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REPORT BY THE
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AUDITOR GENERAL

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HM Revenue & Customs

Progress on reducing costs

Key facts

5%	£296m	£585m
reduction in HMRC's running costs between 2010-11 and 2011-12	cost savings made in 2011-12	remaining savings to be made by 2014-15

25 per cent	gross savings to be achieved over the four years to 2014-15
15 per cent	net cost reduction over four years to 2014-15 after reinvesting £917 million to increase tax revenues
2,400	reduction in average full-time equivalent staff during 2011-12: HMRC plans to reduce overall staff by 10,000 full-time equivalents by 2014-15
138,000m^2	reduction in HMRC's estate in 2011-12: it plans to reduce its estate by 300,000 square metres by 2014-15

Summary

1 Reducing the deficit is a government priority. The 2010 spending review announced significant spending reductions across government departments. The government recognised that HM Revenue & Customs (HMRC) could contribute to reducing the deficit both by reducing its costs and by increasing tax revenues.

2 As the UK's main tax administrator, HMRC collected £474.2 billion of tax in 2011-12 and paid out £42.7 billion in benefits and credits. Its running cost in 2011-12 was £3.7 billion. To address the government's objective of cost reduction, HMRC's 2010 spending review settlement requires it to:

- reduce its annual running costs by 25 per cent (£955 million) by 2014-15; and
- bring in an additional £7 billion a year of tax revenues by 2014-15 by reinvesting 40 per cent of its savings to tackle evasion and avoidance.

3 The main ways in which HMRC plans to make its sustainable savings by 2014-15 are through:

- reducing staff numbers by 10,000;
- reducing its estate by 300,000m^2;
- reducing the cost of its IT by £88 million; and
- increasing staff productivity.

4 HMRC faces significant challenges to achieve its strategic priorities of reducing costs, increasing tax revenues and improving, or at least maintaining, customer service. Its 2010 spending review settlement also includes targets to:

- reduce expenditure on benefits and credits by £8.3 billion by 2014-15;
- hand over administration of tax credits to the Department for Work and Pensions by 2017; and
- introduce a major technology change called 'real time information' (RTI), which will require employers to report their employees' income tax and national insurance deductions as they pay them rather than at year-end.

5 This report covers only HMRC's progress in reducing its running costs. We will report separately on HMRC's progress in reducing tax credit error and fraud, introducing RTI and increasing tax revenues in 2013. We reported on HMRC's customer service in December 2012.

6 This is one of a number of reports on cost reduction across government and our second on HMRC's cost reduction programme. In July 2011 we reported that HMRC had a clear vision for 2015 and had put in place many of the necessary arrangements to reduce costs. However, to achieve value for money it needed to better understand costs and value, the interdependencies between its projects, and the projects critical to achieving the programme. This report assesses HMRC's progress over the last 18 months, its performance in reducing its costs in 2011-12 and its readiness to deliver future savings.

Key findings

Long-term strategy

7 **HMRC's cost reduction and reinvestment plans are aligned with the options HMRC is considering for transforming its business in the longer term.** In our last report and our report on HMRC's 2011-12 accounts, we criticised HMRC's lack of an organisation-wide operational strategy. Though it has yet to decide, HMRC is actively considering options for how it could operate in the future, such as further reducing its budget or broadening its role. Reducing staff time required to help those who pay their tax voluntarily and shifting resources into more enforcement and compliance work is consistent with HMRC's long-term vision for efficient and effective tax administration (paragraphs 3.3 and 3.4).

Performance in 2011-12

8 **In challenging circumstances, HMRC made £296 million of savings in 2011-12, exceeding its target by 19 per cent.** This is about one-third of the total saving it is required to make over the four years of the spending review period (paragraphs 2.2 and 2.9 to 2.24). It achieved savings in five main areas:

- It reduced staff numbers by 2,400 full-time equivalents and improved staff productivity, saving £140 million.
- The government froze pay increases for which HMRC had budgeted in 2011-12, saving £29 million.
- HMRC reduced the price it paid for IT equipment, such as laptops, and services, such as IT support helplines, by £74 million.
- HMRC vacated 118 buildings fully and 28 partially, reducing the size of its estate by 138,000 square metres and resulting in savings of £26.8 million.
- It reduced the cost of other contracts, such as those for postage and printing, by, for example, reducing the amount of unnecessary information HMRC sends to customers, saving around £26 million.

