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REPORT

Administration of Welsh rates of income tax 2022-23

HM Revenue & Customs

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Administration of Welsh rates of income tax 2022-23

HM Revenue & Customs

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

21 December 2023

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Key facts

1.4mn
Welsh taxpayers in 2021-22

£2.4bn
Welsh income tax revenue in 2021-22

£2.6bn
HM Revenue & Customs' estimate of Welsh income tax revenue in 2022-23

£0.4 million costs of administering Welsh income tax in 2022-23

Summary

Introduction

1 The Wales Act 2014 gave the Senedd (Welsh Parliament) power to determine the rates (excluding the personal allowance) paid by Welsh taxpayers on all non-savings, non-dividend income, from 6 April 2017. The Welsh Government receives all income tax revenue generated from non-savings, non-dividend income under Welsh income tax policy.

2 Since April 2019, the UK government has reduced the UK basic, higher and additional income tax rates by 10 percentage points for Welsh taxpayers and the Senedd has had the power to apply Welsh rates in addition. For each tax band, the rate of income tax paid is the sum of the reduced UK rate and the Welsh rate set for the year (**Figure 1** overleaf). As in previous years, for 2022-23 the Senedd set the Welsh rates of income tax at 10% across all bands, which meant that the total rates for taxpayers in Wales matched the UK rates at 20% (basic rate), 40% (higher rate) and 45% (additional rate).

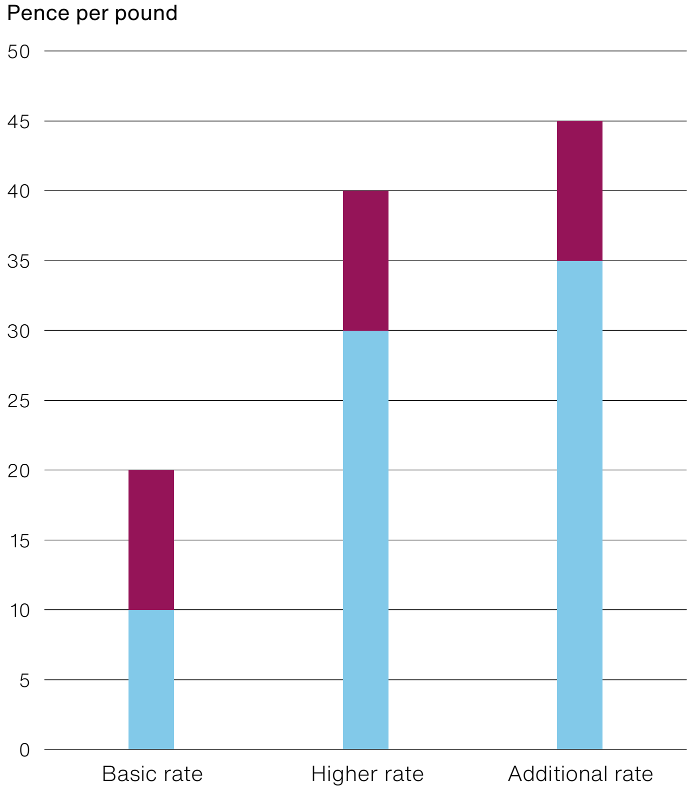
Roles and responsibilities

3 HM Treasury is responsible for paying Welsh income tax to the Welsh Government. HM Revenue & Customs (HMRC) administers and collects Welsh income tax as part of the UK tax system. HMRC identifies taxpayers living in Wales by applying a 'flag' in its systems that indicates they are subject to Welsh income tax rates. HMRC has calculated that there were 1.4 million Welsh taxpayers in 2021-22.

4 Following the end of each tax year, HMRC produces a provisional estimate of Welsh income tax revenue for that year. It calculates the final outturn the following year once it has received further information from taxpayers and employers. This report covers the final outturn for 2021-22 and the provisional estimate for 2022-23. HMRC expects to publish the outturn for 2022-23 in its 2023-24 Annual Report and Accounts.

Figure 1
Welsh rates of income tax for 2022-23

The UK rates of income tax are reduced by 10 pence per pound and replaced with the Welsh rates of income tax



	Basic rate	Higher rate	Additional rate
Welsh rate of income tax (pence)	10	10	10
UK income tax rate reduced by 10 pence per pound (pence)	10	30	35
Total	**20**	**40**	**45**

Notes

1 For each tax band (basic, higher and additional), the UK government reduces the amount of tax it will collect by 10 pence per pound and the Senedd (Welsh Parliament) sets the Welsh rate of income tax to be added to the UK rates of tax.

2 For 2022-23, the Senedd set each Welsh rate of income tax at 10 pence, meaning that Welsh taxpayers pay an amount of tax equivalent to the UK rate for each tax band.

Source: National Audit Office analysis of data from the Welsh Government

5 The Government of Wales Act 2006, as amended by the Wales Act 2014, requires the Comptroller and Auditor General (C&AG) to prepare a report for each financial year on:

- the adequacy of HMRC's rules and procedures, in consequence of the Welsh rate provisions, to ensure the proper assessment and collection of income tax charged at rates determined by those provisions;
- whether HMRC is complying with these rules and procedures;
- the correctness of the sums brought to account by HMRC which relate to income tax that is attributable to a Welsh rate resolution; and
- the accuracy and fairness of amounts reimbursed to HMRC as administrative expenses.

6 This report assesses:

- HMRC's calculation of the 2021-22 income tax revenue for Wales (the 'outturn') and assurance on the correctness of amounts brought to account (Part One);
- HMRC's estimate of the 2022-23 income tax revenue for Wales and our view on the estimate methodology (Part One);
- key controls operated by HMRC to assess and collect income tax (Part Two);
- HMRC's approach to assessing and mitigating the risk of non-compliance with Welsh tax requirements (Part Two); and
- the cost of administering Welsh income tax. We provide assurance on the accuracy and fairness of these amounts in agreement between HMRC and the Welsh Government (Part Three).

7 Appendix One sets out our audit evidence base.

Key findings

Welsh income tax 2021-22 final outturn and 2022-23 estimate

8 **HMRC calculated the final outturn for 2021-22 as £2,384 million, representing amounts collected under Welsh income tax policy.** HMRC's estimate of 2021-22 Welsh income tax revenue, published in July 2022, was £2,356 million, meaning the actual outturn was £28 million (1.2%) higher than HMRC had originally estimated. We examined HMRC's methodology for calculating the actual outturn, which necessarily includes some remaining areas of estimation, for instance where HMRC had not yet received returns from taxpayers. In these areas, we have evaluated the basis of HMRC's estimate, including the relevant assumptions and available data. Based on that audit work, we have concluded that the Welsh income tax revenue outturn for 2021-22 is fairly stated (paragraphs 1.2 to 1.15).

9 **HMRC has estimated Welsh income tax revenue for 2022-23 as £2,589 million.** This represents an increase of £205 million (8.6%) compared with the 2021-22 outturn. Income tax for the whole of the UK increased by 8.9% in 2022-23. The increases in UK and estimated Welsh income tax revenues reflect inflationary rises in earnings and the freezing of income tax bands and thresholds. This increased the size of the taxpayer population and moved some taxpayers into higher tax brackets. HMRC expects to calculate the finalised 2022-23 income tax outturn attributable to Wales in 2024. The estimate HMRC produces is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue that the Welsh Government ultimately receives (paragraphs 1.16 to 1.19).

