Senedd Cymru / Welsh Parliament
Y Pwyllgor Cyllid / Finance Committee
Ymchwiliad i weithredu Deddf Cymru 2014 a'r Fframwaith Cyllidol / Inquiry into the implementation of the Wales Act 2014 and operation of the Fiscal Framework
FFWA 09
Y Swyddfa Archwilio Genedlaethol / National Audit Office

Briefing Note

Submission to the Finance Committee's inquiry into the implementation of the Wales Act 2014 and operation of the Fiscal Framework

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My role in relation to the Welsh rates of income tax

1 As an officer of the House of Commons, my primary responsibility is to examine and report to UK Parliament on whether departments and the bodies they fund have used their resources efficiently, effectively and with economy. I am also the statutory auditor of HM Revenue & Customs (HMRC) and many other UK public bodies. My responsibilities in relation to the Welsh Rates of Income Tax (WRIT) are limited to those set out in the Wales Act 2014. These are to prepare a report each year on the following matters:[1]

a. the adequacy of any of 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,

b. whether the rules and procedures described in paragraph (a) are being complied with,

c. the correctness of the sums brought to account by HMRC which relate to income tax which is attributable to a Welsh rate resolution, and

d. the accuracy and fairness of the amounts which are reimbursed to HMRC as administrative expenses incurred as a result of the charging of income tax.

2 My predecessor published the National Audit Office's first report on WRIT in January 2019. I published the second annual report in January 2020, covering progress made by HMRC in implementing WRIT in 2018-19. I anticipate publishing my next report in January 2021 covering the 2019-20 reporting period, including the introduction of WRIT in April 2019. In **Appendix Two** of this submission I have listed the reports that the Committee may find useful to their inquiry.

3 This briefing note is framed around my statutory responsibilities for reporting on the administration of WRIT, though I have also commented on other relevant areas that fall within

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[1] Wales Act 2014, 116K

my remit and have been covered by work undertaken by the National Audit Office. I have not drawn upon emerging findings from my 2019-20 audit of the administration of WRIT, the work for which is currently ongoing. I would welcome the opportunity to update the Committee on the findings of my next report once it is published.

Taxation

How successful has the administration of Welsh taxes and the Welsh Rates of Income Tax been?

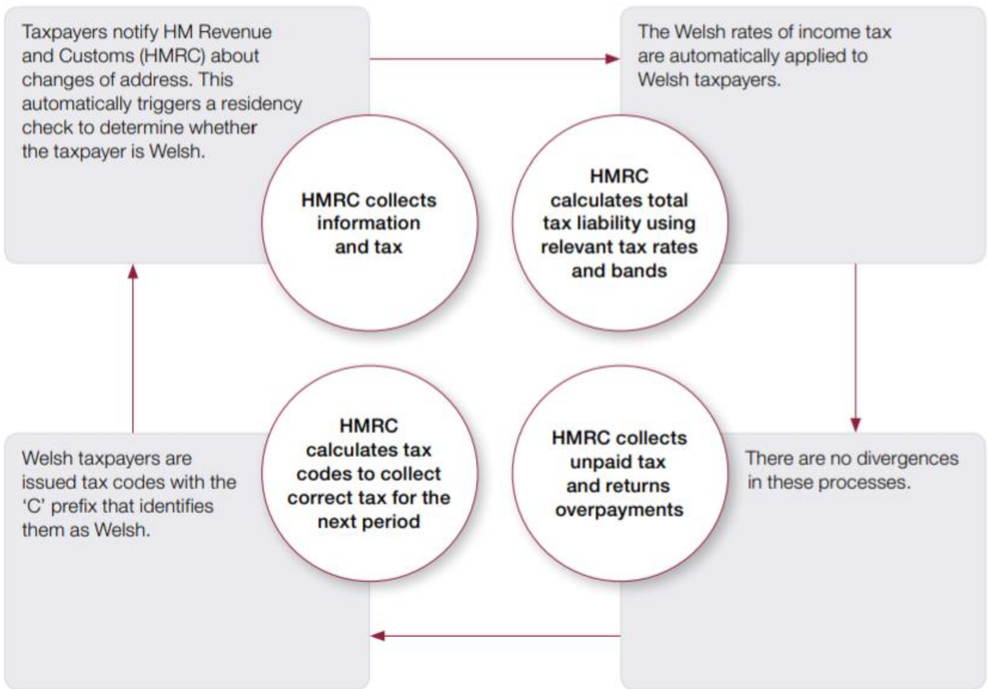
4 My reports on WRIT consider the adequacy of any of HMRC's rules and procedures put in place to manage the tax system for WRIT and whether such rules and procedures are being complied with. The administration of WRIT broadly follows UK-wide processes and I report on these more widely on an annual basis as part of my statutory audit of HMRC. Given that the Welsh rates of income tax remain the same as the rest of the United Kingdom (with the exception of Scotland), divergence from the UK-wide regime is limited and the most significant part of HMRC's administration of WRIT is identifying and maintaining an accurate record of the Welsh taxpayer population. In relation to those parts of HMRC's administration that are specific to WRIT, I have not identified any significant concerns, although I have summarised relevant findings from my reports for the Committee in the next few sections of this submission.

