National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs 2016-17 Accounts

Report by the Comptroller and Auditor General

JULY 2017

Coverage of this report

HMRC corporate document	Coverage of this report
Trust Statement	HM Revenue & Customs (HMRC) reported £574.9 billion of tax revenue for 2016-17. We cover this in Part One. Under the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General (C&AG) must certify whether the Trust Statement is true and fair, and whether HMRC has used the income and expenditure for the purposes Parliament intended. The C&AG has concluded that: • the figures in the Trust Statement are true and fair; and • HMRC has used income and expenditure for purposes Parliament intended. The 1921 Act also requires the C&AG to consider whether HMRC's revenue systems to collect taxes are adequate. We found that HMRC's revenue systems are adequate subject to the observations in this report and our other reports to Parliament (paragraphs 35 and 36).
Resource Accounts	The annual cost of running HMRC was £3.3 billion in 2016-17. HMRC paid £38.8 billion in benefits and credits, including £27.1 billion of Personal Tax Credits payments and £11.7 billion of Child Benefit. Under the Government Resources and Accounts Act 2000, the C&AG must certify whether HMRC's Resource Accounts are true and fair, and whether HMRC has used the income and expenditure for the purposes Parliament intended. The C&AG: • found the Resource Accounts are true and fair; but • found material levels of error and fraud in Personal Tax Credits expenditure (Part Four).
Annual Report	HMRC reported £28.9 billion compliance yield in 2016-17. We reviewed compliance yield data with the agreement of HMRC. Our conclusions about compliance yield are in Part One. We review whether HMRC is getting value for money. We report our findings to Parliament under section 6 and section 9 of the National Audit Act 1983. We refer to our recent work on value for money in this report.

Summary

HM Revenue & Customs' performance, 2016-17

1 This report is our commentary on HM Revenue and Customs' (HMRC's) performance in 2016-17. We report findings from all our statutory audits of HMRC this year including audits of HMRC's financial statements, the adequacy of its systems for collecting revenue and the value for money it achieved from its spending. Each audit comes under different legislation (see Coverage of this report, page R4).

2 Our audit of HMRC covers the tax revenues the government raises and the benefits HMRC pays out. HMRC raised £574.9 billion of tax revenues this year (some 85% of total revenues raised by government) and paid out £38.8 billion in benefits and credits (approximately one-fifth of the government's total benefit expenditure). The annual cost of running HMRC, which is the second-largest government department in terms of staff numbers, was £3.3 billion in 2016-17.

3 Each year, we choose parts of HMRC's business to report on in more detail. Last year's report considered HMRC's transformation plans and improving the management of tax reliefs.

4 This year's report has four parts:

- Part One considers HMRC's objective of maximising revenues and looks at the main components of the £574.9 billion raised during 2016-17;
- Part Two looks at HMRC's progress in transforming the way it administers taxation;
- Part Three considers HMRC's customer service performance; and
- Part Four examines HMRC's progress in managing fraud, error and debt in Personal Tax Credits and Child Benefit and explains the basis of the Comptroller and Auditor General's (C&AG's) qualification of his regularity audit opinion on HMRC's Resource Accounts.

Summary findings

5 HMRC's vision, as published in its *Single Departmental Plan*, is as follows: "We are the UK's tax, payments and customs authority, and we have a vital purpose: we collect the money that pays for the UK's public services and help families and individuals with targeted financial support. We do this by being impartial and increasingly effective and efficient in our administration. We help the honest majority to get their tax right and make it hard for the dishonest minority to cheat the system."[1]

Tax revenues in 2016-17

6 The Trust Statement reports that HMRC collected total tax revenue of £574.9 billion in 2016-17, an increase of £38.1 billion (7.1%) on 2015-16. HMRC records revenues in the Trust Statement on an accruals basis (tax due rather than actual cash received) (paragraphs 1.3 and 1.4).

7 Of the £574.9 billion of total revenue, £127.8 billion relates to amounts that had not been collected as at the year-end. Of this balance, £99.6 billion relates to accrued revenue. While some of the accruals balance can be derived from tax receipts relating to 2016-17 and collected after the end of the financial period, HMRC is required to produce estimates to establish the total tax that will be due where assessment and collection is yet to take place. These estimates are inherently uncertain, as explained in Note 6 of the Trust Statement (paragraphs 1.6 to 1.9).

