Administration of Scottish income tax 2019/20

AUDITOR GENERAL

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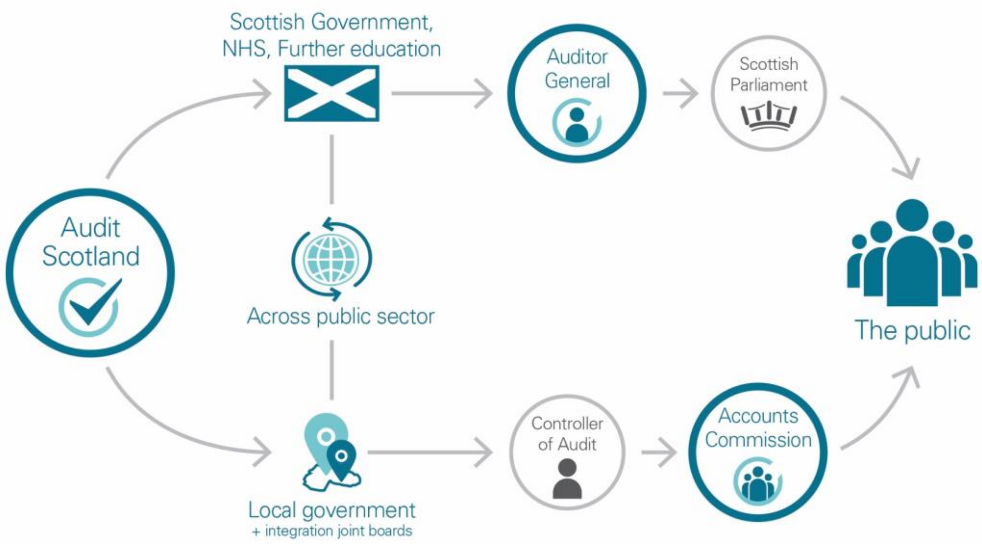

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Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money

- reporting our findings and conclusions in public

- identifying risks, making clear and relevant recommendations.

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Introduction

1. The Scotland Act 2016 extended the Scottish Parliament's power to vary all income tax rates and thresholds to the non-savings, non-dividend (NSND) income of Scottish taxpayers. The power to determine any reliefs or exemptions, including the personal allowance, remains with the UK Government. From 2017/18 onwards, the total amount of NSND income tax, now referred to as Scottish income tax, collected by HM Revenue and Customs (HMRC) in Scotland is paid to the Scottish Government.

2. In 2018/19, two new Scottish income tax bands were introduced:

- The starter rate (19 per cent) and the intermediate rate (21 per cent) either side of the basic rate (20 per cent).
- The higher and additional rates of tax were also increased by one per cent for Scottish taxpayers; increasing from 40 per cent and 45 per cent to 41 per cent and 46 per cent respectively.

The higher rate threshold for the rest of the UK rose to £46,350, whereas for Scotland the higher rate threshold was set at £43,431.

3. Total Scottish income tax revenues rose by 5.9 per cent between 2017/18 and 2018/19 compared to an increase of 4.2 per cent in NSND income tax revenues across the rest of the UK.[1]

4. HMRC collects and administers Scottish income tax as part of the UK's overall income tax system. This includes separately identifying the amounts that relate to Scottish taxpayers. The Scottish Government is responsible for:

- reimbursing HMRC for the cost of implementing Scottish income tax
- ensuring that the cost of implementing Scottish income tax represents value for money
- seeking assurances that the system collects the correct amount of tax.

5. The amount of Scottish income tax collected each year is identified separately in HMRC's annual accounts. HMRC's annual accounts for 2019/20 were published in November 2020. This report relates to 2019/20, including the final outturn calculation of Scottish income tax for the 2018/19 tax year.

6. The National Audit Office's 2019/20 report gives assurance over 2018/19 outturns. This period is wholly before the Covid-19 pandemic took place. No adjustment for Covid-19 has been made to the outturn for the 2018/19 financial year.

7. The report also covers the estimated outturn for 2019/20. While Scottish income tax revenues for 2019/20 will be affected by the pandemic, albeit only for the final weeks of the financial year, these estimates do not affect the Scottish budget. The current estimated impairment to the 2019/20 estimate is £25 million. The impact of Covid-19 on Scottish income tax is likely to feature more prominently in future years.

[1] Scottish Income Tax Outturn Statistics: 2018 to 2019, HM Revenue & Customs, September 2020.

