Administration of Scottish income tax 2021/22

AUDITOR GENERAL

Prepared by Audit Scotland
January 2023

Contents

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. HMRC's accounts are audited by the National Audit Office (NAO) and the Comptroller and Auditor General (C&AG) issued his opinion on the 2021/22 HMRC Accounts in July 2022. 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.[1]

3. 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.[2] I make this report to the Public Audit Committee in response to that recommendation.

Key messages

- The National Audit Office's approach to providing assurance over Scottish income tax is reasonable and covers the key audit risks.
- The Scottish income tax outturn for 2020/21 is £11.948 billion. The economic effects of the Covid-19 pandemic reduced the amount of Scottish income tax collected in this period. Because equivalent tax receipts in the rest of the UK were also affected, the net reconciliation of 2020/21 income tax will increase the 2023/24 Scottish budget by £50 million. This is the first time there has been a positive income tax reconciliation to the Scottish budget.
- HMRC's provisional estimate of Scottish income tax for 2021/22 is £13.295 billion. The provisional estimate is provided for financial reporting purposes and does not affect the Scottish budget. The Scottish Government and HMRC should keep methodologies under review as more data becomes available to ensure provisional estimates are as accurate as possible.

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

- Given ongoing economic uncertainty and volatility and separate Scottish and UK income tax policies, the Scottish Government and HMRC should keep governance and assurance arrangements under continual review.

- There has been a decrease in the percentage of Scottish taxpayer records that could be corroborated by HMRC to third-party data to confirm residency status. Where addresses were not able to be matched, they were instead checked against internal HMRC records, such as information from self assessments and information from employers. The Scottish Government and HMRC should consider if more frequent checks or further actions are required to provide further assurance over the accuracy of HMRC's address records.

- HMRC applies the same risk-based compliance approach to collect income tax in Scotland as it does in the rest of the UK. This is based on its assessment that compliance risk in Scotland is consistent with the rest of the UK. The Scottish Government should regularly consider the costs and benefits of commissioning further compliance activity in Scotland.

- HMRC and the Scottish Government have recently published analysis of taxpayer behaviour which showed some limited evidence of Scottish taxpayers lowering their taxable income in response to increasing tax rates. HMRC is working with the Scottish Government to produce a dataset tracking the behaviour of taxpayers over time in response to any income tax changes between Scotland and the rest of the UK. The first output from this work is expected in summer 2023. Obtaining better quality data about taxpayer behaviour will help inform future tax policy decisions.

Background

4. HMRC collects and administers Scottish income tax on behalf of the Scottish Government 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

- discussing and agreeing with HMRC aspects of the approach to the administration of Scottish income tax as set out in a service level agreement.

5. The amount of Scottish income tax collected each year is identified separately in HMRC's annual accounts. HMRC's annual accounts for 2021/22 were published in July 2022. This report relates to 2021/22, including the final outturn calculation of Scottish income tax for the 2020/21 tax year. This amount was used to calculate the reconciliation applied to the Scottish budget for 2023/24.

6. Total Scottish income tax revenues rose by 1 per cent between 2019/20 and 2020/21 compared to an increase of 2 per cent in NSND income tax revenues across England and Northern Ireland. Between 2018/19 and 2019/20, Scottish income tax revenues rose by 2.4 per cent compared to a rise of 2.3 percent across England and Northern Ireland.[3]

7. The report also covers HMRC's provisional estimate of Scottish income tax receipts for 2021/22. This provisional estimate does not affect the Scottish budget. The final outturn for 2021/22 is expected to be reported in summer 2023.

Audit and assurance

8. The C&AG made his eighth annual report to the Scottish Parliament on 12 January 2023. His report relates to 2021/22 and considers:

- HMRC's calculation of the 2020/21 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account
- HMRC's estimation of the 2021/22 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.

9. 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

[3] Scottish Income Tax Outturn Statistics: 2020 to 2021, HM Revenue & Customs, July 2022.

- the NAO's arrangements for ensuring the quality of the audit work and reporting.

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. 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.

Correctness of the sums brought to account

12. HMRC's 2021/22 Annual Report and Accounts included Scottish income tax outturn figures relating to the 2020/21 year. Scottish income tax in 2020/21 was £11.948 billion.[4]

13. For the 2021/22 tax year, HMRC provided a provisional estimate that Scottish income tax revenue will be £13.295 billion. HMRC will publish the final Scottish income tax outturn for 2021/22 in its 2022/23 accounts, and an adjustment will be made to the 2024/25 Scottish budget. The impact of tax outturns on the Scottish budget is explained in further detail at paragraphs 45-48 of this report.

2020/21 final outturn

14. The C&AG concludes that Scottish income tax revenue outturn for 2020/21 is fairly stated.

15. The 2020/21 outturn calculation of £11.948 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; including, 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. The calculated estimate is required 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.