5 The diagram below is taken from my 2018-19 WRIT report, which the Committee may find helpful in understanding the administration of WRIT and how it diverges from the rest of the UK:

Figure 1

Divergences in the income tax system

The business rules are configured to process income tax using the rates and thresholds applicable to a taxpayers' residency status



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

HMRC’s project to implement Welsh Rates of Income Tax

6 Both the 2017-18 report published by my predecessor and my report covering 2018-19 have looked at HMRC’s project for implementing WRIT. The project was initiated in April 2017, with the Welsh Income Tax Devolution Project Board being established as the decision-making body responsible for the delivery of WRIT. The Welsh Government has representation on the project board and each sub-board or group.

7 The Welsh rates of tax took effect on 6 April 2019 and I noted in my 2018-19 report that HMRC implemented the project on time to enable this date to be met. Several tasks are still to be completed by HMRC during 2019-20, including the development of digital solutions for Welsh self-assessment taxpayers to enable them to identify themselves as Welsh when they submit their return online. Further development of processes for administering tax relief for pension contributions for Welsh taxpayers is also planned. I will assess the progress HMRC has made in these areas in my 2019-20 report. A timeline of HMRC’s progress in implementing the project can be found in **Appendix One** of this briefing note.

Identifying the Welsh taxpayer population

8 Identifying the Welsh taxpayer population is the main challenge for HMRC in implementing the Welsh rates of income tax. As noted in my 2018-19 report, to ensure taxpayers are correctly notified of their Welsh status and the right amount of tax is collected from individuals and allocated to the appropriate government, it is essential that address information is correct.

9 In 2018, HMRC implemented a taxpayer identification strategy which set out three main steps to the initial identification of the Welsh taxpayer population:

- Identify all Welsh addresses and compile a master record of Welsh postcodes using Office for National Statistics (ONS) data and, where necessary, mapping information.
- Cleanse the addresses contained in existing taxpayer records to ensure that they are in a consistent format to facilitate automated processing of residency.
- Update taxpayer records with the appropriate flag when an address is identified as having a Welsh postcode.

10 In 2018-19 HMRC undertook a number of activities to support this strategy. HMRC compared the list of 91,000 live Welsh postcodes from the ONS data, with its Pay As You Earn (PAYE) and Self-Assessment taxpayer records to identify an initial population of Welsh taxpayers. This initial exercise identified 2.7 million potential Welsh taxpayers based solely on address data. All identified taxpayers are flagged on HMRC’s systems, so they will automatically pay tax at the Welsh rate if they incur a tax liability. Two million notification letters were also issued to Welsh taxpayers who have a live record on the National Insurance and PAYE Service (NPS), which is HMRC's system for National Insurance and PAYE accounts.

11 To cleanse the address data held, HMRC conducted several system scans and identified approximately 36,000 records where postcodes were either missing or incorrect. HMRC has used the findings of the initial address cleansing to enhance the effectiveness of the system scans in the future. As a result of this, for example, further scans identified a another 19,000 records were identified as potential Welsh taxpayers, although 15,000 of these were subsequently identified as not currently being in employment or in receipt of a pension.