8 HMRC's estimate of compliance yield in 2016-17 was £28.9 billion, against a target of £27.0 billion.[2] HMRC achieved £26.6 billion of yield in 2015-16 against a target of £26.3 billion. Compliance yield measures the effectiveness of HMRC's compliance and enforcement activities. It is one of HMRC's main internal performance measures and is used to agree targets with HM Treasury for spending on compliance work. It comprises both cash expected and estimates of assessed tax for future accounting periods as a result of compliance activities completed in the year (paragraphs 1.15 to 1.18).

9 **HMRC has robust processes in place for estimating and reporting the value of the yield that it has generated through its compliance activities**. It has continued to develop its governance over compliance measures; its assurance of reported yields; and improve the consistency of its measures across the categories of yield. HMRC recognises, however, that there is inherent uncertainty in some elements of the yield being recorded given the nature of the estimates being made (paragraphs 1.21 to 1.25).

1 HM Revenue & Customs, *Single Departmental Plan 2015 to 2020*, updated February 2017.
2 Note that the £28.9 billion total for compliance yield reflects a change in the methodology for calculating Future Revenue Benefit. The total 2016-17 compliance yield if calculated under the old methodology would be £28 billion.

HMRC's transformation plans

10 In 2015, HMRC committed to highly ambitious plans to transform the tax system by 2020. HMRC's vision is to be one of the most digitally advanced tax administrations in the world, automating the collection of tax data, and encouraging taxpayers to use its new digital services. At the same time it has embarked on a long-term estates replacement programme, and it must make changes to systems, support the introduction of Universal Credit, and implement the Tax-Free Childcare scheme. When we first reported in 2015 it was already clear the scale of the transformation was more complex and far-reaching than previous change initiatives.[3] In 2016, we found that HMRC had a strong rationale for its plans to use technology to modernise services and reduce its costs. However, the plans carried a significant delivery risk and we raised the risk of optimism bias, particularly in assumptions about taxpayers' take-up of new online services (paragraphs 2.1 to 2.4).[4]

11 It is becoming clear that transformation as originally scoped, and its intended benefits, will be challenging to deliver within the timescale. As part of the Spending Review 2015, HMRC received a budget of £1.8 billion for its transformation for the period 2016-17 to 2019-20. In return it committed to achieving total efficiencies of £1.9 billion by 2019-20 and to collect £920 million of additional tax revenue by 2020-21. HMRC is delivering its transformation through 15 main programmes. The latest programme business cases estimated that transformation could cost £2.2 billion, including additional elements that HMRC is able to fund from existing budgets such as the costs of changing IT contracts, programme staff, redundancy costs and contingencies. Early requests for funding based on business cases totalled £710 million in 2017-18, exceeding that year's transformation budget of £457 million. HMRC recognised that it needed to slow, stop or de-scope activity to live within its budget, and subsequently reduced the difference to around £60 million for 2017-18. There are still budget pressures and HMRC is managing the risk through ongoing prioritisation of its programme. This is difficult as many of the programmes are interdependent and some are implementing necessary changes, such as the new customs system. The UK's exit from the EU will add further pressure to the programme and timetable (paragraphs 2.4 to 2.6, 2.13, 2.20, 2.23 to 2.25 and 2.40).

3 Comptroller and Auditor General, *HM Revenue & Customs 2014-15 Accounts,* Report by the Comptroller and Auditor General, National Audit Office, July 2015.
4 Comptroller and Auditor General, *HM Revenue & Customs 2015-16 Accounts*, Report by the Comptroller and Auditor General, National Audit Office, July 2016.

12 **HMRC has recognised these challenges, and has improved the way it is managing transformation.** HMRC has developed its leadership capacity, and improved its accountability arrangements and its financial forecasting. It is managing the programmes as a single portfolio, providing increased visibility of programme risks and interdependencies and enabling better management of cost and delivery pressures. HMRC continues to seek improvements in its approach, and is enhancing its management information and streamlining governance. It is also developing its financial forecasts to narrow the range of uncertainty around the savings it plans to deliver (paragraphs 2.7 to 2.10).

