1.1 billion.

2.11 As we reported last year, the difficulties in the roll-out of NPS resulted in the Department foregoing some tax:

- The Department temporarily raised the threshold for reclaiming underpayments of tax for 2008-09 and 2009-10, and those predating the introduction of NPS (2003-04 to 2007-08) from £50 to £300, excluding an estimated £266 million from recovery. From 2010-11 and subsequent years, it restored the £50 threshold. We examine remissions in paragraph 3.11.
- Some taxpayers have successfully claimed under Extra-Statutory Concession A19[13] that the Department failed to make proper and timely use of information available to it. From September 2010 to 31 March 2012, it received 166,244 claims, to a value of £185 million of which 41,766 were successful at an estimated value of £53.7 million. Since we last reported in June 2011, £12.7 million of this has been remitted.
- In addition, the Department decided to forego tax from 250,000 pensioners whose tax code did not reflect all their state pension income as they could have reasonably claimed the concession described above. The Department does not have an estimate of the value of tax foregone as a result of this decision.

2.12 The Department has started to reconcile tax records for 2010-11 and 2011-12, in line with its plan to operate a 'business as usual' PAYE service by March 2013. So far it has reconciled 30.3 million records relating to 2010-11. From these it has identified 3.8 million overpayments amounting to £1.5 billion, and 1.6 million underpayments amounting to £0.9 billion. While the 2011-12 exercise is at an early stage of completion, the Department expects to complete reconciliations from both years within its March 2013 target.

13 An Extra-Statutory Concession is a relaxation which gives taxpayers a reduction in tax liability to which they would not be entitled under the strict letter of the law. Concession A19 is a concession relating to arrears of tax arising through official error, specifically where the Department has not used the information in a timely manner.

Improving the accuracy of annual tax codes

2.13 The Department encountered significant problems when it issued the annual tax coding notices for 2010-11 using NPS, which led to it suspending production of coding notices. For the 2011-12 and 2012-13 coding exercises, the Department has improved the accuracy and timeliness of the codes by reviewing and repairing potentially inaccurate codes. This year the Department needed to review one million items at risk of inaccurate coding. This is substantially less than the previous year where it had reviewed 11 million items. The Department estimates that 97.2 per cent of 2012-13 tax codes were accurate.

Clearing outstanding reconciliations that predate the introduction of NPS

2.14 The Department has committed to clearing all 17.9 million unreconciled legacy system cases (that is those predating the introduction of NPS) by December 2012. When we last reported in 2010-11, it had cleared 1.1 million. In 2011-12, it cleared 11.7 million open legacy cases leaving 5.1 million cases to clear by December 2012. The Department considers that it is on track to achieve its target.

2.15 The rapid progress of case clearance to date has been possible because large volumes of cases were straightforward and could be cleared in bulk automatically within NPS. The remaining 5.1 million cases are likely to be more complex and therefore more likely to require resource intensive manual work and take longer to complete, slowing the clearance rate. The Department had planned for this and has measures in place that it considers will ensure that it meets the December 2012 deadline. It monitors forecast to actual clearance rates and adjusts resources accordingly. It has also created specialist teams to work on different types of cases.

2.16 The Department estimates that, after clearing the legacy open cases from the 2003-04 to 2007-08 tax years, it may have identified up to £2 billion in overpaid tax.

Managing in-year changes

2.17 The successful stabilisation of the PAYE service requires more than NPS running effectively, the Department also needs to manage its administrative processes well. In addition to completing the annual coding and reconciliation exercises, it has to administer in-year changes to taxpayer records, triggered by taxpayers either through correspondence or telephone, and work generated by the NPS system from in-year processing (collectively called work items) as well as responding quickly to customer contact.

2.18 The Department estimates that the NPS system produces some 20.5 million work items per year, more than its capacity to handle. There are around 150 different types of work item, for example changes to an individual's taxable benefits such as a new company car, and some can be complex and costly in terms of time and manpower to resolve. In 2010-11, the Committee of Public Accounts was concerned that, even with a stabilised PAYE service, the system would generate large backlogs of items. It recommended that the Department determine exactly how it will manage potential in-year changes going forwards so that it amends taxpayer records as people's circumstances change.

2.19 The Department faces resourcing pressures which add to the challenge of dealing with this large volume of work. While stabilising PAYE and implementing Real Time Information (RTI is discussed in paragraphs 2.25 to 2.30), the Department must also reduce staff numbers in the Personal Tax area, which includes PAYE, from 24,900 to 16,400 and reduce costs by £209 million by 2014-15.

2.20 The Department has two strategies to deal with the backlog of work – a short-term process management strategy, and a longer-term process improvement strategy.

Short-term actions

2.21 In the short term, the Department's strategy to deal with the volume of taxpayer-generated in-year changes was to use some of the additional 2,500 temporary staff it recruited to help clear backlogs predating the introduction of NPS for a limited period, and to help with the peak of telephone contact in July to September. It plans to retain these staff until March 2013. This action has improved performance in responding to postal and telephone correspondence in 2011-12, shown in **Figure 5**, although the Department is some way from meeting its targets.

Figure 5
2011-12 performance in responding to telephone and postal contact from customers, and its targets

The Department's performance in responding to customer contact relating to income tax has improved

Measure	2011-12 (%)	2010-11 (%)	Target (%)
Calls answered	74.0	48.0	90.0[2]
Post handled within 15 working days	63.7	36.8	80.0

NOTES

1 Performance is based on contact received on all income tax not just PAYE. This is because the Department does not record performance on PAYE separately.