9 HMRC maintained its performance in key strategic areas while reducing staff and spending. HMRC exceeded its overall 2011-12 target for collecting additional tax revenues, maintained tax collection and reduced the level of tax debt. It restored customer service performance from a low point in 2010-11 but did not meet all of its customer service targets. This was not because of cost reduction but because of problems, from which HMRC is still recovering, in introducing its new National Insurance and PAYE system (NPS) in 2009-10, on which we have previously reported (paragraphs 2.5 to 2.8).

10 HMRC cannot link a quarter of its 2011-12 savings to specific process improvements. In 2011-12, HMRC has improved its efficiency by, for example, making processes consistent across offices, removing duplication, and producing and acting on better management information. This released staff time from work judged to be low value, unnecessary or unproductive. Its business areas have successfully lived within reduced budgets but HMRC does not collect the information it would need on staff time to be able to link savings to actual changes in processes. HMRC risks making changes which add little or no value if it cannot link these savings with the changes made. It estimates it has saved £72 million from process improvements but its estimate is simply the balance of savings made once it has taken other quantifiable productivity improvements, mainly relating to reducing sickness absence, into account (paragraphs 2.12 to 2.14).

11 HMRC's accounts show that running costs reduced by £204 million (5 per cent), after inflation, between 2010-11 and 2011-12. This is what we would expect to see taking into account all savings, reinvestment and additional funding agreed with HM Treasury for specific activities. It is important for HMRC to reconcile cost reductions to movements in the annual accounts to demonstrate that savings result in reduced expenditure and are not offset by cost growth elsewhere in the business (paragraphs 2.2 to 2.3, 2.18 and 2.24).

Managing the change programme

12 HMRC is spending £376 million in total on change projects across the four years of the spending review period to make sustainable savings of £411 million a year by 2014-15. Sustainable savings are those that lead to a permanent reduction in the baseline cost of an activity (paragraph 1.14).

13 HMRC expects change projects to save £162 million less over the spending review period than when we last reported in July 2011. This is partly because its forecasts are more refined and realistic, and partly because, as some projects took longer to start, HMRC expects them to take longer to start realising benefits. In 2011-12, of the £136 million HMRC could invest in cost reduction projects, it spent £102 million. The result is that HMRC may have to forego some of the expected savings. Following its experience in 2011-12, HMRC more closely scrutinises the progress of change projects, both individually and as a portfolio (paragraphs 3.6 and 3.23 to 3.24).

14 **HMRC has strengthened how it manages its change programme in ways that address our recommendations and those of the Committee of Public Accounts on governance and contingency arrangements.** We recommended that HMRC ensure its governance arrangements were working effectively to provide early sight of under-delivery, and that it identify contingency arrangements, which it has done. HMRC has improved how it manages its projects as a portfolio by more regularly reprioritising, accelerating or cancelling projects according to need. It has also identified a pool of additional projects which it is not actively pursuing but it could draw upon. However, it has already committed 77 per cent of its change programme spending, limiting its flexibility to reprioritise projects (paragraphs 3.18 to 3.24).

15 **However, HMRC has some way to go to address those recommendations related to its understanding of interdependencies and of the cost and value of its activities.** HMRC has identified the key projects which enable cost reduction activities and it has identified and apportioned costs to its key, organisation-wide processes. However, it is not yet ready to act on this analysis by identifying further opportunities for cost reduction or performance improvement. While HMRC continues to strengthen its analysis, its understanding in these areas remains immature, considering that HMRC is almost halfway through the spending review period (paragraphs 3.25 to 3.26).

16 **HMRC is now managing the change programme robustly.** HMRC's change programme oversees its cost reduction and reinvestment plans. We agree with findings from the Major Projects Authority review of the change programme, which found that the programme's management arrangements and committee structure were comprehensive and proportionate to its scale and complexity (paragraph 1.17).

Continuing to make cost reductions

17 **HMRC needs to make new savings of £585 million a year by 2014-15 and maintain those savings already made.** At September 2012, HMRC was on track to exceed its 2012-13 cost reduction target by £29 million (paragraph 3.5).