13 **HMRC forecasts its 15 transformation programmes may contribute fewer efficiencies than expected, but it still aims to achieve its efficiency target from change activity elsewhere in the business.** In 2016-17, HMRC made £254 million of efficiency savings against a target of £203 million. Only £181 million of these were sustainable, so it will need to make additional savings in future years. It fell behind its planned profile for achieving sustainable efficiencies from its transformation programmes, reporting £78 million of savings against £189 million originally expected. HMRC made other operational savings and one-off cost reductions which helped to compensate. HMRC assesses that recurrent transformation savings are more likely to fall below target than to achieve it, and HMRC is actively managing a number of risks to delivery. Work to shift customers to online services has not reduced customer demand for telephone contact to the levels expected. HMRC also needs to define further how compliance activities will evolve and release efficiencies. HMRC is managing its overall financial position by targeting efficiency savings from operational activities, for example from its continuous improvement initiatives (paragraphs 2.29 to 2.33).

Recommendations

14 Overall, we have seen that HMRC has made significant progress in managing its transformation plans. The combined scale of these programmes means HMRC must maintain its pace of delivery to secure more sustainable efficiencies. There are risks that transformation will need more funding than the resources available. It is important that HMRC carries out a thorough review of progress to date and reviews alternative options for achieving its objectives to collect more revenue, and reduce its costs and the costs of its customers. HMRC should:

- **Review its plans given the pressures on the cost and affordability of programmes. It should align the transformation portfolio with the funding it has available.** In particular it should ensure it assesses the operational and customer impacts of changes to its plans, and ensure that attempts to prioritise activities to meet short-term budget constraints do not lead to a cycle of reduced savings and further pressures on resources.

- **Ensure it can turn efficiency gains into cash savings without adversely affecting performance.** It should monitor customer service and compliance performance in detail to ensure that resource is only released in areas where transformation has delivered the tools or changed ways of working that will enable adequate performance levels to be maintained.

HMRC's customer service performance in 2016-17

15 Over the past five years the National Audit Office and the Committee of Public Accounts have reported several times on the performance of HMRC's customer services. In 2012, we reported that HMRC's performance in providing services had been unacceptable.[5] HMRC's performance subsequently improved. However, in May 2016, we reported that HMRC's customer service to personal taxpayers had suffered in 2014-15 and 2015-16 because HMRC had, under budget pressure, released staff too quickly.[6] HMRC could not sustain service levels and HMRC's speed to answer the telephone and respond to post were greatly reduced. Performance improved in the second half of 2015-16 after HMRC recruited 2,400 additional staff. HMRC again plans to reduce costs significantly as it implements new digital services. We previously highlighted that poor service can have adverse consequences: the cost to customers from waiting on the telephone can be significant; and the quality of service experienced by personal taxpayers may have an impact on tax compliance. In 2016, HMRC committed to exploring these issues further and improving services significantly (paragraphs 3.2 to 3.8).

5 Comptroller and Auditor General, *HM Revenue & Customs: Customer service performance*, Session 2012-13, HC 795, National Audit Office, December 2012.

6 Comptroller and Auditor General, *HM Revenue & Customs: The quality of service for personal taxpayers*, Session 2016-17, HC 17, National Audit Office, May 2016.

16 In 2016-17, HMRC improved customer service performance significantly, achieving its best performance in the past five years against its key targets. HMRC reported its best performance against both its key telephony measures: the percentage of calls to its helplines that it handled; and the average speed to answer calls from when a caller enters a queue to speak to an adviser. Its performance against the time for processing overseas Tax Credits and Child Benefit claims was also at its highest level. HMRC reduced significantly the time customers spent in queues to speak to a call adviser, from 12 minutes in 2015-16 to under four minutes in 2016-17. HMRC does not routinely measure the cost to all individual customers of using its services. Using a model, we estimated that shorter queue times for the Income Tax and Tax Credits helplines saved customers £8 million in telephone charges in 2016-17 and reduced the opportunity cost of the time they spent in queues by around £73 million. Customer experience measures show improvements of between three to seven percentage points between 2015 and 2016 (paragraphs 3.9, 3.10, 3.24 and 3.25, and Figures 13, 14 and 19).