2 Ninety per cent represents the Department's longer-term target for 2014-15 for answering telephone calls.

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

2.22 To manage the current volumes of NPS-generated work items, the Department has: staggered when NPS produces items through the year; prioritised those that would have an end-year effect on an individual's tax position; and stopped around five million items being generated on the basis that these items would not affect customers' final tax positions, and can be dealt with as part of the normal end-of-year reconciliation process. The Department estimates these changes, with the level of resources planned for 2014-15, offer it the capacity to process around 13.5 million (87 per cent) of the remaining 15.5 million items, assuming five million are prevented from being generated from an original 20.5 million.

Longer-term action

2.23 In order to provide a longer-term solution to the backlog of work items, in 2011-12 the Department undertook an exercise to look at ways of automatically reducing or eliminating some items. As of June 2012, it is in the final stages of the approval process for a project which will automate or eliminate around 2.5 million items and prevent NPS generating a further four million annually. It considers this would make the workload manageable in future.

2.24 However, a sustainable position is dependent on both the future volumes of work items created and the resource available to deal with these items. If the project does not proceed or if the project does not deliver the anticipated reductions in work items, the Department will have an ever increasing backlog of work items to clear as volumes will continue to exceed clearance capacity. This will impact the accuracy of customers' records, leading to increased customer contact and have an adverse impact on its performance targets. The Department does not have a contingency plan should these workload reductions not materialise other than to continue its work on developing further process improvements and to reallocate resources from other activities to continue manual clearance.

Preparing to fully implement Real Time Information

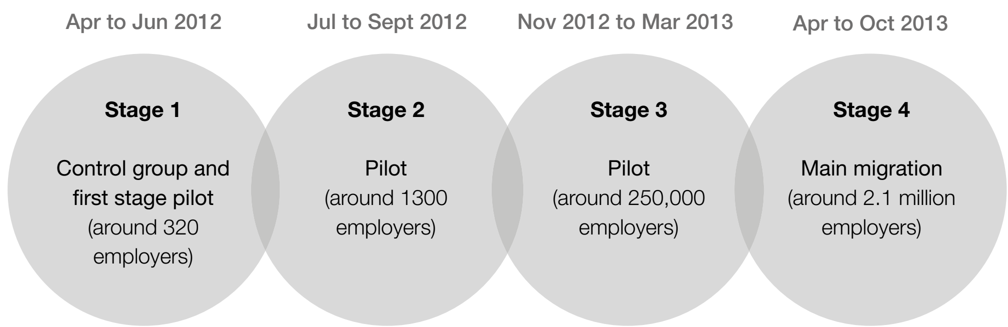
2.25 The next major change for the PAYE service is introducing Real Time Information (RTI), where employers must report employees' income tax and National Insurance deductions as they pay them rather than at year-end. Under RTI, some elements of the PAYE process will no longer be required, such as employer end-of-year returns and in-year forms for starters and leavers. It should also reduce the time to complete end-of-year reconciliations, increasing the number of automated reconciliations. However, end-of-year reconciliations will still be needed, as, for example, the Department would only be notified of benefit in kind information, such as company cars, at the end of the tax year.

2.26 The timetable for implementation of RTI is challenging, as shown in **Figure 6**. The Department for Work and Pension's timetable to implement Universal Credit is driving the timetable to roll-out RTI. The Department for Work and Pensions requires real time PAYE information on employment and pension income to award and adjust Universal Credit. It is rolling out Universal Credit from October 2013 to 2017. All employers and pension providers need to be using RTI by October 2013 to meet this timetable. The Department met its milestone to start its RTI pilot in April 2012 with ten employers. By July 2012, it expects a further 310 employers will be using RTI. At 31 May 2012, 209 PAYE schemes covering 1.5 million individual records were using RTI.

2.27 The Department originally intended that employers would give employee information and payments together through the Bacs[14] payment system. However, payroll providers were concerned that there was not enough time to fully implement the Bacs system by October 2013. To manage this risk, the Department devised an interim solution where employers send employee information separately from payments. The Department then matches employee information and payments separately.

Figure 6
The timetable for rolling out Real Time Information

All employers have to be using Real Time Information by October 2013



NOTE
1 'Employers' includes both employers and pension schemes.

Source: HM Revenue & Customs

14 Bacs is the UK scheme for the electronic processing of financial transactions.

2.28 The Department recognises that poor data quality was a key cause of the problems when issuing previous annual coding notices. It also recognises that it must improve both the quality and frequency with which it receives information to fully realise the benefits of NPS, operate RTI and contribute to the successful operation of Universal Credit. In its 2010-11 report, the Committee of Public Accounts concluded that the Department needed to focus on improving data quality. As a result, the Department completed a data quality review and implemented various measures to improve data quality, among these it has reviewed its NPS records and has started a data quality project working with employers on their data. It has decided that upon entering RTI, employers will have to match their employee records against those of the Department to ensure that data held on NPS is accurate. The Department has seen an improvement in the automatic matching of employers' records (P14) to individuals' records on NPS. In the 2010-11 tax year, 98.3 per cent of records matched compared with 2009-10 when 97.9 per cent of records matched.

2.29 RTI offers the Department the prospect of tracking changes in income and employment in-year, ensuring that individuals remain on the correct tax code when employments change and thereby reducing the risk of identifying under and overpayments during the end-of-year reconciliation process. The Department has yet to decide how far it will use RTI within its in-year PAYE processing. It plans to use information gained during the pilot exercise to inform its view.

2.30 The Committee of Public Accounts was also concerned when implementing RTI the Department should consider employers in small- and medium-sized enterprises and assess the impact on them in the pilot exercise. The Department intends to have representation from small- and medium-sized entities at each pilot stage.

Part Three

Tax debt management

Introduction

3.1 We reported on tax debt management in our report on the Department's 2009-10 accounts. It had recently introduced a new debt management strategy and we reported that there were early signs of improvement in debt collection rates.

3.2 This part sets out:

- how the Department manages tax debt;
- the Department's performance in managing the debt balance in 2011-12; and
- what progress the Department has made to implement its debt management strategy.