10 **External factors have increased the level of uncertainty in HMRC's estimate of Welsh income tax revenue in 2022-23.** HMRC identified the key source of uncertainty as the accuracy with which it can estimate Wales's share of UK income tax liabilities, particularly since its estimate for 2022-23 relies on survey data from 2019-20. HMRC has highlighted high interest rates and inflation, wage growth and high and volatile energy prices as external factors causing increased uncertainty in 2022-23. We consider the approach adopted by HMRC to estimating the impact of these areas of uncertainty on Welsh income tax revenue in 2022-23 to be reasonable (paragraph 1.20).

Administration of Welsh rates of income tax

11 **HMRC has adequate rules and procedures in place to ensure the proper assessment and collection of Welsh income tax and it is complying with those rules**. Our work on Welsh income tax matters builds on our wider assessment of HMRC's rules and procedures, completed as part of our annual audit of HMRC. As part of that audit, we concluded that HMRC had framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that these regulations and procedures are being duly carried out (paragraphs 2.2 to 2.14).

12 **Maintaining an accurate and complete record of the addresses of Welsh taxpayers remains HMRC's key challenge in administering the system.** HMRC relies on taxpayers notifying it of a change of address, although there is no legal requirement for them to do so. We found that there had been a decrease in the number of Welsh postcodes identified by HMRC's address-cleansing work as either missing or invalid, with 4% (52,319) of the overall taxpayer population identified as either missing or invalid in its 2022-23 scan in November 2022. This was lower than the 6% (81,716) in June 2021. HMRC has investigated and updated those cases with taxable income during the year (paragraphs 2.15 to 2.24).

13 **HMRC continues to assess the risk of non-compliance in relation to Welsh income tax as low because there is no divergence between Welsh tax rates and the rest of the UK.** In 2022-23, HMRC produced a Strategic Picture of Risk (SPR) for Welsh rates of income tax. It considers the main areas of risk to Welsh income tax to be the same as those compliance risks which it assesses at the whole-of-UK level. There are no risks that HMRC identifies in this SPR which are specific to Wales as HMRC assesses that compliance risk in Wales is consistent with the rest of the UK (paragraphs 2.26 and 2.27).

14 **HMRC calculated a compliance yield of £120 million relating to Wales for 2021-22, the most recent data available.** HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield: its estimate of the additional revenues it has generated, and the revenue losses it has prevented. HMRC estimated that the Welsh share of net losses from compliance risks for 2020-21, the most recent data available, was £390 million. HMRC calculates these figures as a proportion of the equivalent UK figure, rather than using Welsh-specific data to quantify the risks. HMRC does not consider or report on geographical variations in the level of compliance risk, or the relative success of compliance activity in Wales compared with the rest of the UK (paragraph 2.31).

15 **HMRC has limited performance data about its compliance activities in Wales.** Unlike its income tax system, which flags residents as Welsh, HMRC's compliance system cannot readily identify people living in Wales. HMRC therefore cannot easily track and monitor compliance activity in Wales and this affects its ability to collect performance data about the extent of Welsh non-compliance (paragraph 2.29).

16 **HMRC's compliance activities increased in 2022-23 but it failed to meet its target for compliance yield.** Across the UK, the number of compliance cases that HMRC opened in 2022-23 was higher than in 2021-22 but 17% lower than in 2019-20 before the pandemic. It closed 20% fewer cases than in 2019-20. HMRC says this partly reflects its strategy to focus increasingly on upstream efforts to ensure taxpayers comply in the first place, and to prioritise larger and higher-impact cases. HMRC's yield from its tax compliance activities for the whole of the UK was £34.0 billion in 2022-23, up 10% compared with 2021-22 and higher than the average over the past five years (2018-19 to 2022-23) of £33.2 billion. Compliance yield in 2022-23 was, however, below HMRC's target of £36 billion. As a proportion of total revenue, compliance yield remained at 4.2% (paragraphs 2.28 to 2.30).

17 **UK tax debt has increased since 2022 and remains higher than pre-pandemic levels.** HMRC's debt balance is affected by external factors that have an impact on taxpayers' ability to pay their tax liabilities, including current inflationary pressures and increases in the cost of living. At 31 March 2023, total tax debt for the UK was £43.9 billion, 11.9% (£4.7 billion) higher than the level of debt that HMRC reported at 31 March 2022. Tax debt more than trebled in the first six months of 2020-21 due to the wider economic impact of the COVID-19 pandemic and HMRC's decision to suspend most debt collection. It remains higher than the five years leading up to the pandemic when tax debt was typically around £14 billion. HMRC has a new strategy to bring down tax debt in the long term but expects it to remain high throughout 2023-24. HMRC does not produce an estimate of the total income tax debt attributable to Welsh taxpayers (paragraphs 2.33 and 2.34).

Costs

18 **In 2022-23 HMRC incurred and recharged £0.4 million to the Welsh Government for the cost of administering Welsh income tax.** We examined HMRC's method for estimating the costs of collecting and administering Welsh income tax for the year ended 31 March 2023. Based on our audit work, we have concluded that the amount paid by the Welsh Government was accurate and fair in the context of the agreement between HMRC and the Welsh Government (paragraphs 3.4 and 3.5).

Part One

Income tax collected from Welsh taxpayers

1.1 Part One of this report covers HM Revenue & Customs' (HMRC's) calculation of the final revenue outturn for Welsh income tax in 2021-22 and its provisional estimate of Welsh income tax revenue for 2022-23. This includes:

- our assessment of HMRC's Welsh income tax outturn calculation for 2021-22, including data limitations and HMRC's judgements in areas of uncertainty; and
- our views on HMRC's estimate of Welsh income tax revenue for 2022-23 and the features and limitations of HMRC's methodology.

The Welsh income tax 2021-22 final outturn

1.2 HMRC's calculation of the outturn for Welsh income tax revenue for 2021-22 is £2,384 million (**Figure 2** overleaf). HMRC calculates the final outturn figure from several components, which it aggregates to produce the total Welsh income tax liability for 2021-22. Each component is calculated using one or more sources of data to extract the total Welsh income tax liability. HMRC's previous estimate of 2021-22 Welsh income tax, published in July 2022, was £2,356 million, meaning the actual outturn was £28 million (1.2%) higher than HMRC had originally estimated. This compares with a 1.8% difference in 2020-21 and 1.6% in 2019-20.

1.3 HMRC largely based the outturn calculation on established tax liabilities, some £2,441 million, where HMRC has finalised the tax owed and fully reconciled the taxpayer records. HMRC calculates the established liabilities from the final tax liability data extracted from the Pay As You Earn (PAYE) and Self Assessment income tax systems.

1.4 HMRC makes adjustments or estimates where it has not yet finalised the tax due, or where it must estimate the Welsh share of uncollectable amounts or tax reliefs. The reduction in Welsh income tax outturn arising from these adjustments was £57 million (net) (Figure 2 overleaf). In some areas of the calculation, HMRC does not have data in sufficient detail to identify income tax liabilities, reliefs or other adjustments relating to individual taxpayers. HMRC estimated the Welsh share of these balances by using other available data, such as population and income data, to apportion the balance between Wales and the rest of the UK.

Figure 2

HM Revenue & Customs' (HMRC's) calculation of the 2021-22 Welsh income tax revenue outturn

The majority of the outturn is based on established liabilities with a small proportion estimated by HMRC

	2021-22			2020-21
	Amounts based on established taxpayer liabilities	Adjustments and amounts based on estimated liabilities	Total	Total
	(£mn)	(£mn)	(£mn)	(£mn)
Self Assessment established liabilities[1]	759	(11)	749	674
Pay As You Earn (PAYE) established liabilities[1]	1,682	(8)	1,674	1,506
Estimated further liabilities[2]	–	54	54	50
Deductions from revenue[3]	–	(93)	(93)	(90)
Total	**2,441**	**(57)**	**2,384**	**2,140**

Notes

1 Self Assessment and PAYE established tax liabilities are based primarily on the tax liability data held by HMRC, although some amounts are based on estimates as well.