17 To improve performance HMRC recruited additional staff in 2016-17 and increased service flexibility. In 2016-17, HM Treasury provided HMRC with £28 million as part of a £71 million investment into HMRC's customer service to make it quicker and easier for individuals and small businesses to deal with HMRC.[7] The programme is intended to help HMRC bridge the gap between its customer service levels and industry standards for call-handling. The programme's objectives include HMRC providing a "top-class, multi-channel, seven-day service", and reducing call answering times by April 2017. The programme enabled HMRC to increase its customer service workforce by more than 800 in 2016-17, with new staff recruited on flexible contracts. The additional staff helped HMRC return telephone adviser numbers to 2013-14 levels. HMRC has increased its capacity to meet demand by employing staff on flexible contracts and training advisers to deal with a range of query types (paragraphs 3.6, 3.7, 3.15 and 3.16, and Figure 18).

18 HMRC's operating environment remains challenging as its advisers had to deal with eight million more calls in 2016-17 than forecast. The overall number of call attempts reduced from 61 million in 2015-16 to 50 million in 2016-17 but the number of calls reaching advisers increased. The number of calls handled by advisers increased from 29 million to 34 million while calls terminated in the automated telephony system fell from 14 million to 12 million. In previous years, customers may have been deterred from holding on for advisers because of long waiting times. Other factors have also contributed to higher than expected demand. In 2016-17, HMRC received 1.6 million more calls from customers and agents asking for pay and tax records, or employment histories (paragraphs 3.12 to 3.14, and Figure 17).

7 HM Treasury, *Budget 2016*, March 2016, paragraph 7.38. A further £43 million is being provided in 2017-18.

19 HMRC's set of performance measures could be improved to better reflect customer experience. HMRC has made significant progress improving service levels and as a result it achieved the more ambitious targets set for 2016-17. HMRC's existing telephone measures, however, risk miscategorising or excluding important aspects of customer experience. HMRC's established approach to measuring call-handling counts most calls terminated in its automated telephony system as successfully handled. Independent research commissioned by HMRC concluded that HMRC cannot assume that all customers have had their query resolved at the point a call ends, meaning HMRC could have resolved fewer queries than it has reported (92% in 2016-17). While HMRC includes calls handled by automated telephony, it has excluded customers' time in the automated telephony system when measuring its speed to answer. HMRC told us that typically its customers spend two to four minutes in automated telephony before entering a queue for an adviser. Industry practice in measuring speed to answer is mixed. While some organisations focus on queue time, others measure the time taken for all the stages before a customer's call is answered. HMRC's current approach to measurement could overstate calls handled, and understate the time to answer as experienced by the customer. There is also opportunity for HMRC to improve some of its other performance measures to better reflect customer experience, including whether it resolves customers' queries first time, and the quality of its advice (paragraphs 3.9 and 3.28 to 3.34, and Figures 13, 20 and 21).

Recommendations

20 HMRC has significantly improved its performance against its customer service targets by deploying additional resource and using its workforce more flexibly. HMRC has also signalled its ambition to become a leading customer services organisation, while recognising that this will take time. However, it has not yet defined what this means. In the coming year, HMRC plans further cost reductions, which could put the service under pressure once again. To safeguard customer services while making cost reductions, HMRC should:

- **improve its performance measures so that these better reflect customer experience;**
- **reduce the time, and improve the experience for customers using automated telephony,** for example by improving call routing and offering more self-service options;
- **consider the cost to customers when making strategic decisions about the overall level of resources for customer services.** It has a target to reduce costs for businesses, and a similar target for individuals would help protect against cost transfer from HMRC to individuals; and
- **set out a clear plan for achieving its ambition to be a leading customer service organisation, including timescales and performance levels.**

Progress in reducing error and fraud in Tax Credits and Child Benefit

21 **The C&AG has again qualified his regularity audit opinion on the 2016-17 Resource Accounts because of material error and fraud in Personal Tax Credits (Tax Credits).** HMRC's central estimate of error and fraud resulting in overpayments in 2015-16 is 5.5% of Tax Credits expenditure (4.8% in 2014-15) and its estimate of error resulting in underpayments is 0.7% of Tax Credits expenditure. This equates to overpayments of £1.57 billion and underpayments of £0.21 billion. These estimates of error and fraud are the most recent available (paragraphs 4.3 to 4.5 and 4.8 to 4.13).

