A milestone in tax administration: HMRC anniversary

General Features



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As we mark the 20 year anniversary of the formation of HMRC, we review the issues that it faces, and what the future might hold.

His Majesty’s Revenue & Customs (HMRC) was created in 2005 through the merger of the Inland Revenue (‘the Revenue’) and Her Majesty’s Customs & Excise (‘Customs’). In 2003, Gordon Brown, then Chancellor of the Exchequer, asked Sir Gus (later, Lord) O’Donnell, the permanent secretary to the Treasury, to undertake a review of the departments dealing with tax policy and administration. O’Donnell recommended that ‘a new single revenue department’ should be established, and that the Treasury should become responsible and accountable for tax policy with support from the new department.

The merger

The Revenue and Customs had been in existence for hundreds of years. They had different origins, structures and cultures The Revenue, the larger of the two by far, dealt with direct taxes; Customs was responsible for duties and indirect taxes. The option of merging the Revenue and Customs had been considered before; for example, it was examined during the Fundamental Expenditure Review in 1994. The departments concluded that while a merger could produce savings in staffing, IT and accommodation, 'the short-term costs were likely to outweigh the efficiency gains'.

'Financing Britain's Future: Review of the Revenue Departments' (2004), O'Donnell's report, stated that many of the challenges of tax policy involved considering the effects of taxes that fell across departmental divides, and of integrating tax issues with other economic levers. In other words, the role was more suitable for the Treasury than the Revenue and Customs. O'Donnell argued that merging the Revenue and Customs would produce efficiency savings, better customer service and improved accountability. But he did not include any cost benefit analysis of the proposed change in his report.

The real reasons for the proposed merger

External commentators said that the Treasury had long coveted the tax policy-making powers of the Revenue and Customs. The government's decision to grant operational independence to the Bank of England reduced the Treasury's workload, and made it possible for it to take over responsibility for tax policy.

Treasury ministers had lost patience with the revenue Departments, which had increasingly become embroiled in controversy – for example, the Revenue's decision to transfer its entire property portfolio to a Guernsey-registered company; and Customs' loss of high-profile VAT cases that led to its prosecution powers being brought under the direct supervision of the Attorney General.

Launch of HMRC

Gordon Brown accepted O'Donnell's recommendations. HMRC came into existence following the enactment of the Commissioners of Revenue & Customs Act 2005. HMRC's staff of 97,073 (nearly 80% of whom were from the Revenue) made it the largest department in Whitehall at the time. It shed nearly a third of them within its

first ten years. However, its staffing increased during the pandemic, and the number of its compliance and debt management staff is due to rise under the new government, as mentioned below.

David Varney was appointed as HMRC's first executive chairman. He had no experience of tax policy or management in the public sector. Paul Gray, who had served in the Treasury and the Department of Work & Pensions, was appointed as the deputy chairman. As an experienced former business leader, Varney was aware that the merger of the Revenue and Customs would be expensive; the transitional costs were conservatively estimated at about £100 million. But he was unable to secure any funding from the Treasury to implement the merger.

Culture

The reports of a 'culture clash' in the early days between the staff who had worked in Revenue and Customs were exaggerated. But there were initially 'two cultures' within HMRC, because of the different ethos of the legacy departments. The culture of Revenue staff was heavily influenced by its cadre of fully trained tax inspectors, who held most of the mid-ranking and senior roles in the department. The culture of Customs staff reflected that of its hard-driving investigators.

Some staff with a Customs background feared being 'drowned' in a sea of better trained Revenue staff: they were vastly outnumbered. Whereas some ambitious Revenue staff were concerned about their executive chairman's alleged partiality for staff with a Customs background. He had reportedly quipped that when he wanted anything done, he asked someone with a Customs background. If he needed help with his Times crossword, he asked someone from the Revenue.

HMRC invested in measures to bring its staff together. It negotiated a departmental-wide pay agreement with the trades unions representing its staff to harmonise their pay and conditions. It also launched a review of the powers it had inherited from the legacy departments to remove anomalies such as their different time limits for assessment.