How the Department manages tax debt

3.3 The Department aims to make it easier for taxpayers to pay their tax liabilities and to take a firm line with those who fail to pay, thereby helping to maximise tax revenues. It seeks as far as possible to prevent taxpayers building debt by accruing tax liabilities. This part of the report examines tax debt that occurs when a tax liability remains outstanding after the due payment date. It is defined by the Department as, amounts which are overdue for payment, which remain due for payment and which are legally enforceable.

3.4 Tax debt is not shown separately in the Department's *Trust Statement* but is included within a larger figure described as 'receivables'. Receivables are all tax liabilities that are unpaid, whether or not payment is overdue. A large proportion of the receivables balance is accounted for by sums which the Department considers are not yet due for payment. The gross receivables balance decreased from £24.9 billion at 31 March 2011 to £23.2 billion at 31 March 2012. We focus here on the proportion of this balance – £13.3 billion – which the Department defines as 'tax debt' and is therefore actively managing in order to maximise recovery. The majority of this debt is being cleared by a specialist unit within the Department, the debt management and banking directorate (the directorate).

3.5 Managing tax liabilities and debts is an important part of administering tax to avoid higher administration costs and lower rates of recovery. Most debts relate to self-assessed Income Tax, employers' PAYE, National Insurance, corporation tax and VAT.

Departmental performance in managing the tax debt balance

3.6 At 31 March 2012, the Department's debt balance relating to taxes and duties was £13.3 billion, 11 per cent below the balance of £15.0 billion at the end of 2010-11 (**Figure 7**). This sum excludes tax credit debt, arising when the Department identifies that customers have been overpaid tax credit, which we examine in Part Four.

3.7 During 2011-12, the Department managed £62.9 billion of debt, slightly less than in 2010-11 (£63.0 billion). It collected £37.9 billion, 14 per cent more than in 2010-11 (£33.3 billion).

3.8 The Department's measure of how effectively it manages debt is the 'debt roll rate'. It is a measure of speed of clearance and reports the percentage of new debt cleared by the Department within 30 or 90 days of becoming collectable and overdue. It is a comparable measure to those used by businesses in the private sector. The roll rate includes income tax and corporation tax. It does not include other taxes, or debt managed outside the directorate. In 2011-12, 95.7 per cent of tax debt was cleared within 90 days, compared with 93.3 per cent in 2010-11.

3.9 The Department may clear a debt in one or more of four ways (**Figure 8**):

- Collected. The Department collects the debt either in full or by instalment arrangement.
- Revenue losses remitted. The Department decides not to pursue a tax debt, such as because of hardship or value for money.
- Revenue losses written-off. The Department assesses the debt to be irrecoverable because there is no practical way to pursue the liability, for example, the taxpayer cannot be traced or has gone bankrupt.
- A reassessment of the liability. The Department amends or cancels the debt as further information is received that determines the taxpayer's final liability.

3.10 While the Department's collection rate has improved, the reduction in the debt balance is also due to its ongoing work to improve the accuracy of amounts recorded in its debt management systems.

Figure 7
Debt collection in 2011-12 compared with debt collection in 2010-11

The Department has collected £37.9 billion of tax debt, £4.6 billion more than in 2010-11

	2011-12 (£bn)	2010-11 (£bn)
Total revenue	474.2	469.7
Debt:[1]		
Debt brought forward from prior year	15.0	17.9
New debt created in-year	47.9	45.1
Total debt managed in-year	62.9	63.0
Debt cleared by:		
Collected	37.9	33.3
Revenue losses written-off and remitted[2]	5.2	5.5
Amendments, cancellations and other adjustments	6.5	9.2
Debt balance at 31 March	**13.3**	**15.0**

NOTES
1 The debt balance is a subset of the receivables balance shown in the Department's *Trust Statement* account. The receivables balance at 31 March 2012 was £23.2 billion.
2 Figure 9 is a more detailed breakdown of write offs and remissions.

Source: HM Revenue & Customs

Figure 8
Debt roll rate

Of all debts included in the measure, 95.7 per cent of debt was cleared within 90 days

	January 2012 (%)	January 2011 (%)
Debt cleared within 30 days	92.8	92.8
	November 2011 (%)	**November 2010 (%)**
Debt cleared within 90 days	95.7	93.3

NOTES
1 As full year data for 2011-12 was not available at the time of writing, we have used the most up-to-date information available. The roll rate is calculated on a cumulative basis.
2 The roll rate includes income tax and corporation tax managed within the debt management and banking directorate. It does not include VAT or debt managed outside the directorate.

Source: HM Revenue & Customs data

3.11 In 2011-12, the Department remitted £957 million of tax liabilities compared with £808 million in 2010-11 (**Figure 9**), and wrote off £4.2 billion. Most of the increase in tax liabilities remitted over the last two years was for income tax, where the Department remitted £756 million in 2011-12, compared with £675 million in 2010-11 and £91 million in 2009-10. Following the introduction of NPS, the Department had to reconcile 2008-09 and 2009-10 tax years together and it identified an increased number of underpayments in 2010-11 and 2011-12 as it cleared the reconciliation backlog as part of PAYE stabilisation (paragraph 2.7). The Department applies a threshold to PAYE (currently £50) and does not pursue tax underpaid below this threshold amount on value-for-money grounds. However, to minimise the impact of the reconciliation backlog on customers the Department temporarily increased the threshold to £300, further increasing the amounts remitted. We discuss tax foregone in PAYE in paragraph 2.11. The new NPS system records all underpayments below the threshold as revenue losses; previously, up to 2009-10, such amounts were not recorded. This change has also contributed to the increased level of remissions.