2 This is HMRC's estimate of PAYE tax liabilities that have not yet been finalised and where tax liabilities are expected from future Self Assessment returns or compliance activity.

3 Deductions from revenue include tax relief on pension contributions and Gift Aid.

4 Numbers shown in brackets are negative numbers.

5 Totals do not sum due to rounding.

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

1.5 HMRC and the Welsh Government discussed and agreed the methodology used to calculate the 2021-22 outturn for Welsh income tax at the Welsh Rates of Income Tax Board in May 2023. The methodology HMRC used to calculate the outturn has remained broadly the same since the prior year.

1.6 We examined the methodology for the outturn calculation, which necessarily includes some remaining areas of estimation, for instance where HMRC had not yet received returns from taxpayers. In these areas, we evaluated the basis for HMRC's estimate including relevant assumptions and available data. We concluded that the Welsh income tax revenue outturn for 2021-22 is fairly stated. We describe the key components of the calculation of outturn in more detail below.

Self Assessment established liability

1.7 The Self Assessment established liability of £749 million represents all income tax attributable to Wales from Welsh Self Assessment taxpayers in 2021-22.

1.8 HMRC identifies Welsh taxpayers by using its record of Welsh residency status in its Computerised Environment for Self Assessment (CESA) system. The calculation of Self Assessment liabilities is mainly based on the extraction of Welsh taxpayer records from CESA. HMRC has also made minor adjustments to apportion Wales's share of other relevant Self Assessment balances where specific data are not available.[1]

PAYE established liability

1.9 The PAYE established liability of £1,674 million represents all income tax attributable to Wales from Welsh PAYE taxpayers in 2021-22.

1.10 Under PAYE, employers submit data monthly to HMRC on the earnings and tax deductions made for their employees and HMRC records this information in its National Insurance and PAYE Service (NPS) system. HMRC identifies Welsh taxpayers in the NPS using a residency indicator based on taxpayer postcode information. HMRC identifies total Welsh income tax liabilities by extracting Welsh taxpayer records from the NPS.

1.11 Most PAYE liabilities are based on Welsh taxpayer data extracted from HMRC's systems but some apportionment of other smaller elements is required. HMRC deducts from the total the Welsh share of tax reliefs given against PAYE liabilities. HMRC also makes an adjustment to apportion the tax it collects from employers under PAYE settlement agreements.[2] The Welsh share that HMRC calculated for 2021-22 was £3.2 million. As tax liabilities are settled through one payment for the employer, the identity of individual taxpayers is not recorded and, therefore, HMRC analyses employer submissions to determine the Welsh proportion of UK-wide settlement agreement revenue.

1 This includes an estimate of £4 million from manually entered liabilities and assessments, which do not provide a split of the liability between taxes. It also includes sensitive records, which HMRC does not access when calculating the Welsh share of income tax. HMRC deducted a sum of £17 million for the Welsh share of tax reliefs claimed through Self Assessment.

2 A PAYE settlement agreement allows employers to make one annual payment to cover all tax due on minor, irregular or impracticable expenses or benefits for employees in the scheme.

Estimated further liabilities

1.12 Most Self Assessment liabilities for 2021-22 are established prior to calculating the outturn. Nevertheless, HMRC knows from past years that Self Assessment tax liabilities will continue to be established and collected for up to six years afterwards. This is because HMRC continues to receive additional information from taxpayers and through its compliance activity. HMRC calculates the estimated additional liability for these elements based on past performance and valued it at £54 million in the 2021-22 outturn. HMRC made an estimated adjustment of £17,855 in relation to further PAYE liabilities that had not yet been determined, such as where year-end totals or information about benefits-in-kind received by the taxpayer was still outstanding. Improved IT processes have helped reduce this from £1.4 million in 2020-21.

Deductions from revenue

1.13 HMRC makes a series of deductions from the outturn revenue, recognising that in practice it will not collect all the tax it is owed. It uses historical information to calculate these deductions and apportions an amount for Welsh taxpayers.

1.14 Some PAYE and Self Assessment income tax liabilities are never settled because either employers or taxpayers fail to pay the full amounts due. HMRC analyses historical data for the UK as a whole to determine patterns of uncollected liabilities and then apportions an amount relating to Welsh taxpayers. HMRC calculated this to be £19 million for 2021-22.

1.15 HMRC makes further deductions for pension contributions and Gift Aid, both of which attract income tax relief at the taxpayer's marginal rate of income tax. Pension scheme administrators claim tax relief at the basic rate from HMRC on behalf of their scheme members, while charities claim tax relief at the basic rate from HMRC on behalf of their donors. HMRC calculates both deductions by estimating the Welsh share of each tax relief claimed across the UK using historical data. HMRC calculated the Gift Aid deduction to be £30 million for 2021-22 and pension contributions to be £43 million.

The Welsh income tax estimate for 2022-23

1.16 HMRC estimates it will collect £2,589 million of Welsh income tax revenue relating to the 2022-23 year.[3] This represents an increase of £205 million (8.6%) against the 2021-22 outturn. There was an 8.9% increase for the UK overall. These increases reflect inflationary rises in earnings, together with the freezing of tax bands and thresholds. This increased the size of the taxpayer population and caused some taxpayers to move into a higher tax bracket. HMRC expects to publish the final outturn for the 2022-23 year in its 2023-24 Annual Report and Accounts by July 2024. HMRC's estimate is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue that the Welsh Government ultimately receives.

1.17 HMRC's methodology to estimate Welsh income tax revenue for 2022-23 is based on taxpayer data from its Survey of Personal Incomes. The latest data available to HMRC at the time it produced the estimate were from 2020-21, but HMRC assessed these data would be less indicative of future years given the distorting impact of the COVID-19 pandemic. It instead used Survey of Personal Incomes data from 2019-20. HMRC then determined Wales's percentage share of the overall UK income tax liability by analysing data in a model replicating the UK income tax system, known as the Personal Tax Model. HMRC adjusted the data to reflect demographic and policy changes that it expects or knows have taken place between 2019-20 and 2022-23. HMRC then applied Wales's share to the total UK tax liability to produce an estimate of revenue for Welsh income tax (**Figure 3** overleaf).

1.18 HMRC made a 'calibration' adjustment to the Welsh revenue estimate because its methodology has historically resulted in actual outturn being lower than estimated outturn. HMRC made this adjustment by comparing the 2021-22 outturn with a revised estimate of 2021-22 revenue using the same methodology but with the most recent assumptions and data. The impact of the calibration adjustment reduced the 2022-23 provisional estimate by £63 million (2.4%) (see Figure 3 overleaf).

3 HM Revenue & Customs, *Annual Report and Accounts 2022-23*, HC 1466, July 2023.

Figure 3

HM Revenue & Customs' (HMRC's) method for calculating the Welsh 2022-23 income tax revenue estimate

HMRC's estimate relies upon sample data and an apportionment of UK-wide estimates to calculate a Welsh share of income tax revenue

Survey of Personal Incomes

HMRC collected data from a 1.5% sample of UK taxpayers in 2019-20.[1]

→

Personal Tax Model

HMRC calculated the percentage share of UK income tax that related to Welsh taxpayers to be 1.18%.