Audit and assurance

8. HMRC’s accounts are audited by the National Audit Office (NAO) and received an unqualified auditor's report from the Comptroller and Auditor General (C&AG). The C&AG is also required to report to the Scottish Parliament on HMRC’s administration of Scottish income tax by 31 January of the financial year after the one to which the report relates.[2]

9. In 2014, the predecessor Public Audit Committee of the Scottish Parliament recommended that I should provide additional assurance on the NAO's audit work on Scottish income tax.[3] I make this report to the Public Audit and Post-Legislative Scrutiny Committee in response to that recommendation.

10. Audit Scotland’s review was limited to consideration of the NAO’s audit work; it did not directly review evidence obtained from HMRC or discuss any matters relating to Scottish income tax directly with HMRC. The judgements and conclusions set out in the report of the C&AG are his alone, based on the audit work undertaken by the NAO on his behalf.

11. The C&AG made his sixth annual report to the Scottish Parliament on 22 January 2021. His report relates to 2019/20 and considers:

- HMRC’s calculation of the 2018/19 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account
- HMRC’s estimation of the 2019/20 income tax revenue attributable to Scotland and his view on the methodology used to estimate the amount
- key controls operated by HMRC to assess and collect Scottish income tax
- HMRC’s approach to assessing and mitigating the risk of non-compliance with Scottish tax requirements
- the cost of administering Scottish income tax and provides assurance on whether the amounts are accurate and fair in the context of the costs incurred by HMRC.

12. Audit Scotland considered:

- the NAO’s approach to identifying the key risks to the successful administration of Scottish income tax
- the NAO’s audit working files, with focus on the audit evidence underpinning the key findings and conclusions in its report
- the NAO’s arrangements for ensuring the quality of the audit work and reporting.

13. Based on Audit Scotland’s review, I am satisfied that the NAO’s approach was reasonable and that its audit work covered the key audit risks. I am also satisfied that the findings and conclusions in the C&AG’s report are reasonably based.

[2] Scotland Act 1998, section 80HA as amended by the Finance Act 2014, section 297.
[3] 1st Report, 2014 (Session 4): Framework for auditing the Scottish rate of income tax, Public Audit Committee, 2014.

Correctness of the sums brought to account

14. HMRC's 2019/20 Annual Report and Accounts included Scottish income tax outturn figures relating to the 2018/19 year. Scottish income tax in 2018/19 was £11.556 billion.[4]

15. For the 2019/20 tax year, HMRC provided a provisional estimate that Scottish income tax revenue will be £11.703 billion. HMRC will publish the final Scottish income tax outturn for 2019/20 in its 2020/21 accounts. Any reconciliations will be made through the 2022/23 Scottish Budget.

2018/19 final outturn

16. The C&AG concluded that 'based on our procedures Scottish income tax revenue outturn for 2018/19 is fairly stated'.

17. The 2018/19 outturn calculation of £11.556 billion is largely based on established tax liabilities, after the tax owed has been finalised and the taxpayer records have been reconciled. The remainder is based on estimated liabilities. Estimation is required in some areas of the calculation because the income tax liability data is not available to identify the Scottish share of individual income tax liabilities, reliefs or other adjustments at the point the outturn is calculated. The net effect of these adjustments is to reduce the Scottish income tax outturn arising by £42 million (0.4 per cent of the outturn).

2019/20 provisional estimate

18. From 2018/19, HMRC changed its provisional estimate methodology. The estimate is based on data from its Survey of Personal Incomes (SPI). This amount is then compared to the liabilities from the latest Scottish income tax outturns and adjusted accordingly. HMRC performs this calibration because, to date, actual tax outturns have been lower than what the SPI data alone estimates.

19. This calibration adjustment reduced the provisional estimate for 2019/20 by £0.3 billion (2.3 per cent) to £11.703 billion. The C&AG concludes that HMRC's approach is reasonable, but outlines the continuing limitations described in previous reports in relation to using SPI data rather than previous outturn data as the starting point for the estimate.

20. The calibration adjustment previously applied to the provisional estimate for 2018/19 reduced the difference between the estimated and actual 2018/19 outturn to £104 million, or 0.9 per cent. This compares to a difference of £980 million (8.2 per cent) between the 2017/18 provisional estimate and the 2017/18 outturn, when no adjustment was made. This suggests that the adjusted methodology has improved its accuracy.