Figure 9

Revenue losses in 2011-12 compared with revenue losses in 2010-11

The table shows the revenue losses for each tax, split between write-offs and remissions

	Remissions 2011-12 (£m)	Write-offs 2011-12 (£m)	Total 2011-12 (£m)	Restated[1] Remissions 2010-11 (£m)	Write-offs 2010-11 (£m)	Restated[1] Total 2010-11 (£m)
Income tax	756	743	1,499	675	937	1,612
VAT	13	1,907	1,920	48	1,941	1,989
Corporation tax	3	500	503	2	633	635
Alcohol duties	3	61	64	–	10	10
Tobacco duties	–	1	1	3	–	3
Capital gains tax	4	38	42	3	36	39
National Insurance contributions	74	579	653	66	757	823
Fines and penalties	98	305	403	6	363	369
Other remissions and write-offs	6	80	86	5	18	23
Total revenue losses	957	4,214	5,171	808	4,695	5,503

NOTE

1 2010-11 remittance figures are restated to correct a prior year understatement.

Source: HM Revenue & Customs

3.12 In 2011-12, the Department also remitted substantially more debt resulting from unpaid fines and penalties, from £6 million in 2010-11 to £98 million in 2011-12. This was largely due to its decision to remit PAYE penalties which it judged were not cost-effective to pursue.

3.13 The Department writes off debt when there is no practical or legal way to recover the amounts due, for example when a debtor becomes insolvent. Debts may also be written-off when the Department determines that the debt is irrecoverable, for example as a result of 'missing trader' fraud.[15] In 2011-12, the Department wrote off £4.2 billion, £481 million less than in 2010-11.

Progress in implementing the revised debt management strategy

Improvements arising from the revised strategy

3.14 During 2009-10, the Department began to implement a revised debt management strategy (the strategy) which aimed to target collection activities more effectively to increase the likelihood of recovery, improve the speed of collection, and reduce costs. The strategy was also to help prevent taxpayers getting into debt by supporting them better before their tax liabilities became overdue and communicating more effectively with them so that any queries were resolved and debt paid without needing multiple contact. To implement this revised approach the Department aimed to improve its debt collection processes through:

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

3.15 The Department has made progress in a number of areas in implementing its revised debt management strategy (**Figure 10** overleaf), particularly in rolling out its campaigns-based approach. Previously the directorate used a standard debt collection process for all debts, sending automated debt reminders initially, following up with telephone calls, in writing and through visits. The directorate used this approach regardless of the type of debt, with limited differentiation by value and risk of non-payment. In contrast, a campaign is an individually designed, time-limited set of actions taken for a particular tax stream's debts. It involves segmenting debts into groups, such as by value and behaviour of groups of taxpayers, and tailoring collection activities to each group.

15 Missing Trader fraud is a type of VAT fraud, which in its simplest form involves a business obtaining a VAT registration number in the UK for the purposes of purchasing goods free from VAT in another EU member state. The business sells the goods at a VAT inclusive purchase price in the UK and then goes missing or defaults without paying the output tax due to the Department. The amounts are legally collectible and classed as debts, but because of their nature they may not be recovered.

Figure 10
Summary of progress made in implementing the debt management strategy introduced in 2009-10

The majority of the activities within the debt management strategy have been progressed

Key components	Progress
Adopting a campaigns-based approach	At 31 May 2012, 20 campaigns had been completed and a further 16 were live. See paragraph 3.15.
Better understanding of individual taxpayer behaviour to segment the debtor population, then applying risk-based targeting of interventions	Significant delays. Original delivery date April 2011, forecast delivery date October 2012. See paragraphs 3.18–3.20.
Increased telephone capacity	The Department has substantially increased the capacity of the debt management telephone centre. See paragraph 3.25.
Other components	**Progress**
New payment methods	Taxpayers can now pay using debit cards, credit cards and direct debit as well as by cash and cheque. The Department did not accept the Committee of Public Accounts' recommendation in May 2009 that it should trial systems such as PayPal.
New penalty regime	The Department revised its penalty regime to align penalties across taxes and to improve overall compliance by differentiating penalties according to taxpayer behaviour. It started to use the new PAYE penalty regime for the 2010-11 tax year. The Department considers that it has seen improvements in payment behaviour but it has not yet evaluated the impact of the regime in reducing debt. For example, when fully implemented, it may result in a high volume of low-value debt that is difficult to collect and may ultimately be remitted.
Greater access to arrangements to be given more time to pay	The Business Payment Support Service supports viable businesses experiencing short-term financial difficulties to comply with their tax obligations. See paragraph 3.21.
Recovery through tax codes	From October 2011, the Department can recover debts under £3,000 through employee's tax codes.
Charging for Court costs	Effective from April 2012.
Expanding out of hours working over the telephone and face to face.	In response to the Committee of Public Accounts' recommendation of May 2009, the Department has expanded out-of-hours calls to different taxpayer groups, such as self-employed tradesmen. It has no plans to increase capacity further or extend the hours of face-to-face contact.

Source: National Audit Office

3.16 At 31 March 2012 around £36 billion of debt had been put into a campaign, collecting £18.2 billion. In 2009-10, the Committee of Public Accounts recommended that the Department establish a consistent set of measures, including cost and effectiveness to allow it to make comparisons across campaigns and over time. The Committee also recommended that the Department do activity-based costing. The Department committed to developing activity-based costs within its campaigns approach.

3.17 The Department currently measures the success of each campaign by the collection rate, but has not yet developed broader measures to assess the effectiveness of individual campaigns. Initial evidence suggests that using tailored letters, involving staff and a flexible approach has meant the Department collects debts more quickly, in overall terms. However, the Department is not able to demonstrate how cost-effective campaigns are compared to the previous debt collection process, or which activities are most cost-effective for which types of debt. In addition, the Department has not resolved a long-standing limitation of its systems, which makes it difficult to link different debts owed by the same taxpayer. Linking of debts tends to occur only when the Department initiate court action or other enforcement proceedings. The Department considers that its new debt analysis capability (paragraph 3.18) should improve its ability to link debts where it makes sense to do so.