12 In December 2018, HMRC commissioned a comparison of the data held in its master record of addresses to those of an independent third-party. This process provides HMRC with assurance that its address data are consistent with third-party data sources. Initially, in order to assess the overall level of accuracy of HMRC's address data, all records with a Welsh address were matched to the Royal Mail's Postcode Address File (PAF). Of the 2.7 million Welsh taxpayer records identified, 96.4% of the population were found to have addresses which were consistent with the PAF. Of those that were matched to the PAF, 99.9% were found to have an accurate postcode. HMRC's records were also matched to other independent data sources such as the electoral roll and credit reference agency listings in order to corroborate the address data held in HMRC's systems.

Use of the 'C' tax code

13 HMRC issues tax code notices to all employers to apply the 'C' tax code for all Welsh taxpayers who have been identified. HMRC ran a scan in June 2019 to compare the information held on HMRC systems with employer data. HMRC identified that it had correctly issued the 'C' codes to employers, however, the June scan revealed that 174,000 individuals had the incorrect tax code attributed to them by their employer or pension provider. HMRC worked with the employers most affected by this issue through regular meetings, employer bulletins and phone calls to ensure the correct tax codes were being applied on the employers' systems. In September 2019, HMRC repeated the scan, which found that 57,000 employees had the incorrect tax code. HMRC is continuing work in this area and this is something I will revisit in my next report.

14 Where employers are operating an incorrect tax code, there is a risk that the wrong amount of tax is deducted through PAYE. At the end of the tax year, HMRC will use the Welsh tax code held in their records to calculate the tax and will determine whether or not the correct amount of tax has been deducted through the PAYE reconciliation process.

Compliance activities

15 HMRC applies a risk-based approach to compliance activity for the collection of Welsh income tax in the same way it is applied to the collection of income tax from taxpayers in the rest of the UK. HMRC considers compliance risk annually through its UK-wide Strategic Picture of Risk (SPR) assessment; a specific assessment has not historically been prepared for Wales. I noted in my 2018-19 report that HMRC recognises that the compliance risks arising from the Welsh rates of income tax could change in future should the income tax rate in Wales diverge from the rest of the UK (excluding Scotland). In the future, I expect HMRC to perform a specific risk assessment for Wales and consult with the Welsh Government in accordance with the Memorandum of Understanding, which sets out arrangements between HMRC and the Welsh Government for setting up and operating WRIT.

16 The UK-wide compliance risks that HMRC considers are of most relevance to WRIT are:

- registered individuals or businesses deliberately omitting, concealing or misrepresenting information in order to reduce their tax liabilities;

- the hidden economy, where an entire source of income is not declared or where a declared source of income is deliberately understated; and
- individuals undertaking tax avoidance, exploiting the tax rules to gain a tax advantage that Parliament never intended.

17 In my 2018-19 report I noted that HMRC has taken the following steps to support the administration of devolved income tax:

- making changes to the Self-Assessment online system which require individuals to declare their residency status on their return;
- building address change functionality into taxpayers' personal tax accounts, helping to ensure that the address database is kept up to date; and
- continuing to work with large employers to help prevent, identify and respond to identified issues.

What could possible future tax changes look like and what scope is there for a different approach to taxation in Wales?

18 While it is beyond the scope of my statutory reporting obligations to comment on what possible future tax changes to could look like, I would draw the Committee's attention to the experience in Scotland where HMRC is also responsible for administering the income tax system. Similar to my responsibilities in relation to Wales, I have statutory responsibilities under the Scotland Act 2016 to produce an annual report on the administration of Scottish income tax.

19 In 2017-18, income tax rules in Scotland differed from the rest of the UK for the first time: Scottish taxpayers paid the higher rate of tax (40%) as soon as they earned £43,000 – as opposed to £45,000 in the rest of the UK. For the 2018-19 tax year, the Scottish income tax rules diverged further from those in the rest of the UK. The Scottish Government introduced two new income tax bands for non-savings, non-dividend income, the starter rate and intermediate rate bands.

20 In my 2018-19 report on the administration of Scottish income tax, I looked at the increasing divergence in tax rates between Scotland and the rest of the United Kingdom. I noted that increasing divergence gives rise to a potential risk that taxpayers could manipulate their residency status due to the incentives of reducing their tax liability. This could include failure to notify HMRC of a change of address or the deliberate manipulation of address information. HMRC considers the risk of these behaviours taking place to be very low compared with the overall risk of non-compliance affecting taxpayers across the UK, such as efforts to avoid or reduce liabilities altogether.