→

Adjusted Welsh share

HMRC adjusted the percentage share to reflect changes to population, earnings and tax legislation since the Survey of Personal Incomes.

This resulted in a revised Welsh share of 1.18%.

→

Total UK income tax liability 2022-23

HMRC combined Self Assessment liabilities[2] with PAYE receipts to calculate the total liability[3] for the UK of £228.4 billion.

→

Total Welsh income tax liability 2022-23

HMRC applied the previously calculated Welsh share to the total income tax liability. The estimate of Welsh income tax calculated was £2.7 billion.[4]

→

Calibrated 2022-23 Welsh revenue estimate

HMRC calculated an overall calibration adjustment of 2.4% to reflect that historically the actual outturn has been lower than the initially estimated amount from this methodology. The calibrated estimate is £2.6 billion.[5]

Notes

1 HMRC's annual Survey of Personal Incomes is a sample of UK taxpayers' data from the PAYE and Self Assessment tax systems. The Personal Tax Model projects the outcome for income tax liabilities in 2022-23, adjusting for differing rates of population growth and economic factors such as wage increases, to calculate the Welsh share.

2 Non-savings, non-dividend income only.

3 PAYE data come from HMRC's Real-Time Information system. Self Assessment data come from HMRC's Self Assessment Model.

4 HMRC applied the previously calculated Welsh share to the total income tax liability before Gift Aid, and then removed the estimated share of Welsh Gift Aid along with other much smaller adjustments.

5 HMRC makes the calibration adjustment for Wales on a band-by-band basis. When compared with the outturn, the basic rate adjustment was calculated to be 2.4%, the higher rate 0.7% and the additional rate 7.8%. When looked at in totality, the impact of these adjustments reduced the estimate by 2.4%.

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

1.19 Our review concluded that HMRC's approach is reasonable. However, the limitations we described in previous reports relating to HMRC's methodology for estimating Welsh income tax revenue remain relevant for 2022-23:

- The calibration adjustment assumes the 2022-23 over-estimation is consistent with 2021-22 in percentage terms, but HMRC does not fully understand the causes of the over-estimate in 2021-22 and any socioeconomic factors contributing to the over-estimate may be different in 2022-23.
- HMRC's use of sample data introduces sampling uncertainty into the revenue estimate from which HMRC calculates the Welsh portion as a percentage.
- The methodology combines the calculation of PAYE and Self Assessment liabilities for the UK such that the amount HMRC apportioned to Wales does not reflect the differing proportions of each type of taxpayer between Wales and the rest of the UK.
- The data that HMRC uses for PAYE include all income types and do not exclude tax from savings and dividend income.
- HMRC must make an assumption around the volume and value of under- and over-payments relating to PAYE liabilities.

1.20 HMRC identified the key source of uncertainty in the 2022-23 estimate as the accuracy with which it can estimate Wales's share of UK income tax liabilities. The estimated share that HMRC calculates is based on 2019-20 survey data, so there is an inherent risk that this could change for Wales by 2022-23. HMRC estimates that Welsh income tax liabilities will grow at a slightly slower rate than the UK overall. External factors creating additional uncertainty around estimating Wales's share in 2022-23 included high interest rates and inflation, wage growth and high and volatile energy prices. We consider that HMRC has taken a reasonable approach to estimating the impact of these areas of uncertainty on Welsh income tax revenue in 2022-23.

Part Two

Administering Welsh income tax

2.1 This part of the report covers:

- HM Revenue & Customs' (HMRC's) key processes to administer the income tax system and how we have obtained assurance on them (paragraphs 2.5 to 2.14);
- HMRC's procedures to identify and maintain a complete and accurate record of the Welsh taxpayer population (paragraphs 2.15 to 2.25); and
- how HMRC identifies and responds to compliance risks (paragraphs 2.26 to 2.34).

2.2 HMRC uses the same systems to administer income tax whether it comes from a taxpayer in Wales or the rest of the UK. However, HMRC also operates additional rules and procedures for Wales, and we assess these below. This reflects HMRC's responsibility to administer income tax for Welsh taxpayers in the same way as the service provided elsewhere in the UK.

2.3 Under Section 2 of the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General (C&AG) must consider the adequacy of HMRC's systems to assess and collect tax in the UK, including income tax. Each year we publish a report (the Standard Report) alongside HMRC's Annual Report and Accounts setting out the C&AG's conclusions in this respect. Our 2022-23 Standard Report concluded that 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 duly carried out.

2.4 To support the conclusions of this report, we extended our UK-wide testing to address risks and approaches arising from divergences in income tax policy. We also undertook specific procedures looking at HMRC's address-cleansing and wider tax compliance activities. These informed our assessment of the completeness and accuracy of HMRC's Welsh income tax estimates. To reach our conclusions, we examined several elements of devolved tax administration, such as HMRC's ongoing maintenance of Welsh taxpayer records, and how it identified and responded to devolved tax compliance risks.

The income tax system

2.5 HMRC's system to collect income tax is consistent across the UK. Depending on the type of income an individual receives, income tax is assessed and collected by employers deducting earnings through Pay As You Earn (PAYE), by the taxpayer submitting a Self Assessment return, or both.

2.6 The PAYE and Self Assessment processes share common principles, despite HMRC using different IT systems and data sources to assess and collect tax. **Figure 4** overleaf identifies these principles and describes the main processes for each income tax stream.

Assurance of income tax processing

2.7 Our annual audit work programme on HMRC includes procedures providing assurance over key tax processing controls. These controls are broadly divided into two categories:

- automated system controls around data-handling, storage and processing; and
- complex key business controls that have a high level of automation.