22 **HMRC's estimated increase in error and fraud within Tax Credits is contrary to the significant reductions achieved in previous years, and the rate is expected to increase further.** HMRC analysis shows that during 2015-16 the increase in estimated error and fraud was associated with the income, work and hours, childcare and undeclared partner risk categories. HMRC also expects the level of error and fraud to increase when reported for 2016-17, due to the impact of introducing the 'Commercial with a view to a profit' test for the self-employed as well as the impact of the ending of the Concentrix contract. HMRC forecasts that the new self-employed test will reduce the cost of Tax Credits by over £500 million in the period up to 2021 (paragraphs 4.8 to 4.13, 4.17 to 4.19 and 4.24).

23 **Following the ending of the contract between HMRC and Concentrix, HMRC is undertaking a number of actions aimed at ensuring that the failings of the contract are not repeated.** This includes actions designed to ensure that its compliance interventions achieve an appropriate balance between identification of error and fraud and providing the necessary level of customer service. The proposed changes reflect a change in approach to HMRC's delivery of error and fraud interventions and will come into effect for the High Risk Renewals 2017 compliance campaign (paragraphs 4.25 and 4.26).

24 **HMRC will face further challenges in administering Tax Credits as claimants transfer to Universal Credit.** Some 95,000 claimants have transferred to Universal Credit (62,000 in 2016-17), with a further 220,000 expected to transition in 2017-18. Full transition and migration of claimants to Universal Credit is not expected to be completed until 2022. Uncertainties in the migration to Universal Credit will leave HMRC managing a diminishing but proportionally more complex caseload, with a reducing and potentially less stable workforce as staff transfer to the Department for Work & Pensions (DWP). HMRC has plans in place to ensure a smooth transfer of Tax Credits claimants to Universal Credit over the timeframe for transition. Due to the long timeframe for the transition of Tax Credits claimants to Universal Credit, and relatively small numbers of cases transitioned so far, it is too early to conclude on HMRC's performance in meeting the challenges this transition presents (paragraphs 4.27 to 4.30).

25 The 2016-17 estimate of error and fraud of 1.0% of total spending on Child Benefit is a significant reduction from previous years. HMRC has carried out detailed analysis of the cases where claimants do not respond to contact and their award is counted as error or fraud. This work indicates that the rate of error and fraud may be lower than estimated. HMRC has identified further interventions that it is planning to introduce both over the next 12 months and in the longer term that will seek to reduce the rate of error and fraud further (paragraphs 4.31 to 4.36).

Recommendations

26 HMRC should seek to fully understand the reasons for the increase in error and fraud in Tax Credits in 2015-16 and the reasons behind the predicted increases in error and fraud in 2016-17, to consider how it can best target its error and fraud activities going forwards.

27 HMRC should continue to monitor the transition of claimants to Universal Credit and ensure that its plans meet the challenges that this transition, and the transfer of staff to DWP, will bring, including ensuring that there is an effective response to the risks of error and fraud.

28 HMRC should ensure that it delivers the actions it has identified in response to the failings of the Concentrix contract, and those recommended by the Committee of Public Accounts, to avoid further disruption to claimants.

29 HMRC should continue its work to understand the causes of error and fraud and how best to engage with the Child Benefit claimant population, to support its delivery of Child Benefit systems reform.

Summary of findings from our value for money work

30 We have reproduced below the concluding paragraphs from our value for money work published up to the end of June 2017. We published two reports on HMRC: HMRC's approach to collecting tax from high net worth individuals; and managing the HMRC estate.[8] We also produced two investigations: HMRC's contract with Concentrix; and overseas sellers failing to charge VAT on online sales.[9]

8 Comptroller and Auditor General, *HMRC's approach to collecting tax from high net worth individuals*, Session 2016-17, HC 790, National Audit Office, November 2016; Comptroller and Auditor General, *Managing the HMRC estate*, Session 2016-17, HC 726, National Audit Office, January 2017.

9 Comptroller and Auditor General, *Investigation into HMRC's contract with Concentrix*, Session 2016-17, HC 915, National Audit Office, January 2017; Comptroller and Auditor General, *Investigation into overseas sellers failing to charge VAT on online sales*, Session 2016-17, HC 1129, National Audit Office, April 2017.