HMRC's head office staff worked together from the outset. But there had been little contact between Revenue and Customs staff prior to the merger, other than that between the few staff involved in the inter-departmental Working Together initiative.

The vast majority of the departments' staff remained in their own enclaves in the legacy departments' local office networks. But they had to begin working together when HMRC started merging their offices and co-housing them to reduce expenditure on accommodation and back-office functions.

Tax policy

The Treasury became responsible for the development of 'strategic tax policy' after the merger, and HMRC took charge of 'policy maintenance'. There were no demarcation disputes about the division of the work between the departments. HMRC temporarily seconded 75 experienced policy staff to the Treasury until it was able to recruit additional staff for its new role. The co-location of HMRC staff with the Treasury in Westminster made it easier for them to participate in meetings with ministers.

The Treasury and HMRC operated a policy partnership. The Treasury was responsible for developing new taxes, making structural changes to the tax system, and setting the level of rates and allowances. HMRC took the lead on operational, compliance, anti-avoidance and collection policy, technically complex legislation, and for the tax administration framework. It made policy in close consultation with its operational staff, and its lawyers and economists.

HMRC policy officials continued to deal with the detailed design of new legislation, including in particular the 'machinery' provisions relating to assessments, appeals, claims and the collection of tax. They also drafted instructions to Parliamentary Counsel to prepare new legislation. They supported ministers during the passage of the Finance Bill. They prepared guidance on new legislation and advised operational staff on their implementation and interpretation.

Tax discs

HMRC ran into stormy weather during its early days. Chancellor Alastair Darling told Parliament in 2007 that two discs containing a copy of the department's entire data on the payment of Child Benefit had been lost in transit to the National Audit Office. There was no trace of the discs when uniformed police officers searched HMRC's offices. The discs contained the names, addresses and banking details of 25million

claimants. The chancellor said that there was no indication that the data had fallen into the wrong hands. HMRC worked with the financial institutions to safeguard the compromised accounts.

HMRC Chairman Paul Gray resigned to protect ministers from the parliamentary storm caused by the department’s breach of the Data Protection Act.

Alastair Darling remarked in his memoirs that the discs had probably been destroyed when ‘the hunt was on, probably within days’ and that HMRC’s ‘opaque’ management structure had made it difficult to establish exactly who was responsible for what; the lines of accountability were obscure.

Alleged ‘sweetheart deals’

In 2011, the Public Accounts Committee (PAC) of the House of Commons investigated alleged ‘sweetheart deals’ between tax officials and individual corporations. It investigated information provided by a HMRC ‘whistleblower’ about a settlement with Goldman Sachs. HMRC admitted that it had made a mistake that had resulted in an underpayment of interest on the tax due. But it argued that it acted lawfully in settling the case.

The PAC also wanted to examine cases where the negotiated settlements exceeded £1 billion. HMRC refused to provide any information that would breach taxpayer confidentiality. The National Audit Office asked a retired high court judge to examine the settlements. He noted that HMRC did not seek proper legal advice, involve its own specialists, or even take notes while negotiating settlements with the large companies concerned. Despite this, the National Audit Office and he concluded that the settlements were ‘reasonable’ and fair.

In 2012, to repair the damage done to the department’s reputation by the PAC’s enquiries, HMRC introduced the role of the Tax Assurance Commissioner. It strengthened HMRC’s civil dispute governance and reinforced the procedural changes made to the manner in which large tax investigations were settled. The role provides transparency about the department’s procedures and assurance that it settles disputes even-handedly.

Connect

The department has received scant recognition for its successes, including the launch of Connect, its innovative AI computer program. It was launched in 2010to root out underpaid tax. Connect has more data than the British Library. It automatically analyses the information pouring into its data warehouses daily from third parties, including through recent developments such as the Common Reporting Standard. The Financial Times noted that: ‘It ploughs through disparate, previously unrelated information to detect otherwise invisible networks of relationships.’