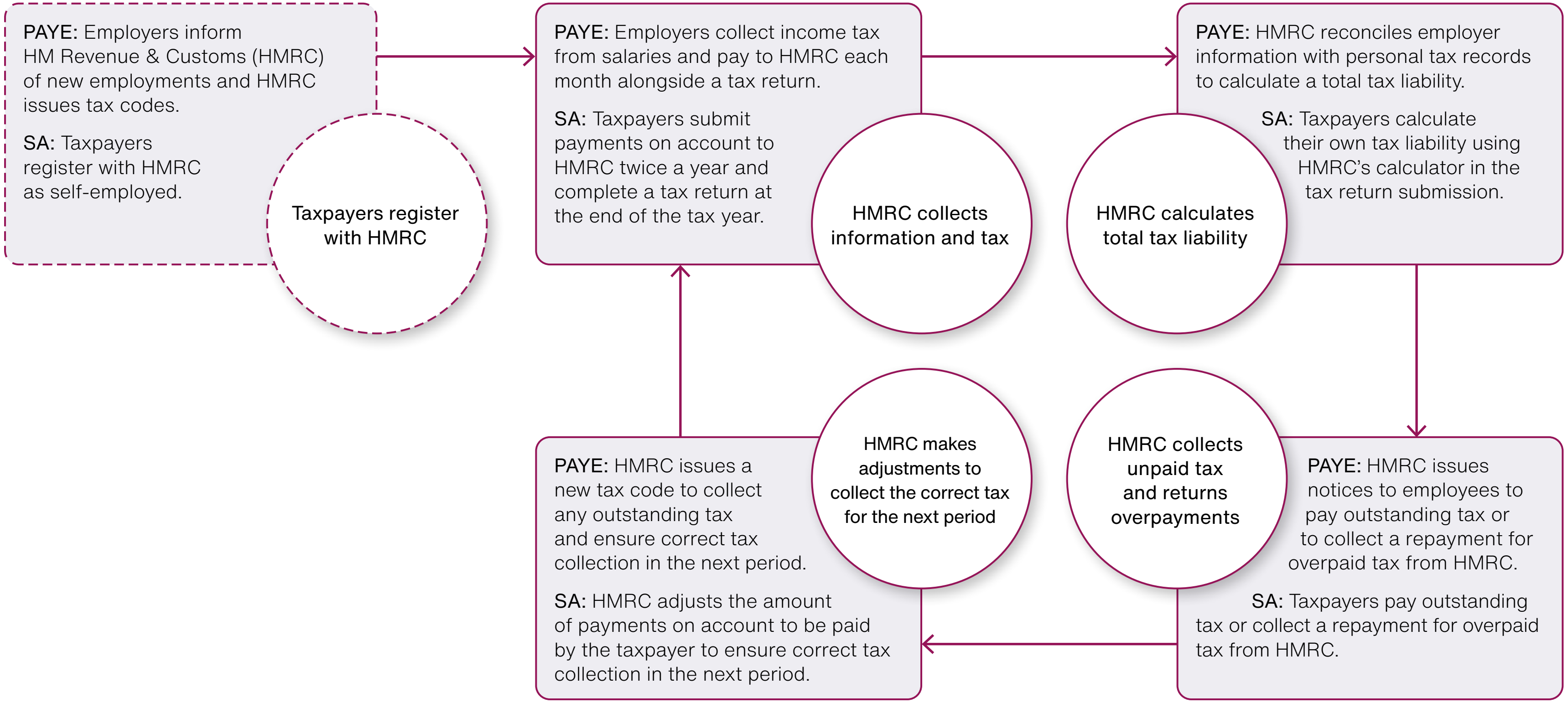
2.8 Following annual updates to business rules to reflect changing tax rates, thresholds and allowances for the UK and devolved administrations, HMRC completes several phases of assurance testing on key business controls to confirm system functionality. We evaluate the scope of this testing and re-perform elements to confirm HMRC's conclusions as part of our audit. The key processes for PAYE include annual:

- reconciling of employer information with personal tax records to confirm tax due on earnings and calculate any over- or under-payments of tax based on country of residence; and
- issuing of tax codes to PAYE taxpayers which incorporate residency information to ensure employers deduct tax under the tax rules of the correct country.

2.9 HMRC applies similar processes to each individual Self Assessment return that it receives. Self Assessment taxpayers make payments on account and at the year-end calculate their own tax liability using HMRC's calculator in the tax return submission.

Figure 4
The UK income tax system

The Pay As You Earn (PAYE) and Self Assessment (SA) processes share common principles in the assessment and collection of income tax



Notes

1 PAYE and Self Assessment processes do not occur simultaneously. PAYE is processed during the tax year and reconciled after the end of the tax year. Self Assessment returns are not submitted until the January following the end of the tax year.

2 After the tax year ends, HMRC's PAYE reconciliation process calculates the income tax liability for each taxpayer using all available data. The calculated liability is compared with amounts deducted at source or collected from taxpayers directly to determine whether the correct tax has been collected.

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

Devolved income tax

2.10 The main differences in administering Welsh income tax, when compared with UK processes, are the business rules that the HMRC system applies when completing tax liability and tax code calculations. There have been no significant changes to system rules since our last report covering 2021-22. The rules that the HMRC system applies for Welsh taxpayers are as follows:

- It checks the individual's residency status and applies the 'C' tax code prefix where they are identified as a Welsh resident. This instructs employers to collect tax under Welsh tax rates. Where an individual is no longer resident in Wales, the system removes the 'C' prefix.
- Where the system identifies an individual as a Welsh resident, it applies Welsh tax rates and bands to the reported income when calculating the liability for the current tax year.
- If an individual has been identified as a Welsh resident and is enrolled on a PAYE scheme, the system uses Welsh income tax rates to calculate a new tax code for the following year.

2.11 Self Assessment returns include a check box for the taxpayer to state whether they resided in Wales during the tax year. If this contradicts HMRC's records, HMRC uses the address it holds to calculate the taxpayer's tax liability. HMRC notifies taxpayers of the discrepancy and asks them to update their address if required. **Figure 5** overleaf shows where these divergences occur within the income tax system.

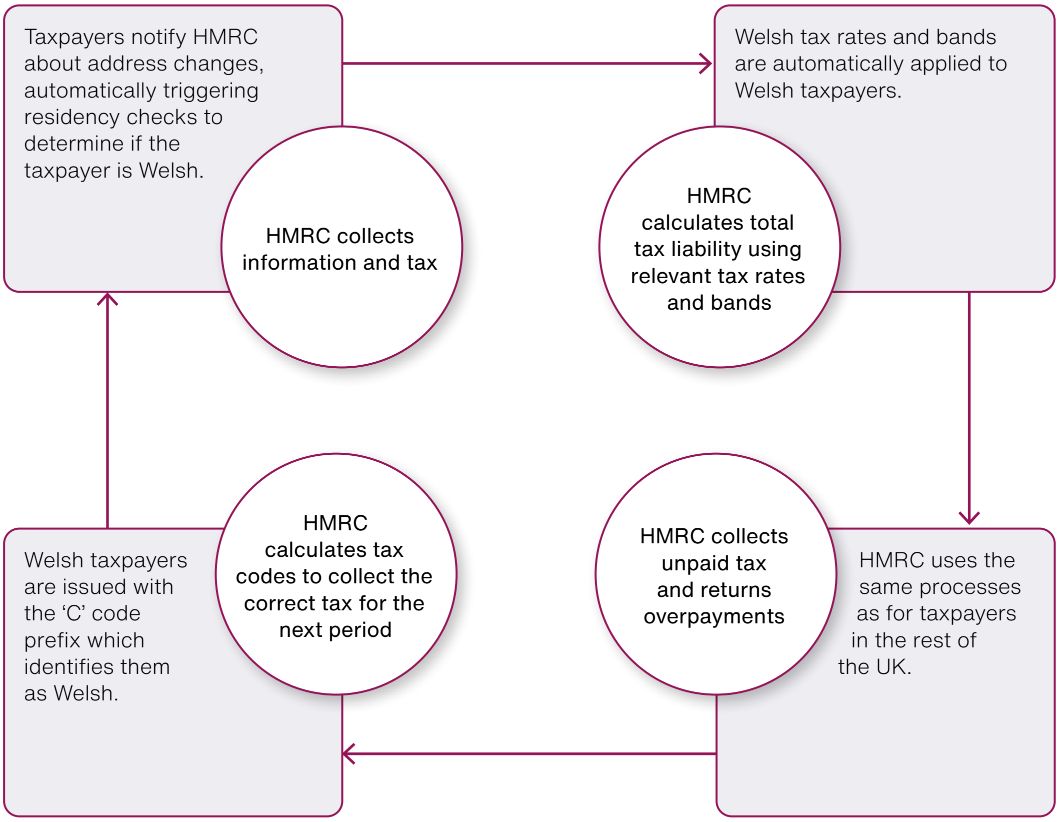
Tax relief on pension contributions

2.12 Pension scheme administrators must identify Welsh taxpayers so that tax relief is correctly allocated. Pension administrators claim tax relief at source on behalf of their members and add this to their members' contributions. HMRC's Relief at Source (RAS) system automatically confirms the residency status of pension scheme members to ensure the correct relief is applied at source. It applies tax relief on pension contributions at the basic rate of 20% for all taxpayers. Welsh taxpayers paying a tax rate above 20% can claim the remaining tax relief through a Self Assessment return or by contacting HMRC.