HMRC's approach to collecting tax from high net worth individuals

31 Assessing the correct amount of tax owed by high net worth individuals is a challenge for all tax authorities. The tax affairs of the wealthiest in society are complex, making it harder for tax authorities to ensure that they are paying the right amount of tax. HMRC has a dedicated team to handle the tax affairs of high net worth individuals, which is a sensible approach given the tax at stake, and follows the best-practice advice of the Organisation for Economic Co-operation and Development. It has allowed HMRC to get a better understanding of the tax affairs and behaviours of these taxpayers, and the yields from HMRC's work in this area have increased. HMRC has now aligned the work of the high net worth unit more closely with other parts of its business that focus on compliance risk. This change should help HMRC increase the expertise it brings to bear in identifying and challenging the behaviour of the wealthiest taxpayers where they do not comply with HMRC's interpretation of tax law.

Managing the HMRC estate

32 It is important to see HMRC's estate strategy in two ways. First as a major programme in its own right, and second, as a component in HMRC's wider business transformation. From the standpoint of the estate strategy itself, we can conclude that the handling of HMRC's STEPS contract has improved, and is more likely to deliver value for money, although significant risks remain. As far as the new programme is concerned, HMRC has already recognised that its original plan was unrealistic and it is considering how it can adjust the scope and timing of the programme to reduce the cost and delivery risk. It is, of course, better management practice to recognise cost underestimates early and to consider options for recovery early as well. However, we think it important for HMRC to step back and consider the benefits afforded by the wider business transformation, and whether they might be reduced or placed at risk by cutting back on, or delaying, the estate plans, before going ahead.

Investigation into HMRC's contract with Concentrix

33 In August 2016, MPs and the public raised concerns that Concentrix had incorrectly suspended or terminated a number of claimants' tax credits awards. For example, Concentrix mistakenly believed claimants were living with individuals unconnected to them. Substantial numbers of claimants also had difficulties contacting Concentrix to discuss their awards. It became clear the contract was not working as HMRC intended. Concentrix was not working on as many cases as HMRC had expected or meeting performance standards. In November 2016, HMRC and Concentrix agreed to end the contract and a number of Concentrix staff transferred to HMRC. This report set out the facts about the contract between HMRC and Concentrix and its termination. Our investigation covered: the aims of the contract; the management of the contract; the decision to terminate the contract; and the impact of the contract termination.

Investigation into overseas sellers failing to charge VAT on online sales

34 Online VAT fraud and error causes substantial losses to the UK Exchequer and undermines the competitiveness of UK businesses. Compliance with the VAT rules is a legal requirement. Not knowing about the rules does not excuse non-compliance. The UK trader groups who raised the issue report having experienced the impact of this problem through progressively fewer sales. They consider HMRC has been slow in reacting to the emerging problem of online VAT fraud and error and that there do not seem to be penalties of sufficient severity to act as a substantial deterrent. It is too soon to conclude on the effectiveness and impact of HMRC's new powers, and whether the resources devoted by HMRC to using them match the scale of the problem. We recognise that HMRC must consider effort and efficiency in collecting VAT but its enforcement approach to online trade appears likely to continue the existing unfair advantage as perceived by UK trader groups. This is contrary to HMRC's policy of encouraging voluntary compliance and it does not take account of the powerful effect that HMRC's enforcement approach has on the operation of the online market as a whole.

Conclusion

35 In fulfilling our statutory duties under the Exchequer and Audit Departments Act 1921, while recognising that no tax collection system can ensure that everyone meets their tax obligations, we conclude that in 2016-17 HMRC had framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are 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.

36 In addition to our statutory duties under the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General has again qualified his regularity opinion on the Resource Accounts due to material levels of error and fraud in Tax Credits. The estimated error and fraud rate in Tax Credits has increased and HMRC has forecast a further increase for the next year as that estimate will include the impact of introducing the 'Commercial with a view to a profit' self-employed test as well as the impact of the failings of the Concentrix contract. HMRC must consider how it can address the causes of error and fraud to reduce levels and prevent further increases, while coping with the challenges presented by the transition of claimants to Universal Credit.