Profiling taxpayer behaviour

3.18 In its reports on debt management in 2004 and 2009,[16] the Committee of Public Accounts recommended the Department use risk profiling of taxpayers to better target collection activities. A key component of the Department's debt strategy is to be able to systematically analyse debt balances and debtor behaviours. This is called 'analytics'. The Department could then assign a score to each taxpayer by risk level and analyse the taxpayer's debts and payment history, and the outcome of previous actions taken to collect debt. It could then assess taxpayer's ability to pay and the risk of non-payment or insolvency. It would also use the information to tailor debt collection activities towards those actions most likely to be effective. For example, a customer who has never been in debt before would be subject to a different approach from a customer who has frequently been in debt but never paid until threatened with enforcement.

3.19 The Department has delayed fully implementing analytics from April 2011 to October 2012. The delay is due to the government's moratorium on IT projects in 2010 and the civil service recruitment freeze, which meant the Department could not recruit specialist analysts. Consequently, the Department has been unable to risk profile individual taxpayers and to tailor interventions to maximise collection according to individual taxpayer behaviour. In October 2011, the Department delivered a major part of the project which has enabled the Department to bring together debt information from different IT systems into a common format. The Department plans to start using the system to do behavioural risk analysis from October 2012.

16 HC Committee of Public Accounts, *HM Revenue & Customs: management of tax debt*, Twenty-sixth Report of Session 2008-09, HC 216, June 2009 and HC Committee of Public Accounts, *The recovery of debt by the Inland Revenue*, Forty-ninth Report of Session 2003-04, HC 584, November 2004.

3.20 The Department does design its campaigns to take account of the behaviour of customer groups. It has run a number of trials informed by behavioural economics theories. In these trials, letters tailored to the individual taxpayer's circumstances have increased collection rates by up to 7.6 per cent and response rates by up to 20 per cent depending on the form of words used.

Time-to-pay arrangements

3.21 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, the Department launched its Business Payment Support Service in November 2008. The service aims to speed up the time it takes to make decisions when businesses apply for a 'time-to-pay' arrangement. The average amount of debt in time-to-pay arrangements in 2011-12 was £908 million, compared with £1,327 million in 2010-11. The number of time-to-pay arrangements agreed has decreased from 254,285 at 31 March 2011 to 222,071 at 31 March 2012. The Department is planning to improve how it centrally tracks and monitors time-to-pay cases.

Building capacity to enhance implementation of the strategy

3.22 The Department's debt capability and capacity have been enhanced by contracting out work to debt collection agencies. Its main reason for using agencies has been to provide additional flexible capacity. Following a pilot in 2009, the Department appointed four agencies from July 2010. This was on a payment-by-results basis. The agencies primarily focus on smaller value debts where taxpayers have not responded to initial follow-up letters from the Department. The Department has increased the number of agencies it uses to ten during 2012.

3.23 In 2011-12, the Department transferred £566.6 million of debt to agencies. During the year, agencies collected £44.3 million of that debt in addition to £66.9 million of the £445.1 million sent in the previous year. By March 2012, agencies had also agreed payment terms for a further £58.6 million of debt placed with them. The value allocated to debt collection agencies in-year represents less than 1 per cent of the total debt managed in 2011-12. In 2012-13, the Department plans to transfer £530 million of debt to agencies.

3.24 The Department has completed limited analysis of the effectiveness of using agencies to collect different types of debt compared with the Department collecting the debt itself. The difference varies according to the tax stream and age, or value, or both, of the debt. It has also evaluated how much additional cash has been collected compared with the amount that would have been collected had agencies not been used to deliver additional capacity. In 2011-12, it found that 77 per cent more cash was collected, while an evaluation in the previous year found that an additional 57 per cent had been collected. The Department plans to use this information to set specific targets and to select the most appropriate debts for agency recovery.

3.25 The Department has also used its debt telephone centres to support the campaigns-based approach. In 2011-12, debt telephone centres handled six million calls, an increase of 9 per cent on 2010-11. The proportion of calls answered by debt telephone centres has increased from 76.2 per cent in 2010-11 to 88.4 per cent in 2011-12. Meanwhile, the Department trained staff on other debt collection activities to increase their effectiveness in progressing cases. However, there are specialist areas within the directorate where the volume of debt exceeds their capacity to pursue all the cases they are sent. The directorate is currently considering how best to deal with this issue.

Management information

3.26 The Department is working on ways to improve its information on internal costs and performance so that it can manage debt more effectively. For example, it has information on the cost of using debt collection agencies, but does not have good information on the cost of other approaches. It must identify the cost of each collection activity before it can assess the value for money of different collection approaches.

Part Four

Personal tax credits

Introduction

4.1 In 2011-12, the Department spent around £30 billion on Child and Working Tax Credits (personal tax credits), which offer financial support to more than six million families, supporting around nine million children.

4.2 The personal tax credits scheme is designed to be flexible enough to react to changes in claimants' circumstances. However, claimants do not always understand their obligations to tell the Department when their circumstances change and to report their actual income and circumstances at the end of the tax year. Claimants may make errors in their applications, which result in incorrect payment awards. For example, claimants may misunderstand what they should report as income, or miscalculate their childcare costs. Claimants' final entitlement, based on their actual income and circumstances in the year, can only be calculated after the end of each year. If claimants have been paid more than they were entitled to, overpayments and debts arise which the Department then seeks to recover.

4.3 In February 2011, the government announced its intention to introduce a new 'Universal Credit' to replace many of the current working-age benefits, including working and child tax credits, with a single means-tested payment. The Department for Work and Pensions plans to launch Universal Credit in October 2013, with all existing tax credits claimants moved on to it by 2017.