Figure 5

Divergences in the income tax system for Welsh taxpayers

HM Revenue & Customs' (HMRC's) business rules are configured to process income tax using the rates and thresholds applicable to a taxpayer's residency status



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

2.13 To administer relief at source, HMRC requires all pension administrators to submit an annual report listing their members' contributions during the previous tax year. HMRC's systems automatically trace scheme members and match them against addresses held to identify Welsh taxpayers. An Annual Notification of Residency Report is then issued to all pension administrators. HMRC confirmed the residency status for 93% of Scottish and Welsh pension scheme members following the 2021-22 tax year, a similar proportion as in the past five years. A Wales-specific figure is not available. Following the 2021-22 tax year, HMRC issued Annual Notification of Residency Reports to pension scheme administrators in January 2023.

Tax relief on Gift Aid contributions

2.14 HMRC provides tax relief on Gift Aid contributions in Wales at the UK basic rate of 20%. This is because HMRC does not have systems in place to establish the residency of taxpayers donating to charity. All taxpayers paying tax above the basic rate can claim the difference between their tax rate and the basic rate on their donation. Where donations are made by Welsh taxpayers, HMRC applies the correct rate of relief when it is notified of the donated amount either through a request to amend a tax code or via a Self Assessment return.

Welsh taxpayer population

2.15 HMRC has calculated that there were 1.4 million Welsh taxpayers in 2021-22.[4] A Welsh taxpayer is someone with a tax liability whose main place of residence during the tax year is Wales.[5] Higher-rate and additional rate taxpayers accounted for 8.5% of the Welsh income tax population in 2021-22 (up from 7.7% in 2020-21) and contributed 42.9% of income tax paid (up from 40.7% in 2020-21). These increases reflect the freezing of tax thresholds and the movement of taxpayers into higher tax brackets. Basic rate taxpayers accounted for 91.5% of the population and provided 57.1% of tax paid (**Figure 6** overleaf).

Address assurance

2.16 Maintaining accurate and complete records of the Welsh taxpayer population continues to be the main challenge for HMRC in administering Welsh income tax. HMRC has many information sources for changes of address but relies primarily on taxpayers informing it of such changes on a timely basis, although taxpayers are not legally required to do this. HMRC also obtains address information from other sources such as employers, although it is not mandatory for employers to provide updates when their employees' addresses change.

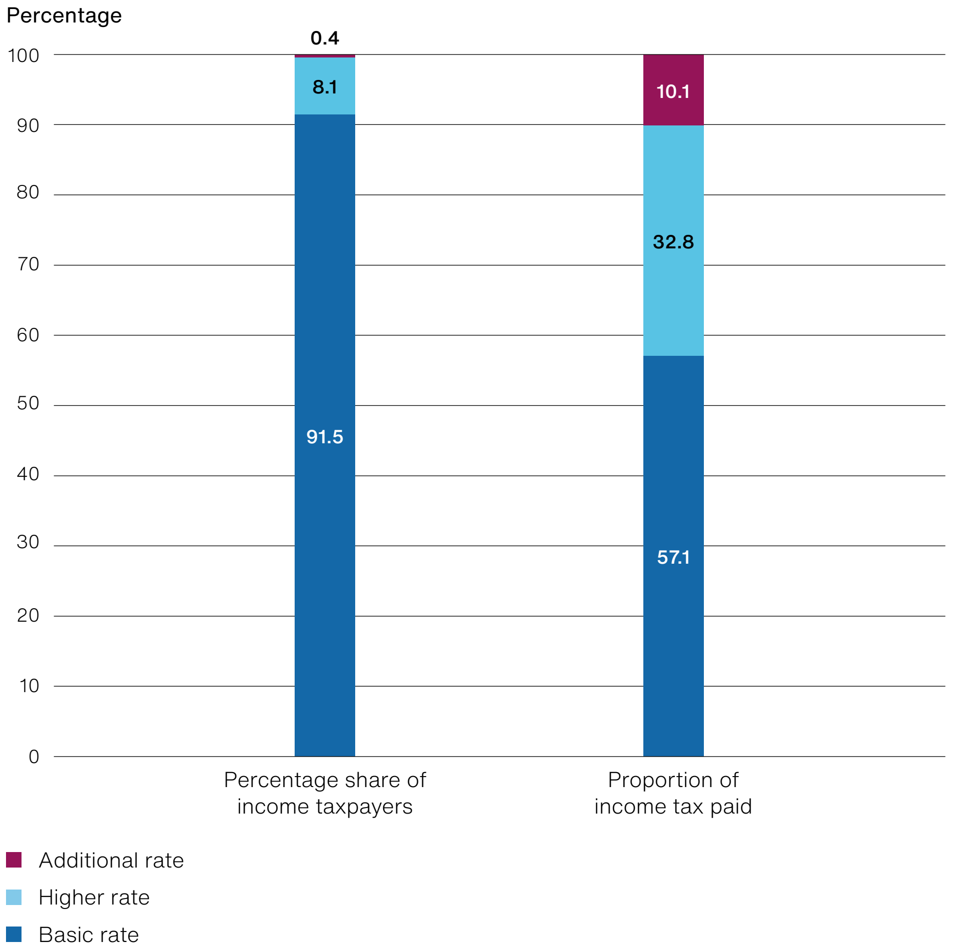
2.17 Address information must be correct to ensure the right amount of tax is collected from individuals and allocated to the appropriate government. HMRC has several assurance processes in place to maintain the completeness and accuracy of the address data it uses to identify Welsh taxpayers (**Figure 7** on page 25).

4 HM Revenue & Customs, *Welsh Income Tax Outturn Statistics: 2021 to 2022*, July 2023.
5 Welsh parliamentarians are also deemed Welsh taxpayers. See paragraph 2.25 for more details.

Figure 6

Proportions of income taxpayers by band and income tax paid by band in Wales, 2021-22

Higher rate and additional rate income taxpayers accounted for 8.5% of the population but contributed 42.9% of the income tax paid



Note

1 2021-22 is the latest year for which data are available.

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

Figure 7

Assurance over the Welsh taxpayer population

HM Revenue & Customs (HMRC) carries out several assurance activities to maintain the completeness and accuracy of the Welsh tax base

Assurance activity	Description and purpose	Results
Controls ensuring Welsh residency is correctly determined using the address held by HMRC		
New postcodes	Comparison of HMRC's list of Welsh postcodes with Office for National Statistics (ONS) data to ensure postcodes are up to date.	HMRC receives postcode data quarterly from the ONS. It added 465 new postcodes in 2022-23.
Address-cleansing	Scans of taxpayer records held by HMRC to identify missing or invalid postcodes which would result in an incorrect residency status being applied.	Scans undertaken in November 2022 identified 15,746 missing postcodes. HMRC updated 418 of these cases because they had a record of current employment or pension. HMRC also identified 36,573 invalid postcodes and updated 352 taxpayer records where there was a record of current employment or pension.[1]
Cross-border postcodes	HMRC's systems flag address changes where new addresses lie in a postcode that crosses the England-Wales border. HMRC reviews these cases to ensure it determines the correct residency.	In 2022-23, HMRC reviewed 434 cross-border cases, of which it amended 68 following investigation.
Missing residency flags	Scans to identify Welsh taxpayer records that are not flagged as such in the system.	HMRC's scans during 2022-23 identified 465 cases, all of which it updated.
Controls monitoring the operation of Pay As You Earn (PAYE) by employers		
Tax code comparison scans	A comparison between tax codes in PAYE submissions with HMRC's taxpayer record to identify cases where the employer is applying a different tax code to HMRC.	In January 2023 HMRC identified 44,852 cases where 'C' prefixes were not correctly applied to tax codes.[2] It writes to employers to ask them to update the incorrect tax codes.
Controls to identify incorrect addresses held by HMRC		
Third-party data comparison	A comparison of taxpayer address records held by HMRC with third-party data sources to identify cases where HMRC records are inconsistent with third-party data. The exercise is HMRC's main source of assurance over the accuracy of its address records.	HMRC and the Welsh Government have agreed to run this exercise every two years. The most recent one was performed in August 2023 and compared 3.0 million Welsh address records. HMRC identified 10,745 records where the residency determined from the address held by HMRC did not match the residency suggested by third-party data.
Wealthy individuals	HMRC performs checks and procedures to review the movements of wealthy individuals and ensure their addresses are up to date. Specialist teams develop an in-depth understanding of the finances, behaviours and compliance risks of these taxpayers.	