21 In relation to Wales, the border between England and Wales is longer in distance and more complex with reference to cross-border residences, than the border between England and Scotland. In my 2018-19 report I noted that in October 2018, HMRC undertook an exercise to review cross-border properties separately. HMRC recognises that individuals living around the Welsh–English border may be more likely to challenge their residency status, with nearly 100 postcodes including some 1,100 properties straddling the border. In 34 cases, the border ran through individual properties and, for these, HMRC used a technique called centroid determination to ascertain whether properties were mainly in Wales or England.[2] HMRC has said it will continue to monitor cross-border postcodes and check for any new houses which may be built or new postcodes assigned.

22 My predecessor, in his 2017-18 report on WRIT, considered the learning that HMRC had taken from its experience of implementing and administering the Scottish income tax system. HMRC identified a number of lessons covering project requirements, project management, finance and communications. I also understand there is regular communication between the Welsh and Scottish governments in relation to the administration of devolved taxation. This is an area of inquiry I intend to return to.

The Fiscal Framework

Consider the fiscal framework processes and how funding is allocated to the Welsh block grant.

Examine the application of the Barnett Formula and the criteria for excluding specific funding from the formula.

23 I would draw your attention to my predecessor's investigation into devolved funding, published in March 2019, which focused on how decisions on funding are reached and the different mechanisms and formulas that result in funding allocations. The investigation covered:

- The way the UK government allocates funding to the devolved administrations and the adjustments that are required, particularly in light of devolution of tax and revenue-raising powers;
- the different UK government funding streams available to the devolved administrations and the mechanisms for calculating and allocating funding; and
- the implications of changes in UK government spending plans and how these impact on the funding allocated to the devolved administrations.

24 The Barnett formula ensures that the devolved administrations receive a share of the changes in planned UK government spending on functions that are devolved in Scotland, Wales and Northern Ireland. The formula has no legislative basis. Devolved administrations receive additional funding when new, additional funding is provided to UK government departments for comparable services or functions. The report found that it can be unclear whether consequential amounts of funding are due to the devolved administrations for funding allocated to new services or functions, for example in relation to changes resulting from funding allocated to EU exit-related activities.

25 The report also highlighted that HM Treasury may allocate direct, special or ad hoc funding (sometimes referred to as 'non-Barnett additions') without consequential amounts of funding for other nations. Examples of such funding highlighted in the report were the £410 million allocated to Northern Ireland in 2018-19 as part of the agreement reached between the Conservative Party and the Democratic Unionist Party, and funding allocated to the devolved administrations for city deals or growth deals in their localities.

26 Specifically, in relation to Wales, the report noted that from the 2018-19 financial year, a

[2] Centroid determination is a mathematical concept whereby the central point of a figure is plotted. HMRC plotted this point on cross-border properties. The side of the border the centroid fell within was used to ascertain which side of the border the property fell within

new, needs-based factor was introduced into the Barnett formula specifically for Wales. This was introduced in response to the findings and recommendations of an independent commission, which reported that Wales needed additional funding in recognition of its more dispersed population and greater prevalence of poverty. It is intended to ensure that block grant funding for the Welsh Government does not fall below 115% of equivalent funding per head in England. This means that the Barnett formula calculation for Wales has one additional component (the needs-based factor), which is applied, along with comparability and population factors, when calculating the block grant funding for Wales.

27 Thank you for the opportunity to contribute to your inquiry and I look forward to working with the Committee as I continue my work on WRIT.