4.4 This part describes how the Department's accounts report personal tax credits; explains why the C&AG has qualified his audit opinion in 2011-12 and reviews the actions the Department is taking to:

- reduce personal tax credits error and fraud;
- manage personal tax credits debt; and
- prepare for the implementation of Universal Credit.

Accounting for personal tax credits

4.5 The Department has reported personal tax credits in its 2011-12 *Resource Accounts*[17] for the first time. The *Resource Accounts* record all the Department's running costs and wider expenditure. Previously the Department's *Trust Statement*, which records the tax revenue it has collected, reported personal tax credits. This change comes from the Treasury's 'clear line of sight' initiative which is designed to align budgets, estimates and accounts to improve parliamentary oversight and control. Total expenditure recorded in the Department's 2011-12 *Resource Accounts* is £46.5 billion, of which £30 billion was on personal tax credits.

The C&AG's audit opinion

4.6 In forming his audit opinion on the Department's Resource Accounts, under the Government Resources and Accounts Act 2000, the C&AG is required to obtain evidence sufficient to give reasonable assurance that the expenditure and income reported have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them (his regularity opinion).

4.7 The C&AG has qualified his regularity opinion on the Department's 2011-12 *Resource Accounts* due to the material level of error and fraud in personal tax credits expenditure. 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 Act specifies the criteria which govern entitlement to personal tax credits and the method to be used to calculate the amounts to be paid. Transactions do not conform with the governing legislation and are therefore irregular for one of two reasons:

- error or fraud results in payments of personal tax credits to households which are not entitled to those credits; or
- error or fraud results in under or overpayments which differ from the entitlement specified in the legislation.

4.8 Although this is the first year in which the Department's *Resource Accounts* have been qualified in respect of the regularity of personal tax credits expenditure, the Department's *Trust Statement*, in which personal tax credits were reported in previous years, received similar qualified audit opinions since the scheme commenced in 2002-03. The C&AG has consequently reported on personal tax credits every year since personal tax credits were introduced.

17 *HM Revenue & Customs annual report and accounts 2011-12,* July 2012.

Reducing personal tax credits error and fraud

4.9 Note 10.3 to the Department's *Resource Accounts* discloses the Department's best estimate of all error and fraud within the personal tax credits system. **Figure 11** shows that the Department's estimate of the overall level of error and fraud in finalised awards increased from between 7.0 and 8.6 per in 2009-10 to between 7.5 and 8.8 per cent in 2010-11. This equates to payments of between £2.08 billion and £2.46 billion being made to claimants incorrectly because of error or fraud and further amounts of between £170 million and £290 million not being paid to claimants due to error. The levels of error and fraud are material within the context of the £30 billion spent on personal tax credits in 2011-12.

Figure 11
HM Revenue & Customs' estimates of error and fraud

The estimated percentage of error and fraud within finalised awards has increased during 2010-11 compared to the previous year

	2010-11	2009-10[3]	2008-09
Value of finalised awards	27.9bn	£26.4bn	£23.6bn
Error and fraud favouring the claimant (overpayments):[1]			
Percentage of finalised awards[2]	7.5–8.8%	7.0%–8.6%	8.3%–9.6%
Value	£2.08–£2.46bn	£1.85–£2.28bn	£1.95–£2.27bn
Error favouring the Department (underpayments):			
Percentage[2]	0.6–1.0%	0.9%–2.0%	0.8%–1.3%
Value	£0.17–£0.29bn	£0.23–£0.53bn	£0.20–£0.31bn

NOTES

1 The Department estimates levels of error and fraud based on the examination of a random sample of 3,352 finalised awards under its annual error and fraud analytical programme. As awards for 2011-12 are not due to be finalised until July 2012 and in some cases later, the Department will not be able to complete its error and fraud analysis of these awards until summer 2013.

2 The percentages shown in Figure 11 represent the estimated ranges of error and fraud as a percentage of finalised personal tax credits entitlement. Ranges are used as the estimated midpoints are subject to margins of error. The Department publishes child and working tax credits error and fraud statistics each year from where further details may be obtained at: www.hmrc.gov.uk/stats/personal-tax-credits/menu.htm

3 The Department has updated the 2009-10 estimates using final results after initial error and fraud statistics were published in June 2011. It has revised the estimate for error and fraud in 2009-10 awards upwards from between 6.6 and 8.1 per cent to between 7.0 and 8.6 per cent.

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

4.10 In July 2008, the Department announced a target to reduce personal tax credits losses due to error and fraud to no more than 5 per cent of the value of finalised entitlement by March 2011. In June 2012, the Department announced that, based on the midpoint of 8.1 per cent in its estimate of the overall level of error and fraud in finalised awards, it had not achieved this target. Error and fraud levels for 2010-11 fell in respect of childcare costs, income and disability, but increased substantially in respect of undeclared partners and improper payments relating to children.[18] The Department is now investigating the reasons for this unexpected reverse in the previous trend of annual reductions in the level of error and fraud. The Department will use the results of that investigation to determine if and how it should modify its strategy to achieve the 5 per cent target by 31 March 2015.

4.11 The Department had identified escalated risks around undeclared partners prior to the publication of the latest estimates. During 2011-12, it enhanced controls by validating claim details against third party data held by credit reference agencies. It had not anticipated a heightened risk associated with paying tax credits for non-eligible children and had not developed significant new initiatives in this area.

Error and fraud strategy

4.12 The Department's approach, launched in April 2009, seeks to: provide better support to claimants by helping them through the claim and renewals process, confirming that information held is accurate; prevent error and fraud from entering the system at key stages in the process; and tackling non-compliance by targeting high risks claims for compliance and other enquiries.