21. HMRC's provisional estimates in future years are likely to include larger amendments to reflect the impact of Covid-19 and other external factors. The C&AG recommends that 'HMRC should consider how it reflects the impact of Covid-19 in its calculation of the revenue outturn and estimate for future years, including consideration of what additional data might be available to refine the calculation and better reflect the uncertainties caused by the pandemic.'

22. The risks to the budget caused by increasing uncertainty, complexity and volatility have never been higher, and it will be challenging to match spending to the available funding in the coming years. In my view, it is important that the Scottish Government and HMRC keep the estimation methodologies under review as more data becomes available to ensure they are as accurate as possible.

[4] Administration of Scottish income tax 2019-20, National Audit Office, January 2021.

Adequacy of HMRC's rules and procedures and compliance with these

23. The C&AG concluded that 'HMRC has adequate rules and procedures to ensure the proper assessment and collection of Scottish income tax and that those rules are being complied with'.

24. The administration of Scottish income tax is governed by a Service Level Agreement (SLA) between HMRC and the Scottish Government.[5] This is updated every year to reflect HMRC's planned work. The SLA sets out the requirements and performance measures for the operation of Scottish income tax. HMRC shares the results of assurance exercises and compliance activities with the Scottish Government throughout the year and publishes an annual summary of its performance against the requirements.[6]

25. The Scottish Income Tax Board meets quarterly as part of its annual cycle of governance and discusses the performance of HMRC procedures on Scottish taxpayer checks, PAYE reconciliations and compliance plans. The Scottish Government has told us this provides it with a high level of assurance over HMRC's administration of Scottish income tax.

26. Given the economic implications of Covid-19 and differences between Scottish and UK tax policies, it will be important to keep performance against the SLA and governance arrangements under continual review.

Scottish Tax Base

27. Accurate identification of Scottish taxpayers remains fundamental to the effective operation of the Fiscal Framework, to the size of the Scottish budget and in ensuring that the right amount of tax is collected from individuals.

28. The C&AG reports that HMRC has implemented processes to maintain the completeness and accuracy of the Scottish taxpayer population. This includes a series of checks on the overall taxpayer population.

29. HMRC conducted a third-party data check in November 2019, which was previously completed in November 2017. This involves comparing taxpayer address records held by HMRC with third-party data sources (including credit reference agencies and the electoral roll) to identify cases where HMRC records are inconsistent with third-party data. HMRC reported that its 2019 third-party data check suggested its record of Scottish taxpayers was 98-99 per cent accurate.[7]

30. Not all taxpayer records could be corroborated against third party information. Where this was the case, the addresses were instead checked against internal HMRC records. While there are 2.5 million NSND Scottish taxpayers, HMRC holds 5.2 million taxpayer records, including duplicates, temporary numbers, deceased taxpayers and inactive records.

31. From these taxpayer records, 78.7 per cent were able to be checked to third party data. Most of these records were matched, with only 8,587 mismatches. In the case of a mismatch, HMRC wrote to the address it held in its records, asking the taxpayer to confirm their address. The remaining 21.3 per cent of records were checked against internal data, such as information from Self Assessments and information from employers.

[5] HM Revenue & Customs, Service level agreement for operation of Scottish Income Tax by HMRC, 26 June 2019.
[6] Scottish Income Tax HMRC Annual Report 2020, HMRC, September 2020.
[7] Scottish Income Tax HMRC Annual Report 2020, HMRC, September 2020.

32. The process of matching against internal information where third party data is not available is in line with the SLA in place between HMRC and the Scottish Government, with third party checks being preferable. The C&AG has recommended that HMRC should ‘review, by March 2022, how it can enhance the effectiveness of its third-party data comparison exercise in providing assurance over the accuracy of its address records.’ The C&AG also recommended that HMRC consider whether there are any additional ways it can communicate with taxpayers to confirm addresses.

33. For the 2019/20 tax year, 45 MSPs had not initially been provided with a Scottish residency tax code. Following a period of weekly manual checks of MSPs tax codes (as NAO reported last year), in August 2020 HMRC introduced a system where MSP’s are automatically assigned a Scottish residency code. This is fixed until the end of their parliamentary term. The NAO plan to audit this automated process as part of its 2020/21 audit.

Compliance risks

34. HMRC continues to assess compliance risk for Scottish taxpayers in the same manner as it does for the entire UK taxpayer population; through its Strategic Picture of Risk (SPR). The Scottish SPR identifies risks for Scottish income tax by taking the Scottish share of UK NSND income tax.