Notes

1 Invalid postcodes identified are corrected or manually set as Welsh where the correct postcode cannot be determined from the address.

2 Figures are from HMRC's analysis of monthly tax code scans and show the number of tax codes where the Welsh 'C' prefix was not correctly applied, and where the tax code would have otherwise been correct.

Source: National Audit Office summary of HM Revenue & Customs activities

Postcode scans

2.18 HMRC scans taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied. The 2022-23 scan, performed in November 2022, identified 52,319 postcodes either missing or invalid (4% of the overall taxpayer population), compared with 81,716 (6%) and 53,467 (4%) in the previous scans in June 2021 and September 2020 respectively. HMRC investigates and updates all cases where individuals were either employed or receiving a pension. In 2022-23, HMRC updated 770 records, compared with 1,708 in 2021-22 and 6,343 in 2020-21. Cases that HMRC has not updated are identified as dormant because they have no current taxable income.

The administration of Welsh tax codes

2.19 Where an employer does not apply the ‘C’ prefix to an employee’s tax code, they will deduct tax at the UK rate. HMRC reconciles what each taxpayer has paid in tax against what it thinks they should have paid at the end of the tax year. HMRC then uses this finalised information and the residency status held on its systems to calculate the tax liability each taxpayer should pay. The outturn for Wales is, therefore, unaffected where the ‘C’ prefix in an individual’s tax code is not correctly applied by an employer.

2.20 Each month, HMRC compares tax codes in PAYE submissions with its own taxpayer record to identify cases where employers are using a different tax code. In January 2023, there were 44,852 cases (2.4% of cases) where employers were not operating a tax code with a ‘C’ prefix. This number varies across the year but has remained below 3% since March 2021. We noted in previous reports that HMRC has not set a target for how low the number of missing ‘C’ prefixes would be before it considers that its compliance activity has been successful.

2.21 When HMRC identifies an employer is not using the correct tax code, it issues a P6 notification to the employer asking them to update the employee’s tax code. HMRC identifies employers making persistent errors and works with them to implement the correct tax code. HMRC told us that the number of employers who repeatedly use the incorrect tax code is very small and so it does not routinely track this information.

Third-party data exercise

2.22 HMRC periodically compares the Welsh taxpayer address records it holds with third-party data to identify differences. This comparison is HMRC’s main source of assurance over its address information and it previously agreed with the Welsh Government to run the exercise every two years.

2.23 In August 2023, 3.0 million records held by HMRC were compared with third-party data, showing that:

- 2.2 million records (75.8% of records analysed) held by HMRC were successfully matched to third-party data with a Scottish address. This is in line with the match rate in the previous third-party data exercise in 2021 (75.7%) and remains lower than the 80.7% matched in 2019;
- 10,745 records (0.4% of records analysed) were identified where the residency determined from the address held by HMRC did not match the residency suggested by third-party data; and
- the residency status of taxpayers for 0.7 million records (24.1% of records analysed) could not be corroborated by comparison with the third-party data. HMRC reviewed these records against other internal data sources to gain assurance over the accuracy of the addresses held.[6]

2.24 The results from the 2023 exercise became available in December 2023 and HMRC has not yet assessed what factors contributed to any trends in data. For the decline between 2019 and 2021 in the proportion of records matched to third-party data, HMRC identified several potential factors, including: the impact of data protection regulations on third-party data sets; a higher death-rate due to the COVID-19 pandemic; the inclusion of 16- to 18-year-olds on the electoral roll; and an increase in people changing address.

Welsh parliamentarians

2.25 Welsh parliamentarians are automatically deemed as Welsh taxpayers in any tax year they are in office. This applies to the 60 elected members of the Senedd (MSs) and the 40 members of Parliament in Westminster representing a constituency in Wales. HMRC introduced system changes in August 2020 designed to remove the need for it to manually update parliamentarians' records each year to record them as Welsh taxpayers. Once HMRC records a Welsh parliamentarian as a Welsh taxpayer, its system automatically overrides its normal business rules, until HMRC manually resets the override for each parliamentarian. HMRC told us that it did not identify any issues in relation to Welsh parliamentarians being recorded as Welsh taxpayers during 2022-23.

6 Approximately 71,000 records were discounted from any analysis as the individuals concerned were under the age of 18, deceased, indicated as living abroad or were duplicate records.

Compliance risk assessment and planning

2.26 HMRC applies the same risk-based compliance approach to collect income tax in Wales as it does in the rest of the UK. This approach involves:

- **promoting** compliance by designing processes to encourage and help customers get things right first time;
- **preventing** non-compliance through process design and customer insight and providing an opportunity to correct mistakes; and
- **responding** to, investigating and correcting compliance risks using tailored activity when intervention is needed.

2.27 As part of its Service Level Agreement with the Welsh Government, HMRC produces an annual Strategic Picture of Risk (SPR) for Welsh rates of income tax to assess and plan for compliance risks applicable to Wales. For this SPR, HMRC considers key compliance risks at the overall UK level and applies a value to represent the Welsh proportion of these risks. It calculates each risk in line with Wales's share of UK income tax in the Welsh Income Tax Outturn Statistics. HMRC does not vary the size of this proportion for each risk and has not tested its assumption that non-compliance in Wales is the same as the rest of the UK. It said doing so would involve considerable methodological challenges and costs. As in previous years, HMRC has not identified any significant risks specific to Wales and considers the main risks to Welsh income tax are the same as for the whole of the UK. These risks include:

- evasion, where individuals or businesses deliberately omit, conceal or misrepresent information to reduce their tax liabilities;
- the hidden economy, where taxable income is not declared or where declared income is deliberately understated; and
- tax avoidance, where tax rules are exploited to gain a tax advantage that Parliament never intended.

HMRC's compliance activity and debt management

2.28 Across the UK, the number of compliance cases that HMRC opened in 2022-23 was higher than in 2021-22 but remained 17% lower than in 2019-20 before the pandemic. In 2022-23, it closed 20% fewer cases than in 2019-20. HMRC says this partly reflects its strategy to focus increasingly on upstream efforts to ensure taxpayers comply in the first place, and to prioritise larger and higher-impact cases.

2.29 HMRC has limited information on total compliance activity undertaken in Wales. Its compliance system allows HMRC to raise a flag where potential manipulation of residency status has been identified. We understand there are currently no such flags on the compliance system. HMRC told us that information about numbers of active compliance cases relating to Welsh taxpayers for reasons not related to their status as a Welsh taxpayer requires interrogation of separate information systems. Unlike the income tax system, which can flag Welsh residents, HMRC's compliance management information system cannot readily identify people living in Wales and information must be compared with other data to provide numbers on the extent of Welsh non-compliance in total.