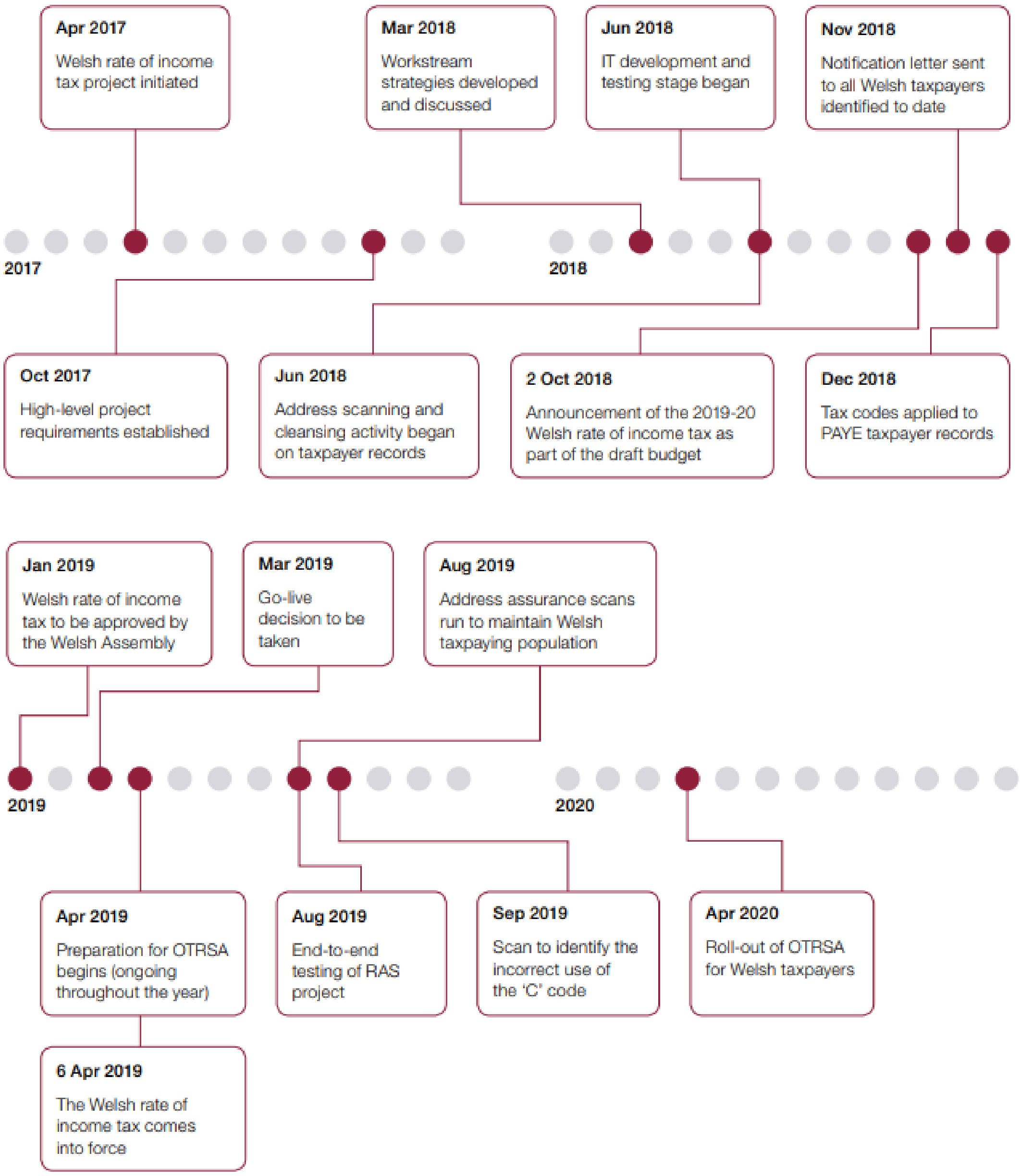
Gareth Davies

Comptroller and Auditor General

Appendix One

Welsh rates of income tax project milestones

The project was initiated and planned in 2017-18. HM Revenue & Customs (HMRC) has implemented those plans in 2018-19 and is continuing to roll out additional elements to the project in 2019-20



Notes

1. The Relief at Source (RAS) changes made by HMRC bring the Welsh project in line with Scotland.
2. The Online Tax Return Self Assessment (OTRSA) scheme is due to be fully operational by April 2020.
3. National Audit Office analysis of HM Revenue & Customs Information included in report by the Comptroller and Auditor General, Administration of Welsh income tax 2018-19, January 2020

Appendix Two

Reports relevant to the Committee's inquiry

Relevant previous NAO reports on devolved income tax

2018-19 reports

Administration of Scottish income tax 2018-19

Administration of Welsh income tax 2018-19

2017-18 reports

The administration of Scottish income tax 2017-18

The administration of the Welsh rate of income tax 2017-18

Other reports

Investigation into devolved funding