Better support to claimants

4.13 In 2011-12, the Department contacted 341,000 claimants to check whether information held was correct and to update it as necessary. It focused on those categories of claim where error and fraud is most prevalent – childcare costs, declaring partners, overstating working hours, disability claims, and eligible children. The Department estimates that these interventions to confirm whether information is accurate have prevented £232 million of error and fraud in 2011-12.

Preventing error and fraud

4.14 The Department increased its focus on preventing error and fraud from entering the system at the application, change of circumstances and renewals stages. Primarily, it validated data before making awards. During 2011-12, the Department made 528,000 checks (55 per cent more than in the previous year), and prevented £321 million (£238 million in 2010-11) of error and fraud from entering the personal tax credits system.

18 Parental claims for children may be ineligible if, for example, the child is no longer in full-time education.

Tackling non-compliance

4.15 The Department continues to identify tax credits claims for compliance and other enquiries, using specified verification and risk-scoring criteria when it processes awards. It examines awards post-payment by comparing tax credits data to other systems and targeting specific areas of concern including where income stated for tax credits does not match income stated for other taxes. Through these improved risk-management processes, the Department identified £408 million of error and fraud in the system in 2011-12. In these circumstances the Department corrects the awards and seeks to recover overpayments.

4.16 As indicated in **Figure 12**, in the last year, the total value of losses prevented has increased by 21 per cent from £792 million to £961 million as the total number of checks and other interventions has reduced from 1.8 million to 1.4 million. The Department has consciously shifted its activity from providing better support to claimants and tackling non-compliance, to preventing error and fraud. The Department is now more successful in preventing error and fraud in new awards and renewals than in changes of circumstances reported by claimants. The Department is considering the merits of developing an alternative approach to enable them to better identify cases most likely to contain error and fraud. Currently, it uses a manual process to prioritise cases for investigation and possible corrective action.

Figure 12
Outcomes of interventions to reduce error and fraud

The value of losses prevented has increased by 21 per cent from £792 million in 2010-11 to £961 million in 2011-12, as the total number of checks and other interventions has reduced from 1.8 million to 1.4 million

	2011-12		2010-11		2009-10	
Interventions	**Number (000s)**	**Estimate of loss prevented (£m)**	**Number (000s)**	**Estimate of loss prevented (£m)**	**Number (000s)**	**Estimate of loss prevented (£m)**
Better support to claimants[1]	341	232	470	215	524	40
Preventing error and fraud[1]	528	321	340	238	104	173
Tackling non-compliance[1]	485	408	984	339	653	356
Total	1,354	961	1,794	792	1,281	569

NOTE

1 Each category includes an amount arising from interventions undertaken by Compliance, Operations and Customer Contact Directorate. Some of these measures impact on more than one area and have been allocated to the most appropriate category.

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

Measuring in-year error and fraud performance

4.17 The Department can only measure the personal tax credits error and fraud in any year once the awards for that year are finalised. It has, therefore, developed proxy indicators to allow it to track ongoing progress in reducing error and fraud in-year. The indicators measure by how much each award is amended as a result of the Department's interventions (£961 million), as well as assessing the wider deterrent effect (£97 million) and benefits accruing in previous years (£432 million). Together these add to the total of £1.5 billion achieved to 31 March 2012. The Department has a target to identify £1.7 billion of error and fraud by July 2012, once the majority of 2010-11 awards are finalised. The Department believes it will achieve this target.

4.18 We have previously recommended that the Department improve the accuracy and reliability of measuring losses prevented by its interventions. During 2010-11, the Department issued new guidance and training for personal tax credits teams on measuring interventions and introduced new assurance arrangements. Despite some improvement, we have continued to find inconsistent measurement and occasions where staff inaccurately recorded results of interventions, resulting in both over- and under-reporting of losses prevented in 2011-12.

4.19 A proportion of the losses prevented claimed by the Department is not being realised. This is because the Department has not always made the required changes to records on the tax credits system to reduce the claimant's awards and future payments. In the sample of new application interventions we tested, we found that 10 per cent had not been corrected in the system, resulting in incorrect awards continuing to be paid. In addition, terminated awards may subsequently be reinstated when claimants clarify their situations, but the losses prevented calculations are not adjusted to reflect these changes because the Department does not consider that there is a need to make adjustments for changes occurring after the initial measurement point.

4.20 The relationship between the Department's estimate of the levels of error and fraud and the proxy losses prevented derived from its in-year interventions and the error and fraud result is not clear. Losses prevented increased by £223 million between 2009-10 and 2010-11, but the Department's estimate is that the level of error and fraud increased by approximately £200 million between these years. The Department is now reviewing the relationship between its claim for losses prevented and the outcome of its annual measurement of error and fraud in tax credit awards, to determine why expected reductions in error and fraud did not occur.

4.21 The Chancellor of the Exchequer wrote to the Department's Accounting Officer in March 2012 confirming the priorities for the Department in the coming year. These include an expectation that the Department continues its efforts to sustain the level of tax credits error and fraud at no more than 5 per cent of entitlement over the current spending review period (that is, until March 2015). This assumed that the Department had met its target to reduce error and fraud on 2010-11 finalised awards to no more than 5 per cent, which it did not achieve. The Department will use the results of its investigation of the current methodology to determine if and how it should modify its strategy to achieve the 5 per cent target by 31 March 2015.

4.22 In October 2010, as part of the spending review, the Department and the Department for Work and Pensions launched a *joint fraud and error strategy*.[19] Within the context of the strategy, and as part of the 2010 spending review, the Department has a target to prevent £8 billion of personal tax credits losses, through interventions up to 31 March 2015. The targets are particularly challenging as the amounts increase year on year. They will be harder to achieve as the Department reduces staff numbers and implements policy changes tightening the eligibility criteria.