35. The C&AG reports HMRC estimated it generated an additional £210 million in Scottish income tax through its compliance activities in 2017/18; through generating additional revenues or preventing revenue losses. This is calculated based on a proportion of the UK figure, rather than using Scotland-specific data to quantify the risks.

36. The divergence of Scottish and UK tax policies presents the risk that taxpayers will manipulate their place of residence to reduce their tax liability. HMRC currently considers this risk to be very low compared to the overall risk of non-compliance affecting taxpayers across the UK, such as efforts to avoid or reduce liabilities altogether. HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage.

37. The C&AG notes that HMRC does not consider geographical variations in the level of compliance risk, or the relative success of compliance activity in Scotland compared with the rest of the UK. He also notes the UK Government’s Committee of Public Accounts (PAC) recommends that HMRC should consider the benefits and challenges of estimating a Scotland-specific tax gap, which is the difference between the amount of tax that should be paid and what is actually paid.

38. In my view, further consideration of both the relative success of compliance activity in Scotland and the Scotland-specific tax gap would help assess whether any Scottish income tax compliance risks are emerging. This would help the Scottish Government to understand the compliance risks better, and any implications for its future tax policies.

The accuracy and fairness of the administrative expenses

39. The C&AG noted that ‘based on our procedures, we have concluded that the amount repaid by the Scottish Government for the year ended 31 March 2020 is accurate and fair in the context of the agreement between HMRC and the Scottish Government’.

40. HMRC initially estimated that total implementation costs associated with the introduction of SRIT would be up to £35 million. This was revised down to between £20 million and £25 million in April 2017, and to between £20 million and £23 million in April 2018.

41. HMRC has now completed its work to set up the systems needed to administer Scottish income tax. As noted in the C&AG's report, £24.3 million had been spent up until April 2020 on implementing the Scottish rate of income tax and the two associated HMRC projects: further Scottish income tax powers and relief at source.

Impact of tax outturns on the Scottish Budget

42. The block grant received from the UK Government remains the main source of funding for the Scottish budget. Since NSND income tax was devolved to Scotland in 2017/18, the block grant is now adjusted to take account of actual Scottish income tax revenues raised in Scotland. These are known as block grant adjustments (BGAs).

43. For Scottish income tax, the block grant is reduced by the amount of income tax foregone by HM Treasury by devolving it. Scottish income tax receipts are then added to the block grant in its place (Exhibit 1).

Exhibit 1
The block grant is adjusted for NSND Scottish income tax

Source: Audit Scotland

44. 2018/19 budget figures for Scottish income tax were based on independent forecasts prepared by the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR). A budget adjustment (or 'reconciliation') is made in later years once outturn data is known.

45. The reconciliation resulting from 2018/19 outturn figures is a budget reduction of £309 million. This will be made through the upcoming 2021/22 Scottish budget. Forecasts originally increased the Scottish budget by £428 million, the net difference between forecast tax foregone by HM Treasury and forecast Scottish income tax receipts. Outturns show that the increase was £119 million, £309 million less than the forecasted difference (Exhibit 2, page 10).

Exhibit 2
How the Scottish Income Tax outturn relates to the 2021/22 budget reconciliation

£ million	BGA – reflecting income tax foregone by HM Treasury	Revenue from NSND Scottish income tax	Net effect on budget
Forecasts used for the 2018/19 budget	-11,749	12,177	428
Final outturn	-11,437	11,556	119
Reconciliation required through the 2021/22 budget (reduction)			**-309**

Source: Audit Scotland, based on Supplementary Forecast Evaluation Report: Income Tax, Scottish Fiscal Commission, October 2020

46. The Scottish Government has options on how to meet this reconciliation. It can do one or a combination of:

- borrow up to £300 million to cover most of the forecast error. This would protect the 2021/22 budget, but it would need to be repaid over three to five years, and would be on top of the £204 million it borrowed for the same purpose in the 2020/21 budget [8]
- use some or all of its Scotland Reserve balance
- reduce spending in other areas of the budget.

47. The budget challenges facing the Scottish Government are significant and are made more acute by the ongoing uncertainty and volatility caused by Covid-19. As the Scottish Government navigates these challenges, it will need to direct resources towards its priorities, maintain transparency to the public and continue its focus on long-term outcomes for people in Scotland.

[8] Scottish Budget 2020-2021, Scottish Government, February 2020.

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