HMRC uses the system to select cases for its compliance activities, including its campaigns about specific trades and customer groups. The system sucks in information about taxpayers from numerous sources, including social media, credit card payments, online platforms, licence applications and the Land Registry. Taxpayers selected for enquiry are often disconcerted to discover that HMRC knows more about their financial transactions, spending patterns and movements than they know themselves.

Transforming Pay As You Earn

HMRC modernised the Pay As You Earn (PAYE) system, which was originally introduced in 1944. It was operated by employers to deduct income tax at source from remuneration using tax codes and tables provided by the Revenue. Despite its computerisation in 1984, the regionally based system had become increasingly unwieldy in a world of flexible work and multiple employments.

The new National Insurance and PAYE Service (NPS) was launched in 2010. It holds details of real time earnings and of income tax and National Insurance paid by employees and office holders in a single database. The old system was regionally based, which made it hard for HMRC to do year-end reconciliations, as individuals could be included in more than one database. The new system speeded up all the processes of the former system. It can be accessed from any HMRC location and enables the department to move work to wherever there is spare capacity. The NPS reinforced PAYE’s reputation as ‘the most sophisticated [tax] withholding system in the world’, as the former Exchequer Secretary David Gauke stated in an article in Taxation magazine (see tinyurl.com/3u7tj2mx). However, the NPS almost immediately attracted controversy.

Administering tax means having to say sorry

Unfortunately, delays in introducing NPS meant that millions of cases where tax had been under or overpaid were notified more than a year late. The overwhelming majority of the notices HMRC issued informed the recipients of repayments of overpaid tax. But some of the taxpayers who received belated notification informing them that they had to pay overdue tax complained to their members of parliament.

The media accused HMRC of ‘getting its sums wrong’. The department’s attempts to explain that the tax was legally due made the situation worse. It was accused of insensitivity towards those who had received unexpected bills. HMRC was forced to apologise to them under ministerial pressure – even though it had done nothing wrong.

Covid crisis

HMRC and the Treasury jointly developed the government’s financial response to the economic lockdown introduced in 2020 by Prime Minister Boris Johnson. HMRC was praised for speedily implementing the job furlough scheme (the Coronavirus Job Retention Scheme). It was used by 1.3 million employers to support 11.7 million workers, and cost £70 billion. It was delivered only six weeks after Johnson’s announcement. It would normally have taken years to design and implement such a scheme. Chancellor Rishi Sunak was so enthusiastic about the plans that he offered to write the computer coding for the scheme himself!

Making Tax Digital

HMRC is the most advanced digital delivery department in Whitehall. Making Tax Digital (MTD) is the department’s flagship digital transformation scheme. It was supposed to increase tax revenues, reduce HMRC’s costs and improve customer service but it has been repeatedly delayed. The National Audit Office has said that the programme will cost five times more than originally forecast. The Office for Budget Responsibility has said that the projected tax revenues from the programme are uncertain.

MTD fell behind its original timetable because HMRC was slow to correct flaws in its design and it didn't involve software providers and tax agents from the outset. HMRC's insistence on quarterly reporting without providing credible evidence of its benefits contributed to the resistance to the scheme. The project is intended to make it easier for taxpayers to calculate their tax liabilities correctly the first time by reducing error and carelessness. However, the National Audit Office reported in 2023 that HMRC itself omitted estimated transitional costs of £1.5 billion from its own business case for additional funding!

The government has awarded HMRC additional funding to continue MTD, in the expectation that it will increase tax revenues. But the uncertainty about its yield, and HMRC's failure to address concerns about the digital exclusion of low-paid and other vulnerable taxpayers who cannot interact digitally with HMRC, make it a risky project.

Use of AI in decision making

The Tax Law Review Committee of the Institute of Fiscal Studies published a report (2024) on HMRC's use of artificial intelligence in some of its decision making. HMRC has never publicly divulged the extent to which it utilises AI. Its cost and efficiency pressures make it inevitable that it will have to expand its use of AI. The introduction of widespread automated decision making could result in a fundamental shift in the transparency of HMRC's decision-making processes and erode taxpayer safeguards.