18 **Because HMRC expects change projects to make fewer savings than originally planned, £66 million more savings than planned will need to come from other initiatives such as productivity improvements or renegotiating its IT contract.** HMRC expects business areas to make efficiency savings of £448 million by 2014-15. At July 2012, business areas had not yet fully worked out how they would make such savings in 2013-14 or beyond. Neither did they know how the savings may affect customer service performance (paragraphs 2.5 and 3.7 to 3.8).

19 Risks to reducing costs remain, mainly due to the complex interdependencies between projects (paragraphs 3.9 to 3.17). For example:

- HMRC has projects that aim to reduce the number of staff required to administer personal taxes by 8,500. This is intended both to reduce costs as some staff leave HMRC and to release staff who can be retrained to undertake enforcement and compliance activities. However, HMRC is uncertain about the impact of introducing RTI and universal credit on customer contact, which may impact on its ability to reduce staff in this area. In 2011-12 it did not move as many staff as planned into enforcement and compliance and therefore did not meet its target for reinvestment-funded work. It redeployed these staff into customer contact. It also employed more temporary staff.
- HMRC plans to reduce its estate by 300,000m^2, reducing its costs by £88 million by 2014-15. This will depend on HMRC reducing staff numbers as forecast and being ready to vacate buildings.

20 It is too early to tell what the long-term impact of cost reduction will be on performance. HMRC has maintained performance in 2011-12 while reducing costs. However, it is challenging for it to make more and deeper reductions over the spending review period and maintain performance, particularly customer service. HMRC's performance is not starting from a stable position. It is still recovering from introducing NPS and in the next two years has to introduce RTI and manage changes to benefits and credits. We and the Committee of Public Accounts recommended that HMRC model the impact of cost reduction on tax revenues and customer service over the spending review period. It is modelling the impact on tax revenues and has just started work to assess the impact on customer service (paragraph 2.5).

21 HMRC is improving the rigour of its approach to costing. When we last reported, HMRC had started work to cost its end-to-end processes. It has now calculated the costs of 23 common processes and is using this information to identify and prioritise areas where it can redesign or streamline processes. This work is still at an early stage and HMRC does not expect to make any savings from it before 2013-14 (paragraph 3.27).

Conclusion on value for money

22 HMRC faces a challenge to reduce costs over the spending review period while increasing tax revenues, improving customer service and introducing RTI and changes to benefits and credits. It has made good progress in creating the conditions to make cost reductions, putting in place and using strong governance arrangements. HMRC is moving from making tactical efficiency savings and quick wins towards a more strategic approach to managing and using its resources. Its cost reduction plans for the spending review period are consistent with its longer-term vision for transforming its business. HMRC exceeded its savings target for 2011-12 by 19 per cent, although it did not reconcile its savings to its accounts as part of its year-end processes. It is on track to meet its target again in 2012-13. It has maintained performance across key areas. We therefore conclude that it improved its cost-effectiveness and value for money in 2011-12.

23 HMRC has much work to do to meet its spending review targets by 2014-15 without impairing its performance. Its understanding of costs and the value of activities across the organisation is not yet sophisticated. This potentially undermines HMRC's ability to identify and implement sustainable cost savings. It has ongoing work in this area. HMRC will need to address these areas to deliver value for money in the future.

Recommendations

a **HMRC has made reasonable progress against NAO and PAC recommendations from our previous cost reduction report, but it should continue to implement and fully embed them.**

b **HMRC should continue to strengthen its management and governance of efficiency savings that are not related to defined projects.** In particular, it should continue to:

- require all business areas to submit more detailed plans explaining how they intend to live within reduced budgets for the rest of the spending review period and how they will monitor how they are making savings and fully test the assumptions underlying them;
- ensure all directorates are able to link costs and the value of their activities to enable them to identify realistic savings;
- track how areas are achieving savings in-year;
- link more closely cost reductions and performance at an operational level; and
- improve its understanding of costs and savings in the enforcement and compliance business area.

c **HMRC should reconcile the savings it claims back to changes in its administrative spending as reported in its annual accounts.** We made a similar recommendation in relation to the savings that HMRC was seeking to make from the 2007 spending review. HMRC has yet to build such a reconciliation into its year-end reporting process. Reconciling back will allow it to demonstrate that savings actually result in reduced expenditure and are not offset by cost growth in other parts of its business.