16. The net effect of these estimation adjustments is to reduce the Scottish income tax outturn arising by £119 million (1 per cent of the outturn). The methodology used to arrive at these adjustments was agreed between the Scottish Government and HMRC at the Scottish Income Tax Board in April 2022. The C&AG notes that this methodology has remained broadly the same since the prior year.

[4] Administration of Scottish income tax 2021-22, National Audit Office, January 2023.

The impact of Covid-19 on 2020/21 outturns

17. Lockdown measures in Scotland began on 23 March 2020, shortly before the beginning of the 2020/21 tax year. The Scottish Fiscal Commission has reported[5] that the economic effects of the pandemic reduced the amount of income tax collected in this period, noting that:

> "The Coronavirus Job Retention Scheme (CJRS) and the Self-Employment Income Support Scheme (SEISS) largely protected the labour market from the economic consequences of the pandemic. While GDP fell sharply in 2020 because of lockdown restrictions, there was lesser effect on the employment and earnings data for 2020-21."

18. Estimated liabilities (amounts still expected from 2020/21 taxes but not yet received) included a deduction for taxes that may never be collected. The overall estimate of uncollectable revenue deducted by HMRC from the 2020/21 outturn was £97 million. This is £8 million higher than the figure deducted from the 2019/20 outturn for uncollectable amounts. This means that Covid-19 has not resulted in any substantial change to the overall collectability deductions to the Scottish outturn in 2020/21.

2021/22 provisional estimate

19. HMRC's provisional estimate is for reporting purposes and does not affect the Scottish budget. Since 2018/19 the provisional estimate methodology is based on data from its Survey of Personal Incomes (SPI) and Personal Tax Model to give a Scottish percentage share of UK NSND tax income. HMRC compares this amount to the liabilities from the latest (2020/21) Scottish income tax outturns and adjusts its estimate accordingly. HMRC performs this calibration because, to date, actual tax outturns have been lower than what the SPI data alone estimates. The C&AG notes that the methodology is largely consistent with that used to calculate last year's 2020-21 estimate.

20. HMRC identifies the key source of uncertainty in the 2021-22 provisional estimate as the accuracy with which it can identify the Scottish percentage share of UK NSND tax income. HMRC estimates that Scottish income tax revenue will grow at a slower rate than the UK overall in 2021/22. HMRC took account of this as part of its calibration adjustment.

21. 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. The C&AG also concludes that the impact of other external factors such as Covid-19 and the Ukraine conflict on both the economy and individual taxpayers increases the level of uncertainty in HMRC's estimate of Scottish income tax revenue.

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

[5] Forecast Evaluation Report, Scottish Fiscal Commission, August 2022.

review as more data becomes available to ensure they are as accurate as possible.

23. I note that the Scottish Fiscal Commission's most recent forecast for 2021/22 Scottish income tax receipts is £13.337 billion which is within 1 per cent of HMRC's provisional estimate.

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

24. The C&AG concludes 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.'

25. The administration of Scottish income tax is governed by a service level agreement (SLA) between HMRC and the Scottish Government.[6] 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.[7]

26. 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 (Pay As You Earn) 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.

27. Given ongoing economic uncertainty and volatility and separate Scottish and UK income tax policies, it will be important to keep performance against the SLA and governance arrangements under continual review.

Scottish Tax Base

28. 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.

29. The C&AG reports that HMRC carries out several assurance activities to maintain the completeness and accuracy of the Scottish taxpayer population. This includes a series of checks on HMRC's records of Scottish taxpayers. The Scottish Government and HMRC agreed in October 2020 that third-party data checks (where taxpayer address records held by HMRC are compared with third-party data sources) should be run every two years. This comparison is the

[6] HM Revenue & Customs, Service level agreement for operation of Scottish Income Tax by HMRC, 3 November 2021.
[7] Scottish Income Tax HMRC Annual Report 2021, HMRC, December 2021.

main source of assurance over HMRC's address information and is part of a wider suite of assurance activity detailed in Figure 8 of the C&AG's report.

30. HMRC conducted a third-party data check in April 2021, which was previously completed in November 2019. 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.

31. 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, such as information from self assessments and information from employers. In the case of a mismatch, HMRC wrote to the address it held in its records, asking the taxpayer to confirm their address.

32. While there are 2.5 million NSND Scottish taxpayers, HMRC holds 5.1 million taxpayer records, excluding duplicates, temporary numbers, deceased taxpayers and inactive records. The C&AG reports that overall, the residency status of taxpayers for 72.2 per cent of these records could be corroborated to third party data with a Scottish address. This is a decrease from 78.7 per cent of records corroborated in the previous third-party data exercise, meaning there is an increased reliance on internal HMRC records and other assurance activity compared to 2019. In my view, given this reduction in third-party matches, the Scottish Government should consider if more frequent checks or further actions should be requested to provide further assurance over the accuracy of HMRC's address records.

33. The C&AG also reports that system changes designed to remove the need to annually update parliamentarians' records were introduced in August 2020, and that HMRC did not identify any issues in relation to Scottish Parliamentarians' tax during 2021/22.