It is essential that there is transparency and proper parliamentary scrutiny of the potential risks and implications of any use by HMRC in decision making.

Tax gap

HMRC estimates suggest that just under 5%of the tax owed is currently not paid. There is a 'tax gap' of about £40 billion. The new Labour government has announced an investment of £1.4 billion in HMRC over five years to enable it to recruit 5,000 additional compliance staff and 1,800 debt management staff, to raise extra revenues of £6.5 billion by 2029/30.

The government expects results for its increased investment in the department's compliance activities. They will be monitored by a Board sub-committee that includes external tax professionals.

HMRC's research suggests that the failure of taxpayers to take reasonable care accounts for about 45% of the tax gap, more than twice that attributed to evasion or avoidance. At 60%, the tax gap attributable to small businesses is the largest component by customer group; it's more than a dozen times larger than the tax gap attributable to the Wealthy and Individual taxpayers.

The Office for Budget Responsibility has suggested that while factors such as the digitalisation of the tax collection system and the reduction in the use of cash in the economy could reduce the tax gap, subdued economic growth and cost of living pressures could lead to wider non-compliance.

New approach

HMRC has changed its approach to tax compliance. Instead of countering non-compliance after it occurs, the department now seeks to prevent it 'upstream'; i.e. from happening in the first place. HMRC's upstream activities accounted for a third of its total £41.8 billion compliance yield during 2023/24.

The National Audit Office has suggested that there are significant gaps in HMRC's understanding of the cost effectiveness and impacts of its upstream compliance interventions. Reducing the tax gap will require HMRC to strike a balance between its upstream and downstream interventions, and to improve its measurement and understanding of its outcomes.

HMRC's ability to reduce the tax gap is dependent, among other things, on the calibre and the number of tax professionals that it employs. But the number of tax professionals in the department has fallen by nearly 40% since 2016. It will have to increase the salaries it offers to recruit and retain the tax professionals that it needs. Their salaries are significantly below the earnings of tax professionals in the private sector.

Customer service

The number of taxpayers rose from 31.7 million in 2020/21 to 36.2 million in 2023/24. The recent inflation and the freeze in the personal allowance and the threshold at which tax becomes payable has sucked many more people into the income tax system, many for the first time. According to the National Audit Office, the level of trust that individuals and businesses have in HMRC has fallen since 2020. The cost of complying with their tax responsibilities has risen considerably higher than the prior estimate of £15.4 billion. Poor customer service by HMRC creates uncertainty and additional costs for taxpayers.

Some taxpayers don't understand what they have to do in order to comply because of the complexity of the tax rules. If HMRC were to provide better customer service to taxpayers it would result in fewer errors by compliant taxpayers and reduce evasion. Some older tax agents speak nostalgically about the days when practically every town in Britain had a tax office with a public enquiry counter. But it's no longer possible for HMRC to provide such service to taxpayers. The only channels for seeking advice from HMRC are digital and its helpline. Many taxpayers choose to telephone the department's helpline, but most of them are content to use the digital channel.

Sir Jim Harra, the outgoing chairman of HMRC, recently told the PAC that HMRC has to reduce the volume of its contact with the public via telephone and post by at least 30% to deliver services with the resources it has. The Public Accounts Committee accused HMRC of pushing taxpayers into digital services by deliberately degrading its phonelines. It said that HMRC had been 'too quick to restrict access to its helplines before ensuring replacement digital services [were] fully in place'. Harra described the Public Accounts Committee's claims as 'completely baseless' and pointed out that HMRC had more than halved its call wait times.

Costs, efficiency and productivity

HMRC keeps rolling along quietly doing its job. Even though it is often an Aunt Sally for the tabloids, HMRC is respected for its competence and cost-effectiveness. It spent £4.3 billion to collect £829 billion of tax in 2023/24. It costs HMRC just ha'pence to collect each pound of tax revenue. The department's productivity hasn't yet returned to its pre-pandemic level, partly because some of HMRC's experienced staff chose to leave when it closed its remaining 170 local offices. It moved the rest

of the staff in these offices to 14 large regional centres to cut its costs.

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