Managing personal tax credits debt

4.23 In 2011-12, the Department set itself a target to reduce the gross personal tax credits debt balance from £4.7 billion to £4.0 billion by March 2012, falling to £3.7 billion by March 2015. The Department also has a target to recover £0.8 billion of recoverable debt in 2012-13, without using additional resources, and prevent a further £0.1 billion of new debt arising.

4.24 As disclosed in the 2011-12 *Resource Accounts*, the Department has met its personal tax credits debt balance target of £4.0 billion. Some of this debt is unlikely to be recoverable, and the Department has accordingly made a provision for irrecoverable debt of £2.3 billion [to confirm] at 31 March 2012 (£3.0 billion at 31 March 2011).

4.25 The £0.7 billion reduction in total debt between 31 March 2011 and 31 March 2012 is the net effect of £1.8 billion of new debts identified in-year offset by £0.8 billion of recoveries and £1.7 billion of debt remissions. In his 2010-11 Report, the C&AG stated that the Department intended to review and remit uneconomic and unenforceable personal tax credits debt where there was no possibility of collection. The Committee of Public Accounts recommended that the Department write off debt where there is a value-for-money case for doing so.[20]

4.26 During 2011-12, the Department remitted debt balances of £1.7 billion. The Department had previously considered that much of this balance was not recoverable and had reflected this in previous years' trust statements. Of this sum £1.2 billion related to debts where there had been no activity over the previous 12 months on terminated and other awards over three years old. The remainder related to more current cases where debt collection had proven to be unsuccessful or uneconomic. The Department estimated that it could have recovered up to £0.16 billion of the £1.3 billion of inactive debt. However, it did not consider this to be cost-effective as it would have required the Department to divert resources away from pursuing other higher priority debts or tackling error and fraud. The Department secured HM Treasury approval for the write-off in June 2012.

19 *Tackling fraud and error in the benefits and tax credits systems,* Department for Work and Pensions, HM Revenue & Customs, October 2010.

20 HC Committee of Public Accounts: *HM Revenue & Customs: PAYE, tax credit and cost reduction*, Fifty-eighth Report of Session 2010–2012, HC 1565, December 2011.

4.27 The Department has inadequate management information on the age profile and recoverability of tax credits debt. Our analysis of the Department's debt balance at 31 March 2012 indicated that the level of irrecoverable debt could be substantially higher than it had initially estimated. As a result, the Department revisited its calculations and increased the provision in its accounts for irrecoverable debts at 31 March 2012 by £638 million, from £1,637 million to £2,275 million between the initial and final versions of the Resource Accounts.

4.28 Personal tax credits debt will continue to increase if the Department does not take any further steps to better recover and clear debt. In 2011-12, the Department generated £1.8 billion of new personal tax credits debt by identifying overpayments from the award finalisation process and from changes reported by claimants or identified in-year through error and fraud interventions. Personal tax credits debt levels are likely to increase further from the government's Budget changes affecting eligibility.[21] The Department estimates that it is likely to generate £1.6 billion of new personal tax credits debt in 2012-13 and, without any further intervention, total debts could increase to £6.5 billion by 2014-15.

4.29 The Department is developing a number of strategies and initiatives, geared around debt collection, to address existing and new tax credits debt. These include:

- allocating additional resources to target the collection of tax credits debt including the use of enhanced segmentation data to improve the design and effectiveness of debt campaigns;
- increasing the use of operational staff to pursue debts at the point that these are created;
- exploring the feasibility of using private sector support through innovative payment models; and
- reviewing policy options to ensure that its debt recovery strategy appropriately differentiates between those customers committing fraud and those making genuine errors.

4.30 The Department's latest tax credits debt campaign again focuses on new debt. For this campaign, which commenced in autumn 2011 and will continue until the end of July 2012, the Department has categorised the debt into segments. This enables the Department to tailor how it pursues debt, depending upon the claimant's circumstances and ability to pay. At the end of March 2012, of the 817,000 cases (value £870 million) in the debt campaign, the Department has tackled 407,000 (value £353 million). This included cases where the Department had agreed repayments under time-to-pay arrangements, as well as debts recovered in full and cancelled debts. Full repayments of debts had been made in some 18,000 cases (£13 million) with time to pay arrangements set up for a further 339,000 items with a value of £283 million. Converting tax credits debt into cash remains challenging and needs to be set in the context of the Department's obligation not to cause hardship through its approach to debt recovery.

21 The level by which income can increase before it impacts on the level of award has been reduced from £25,000 in 2010-11 to £10,000 from April 2011, and £5,000 from April 2013. Overpayments that were previously out of scope for recovery will be pursued and will increase the number of cases being included in future debt campaigns.

4.31 In addition to its debt campaign, the Department has been piloting several new approaches to recovering debts including directly recovering debts through PAYE coding. During 2012-13, the Department expects to recover up to £4 million in this way.

Preparing to implement Universal Credit

4.32 In February 2011, the government announced its intention to introduce a new Universal Credit to replace many of the current working-age benefits, including working and child tax credits, with a single means-tested payment. Universal Credit is designed to simplify the benefits system, creating a single streamlined working-age benefit. This should be easier for people to understand, and easier and cheaper for staff to administer, thereby reducing the opportunities for error and fraud and improve work incentives.

4.33 The Department for Work and Pensions will introduce Universal Credit in October 2013. The Department will phase out the majority of all new claims to the current tax credits scheme by April 2014. Existing tax credits claimants will subsequently be migrated to Universal Credit. The process is scheduled to be completed by 2017.

4.34 The Department is working with the Department for Work and Pensions to help design Universal Credit, share lessons learned and minimise the risk of error and fraud. The Department has not yet decided how it will migrate existing tax credits awards to Universal Credit and how it will treat outstanding debts when it has migrated awards.