2.30 HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield, its estimate of the additional revenues it considers it has generated and the losses it has prevented. HMRC's yield from its tax compliance activities for the whole of the UK was £34.0 billion in 2022-23, up 10% compared with 2021-22 and higher than the average over the past five years (2018-19 to 2022-23) of £33.2 billion. Compliance yield in 2022-23 was, however, below HMRC's target of £36 billion. As a proportion of total revenue, compliance yield remained at 4.2%. HMRC explained it was still seeing the effects of reduced compliance activity during the COVID-19 pandemic in its 2022-23 performance.

2.31 HMRC estimates a compliance yield of £120 million in 2021-22 for Wales's share of the risks in the SPR. HMRC also estimates that Wales's share of net losses from the risks in the SPR was £390 million in 2020-21. These data are the most recent available. HMRC calculates these figures as a proportion of the equivalent UK figure, rather than using Wales-specific data to quantify the risks. HMRC does not consider or report on geographical variation between Wales and the rest of the UK when assessing compliance risk or the relative success of compliance activity.

2.32 The tax gap is the difference between the amount of tax that should be paid and what is actually paid. HMRC does not currently produce a Welsh-specific tax gap. In response to a report by the Committee of Public Accounts, HMRC noted that calculating a Welsh-specific tax gap would be difficult for methodological reasons and the high degree of uncertainty of such an analysis.

2.33 HMRC's management of tax debt affects how much income tax that is initially unpaid is subsequently collected across the UK, including in Wales. HMRC's debt balance is affected by external factors that have an impact on taxpayers' ability to pay their tax liabilities, including current inflationary pressures and increases in the cost of living. At 31 March 2023, total tax debt for the UK was £43.9 billion, 11.9% (£4.7 billion) more than the debt reported at 31 March 2022. Tax debt more than trebled in the first six months of 2020-21 due to the wider economic impact of the COVID-19 pandemic and HMRC's decision to suspend most debt collection. It remains higher than the five years leading up to the pandemic, when tax debt was typically around £14 billion. HMRC has a new strategy to bring down tax debt in the long term but expects it to remain high throughout 2023-24. HMRC does not produce an estimate of the total income tax debt attributable to Welsh taxpayers.

2.34 HMRC has taken steps to increase its capacity for managing debt. The number of staff in its debt management function increased from 4,289 in 2021-22 to 4,720 in 2022-23. In the Spring Budget 2023, HM Treasury gave HMRC an additional £47.2 million to improve its ability to manage tax debts, including increasing its capacity through debt collection agencies and making it easier for taxpayers to service their own debt arrangements online, for instance, by setting up time-to-pay arrangements. HMRC expects this investment to help it recover an additional £1.4 billion in tax debt between 2022-23 and 2027-28. HMRC spent £34.0 million in 2022-23 on debt collection agencies to recover tax debt, compared with £20.6 million in 2021-22, and since September 2022 it has entered a new contract that allows it to place more debt with agencies for the same level of investment. In 2022-23, private agencies recovered £813 million in tax debt, an increase from £455 million in 2021-22. HMRC manages its contracts with debt collection agencies on a UK basis and cannot provide these data for Wales only.

2.35 Having completed our additional work on devolved tax issues, we are satisfied HMRC has adequate rules and procedures in place to assess and collect Welsh income tax and that these are being complied with.

Part Three

Costs

3.1 This part considers the administrative costs invoiced to the Welsh Government from HM Revenue & Customs (HMRC) for Welsh income tax and whether they are reasonable.

3.2 Under the Service Level Agreement between HMRC and the Welsh Government, the Welsh Government must reimburse HMRC for net additional costs incurred through administering Welsh income tax powers.

3.3 A supporting framework sets out the principles for identifying net additional costs. HMRC recharges the Welsh Government only for costs that specifically relate to administering devolved Welsh income tax powers, not for the costs of administering the overall income tax system in Wales.

Costs incurred in 2022-23

3.4 HMRC invoiced the Welsh Government for £0.4 million of costs relating to the administration of Welsh income tax in 2022-23, the same as the amount HMRC recharged in 2021-22. All of the spending related to operating costs. Costs incurred in 2022-23 were below the budget of £0.6 million. Reasons for this underspend included less time spent on Welsh income tax by HMRC staff than planned. There have been no significant changes to the recharging process in 2022-23.

3.5 We examined HMRC's method for estimating the costs to collect and administer Welsh income tax for the year ended 31 March 2023. Based on our audit work, we concluded that the amount paid by the Welsh Government was accurate and fair in the context of the agreement between HMRC and the Welsh Government.

Appendix One

Our evidence base

1 Section 80HA of the Wales Act 1998, as amended by the Finance Act 2014, requires the Comptroller and Auditor General (C&AG) to prepare a report for each financial year on:

- the adequacy of any of HM Revenue & Customs' (HMRC's) rules and procedures put in place, in consequence of the Welsh rate provisions, for the purpose of ensuring the proper assessment and collection of income tax charged at rates determined under those provisions;
- whether these rules and procedures are being complied with;
- the correctness of the sums brought to account by HMRC which relate to income tax which is attributable to a Welsh rate resolution; and
- the accuracy and fairness of the amounts which are reimbursed to HMRC as administrative expenses.

2 To reach the conclusions of this report relating to the rules and procedures operated by HMRC, we drew directly from our statutory audit work on HMRC's Annual Report and Accounts, including the C&AG's report on HMRC's controls for the proper assessment, collection and allocation of tax under Section 2 of the Exchequer and Audit Departments Act 1921. We also completed specific audit procedures over controls relevant to administering devolved taxes.

Financial audit

3 We audited the data, methodologies, assumptions and mechanics of the calculation for the revenue outturn for 2021-22 and the revenue estimate for 2022-23, which are described in this report. For the estimate, and where appropriate for the outturn, we applied the principles set out in International Standards on Auditing (UK) 540 Auditing Accounting Estimates and Related Disclosures to design audit procedures relevant to the nature of the estimates and to a sufficient level of precision.

4 In relation to administration costs, we based our conclusion on the accuracy and fairness of the costs HMRC charged to the Welsh Government upon evaluating costs against the details of the Service Level Agreement and supporting framework for costs agreed between both parties. HMRC estimated some of the incurred costs from available data on customer contacts and staff time. During the audit, we saw evidence that both parties regularly discuss and review cost budgets and forecasts as well as agreeing any amounts to be invoiced and paid.

5 All of these audit procedures were planned, performed and reviewed in accordance with our internal quality control procedures for financial audit.

6 We completed our financial audit fieldwork between April 2023 and July 2023.

Document review

7 To evaluate HMRC's approach to compliance risk, we reviewed published and unpublished HMRC documents about Welsh income tax including project documentation, risk and compliance documentation, and details of key assurance work performed by HMRC.

8 Our review was carried out between September 2023 and December 2023.

Interviews with departmental officials

9 We carried out two interviews with officials from HMRC, selected to participate because of their job role and their relevance to the audit. This included staff responsible for (or involved in) devolved tax policy and compliance.

10 We also spoke to the Welsh Government to inform our risk assessment and planning for this report.

11 Fieldwork took place between October 2023 and November 2023. We carried out interviews online. They typically lasted one hour and we took notes.

Quantitative analysis

12 We analysed financial data from HMRC on Welsh income tax revenue, HMRC's estimate of Welsh income tax revenue and the administrative costs of Welsh income tax.

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