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 that HMRC generated an estimated additional £280 million in Scottish income tax through its compliance activities in 2020/21 through generating additional revenues or preventing revenue losses. The estimated revenue lost in 2019/20 (the latest year for which data is available) from risks identified in the SPR, such as tax evasion and not declaring income, is £970m.

36. Both figures are calculated based on a proportion of the UK figure, rather than using Scotland-specific data to quantify the risks. The C&AG emphasises that HMRC has limited information on specific compliance activity undertaken in Scotland. Unlike the income tax system which can flag Scottish taxpayers HMRC's compliance system cannot readily identify people living in Scotland.

37. The C&AG notes that, as in previous years, HMRC's compliance approach is based on its assumption that compliance risk in Scotland is consistent with the rest of the UK. This assumption is not tested by HMRC because of the methodological challenges and costs involved. There is a subsequent risk that HMRC's current assessment that compliance risk in Scotland is consistent with the rest of the UK may not be sustainable in the longer-term, particularly if further divergence between tax policies between the rest of the UK and Scotland occurs.

38. The C&AG states that the Scottish Government did not request any specific compliance activity in 2021-22, over and above the work undertaken as part of HMRC's UK-wide compliance approach. In line with the SLA, further compliance activity can be undertaken by HMRC and paid for by the Scottish Government if such activity is requested by the Scottish Government and agreed by HMRC. In my view, the Scottish Government should regularly consider the costs and benefits of additional compliance activity in Scotland.

39. The C&AG states that the divergence of Scottish and UK tax policies presents an additional risk that taxpayers will manipulate their place of residence to reduce their tax liability, while also highlighting the potential for further income tax divergence in future budgets. HMRC currently considers this risk to be low compared to the overall risk of non-compliance affecting taxpayers across the UK, such as efforts to avoid or reduce liabilities altogether.

Taxpayer behaviour

40. The C&AG highlights that as a result of work that HMRC commenced in 2020 looking into Scottish taxpayer liabilities and behaviour over time, an analysis was published in December 2021. This showed some limited evidence of Scottish taxpayers lowering their taxable income in response to increasing tax rates. The analysis also found that generally taxpayers earning higher levels of income decreased their declared income by more than those on lower incomes. Potential behavioural responses could include taxpayers reducing hours worked, re-arranging their tax affairs to reduce their tax liability through incorporation, or non-compliant tax evasion behaviour. The Scottish Government reflected the findings in relation to Scottish taxpayers in its policy evaluation of Scottish income tax, also published in December 2021.

41. HMRC has started work with the devolved administrations to analyse cross-border migration and taxpayer characteristics over time. This aims to analyse any behavioural response to income tax differences between devolved administrations and the rest of the UK. HMRC has established a working group which includes representatives from the Scottish Government to decide what analysis it will complete. The first dataset from this work is expected in time for the publication of the Scottish Income Tax Outturn Statistics for 2021-22 in summer 2023.

42. In my view, the publication of the income tax behavioural analysis and the development of a dataset to track taxpayer responses to income tax changes over time is a positive development. Obtaining better quality data will help inform future tax policy decisions.

The accuracy and fairness of the administrative expenses

43. The C&AG notes that 'based on our audit work, we have concluded that the amount paid by the Scottish Government (for the year ended 31 March 2022) was accurate and fair in the context of the agreement between HMRC and the Scottish Government'.

44. HMRC invoiced the Scottish Government for £0.6 million of costs relating to the administration of Scottish income tax in 2021/22 (£0.7 million in 2020/21). The C&AG highlights 2021-22 as the second year in which expenditure relates entirely to operating costs.

Impact of tax outturns on the Scottish Budget

45. 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).

46. 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

47. 2020/21 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.

48. The reconciliation resulting from 2020/21 outturn figures is a budget increase of £50 million. This is the first time there has been an increase to the budget resulting from the budget reconciliation. This will be made through the 2023/24 Scottish budget. Forecasts originally increased the Scottish budget by £46 million, the net difference between forecast tax foregone by HM Treasury and forecast Scottish income tax receipts. Outturns show that the increase was £96 million, £50 million more than the forecasted difference (Exhibit 2).

Exhibit 2

How the Scottish income tax outturn relates to the 2023/24 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 2020/21 budget	-12,319	12,365	46
Final outturn	-11,852	11,948	96
Reconciliation required through the 2023/24 budget			**50**

Source: Audit Scotland, based on Scotland's Economic and Fiscal Forecasts, Scottish Fiscal Commission, December 2022

Administration of Scottish income tax 2021/22

Audit Scotland's published material is available for download on the website in a number of formats. For information on our accessibility principles, please visit:
www.audit-scotland.gov.uk/accessibility

For the latest news follow us on social media or
subscribe to our email alerts.

Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
Phone: 0131 625 1500 Email: **info@audit-scotland.gov.uk**
www.audit-scotland.gov.uk

AS.4.0